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SEC REGULATORY ANALYSIS
"A Long Way to Go and a Short Time to Get There"

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The subtitle quotation comes from Jerry Reed, “East Bound and Down” (RCA Records 1977).

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Abstract

Federal appeals courts have vacated several Securities and Exchange Commission (SEC) rules due to inadequate economic analysis. The SEC, pledging to do better, published staff economic analysis guidance in March 2012 that covers many of the same topics executive branch agencies address in regulatory impact analyses (RIAs) of major regulations. This paper employs the Mercatus Center at George Mason University’s Regulatory Report Card methodology to evaluate the quality of the SEC’s regulatory analysis. The economic analysis accompanying a sample of final SEC regulations published in 2010 and 2011 was seriously incomplete and rarely used. The SEC analyses scored well below the RIAs produced by executive branch agencies during the same period. The SEC often ignored relevant academic literature and declined to examine alternatives, benefits, and costs that expert financial regulators should have been aware of. Thus, our baseline assessment of pre-2012 regulations shows that the SEC’s new economic analysis guidance was necessary and appropriate.

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SEC Regulatory Analysis:

"A Long Way to Go and a Short Time to Get There"

Jerry Ellig and Hester Peirce

The Securities and Exchange Commission (SEC) regulates the U.S. securities markets. Its rules affect the participants in those markets, including retail investors and public companies. SEC rules are supposed to help protect investors, facilitate capital formation, and foster fair, orderly, and efficient markets. The SEC writes disclosure rules for public companies and oversees the activities of more than 20,000 financial firms, including investment advisers, mutual funds, exchange-traded funds, broker-dealers, national securities exchanges, credit-rating agencies, and a number of financial market utilities and quasi-government regulators.

Given that SEC rules can have sweeping effects on the U.S. economy, the role of economic analysis in shaping those rules is crucial. Without an evidence-based assessment of a problem that the commission seeks to solve and the pros and cons of alternative solutions, the commission would be flying blind. Recognizing this reality, Congress included in the SEC's authorizing legislation a requirement that the commission conduct economic analyses whenever it determines whether new rules are in the public interest. Federal appeals courts recently vacated several SEC rules due to inadequate economic analysis. The SEC, pledging to do better, published staff economic analysis guidance in March 2012 that cover many of the same topics that executive branch agencies are expected to address in regulatory impact analyses (RIAs) of major regulations.

Considering the controversy generated by recent court cases, an evaluation of the economic analysis conducted in SEC regulations is highly timely. This paper critically examines

the quality and use of economic analysis in seven major final rules promulgated by the SEC prior to the issuance of its March 2012 staff economic analysis guidance and one major rule issued after the new guidance. We apply the Mercatus Center at George Mason University's Regulatory Report Card, a standardized scoring system employed in published research on executive agency rulemaking, to assess the regulatory analysis conducted in connection with these SEC rulemakings. The scoring system allows us to compare the quality and use of economic analysis at the SEC with the standards that guide executive branch agencies and with executive branch agencies' actual performance.

Important as the SEC is, our study has implications beyond SEC rulemaking. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) granted significant new responsibilities and regulatory authority to numerous financial regulators, including the Commodity Futures Trading Commission (CFTC), the Board of Governors of the Federal Reserve System, and the newly created Bureau of Consumer Financial Protection. Dodd-Frank charged these regulators with writing new rules governing—among other things—the over-the-counter derivatives markets, mortgage origination, and the interconnected activities of large financial institutions. Sound regulation of financial markets and market participants (based on accurate information and rigorous analysis) can help prevent a future financial crisis. The Government Accountability Office (GAO) recently identified inadequacies in economic analysis conducted by multiple financial regulatory agencies.[1] An examination of the role of economic analysis in SEC rulemaking could reveal best practices from which other agencies could learn or highlight significant pitfalls they should avoid in economic analysis of their own rules. In addition, looking at how the SEC has interpreted its statutory rulemaking obligations can provide

[1] U.S. GOVERNMENT ACCOUNTABILITY OFFICE, GAO-13-101, DODD-FRANK ACT: AGENCIES' EFFORTS TO ANALYZE AND COORDINATE THEIR RULES (Dec. 2012), *available at* http://www.gao.gov/assets/660/650947.pdf.

insights for Congress as it considers various regulatory reform bills designed to foster the use of economic analysis in agency decision-making.

Our principal findings suggest that the SEC's decision to adopt new economic analysis guidance was a necessary and appropriate response to the significant flaws in its previous economic analysis:

The economic analysis accompanying most of these regulations was seriously incomplete and rarely used. The SEC regulation we examined that scored the highest on the Mercatus Regulatory Report Card earned just 20 out of 60 possible points, or thirty-three percent. The highest score for use of analysis was just 5 out of 20 possible points, or twenty-five percent.

The SEC regulations we examined scored well below executive branch regulations proposed in 2010–2011. Executive branch regulations earned an average of 29.7 out of 60 possible points (fifty percent), suggesting that many regulatory impact analyses from executive branch agencies are seriously incomplete. But the SEC regulations averaged just half this score—15.7 out of 60 possible points (twenty-six percent). Similar results occurred when we compared the analysis for SEC regulations with the analysis for financial regulations issued by executive branch agencies.

The SEC regulations scored much more poorly than executive branch regulations on the Report Card criteria most directly relevant to the topics in the SEC's March 2012 economic analysis guidance. On average, executive branch agencies earned more than twice the score of the SEC regulations on the criteria the SEC has identified as crucial for a good economic analysis.

The pre-2012 SEC analyses often failed to seriously assess the problem the regulation was supposed to solve. For example, the SEC promulgated a rule requiring certain

broker-dealers to establish risk management controls based on an intuited—rather than evidence-based—fear that broker-dealers might not be employing proper risk controls. The SEC also required public companies to hold votes related to executive compensation without looking at whether state law, which has traditionally governed such matters, was working properly. The SEC also suggested in that same rulemaking that shareholders were already getting much of the information that would be required in the rule's new disclosures, which begs the question of why the rule is needed.

The pre-2012 SEC analyses often ignored important alternatives that should have been obvious to an expert agency. The SEC's rulemaking to implement its new whistleblowing regime, for example, could have looked at alternatives based on some of the many other state and federal whistleblowing programs. The SEC's large trader reporting rule could have assessed the alternative approach of obtaining the needed information through the consolidated audit trail, a separate rulemaking with broader, but similar, objectives. Alternatives to new hedge fund reporting requirements might have included enhanced requirements for private parties to monitor hedge funds.

The pre-2012 SEC analyses often ignored significant costs. In drafting the whistleblower rule, the SEC downplayed the significant damage that it could do to companies' internal control systems by encouraging employees to view the SEC as the first place to go when they discover a potential problem at their companies. In the rulemakings related to hedge fund adviser registration and new hedge fund disclosures, the SEC did not take into account costs to itself and the risks created by decreased private sector monitoring in response to a perception of increased government monitoring of hedge funds.

The pre-2012 SEC analyses often asserted significant benefits without providing evidence that the regulation was likely to achieve them. In the rulemaking instituting the new Form PF, the SEC asserted that there would be financial stability benefits from all the new information that the Financial Stability Oversight Council (FSOC) would have at its disposal, without explaining how that would happen. Similarly, the large trader rulemaking simply assumes that the SEC, armed with the new information required by the rule, will be a better regulator.

It is too early to tell whether the new economic analysis guidance is working. We conducted a Report Card evaluation of one rulemaking that was finalized after the economic analysis guidance was put in place. The results from that rulemaking show little improvement in the quality of analysis. This rule achieved about the same total, openness, analysis, and use scores as the seven pre-2012 SEC rules, but it did score slightly better than the average pre-2012 SEC rule for analysis of the baseline and alternatives. However, because the SEC has only promulgated a handful of major rules with the full benefit of the guidance, it is too early to conclude whether the analysis has improved. The guidance represents an important milestone for the SEC, and as the agency gains more experience applying it, there is reason to be optimistic that its analysis will improve.

We begin in section I with a discussion of why regulatory analysis matters, the economic analysis requirements faced by the SEC, and the commission's struggles with those requirements. Section II describes the rules that we have chosen to analyze. Section III reports the results of the evaluations of the rules using the Report Card and compares regulatory analyses conducted by the SEC, an independent regulatory agency, with analyses conducted by executive branch agencies. In section IV, we suggest how the SEC could have improved its economic analysis in each of the seven rules we discuss, using scholarly literature and data that

should be readily available to the commission. In section V, we analyze one rule that was adopted after the SEC staff guidance took effect and consider additional indicators of the SEC's progress in regulatory analysis since the staff's guidance took effect. We conclude in section VI with a discussion of the implications of getting the analysis wrong and some suggestions for how the SEC can further improve its analysis.

I. Economic Analysis: It's Not Just a Good Idea; It's the Law

The SEC, an independent regulatory agency, is not subject to the same economic analysis requirements applicable to executive agencies.[2] A series of executive orders has required executive agencies to perform regulatory analysis as part of their rulemaking process.[3] The Office of Information and Regulatory Affairs (OIRA), in the Office of Management and Budget (OMB), reviews these regulatory impact analyses.[4] The question of whether the president could and should extend the executive orders and OIRA review obligations to independent regulatory agencies has been debated for some time, but no president has sought to do so.[5]

Although the executive orders have not, to date, been extended to the SEC, the SEC has statutory analysis requirements. Most important among these obligations is a requirement that whenever the SEC has to consider whether a rulemaking is consistent with the public interest, the

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[2] *See* Paperwork Reduction Act, 44 U.S.C. § 3502(5) (2012) (listing independent regulatory agencies, including the SEC); Exec. Order No. 12,866, 58 Fed. Reg. 51,735, § 3(b) (Sept. 30, 1993) (defining "agency" as any authority of the United States that is an "agency" under 44 U.S.C. § 3502(1), other than those considered to be independent regulatory agencies).

[3] *See, e.g.*, Exec. Order No. 12,291, 46 Fed. Reg. 13,193 (Feb. 17, 1981); Exec. Order No. 12,866, 58 Fed. Reg. 51,735 (Sept. 30, 1993); and Exec. Order No. 13,563, 76 Fed. Reg. 3821 (Jan. 18, 2011).

[4] *See* Exec. Order No. 12,866, 58 Fed. Reg. 51,735, § 3(b) (Sept. 30, 1993) (directing OIRA to review executive agency rulemaking).

[5] The former head of OIRA "encouraged" independent agencies "to give consideration to" President Obama's Executive Order 13,563. *See* Cass R. Sunstein, Admin'r, OIRA, Memorandum for the Heads of Executive Departments and Agencies and Independent Regulatory Agencies (Feb. 2, 2011), *available at* http://www.whitehouse.gov/sites/default/files/omb/memoranda/2011/m11-10.pdf.

agency must "consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."[6] If it is to be more than a superficial box-checking exercise, consideration of a rulemaking's effect on efficiency, competition, and capital formation requires an analysis of the rule's benefits and costs. As Professors Paul Rose and Christopher Walker explain, "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 [Administrative Procedure Act]."[7] Section 23(a)(2) of the Securities Exchange Act of 1934 ("Exchange Act") also requires rulemakings under that act to include a "determination that any burden on competition imposed by such rule or regulation is necessary or appropriate."[8] In addition, a number of discrete statutory provisions require the SEC to consider the economic effects of rules adopted pursuant to those provisions.[9] In fulfillment of these statutory obligations, the SEC typically includes an analysis section—the so-called back end—in its notices of proposed and final rulemaking.

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[6] Section 2(b) of the Securities Act of 1933 (15 U.S.C. § 77b); section 3(f) of the Securities Exchange Act of 1934 (15 U.S.C. § 78c(f)); and section 2(c) of the Investment Company Act of 1940 (15 U.S.C. § 80a-2(c)). This requirement was added to these statutes by the National Securities Market Improvement Act of 1996. The Gramm-Leach-Bliley Act of 1999 added the language to the Investment Advisers Act of 1940. *See* section 202(c) (15 U.S.C. § 80b-2).

[7] Paul Rose & Christopher Walker, *The Importance of Cost-Benefit Analysis in Financial Regulation*, Center for Capital Markets Competitiveness Report 27 (Mar. 2013), *available at* http://www.centerforcapitalmarkets.com /wp-content/uploads/2010/04/CBA-Report-3.10.13.pdf. *But see* Nat'l Ass'n of Mfrs. v. Sec. and Exch. Comm'n, 2013 U.S. Dist. LEXIS 102616, *35–36 (July 23, 2013) (explaining that reading the requirement to consider competition, capital formation, and efficiency to require "that the SEC conduct some sort of broader, wide-ranging benefit analysis simply reads too much into this statutory language").

[8] 15 U.S.C. § 78w(a)(2).

[9] *See, e.g.*, Securities Exchange Act § 6(k)(1) (15 U.S.C. § 78F(k)(1)) ("To the extent necessary or appropriate in the public interest, to promote fair competition, and consistent with the promotion of market efficiency, innovation, and expansion of investment opportunities, the protection of investors, and the maintenance of fair and orderly markets, the Commission and the Commodity Futures Trading Commission shall jointly issue such rules, regulations, or orders as are necessary and appropriate to permit the offer and sale of a security futures product traded on or subject to the rules of a foreign board of trade to United States persons."); Securities Exchange Act § 15(n)(2) [15 U.S.C. § 78o(n)(2)] ("In developing any rules under [the prior paragraph relating to disclosures by broker-dealers to retail investors], the Commission shall consider whether the rules will promote investor protection, efficiency, competition, and capital formation.").

The quality and extent of such analyses have been called into question by academics, oversight bodies, and courts. Arthur Fraas and Randall Lutter, in their examination of three major SEC rules, identify a number of flaws in the SEC's approach to economic analysis.[10] They find that, aside from paperwork burden estimates, discussions of costs and benefits were largely qualitative.[11] The SEC did not attempt to quantify costs such as "increased transactions costs or a reduction in market efficiency."[12] A rule related to short selling included some analysis of data about the effect of short sale restrictions, but lacked "a framework of analysis that would pull together the various pieces of evidence and analysis into a more complete whole."[13]

The SEC's inspector general undertook an assessment of the SEC's cost-benefit analysis practices in connection with certain Dodd-Frank rulemakings and identified a number of issues with the SEC's approach.[14] This assessment did not, however, attempt to quantify benefits or costs other than information collection costs.[15] Ignoring the analysis of the elements of the rulemaking that were statutorily mandated, the focus of the assessment was on discretionary elements of the rulemaking.[16] "[T]he SEC sometimes used multiple baselines in its cost-benefit analyses that were ambiguous or internally inconsistent."[17] In some cases, the SEC did not

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[10] Arthur Fraas & Randall Lutter, *On the Economic Analysis of Regulations at Independent Regulatory Commissions*, 63 ADMIN. L. REV. 213 (2011).
[11] *Id.* at 232–33.
[12] *Id.* at 233.
[13] *Id.* at 234.
[14] SEC OFFICE OF THE INSPECTOR GEN., FOLLOW-UP REVIEW OF COST-BENEFIT ANALYSES IN SELECTED DODD-FRANK RULEMAKINGS, Audit Report No. 499, vi–vii (Jan. 27, 2012) [hereinafter SEC 2012 IG REPORT], *available at* http://www.sec-oig.gov/Reports/AuditsInspections/2012/499.pdf. This report was a follow-up to an earlier, less-in-depth report on the same subject. Office of the Inspector General, Securities and Exchange Commission, REPORT OF REVIEW OF ECONOMIC ANALYSIS PERFORMED BY THE SECURITIES AND EXCHANGE COMMISSION IN CONNECTION WITH DODD-FRANK ACT RULEMAKINGS (June 13, 2011), *available at* http://www.sec-oig.gov/Reports/Audits Inspections/2011/Report_6_13_11.pdf.
[15] SEC 2012 IG REPORT, *supra* note 14, at vi.
[16] *Id.*
[17] *Id.*

clearly justify the regulatory action being undertaken.[18] For most rules, the SEC failed to take into account its own administrative costs.[19] There was redundancy between the cost-benefit analysis and efficiency, competition, and capital formation sections of the release.[20] The inspector general made six corresponding recommendations and urged the SEC to deepen economists' involvement in the process.[21]

The Government Accountability Office also reported on rulemaking by the federal financial regulators, including the SEC, and concluded the following:

> While the regulators identified the problem to be addressed in their rule proposals, CFTC, the Federal Reserve, and SEC did not present benefit-cost information in ways consistent with certain key elements of OMB's Circular A-4 [which guides executive agencies in their performance of RIAs]. For example, CFTC and SEC did not evaluate the benefits and costs of regulatory alternatives they considered for key provisions compared to their chosen approach. . . . SEC did not quantitatively analyze the benefits . . . . CFTC and SEC monetized and quantified paperwork-related costs under [the Paperwork Reduction Act], but did not quantify any other costs.[22]

Courts have also weighed in. Over the past seven years, the SEC has lost several important court cases based on how it has attempted to fulfill its analysis obligations.[23] The first of these cases, *Chamber of Commerce v. SEC*, arose from a rulemaking that would have effectively required mutual funds to have a super-majority of independent directors and an independent chairman.[24] The court held that the SEC had "violate[d] the [Administrative Procedure Act] by failing adequately to consider the costs mutual funds would incur . . . and by failing adequately to consider a proposed alternative to the independent chairman

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[18] *Id.* at vii.
[19] *Id.*
[20] *Id.* at vi.
[21] *Id.* at vii–viii.
[22] U.S. GOVERNMENT ACCOUNTABILITY OFFICE, *supra* note 1. It should be noted that the GAO reviewed in depth only one major SEC rule. *Id.* at 4.
[23] Business Roundtable and Chamber of Commerce v. SEC, 647 F.3d 1144 (D.C. Cir. 2011); American Equity Inv. Life Ins. Co. v. SEC, 572 F.3d 923 (D.C. Cir. 2009); Chamber of Commerce v. SEC, 443 F.3d 890 (D.C. Cir. 2006); Chamber of Commerce v. SEC, 412 F.3d 133 (D.C. Cir. 2005).
[24] 412 F.3d.

condition."[25] The court expressly refused to hold that the SEC was required to conduct an empirical study of its own or that it could not reject a study submitted to it based on legitimate concerns about the study, but the court faulted the SEC for not doing what it could to understand the costs of the rule.[26] The court explained that "uncertainty may limit what the Commission can do, but it does not excuse the Commission from its 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."[27] The court also held that the SEC was required to consider a reasonable alternative raised by the dissenting commissioners and commenters.[28]

On remand, the SEC upheld the rule after about a week of deliberation without reopening the comment period.[29] The SEC responded to the court's determination that it had not adequately assessed the costs of its rulemaking by undertaking a new assessment using "the existing record and other publicly available information."[30] The SEC's action was again challenged, and the court found that the SEC's reliance on extra-record data was inappropriate because the public had not had a chance to comment on it.[31] One component of a good RIA is notifying the public of the data upon which the agency relies so that members of the public can respond to it.[32] Moreover, the court found that, despite admitted gaps in cost data, the SEC had not considered

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[25] *Id.* at 136.
[26] *Id.* at 142–44.
[27] *Id.* at 144.
[28] *Id.* at 144–45 ("the disclosure alternative was neither frivolous nor out of bounds and the Commission therefore had an obligation to consider it") (citing standard set forth in Laclede Gas Co. v. FERC, 277 U.S. App. D.C. 237, 873 F.2d 1494, 1498 (D.C. Cir. 1989)).
[29] SEC, Investment Company Governance, 70 Fed. Reg. 39,390 (July 7, 2005).
[30] *Id.* at 39,391.
[31] Chamber of Commerce v. SEC, 443 F.3d 890, 906 (D.C. Cir. 2006).
[32] *See, e.g.*, OFFICE OF MANAGEMENT AND BUDGET, CIRCULAR A-4 17 (Sept. 17, 2003) (setting forth guidelines for transparency and reproducibility of RIAs and their underlying assumptions, methods, and data), *available at* http://www.whitehouse.gov/sites/default/files/omb/assets/regulatory_matters_pdf/a-4.pdf.

actual cost data from funds that were already complying with the new requirements in anticipation of the rulemaking compliance date.[33]

The SEC's approach to assessing the effects on efficiency, competition, and capital formation was central to the court's holding in *American Equity Investment Life Insurance Company v. SEC*.[34] The rule at issue in that case deemed fixed index annuities to be governed by the securities laws rather than state insurance laws—which meant that the SEC, rather than states, would regulate these annuities. The court held that the SEC's analysis of each of the three elements under section 2(b) of the Securities Act[35]—efficiency, competition, and capital formation—was arbitrary and capricious.[36] The SEC had concluded that the rule would increase competition, but the basis it cited in reaching that conclusion was that the rulemaking would decrease uncertainty, a rationale that—the court pointed out—could have applied to any rulemaking, not just the particular rule at issue.[37] The court also cited the SEC's failure to assess the existing level of competition under the existing state regulatory framework.[38] The SEC's efficiency analysis failed "to analyze the efficiency of the existing state law regime."[39] The capital formation analysis relied on the efficiency analysis, so it too was arbitrary and capricious.[40]

Business Roundtable v. SEC was a challenge to the SEC's first rulemaking under the Dodd-Frank Act.[41] The rule at issue would have required public companies to include in their

[33] Chamber of Commerce v. SEC, 443 F.3d 890, 906 (D.C. Cir. 2006).
[34] American Equity Inv. Life Ins. Co. v. SEC, 572 F.3d 923 (D.C. Cir. 2009).
[35] 15 U.S.C.S. § 77b(b) (2012).
[36] 572 F.3d at 934–36.
[37] *Id.* at 934–35.
[38] *Id.* at 935–36.
[39] *Id.* at 936.
[40] *Id.*
[41] The rule at issue was proposed prior to Dodd-Frank's becoming law, even though the SEC arguably did not have the authority to adopt the rule before Dodd-Frank was finalized. *See, e.g.*, Kathleen L. Casey, Commissioner, SEC, Statement at Open Meeting to Propose Amendments Regarding Facilitating Shareholder Director Nominations (May 20, 2009), *available at* http://www.sec.gov/news/speech/2009/spch052009klc.htm ("the Commission's authority to enact these rules is subject to significant doubt. The Supreme Court has made clear that, in the absence of an explicit

proxy materials (and at their expense) information about shareholder-nominated candidates for company boards of directors. The court held that "the Commission was arbitrary and capricious in promulgating" the rule and vacated it.[42] The court's holding was based on the SEC's "failure to 'apprise itself—and hence the public and the Congress—of the economic consequences of'" the rule as required by the SEC's organic statute.[43]

In determining that the SEC's assessment of the economic effects of the rule was flawed, the court pointed to a number of problems. First, the SEC did not attempt to estimate the costs that companies would incur as a result of the rule even though there was available evidence about costs.[44] Second, the SEC did not have sufficient empirical support for its prediction that the rule would enhance board performance and enhance shareholder value.[45] Third, the SEC discounted the rule's costs by attributing them to the state law granting shareholders the right to elect directors, not to the rule's requirement that companies pay for shareholder nominees to be included in the company's proxy materials.[46] Fourth, the rule did not take adequate account of the possibility that the rule would be used to further the special interests of particular shareholders at the expense of the company.[47] Fifth, the SEC failed to properly assess net benefits because it did not consider the degree to which it would simply displace traditional election contests (rather than encourage new ones).[48] Sixth, the SEC used different estimates about how often the rule would be used in calculating the costs and the

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federal law, state law governs the internal affairs of the corporation, and the D.C. Circuit has held that proxy rules that are substantive, rather than procedural or related to disclosure, are not valid. As I have discussed, the rules that the Commission proposes today regulate matters at the heart of corporate law, and thus our authority to adopt them is questionable.").

[42] Business Roundtable and Chamber of Commerce v. SEC, 647 F.3d 1144, 1156 (D.C. Cir. 2011).

[43] *Id.* at 1148 (citing Chamber of Commerce v. SEC, 412 F.3d 133, 144 (D.C. Cir. 2005)).

[44] *Id.* at 1150.

[45] *Id.* at 1150–51.

[46] *Id.* at 1151.

[47] *Id.* at 1151–52.

[48] *Id.* at 1153.

benefits of the rule.[49] Seventh, the SEC did not adequately consider the degree to which the costs and benefits for investment companies would be different from the costs and benefits experienced by other companies.[50]

The *Business Roundtable* case focused attention on the SEC's use of economic analysis. Some argue that the court went too far and imposed extra-statutory requirements.[51] The SEC, however, faced with *Business Roundtable* and its other court losses and juggling a heavy rulemaking load under Dodd-Frank that could lead to future legal challenges,[52] did not appeal the decision. Instead, it took important steps to improve the quality of its analysis. In March 2012 (approximately eight months after the *Business Roundtable* decision), the SEC's general counsel and chief economist issued a joint memorandum to the staff that provides guidance on conducting economic analysis.[53] The guidance explains that "[h]igh-quality economic analysis . . . ensures that decisions to propose and adopt rules are informed by the best available information about a rule's likely economic consequences, and allows the Commission to

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[49] *Id.* at 1154.
[50] *Id.* at 1154–56.
[51] *See, e.g.*, Robert B. Ahdieh, *Reanalyzing Cost-Benefit Analysis: Toward a Framework of Function(s) and Form(s)*, 88 N.Y.U. L. REV. 1983, 2064 (2013) (arguing that the *Business Roundtable* decision imposed requirements on the SEC that are not in the statute); James D. Cox & Benjamin J. C. Baucom, *Symposium: Reshaping Capital Markets & Institutions: Twenty Years On: The Emperor Has No Clothes: Confronting the D.C. Circuit's Usurpation of SEC Rulemaking Authority*, 90 TEX. L. REV. 1811, 1828 (2012) (arguing that the D.C. Circuit's calls for cost-benefit analysis go beyond what the statute demands); Jill E. Fisch, *The Long Road Back:* Business Roundtable *and the Future of SEC Rulemaking*, 36 SEATTLE UNIV. L. REV. 695, 712 (2013) ("The D.C. Circuit appears to have extended hard look analysis in Business Roundtable and its predecessor cases by adding a specific requirement concerning cost-benefit analysis. In Business Roundtable, the court stated that the SEC is required to 'apprise itself—and hence the public and the Congress—of the economic consequences of a proposed regulation.' The source of this additional obligation is unclear.") (footnotes omitted); 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, 794 (2012) (arguing that, in the face of "extensive evidence" in support of the SEC's position, the court should have been more deferential in its review of the SEC's decision).
[52] Pub. L. No. 111-203, 124 Stat. 1376 (2010). According to one count, the SEC has 95 rulemaking mandates under Dodd-Frank. DAVIS POLK, DODD-FRANK PROGRESS REPORT (June 3 2012), at 5, *available at* http://www.davispolk.com/files/Publication/7fcba133-a0f9-4f21-99bf-058fb1549967/Presentation/PublicationAttachment/49342d7b-2f7f-45ea-b328-0639e232fa85/Oct2012_Dodd.Frank.Progress.Report.pdf.
[53] Memorandum from the SEC's Division of Risk, Strategy, and Financial Innovation and the Office of General Counsel to the Staff of the Rulemaking Divisions and Offices (Mar. 16, 2012) [hereinafter SEC Guidance], *available at* http://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf.

meaningfully compare the proposed action with reasonable alternatives, including the alternative of not adopting a rule."[54]

The guidance sets forth a fairly robust set of principles for economic analysis. It is based on the executive orders and the accompanying OIRA guidance governing economic analysis at executive agencies. The guidance describes the key components that should be included in the economic analysis accompanying every SEC rulemaking, namely a statement of need, identification of a baseline against which to measure the effects of the regulation, identification of reasonable alternatives, and an evaluation of the costs and benefits of the proposed regulation and the alternatives.[55]

The first two components of the SEC's guidance mirror the very first principle enunciated in Executive Order 12866: "Each agency shall identify the problem that it intends to address (including, where applicable, the failures of private markets or public institutions that warrant new agency action) as well as assess the significance of that problem."[56] *Circular A-4*, OMB's guidance to agencies on regulatory analysis, offers more specific instructions:

> If the regulation is designed to correct a significant market failure, you should describe the failure both qualitatively and (where feasible) quantitatively. . . . For other interventions, you should also provide a demonstration of compelling social purpose and the likelihood of effective action. Although intangible rationales do not need to be quantified, the analysis should present and evaluate the strengths and limitations of the relevant arguments for these intangible values.[57]

Analysis of the need for the regulation and the baseline are the crucial first steps in regulatory impact analysis. If an agency does not understand the systemic problem the regulation

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[54] *Id.* at 1.
[55] *Id.* at 4–15.
[56] *See* Exec. Order No. 12,866, 58 Fed. Reg. 51,735, § 1(b)(1). "Market failure" and "government failure" are both pieces of economic terminology that have specific meanings; they indicate situations when markets or the government fails to produce economically efficient results, for several well-defined reasons. For a highly readable and brief description, *see* SUSAN E. DUDLEY & JERRY BRITO, REGULATION: A PRIMER 12–20 (2012).
[57] OMB CIRCULAR A-4, *supra* note 32, at 4.

seeks to solve or how markets are likely to evolve in the absence of a new regulation, it cannot know whether a new regulation is actually necessary. If an agency does not understand the root cause of the systemic problem, it cannot reliably devise an effective solution, and it may not even recognize the most effective alternative. And if the agency does not know what problem it is trying to solve or whether that problem is likely to continue in the future, it cannot reliably estimate the benefits of a proposed regulation or alternatives. For these reasons, a thorough analysis of the systemic problem and the baseline are necessary not just to determine whether a regulation is needed, but also to design an effective regulation when the agency determines that a regulation is needed or when Congress has already directed the agency to issue a regulation.

It is not clear whether the SEC has fully committed itself to an analysis of the systemic problem that is as extensive as OMB has suggested. On the one hand, the guidance's section on justification for rulemakings includes a discussion of market failure, and the section on baselines notes, "[W]here a statute directs rulemaking, rulewriting staff should consider the overall economic impacts, including *both* those attributable to Congressional mandates *and* those that result from an exercise of the Commission's discretion."[58] On the other hand, the guidance also mentions that a statutory requirement for regulation counts as an independent justification for the regulation,[59] and SEC chief economist Craig Lewis has said that the justification for a regulation can be as basic as "Congress told us to."[60] Citing a statute, however, is not the same thing as analyzing a problem. Without identifying a problem, it will be difficult for the SEC to assess

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[58] *See* SEC Guidance, *supra* note 53, at 8.
[59] *Id.* at 5.
[60] *See* Craig M. Lewis, The Expanded Role of Economists in SEC Rulemaking, Remarks Before the SIFMA Compliance & Legal Society Luncheon (Oct. 16, 2012) ("We must define our goals so that we can then thoughtfully examine the various avenues that are available to us. This can be more difficult than it sounds. Sometimes it can be clear, as with a specific market failure that cannot be solved without regulatory intervention. Other times—as we see with the Dodd-Frank Act and the JOBS Act—Congress has identified a problem for us and directed us to engage in rulemaking to address it. In that case, the justification for why regulation is necessary can be something as basic as, 'Congress told us to.'"), *available at* http://www.sec.gov/news/speech/2012/spch101612cml.htm.

whether a new regulation is necessary or to analyze how effectively different regulatory approaches will solve the problem.

The guidance also sets out an integrated role in the rulemaking process for the economists—whom SEC lawyers typically had brought in only at the end of the rulemaking process.[61] The SEC's chief economist explained that the guidance "lays out a general approach to rulewriting to ensure that economists are involved at each step of the rule development process, from the policy development stage—before a release is even drafted—up through final adoption," and the guidance "provid[es] general principles to guide staff . . . as to the substantive elements of a robust economic analysis."[62]

In addition to the new guidance regarding economic analysis, the SEC reversed an earlier structural change that had severed the chief economist's direct reporting line to the SEC chairman. The direct reporting line was restored by merging the positions of division director and chief economist, thus ensuring that the chief economist would again have direct responsibility and accountability to the chairman for economic analysis at the SEC. In May 2011, Craig Lewis took over as chief economist and director of the SEC's Division of Risk, Strategy, and Financial Innovation,[63] subsequently renamed the Division of Economic and Risk Analysis.[64] In that capacity, Lewis, as the chief economist, has a division reporting to him and he reports directly to the chairman, which presumably gives him greater ability to influence rulemaking and makes the position a more powerful one at the SEC.

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[61] SEC Guidance, *supra* note 53, at 15–17.
[62] Lewis, *supra* note 60.
[63] Press Release No. 2011-114, SEC, Vanderbilt Professor Craig Lewis Named SEC Chief Economist and Director of RiskFin Division (May 20, 2011), *available at* http://www.sec.gov/news/press/2011/2011-114.htm.
[64] SEC, *SEC Renames Division Focusing on Economic and Risk Analysis*, June 6, 2013, *available at* http://www.sec .gov/News/PressRelease/Detail/PressRelease/1365171575272#.UgFl8Kxkj_Y.

II. Rules Selected for This Study

As the SEC implements its new approach to economic analysis, it will be helpful to have a baseline that indicates the quality of the SEC's analysis in the recent past. This paper, through a detailed look at seven SEC rulemakings finalized before the SEC's staff issued its new guidance memorandum in March 2012,[65] identifies some areas in which the SEC's analysis is deficient and could be improved. We looked at final rulemakings so that we could assess the SEC's analysis at a stage when it had the benefit of being informed by commenters. To see whether the SEC's economic analysis has improved since March 2012, in section V we also assess one rule finalized in November 2012.[66]

The seven pre-guidance rules were selected in a manner intended to provide a meaningful look at the quality of rules across the SEC's different divisions. Using the Government Accountability Office's Federal Rules Database, we selected major rules adopted by the SEC.[67] All the rules are final rules adopted after a notice of proposed rulemaking and a comment period. We began the study in February 2012 by selecting the two most recent major rules (by Federal Register publication date) from each of the SEC's major rulemaking divisions—the Division of Corporation Finance,[68] the Division of Investment Management,[69] and the Division of Trading

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[65] Although the July 2011 *Business Roundtable* decision was a meaningful warning that the SEC's economic analysis program needed improvement, the issuance of the guidance was a more important landmark as it laid out a uniform approach to economic analysis. For this reason, we believe that changes in the quality of the SEC's economic analysis are more likely to be observable after its issuance, as opposed to immediately after the *Business Roundtable* decision. We report *infra* that there appears to be no significant difference in the quality of SEC regulatory analysis before and after July 2011.

[66] SEC, Clearing Agency Standards: Final Rule, 77 Fed. Reg. 66,220 (Nov. 2, 2012) (to be codified at 17 C.F.R. pt. 240).

[67] U.S. Government Accountability Office, GAO Federal Rules Database Search, *available at* http://www.gao.gov /legal/congressact/fedrule.html.

[68] Net Worth Standard for Accredited Investors, 76 Fed. Reg. 81,793 (Dec. 29, 2011); Shareholder Approval of Executive Compensation and Golden Parachute Compensation, 76 Fed. Reg. 6010 (Feb. 2, 2011).

[69] Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, 76 Fed. Reg. 71,128 (Nov. 16, 2011) [hereinafter Form PF Rule]; Rules Implementing Amendments to the Investment Advisers Act of 1940, 76 Fed. Reg. 42,950 (July 19, 2011).

and Markets.[70] One rule (again the most recent major rule) was selected from the Division of Enforcement, which does not typically write rules but was charged with carrying out a significant Dodd-Frank rulemaking related to whistleblowing.[71]

The purpose of selecting rules from each division was to ensure that we captured a broad view of rulemaking issues within the SEC's regulatory jurisdiction. Each rule is unique; therefore, a complete analysis would require an assessment of every SEC rulemaking. However, selecting major rules from each division offers a useful cross section of significant SEC rulemaking. Each division has its own regulatory agenda that corresponds to the portion of the SEC's jurisdiction for which it is responsible. The Office of General Counsel and Division of Economic and Risk Analysis assist the divisional rulewriting teams. In addition, selecting rules from each division helped to capture the differences in approach employed by different division directors and staff. One of the rules happened to be a joint rule with the CFTC.[72] All the rules predate the new guidance on economic analysis and were finalized during a very busy period of SEC rulemaking in fulfillment of the SEC's mandates under Dodd-Frank. The rules are grouped by responsible SEC division and summarized in table 1 below.

[70] Large Trader Reporting, 76 Fed. Reg. 46,960 (Aug. 3, 2011); Risk Management Controls for Brokers or Dealers with Market Access, 75 Fed. Reg. 69,792 (Nov. 15, 2010).
[71] Whistleblower Incentives and Protections, 76 Fed. Reg. 34,300 (June 13, 2011).
[72] Form PF Rule, *supra* note 69.

Table 1. SEC Rules Analyzed in This Study

Rule	Summary of rule
Risk Management Controls for Brokers or Dealers with Market Access (Nov. 15, 2010) Division of Trading and Markets	New rule 15c-3 under the Exchange Act requires brokers or dealers offering direct access to an exchange or alternative trading system (ATS) to • establish, document, and maintain a system of risk management controls and supervisory procedures to limit the financial, legal, and operational risks of the broker or dealer and ensure compliance with regulatory requirements; • craft controls reasonably designed to prevent the entry of orders that are erroneous, exceed certain credit and capital thresholds, or violate regulatory requirements.
Large Trader Reporting (Aug. 3, 2011) Division of Trading and Markets	New rule 13h-1 • requires large traders to self-identify to the SEC in order to receive an identification number; • requires large traders to provide this identification number to broker-dealers that effect transactions on their behalf; • requires broker-dealers to use the large trader identification number to maintain records and report transactions to the SEC; • requires monitoring by broker-dealers of activity that could trigger large trader requirements.
Securities Whistleblower Incentives and Protections (June 13, 2011) Division of Enforcement	These new rules and forms under section 21F of the Exchange Act (section 922 of Dodd-Frank) establish a new whistleblower program at the SEC. The new rules establish procedures governing • the reporting of potential securities laws violations to the SEC; • the determination and payment of an award of 10–30% of the total amount collected by the SEC if a tip leads to a successful enforcement action by the SEC that generates more than $1 million in monetary sanctions.
Rules Implementing Amendments to the Investment Advisers Act of 1940 (July 19, 2011) Division of Investment Management	These amendments to the Investment Advisers Act of 1940 (Advisers Act) and to Form ADV largely implement provisions of Dodd-Frank. Specifically, the new rules • provide for transition of medium-sized advisers to state registration from SEC registration; • require advisers to hedge funds and certain other private funds to register with the SEC and provide certain information to the SEC on Form ADV; • implement Dodd-Frank registration exemptions for certain foreign advisers and advisers to venture capital funds and small private funds; • Require these “exempt reporting advisers” to file certain reports with the SEC; • amend pay-to-play rules and make certain technical amendments.
Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF (Nov. 16, 2011) Division of Investment Management and CFTC	This joint SEC-CFTC rulemaking implements provisions of Title IV of Dodd-Frank. Specifically, the new rules • require investment advisers to one or more large private funds to file Form PF with the SEC; • require certain commodity pool operators and commodity trading advisors to file Form PF with the SEC and allow these entities to satisfy future CFTC filing requirements with respect to commodity pools that are not private funds with the Form PF filing.

Rule	Summary of rule
Shareholder Approval of Executive Compensation and Golden Parachute Compensation (Feb. 2, 2011) Division of Corporation Finance	This rulemaking, which implements section 951 of Dodd-Frank, • requires companies to conduct a separate shareholder advisory vote to approve executive compensation; • requires companies to conduct a vote to determine how often they will conduct a shareholder advisory vote on executive compensation; • requires companies that are conducting a shareholder vote on merger and acquisition transactions to disclose golden parachute compensation agreements and, in certain cases, to conduct a shareholder advisory vote on those arrangements; • affords smaller companies an extended transition period to come into compliance with the new requirements.
Net Worth Standard for Accredited Investors (Dec. 29, 2011) Division of Corporation Finance	This rulemaking, which implements section 413(a) of Dodd-Frank, • revises the definition of "accredited investor" to exclude the value of a person's primary residence and certain associated debt when calculating the person's net worth. • makes a number of related technical corrections.

III. Evaluation of Rules Using the Mercatus Center's Regulatory Report Card

One way to assess the quality of SEC regulatory analysis is to use a standardized scoring system that has already been applied to evaluate the quality and use of regulatory analysis by other federal agencies. The Mercatus Center's Regulatory Report Card has assessed the quality and use of regulatory analysis for proposed, economically significant regulations issued by executive branch agencies since 2008.[73] Two years of these evaluations (2010 and 2011) are thus roughly contemporaneous with the period when the seven SEC regulations described above were developed, proposed, and finalized. The Report Card consists of 12 criteria grouped into three categories (openness, analysis, and use), which are derived from Executive Order 12866 and OMB *Circular A-4*. Table 2 lists the twelve criteria.

[73] The Report Card methodology is explained in Jerry Ellig & Patrick A. McLaughlin, *The Quality and Use of Regulatory Analysis in 2008*, 32 RISK ANALYSIS 255 (2012). An explanation of the scoring method and all score data for the Mercatus Regulatory Report Card are available at http://mercatus.org/reportcard.

Table 2. Regulatory Analysis Assessment Criteria
from the Mercatus Regulatory Report Card

<u>Openness</u>

1. *Accessibility.* How easily were the Regulatory Impact Analysis, the proposed rule, and any supplementary materials found online?
2. *Data documentation.* How verifiable are the data used in the analysis?
3. *Model documentation.* How verifiable are the models and assumptions used in the analysis?
4. *Clarity.* Was the analysis comprehensible to an informed layperson?

<u>Analysis</u>

5. *Outcomes.* How well does the analysis identify the desired benefits or other outcomes and demonstrate that the regulation will achieve them?
6. *Systemic problem.* How well does the analysis identify and demonstrate the existence of a market failure or other systemic problem the regulation is supposed to solve?
7. *Alternatives.* How well does the analysis assess the effectiveness of alternative approaches?
8. *Benefit-cost analysis.* How well does the analysis assess costs and compare them with benefits?

<u>Use</u>

9. *Some use of analysis.* Does the preamble to the proposed rule or the Regulatory Impact Analysis present evidence that the agency used the analysis?
10. *Cognizance of net benefits.* Did the agency maximize net benefits or explain why it chose another option?
11. *Measures and goals.* Does the proposed rule establish measures and goals that can be used to track the regulation's results in the future?
12. *Retrospective data.* Did the agency indicate what data it will use to assess the regulation's performance in the future and establish provisions for doing so?

The Report Card methodology is a middle ground between "checklist" systems for scoring regulatory analysis[74] and in-depth qualitative case studies.[75] Using the Report Card, expert reviewers trained in the evaluation method assign each regulatory analysis a Likert Scale

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[74] Government Accountability Office, *Air Pollution: Information Contained in EPA's Regulatory Impact Analyses Can be Made Clearer* (1997); Government Accountability Office, *Regulatory Reform: Agencies Could Improve Development, Documentation, and Clarity of Regulatory Economic Analyses* (1998); Robert W. Hahn et al., *Assessing Regulatory Impact Analyses: The Failure of Agencies to Comply with Executive Order 12,866*, 23 HARVARD J. LAW & PUB. POLICY 859 (2000); Robert W. Hahn & Patrick Dudley, *How Well Does the Government Do Cost-Benefit Analysis?*, 1 REV. ENV. ECON. & POLICY 192 (2007); Robert W. Hahn & Robert Litan, *Counting Regulatory Benefits and Costs: Lessons for the U.S. and Europe*, 8 J. INTL. ECON. LAW 473 (2005); Art Fraas & Randall Lutter, *The Challenges of Improving the Economic Analysis of Pending Regulations: The Experience of OMB Circular A-4*, 3 ANN. REV. RES. ECON. 71 (2011); Stuart Shapiro & John F. Morrall III, *The Triumph of Regulatory Politics: Benefit-Cost Analysis and Political Salience*, 6 REG. & GOVERNANCE 189 (2012).

[75] THOMAS O. MCGARITY, REINVENTING RATIONALITY (1991); Art Fraas, *The Role of Economic Analysis in Shaping Regulatory Policy*, 54 LAW & CONTEMP. PROB. 113 (1991); RICHARD D. MORGENSTERN, ECONOMIC ANALYSIS AT EPA: ASSESSING REGULATORY IMPACT (1997); Eric Posner, *Transfer Regulations and Cost-Effectiveness Analysis*, 53 DUKE LAW J. 1067 (2003); WINSTON HARRINGTON, LISA HEINZERLING & RICHARD MORGENSTERN, REFORMING REGULATORY IMPACT ANALYSIS (2009).

(0–5) score. For each criterion, the evaluators assign a score ranging from 0 (no useful content) to 5 (comprehensive analysis with potential best practices).[76] Since there are twelve criteria, the maximum possible score is 60 points. The scores are ordinal, not cardinal, and so we caution the reader to interpret the numerical comparisons below the same way one would interpret student test scores. An analysis that earns twice as many points as another one is clearly better, but not necessarily twice as good.

A 2012 article in the peer-reviewed journal *Risk Analysis* describes the Report Card's methodology and first year's results; we refer readers to that article for a more detailed description.[77] Several articles using Report Card data have been published in scholarly journals.[78] Statistical tests show that the method has produced consistent results from scorers trained in the evaluation method.[79] Report Card findings on the quality of agency regulatory analysis are generally consistent with the results of prior researchers' quantitative and qualitative evaluations of RIAs.[80]

Several trained Report Card scorers evaluated the SEC regulations that are the subject of this paper according to the method described above. These individuals have also evaluated executive branch regulations using the Report Card methodology.[81] We can thus use the score

[76] Ellig & McLaughlin, *supra* note 73, provide an extensive explanation and justification of the evaluation method.
[77] *See id.*
[78] *See also* Jerry Ellig, Patrick A. McLaughlin & John F. Morrall III, *Continuity, Change, and Priorities: The Quality and Use of Regulatory Analysis Across US Administrations*, 7 REG. & GOVERNANCE 153 (2013); Patrick A. McLaughlin & Jerry Ellig, *Does OIRA Review Improve the Quality of Regulatory Impact Analysis? Evidence from the Bush II Administration*, 63 ADMIN. L. REV. 179 (2011).
[79] Ellig & McLaughlin, *supra* note 73; an evaluation of inter-rater reliability is available at http://mercatus.org/reportcard.
[80] Ellig & McLaughlin, *supra* note 73.
[81] The evaluators were Sherzod Abdukadirov, a research fellow at the Mercatus Center; James Broughel, the manager of the Report Card project and a doctoral student in economics at George Mason University; Jerry Ellig, a senior research fellow at the Mercatus Center and one of the creators of the Report Card; and Todd Nesbit, an assistant professor of economics at Ohio State University.

data to assess the quality and use of the SEC's economic analysis and compare it to the analysis produced by executive branch agencies.[82]

Evaluators approached the project with no prior expectation about whether the SEC's economic analysis was likely to be better or worse than that of executive branch agencies. On the one hand, judicial review of SEC analysis could motivate the SEC to produce better analysis than executive branch agencies. On the other hand, detailed guidance provided by Executive Order 12866, OMB *Circular A-4*, and OIRA review could assist executive branch agencies in producing better analysis than the SEC.

Table 3 and figure 1 show the most basic results. The seven pre-2012 SEC regulations scored very poorly, earning an average of 15.7 out of 60 possible points (a score of just twenty-six percent). The highest-scoring regulation, Whistleblower Incentives and Protections, earned just 20 out of 60 possible points (thirty-three percent). Interestingly, that rule came out of the SEC's enforcement division, a part of the SEC that does not normally write rules. The regulations scored higher on openness than on analysis or use—largely because the first openness criterion assesses whether the rules and analysis are easy to find online. The highest scores for the analysis and use categories were 5 points out of 20 possible points (twenty-five percent).

One anonymous reviewer of a previous version of this article suggested that the SEC initiated changes to its economic analysis process after the July 2011 decision in the proxy access case. If any improvement occurred as a result of these changes, it is not obvious from the scores in table 3. One regulation in our sample was finalized in November 2011 and another in December 2011, but their average scores are approximately the same as those of the other

[82] All the executive branch regulations used for comparison in this article were "prescriptive" regulations that contain mandates or prohibitions. (The term is from Posner, *supra* note 75.) We omitted budget regulations, which implement federal spending or revenue collection programs. Since the SEC regulations are prescriptive regulations, not budget regulations, this is the appropriate comparison.

regulations in the sample. Even if the SEC began initiating changes after July 2011, it is unlikely that significant effects of those changes would show up in final rules issued just a few months later, given that those rules were initially proposed in January 2011.

Table 3. SEC Regulations' Report Card Scores

	Date	Total	Openness	Analysis	Use
Whistleblower incentives and protections	6/13/11	20	11	4	5
Reporting by investment advisers	11/16/11	18	11	5	2
Executive compensation	2/2/11	15	9	3	3
Risk management controls	11/15/10	15	9	4	2
Amendments to the investment advisers act	7/19/11	14	9	4	1
Large trader reporting	8/3/11	14	9	3	2
Net worth standard for accredited investors	12/29/11	14	8	4	2

Figure 1. Openness, Analysis, and Use of Economic Analysis in Seven SEC Rules

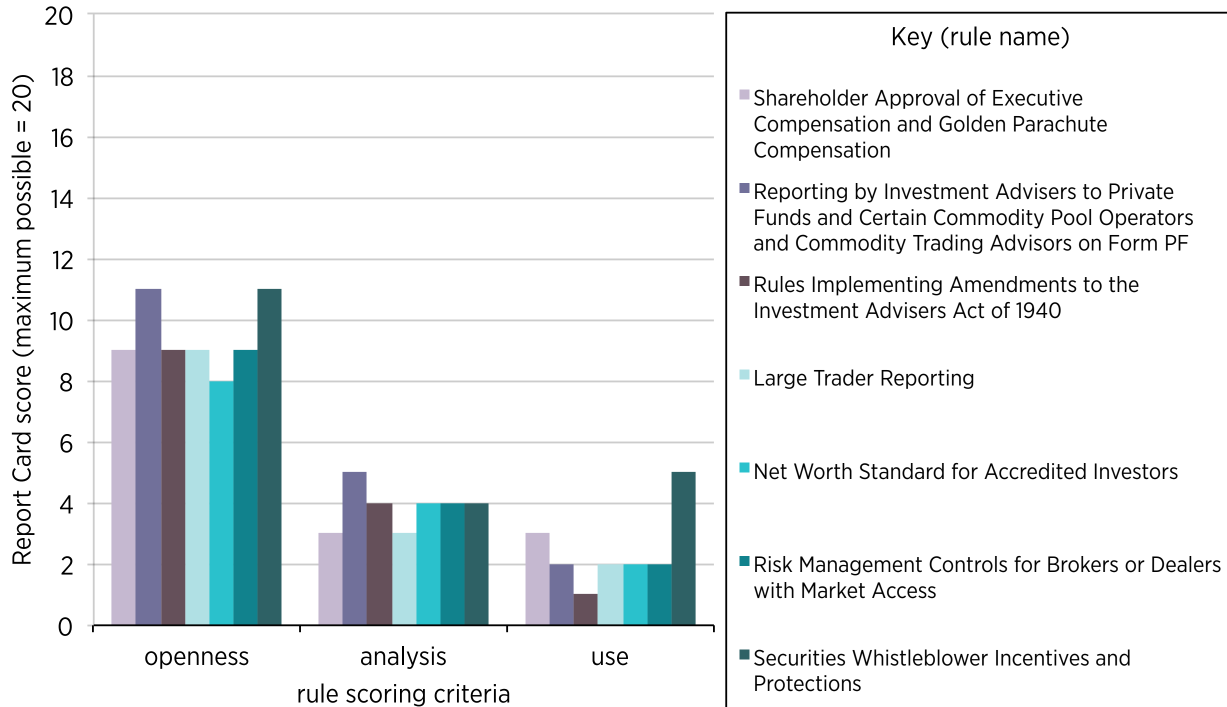
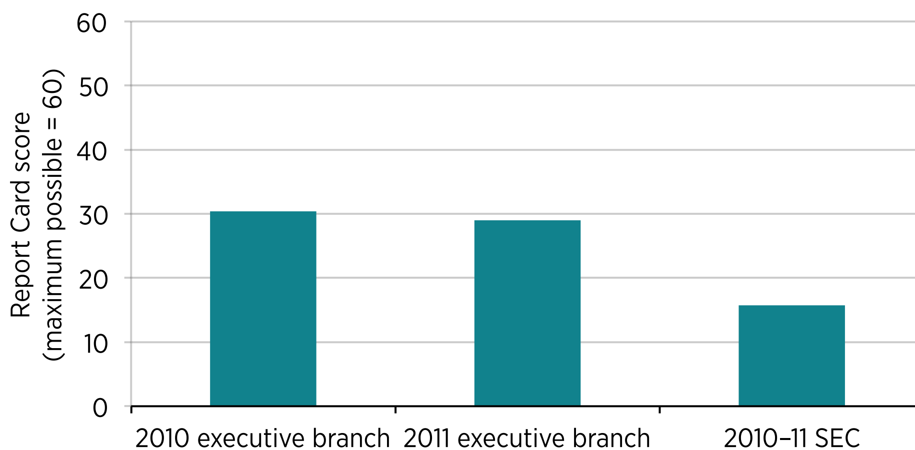


Figure 2 compares the scores for the SEC regulations with scores for executive branch regulations. Executive branch agencies often produce incomplete regulatory impact analysis, averaging just 29.7 out of a maximum possible 60 points for 2010–2011. Nevertheless, this is almost double the average score for the seven SEC regulations.[83]

Figure 2. Comparison of Report Card Scores for SEC and Executive Branch Rules

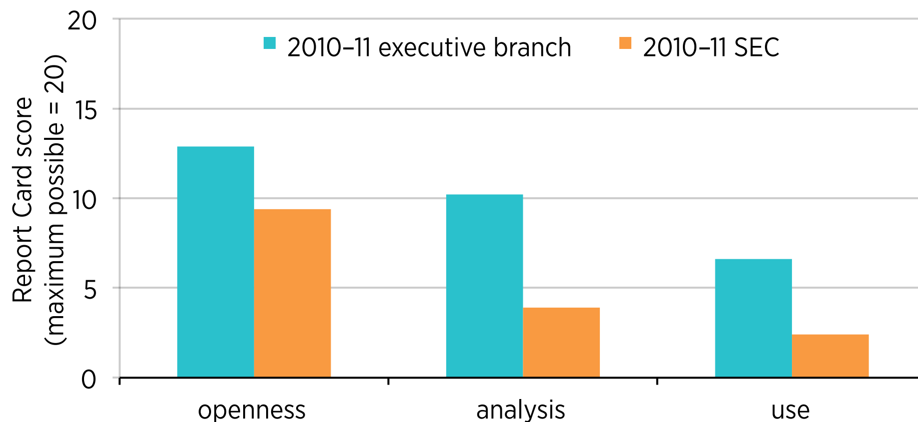


Note: The differences in means are statistically significant at much greater than the one percent level.

Figure 3 shows how the SEC regulations compare with executive branch regulations on the three major categories of criteria in the Report Card: openness, analysis, and use. The SEC regulations' scores for quality of analysis and use of analysis to inform decisions fall far short of both the maximum possible score and the average scores earned by executive branch agencies. For both analysis and use of analysis, the executive agencies' average score was more than twice the SEC's average score.

[83] Differences in means are statistically significant at much greater than the one percent level.

Figure 3. Comparison of SEC and Executive Branch Scores for Openness, Analysis, and Use



Note: The differences in means are statistically significant at much greater than the one percent level.

The low scores for the SEC regulations might arguably be attributed to the fact that economic analysis of proposed financial regulations involves unique difficulties. Former SEC Chairman Mary Schapiro took the position that

> [a]nalyzing the predicted economic effects of proposed rules, while critical to the rulemaking process, can be challenging. As the GAO noted in its recent review of Dodd-Frank cost-benefit analyses, "the 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."[84]

Figure 4 sheds some light on this argument by comparing the SEC regulations' average scores with the average scores executive branch agencies earned for their analysis of financial regulations. Several executive branch agencies issue regulations that address financial topics—for example, the

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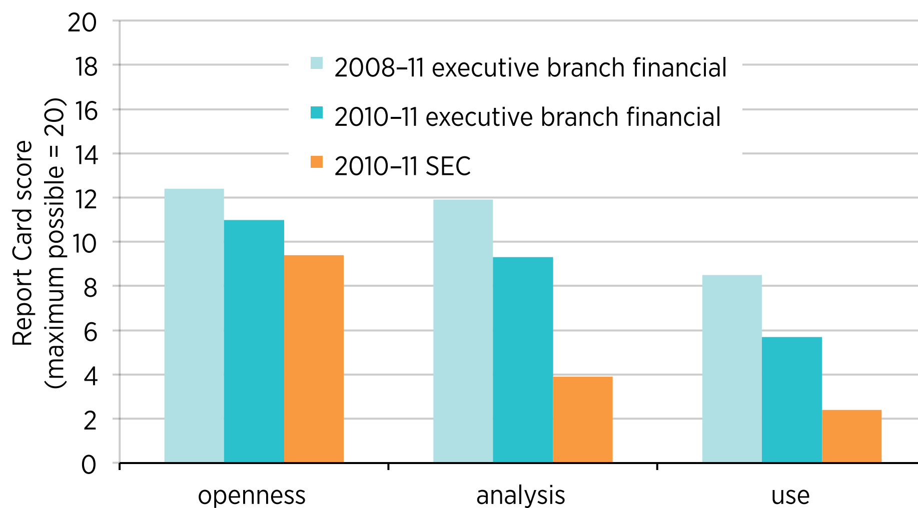
[84] Mary Schapiro, Chairman, SEC, *Testimony Before the Subcommittee on TARP, Financial Services, and Bailouts of Public and Private Programs of the House Committee on Oversight and Government Reform* (Apr. 17, 2012) (quoting GAO Report 12-151 at 19), http://www.sec.gov/news/testimony/2012/ts041712mls.htm. *See also* Curtis W. Copeland, *Economic Analysis and Independent Regulatory Agencies*, Draft Report Prepared for the Administrative Conference of the United States (Apr. 30, 2013) (cataloguing the SEC's stated reasons for finding it "difficult to quantify certain regulatory costs and/or benefits," including the difficulty of understanding the effects when the SEC is regulating a new area and the difficulty of estimating the benefit of one rule that is part of an interrelated set of rules), *available at* http://www.acus.gov/sites/default/files/documents/Copeland%20Final%20BCA%20Report%204-30-13.pdf.

Department of Labor (pension and retirement savings plans), the Department of the Treasury (banking), and the Department of Housing and Urban Development (mortgage finance). The Regulatory Report Card evaluated three executive branch financial regulations in 2010–2011 and eight in 2008–2011. We include scores from both time periods in figure 4 to provide a larger sample of Report Card regulations for comparison. Even when compared to the analysis of other agencies' financial regulations, the SEC regulations score poorly. In fact, executive branch agencies' average scores for financial regulations are about the same as the average scores for all executive branch regulations.[85] Thus, it is doubtful that the low scores for the SEC regulations reflect some unique difficulties associated with analyzing financial regulations.

Figure 4. Executive Branch Financial Regulations Outscore SEC Regulations in Regulatory Report Card



Note: The difference in means is statistically significant at the one percent level for openness and at much greater than the one percent level for analysis and use.

[85] Calculated from data downloaded from www.mercatus.org/reportcards.

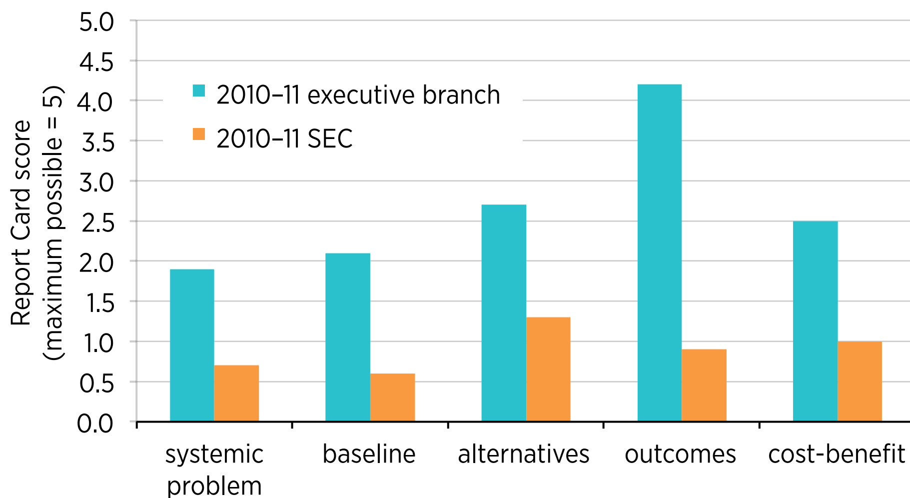
The SEC economic analysis memorandum lists four major substantive requirements for the analysis of rulemakings, which are reproduced in table 4. Each of these requirements corresponds to one or more Report Card criteria, or to one or more subquestions within a criterion. Therefore, we can compare the scores on these criteria to see how the SEC has been doing on the specific topics the SEC staff identified as important in the economic analysis memorandum.

Table 4. Substantive Requirements for Regulatory Analysis in SEC Memorandum

SEC economic analysis requirement	Report Card criterion or question(s)
1. Clearly identify the justification for the proposed rule.	Criterion 6: How well does the analysis demonstrate the existence of a market failure or other systemic problem the regulation is supposed to solve?
2. Define the baseline against which to measure the proposed rule's economic impact.	Criterion 7, question D: Does the analysis adequately assess the baseline—what the state of the world is likely to be in the absence of further federal action?
3. Identify and discuss reasonable alternatives to the proposed rule.	Criterion 7: How well does the analysis assess the effectiveness of alternative approaches?
4. Analyze the economic consequences of the proposed rule and the principal regulatory alternatives.	Criterion 5: How well does the analysis identify the desired outcomes and demonstrate that the regulation will achieve them? Criterion 8: How well does the analysis assess costs and compare them with benefits?

Figure 5 demonstrates that the SEC has ample room to improve its analysis for all the topics listed in the memorandum. The SEC's highest-scoring topic is discussion of alternatives, where it earned just 1.3 out of a possible 5 points, compared to an average of 2.7 points earned by executive branch agencies. On several topics the SEC regulations received average scores of less than 1 point. A score of 1 point means that the analysis made some assertions about the topic, but provided only cursory argument and little evidence to back up its claims. Even though the executive branch agencies often produced seriously incomplete analysis, they always outscored the SEC substantially on the topics that the SEC has identified as critical to sound economic analysis of rulemakings.

Figure 5. How the SEC Compares with Executive Branch Agencies on Topics the SEC Identifies as Important



Note: The differences in means are statistically significant at much greater than the one percent level.

IV. Opportunities for Improvement in the SEC's Economic Analysis

Although performing a comprehensive regulatory analysis for the rules is beyond the scope of this paper, in this section we endeavor to point out some ways in which each analysis could have been improved. For each rule, we suggest ways in which the SEC could have more thoroughly evaluated the systemic problem it was trying to solve, the available alternatives, and the economic consequences—three critical components of the SEC's staff guidance on economic analysis. The fourth component mentioned in the guidance—the baseline—is in some cases an important part of assessing the need for the regulation and in other cases an important component of assessing alternatives. Where baseline issues are significant, we consider them as part of our discussion of the systemic problem or the alternatives.

As this discussion demonstrates, the SEC could have drawn on its own expertise, literature, and economic theory in analyzing the rules. Instead, much of the SEC's analysis appears to be grounded in the SEC's beliefs, the basis for which is generally not provided. The

phrase "we believe" appears an average of forty times in the Federal Register notices for the seven pre-2012 regulations. In contrast, the same phrase appears in the notices for the 2010–2011 executive branch regulations an average of ten times—and not at all in the notices of proposed rulemaking (NPRMs) and RIAs for twenty-one executive branch regulations![86] While this tabulation may to some extent reflect merely stylistic differences between agencies, combined with the SEC's lower Report Card scores, it suggests that the SEC has been more willing than executive branch agencies to base decisions on beliefs or assertions rather than on evidence.

Perhaps because the analysis is relatively thin, we find few examples where the SEC claimed that the economic analysis affected its decisions. Below, we describe opportunities for improvement that would have been quite feasible for the SEC to implement, particularly if it had applied the methodology set forth in the staff guidance. Better analysis, in turn, could perhaps have led to more effective, more efficient, or less costly regulations.

A. Risk Management Controls for Brokers or Dealers with Market Access

The Risk Management Rule requires brokers or dealers that offer their customers direct access to an exchange or alternative trading system (ATS) to establish, document, and maintain a system of risk management controls and supervisory procedures to limit the financial, legal, and operational risks of the broker or dealer and to ensure compliance with regulatory requirements.[87] Direct access allows customers of a broker-dealer—such as hedge funds and mutual funds—to conduct electronic trades directly, using the broker-dealer's access credentials on exchanges or alternative trading systems, without the delay associated with having the broker-

[86] In five of the seven SEC notices, the phrase "we believe" appeared between thirty and ninety-three times.
[87] Risk Management Controls for Brokers or Dealers with Market Access, 75 Fed. Reg. 69,792 (Nov. 15, 2010) (to be codified at 17 C.F.R. pt. 240).

dealer effect the trade for them. Under the rule, the required controls must be reasonably designed to prevent the entry of orders that are erroneous, that exceed certain credit and capital thresholds, or that violate regulatory requirements.[88] The rule also includes an annual review requirement and an annual certification requirement for the chief executive officer.[89]

This rule received a Report Card score of 15 out of 60—close to the average for the seven pre-guidance rules we reviewed. There is little evidence in the *Federal Register* notice that the economic analysis affected any significant SEC decisions. The SEC's analysis could have been improved in several concrete ways that would have made it more useful for the SEC's decision-making.

Systemic problem. The SEC failed to identify with precision the nature and extent of the problem that it was setting out to solve. Instead, the SEC cited the so-called flash crash on May 6, 2010, as evidence that problems can spread quickly through the securities markets, and then the SEC identified some high-level benefits that it anticipated as a result of the rule.[90] The notice[91] states that "[t]he Commission believes that Rule 15c3-5 should reduce the risks faced by broker-dealers, as well as the markets and financial system as a whole, as a result of various market access arrangements," but it does not explain what those risks are or attempt to quantify them.[92] The notice makes a generalized reference to the SEC's desire to prevent "potentially severe, widespread incidents that could arise as a result of inadequate risk controls on market

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[88] *Id.*
[89] *Id.*
[90] *Id.* at 69,794. For a discussion of the flash crash, *see* STAFFS OF THE SEC AND CFTC, FINDINGS REGARDING THE MARKET EVENTS OF MAY 6, 2010: REPORT TO THE JOINT ADVISORY COMMITTEE ON EMERGING REGULATORY ISSUES (Sept. 30, 2010).
[91] Unless otherwise noted, "notice" refers to a notice of final rulemaking. The SEC typically uses the alternative term "release."
[92] 75 Fed. Reg. at 69,794.

access."[93] The notice also anticipates that "these financial and risk management controls should reduce risks associated with market access and thereby enhance market integrity and investor protection in the securities markets."[94] The SEC asserted—rather than established—the link between market access controls and investor confidence.[95]

To obtain a better understanding of the magnitude of the problem, the SEC could have undertaken a systematic search of erroneous trades and their relationship to direct customer access using, at least in part, publicly available data. Indeed, the notice mentions that "certain exchanges provide a searchable history of erroneous trade cancellations on their website, which indicate that erroneous trades occur with some regularity."[96] In addition, the SEC easily could have obtained additional information about erroneous trades from the exchanges, which the SEC regulates.

Another facet of justifying the rule could have included considering the extent and adequacy of the controls that the notice acknowledges many broker-dealers already have in place.[97] If controls such as the automatic rejection of trades above a certain size or checks to ensure that customers are not exceeding their credit limits reduce risks, broker-dealers already have substantial incentives to voluntarily adopt access controls. In framing the problem, the SEC should have looked at how many broker-dealers had systems in place and the efficacy of those systems, information that the SEC could have obtained from the Financial Industry Regulatory Authority (FINRA), the quasi-governmental organization that regulates broker-dealers. Because the SEC regulates FINRA, it has access to FINRA data.

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[93] *Id.*
[94] *Id.*
[95] *See, e.g.*, *id.* at 69,823 ("Rule 15c3–5 should promote confidence as well as participation in the market by enhancing the fair and efficient operation of the U.S. securities markets, thus promoting capital formation.").
[96] *Id.* at 69,794, n. 16.
[97] *Id.* at 69,798–99 (noting that for certain broker-dealers, the rule's requirements "should be substantially satisfied by existing risk management controls and supervisory procedures already implemented").

Alternatives. The SEC did not consider alternatives to the approach it took. Given that many broker-dealers already implement market access controls, the SEC could have considered an alternative rule that would target the firms that do not currently have such controls. Such an approach would have avoided imposing additional costs on firms with effective controls in place. The SEC also could have considered ways to establish incentives for firms to implement controls without an SEC prescription. For example, a rule providing that enforcement sanctions would be higher for broker-dealers that experience problems and do not have effective controls in place could motivate firms to improve their controls. It is common for the SEC to consider, in setting penalties in its enforcement cases, whether firms made a good-faith attempt to establish effective procedures to prevent illegal conduct. Alternatives that rely on, rather than displace, existing firm rules would also help to avoid one-size-fits-all approaches, which can diminish the effectiveness and increase the cost of rules.

The SEC also could have looked at the role that exchanges and ATSs can play in fostering effective risk management. The SEC could have looked at the rules that govern participation in those venues to see whether certain rules were more effective than others, and then it could have considered whether adjustments in rules at the exchange and ATS level would suffice. The SEC recognized a role for other rulewriters when it explained that the rule "is intended to complement and bolster existing rules and guidance issued by the exchanges and [FINRA],"[98] but it did not extend this reasoning to consider whether those rules could be strengthened. Commenters suggested placing the onus for risk management on exchanges and ATSs, which—before the rule was adopted—routinely provided risk management tools to

[98] *Id.* at 69,794.

broker-dealers.[99] The SEC dismissed this option without clearly explaining why it was inferior to the final rule.[100]

Economic consequences. The SEC could have used the fact that there were two sets of firms—one with controls already in place and one without—to assess the effects the rule would have. Controlling for other variables, it could have conducted a rigorous comparison between the two sets of broker-dealers. The results would have helped establish not only whether there is a link between an absence of controls and trading problems, but also what the consequences of mandating controls might be.

B. Securities Whistleblower Incentives and Protections

The Securities Whistleblower Incentives and Protections rulemaking implements a new Dodd-Frank regime for processing tips to the SEC and compensating people who provide original information to the SEC that forms the basis of successful enforcement actions.[101] In actions that generate monetary sanctions of more than $1 million, these whistleblowers must receive ten to thirty percent of the amount collected.[102] The basic elements of the whistleblower program were prescribed by Dodd-Frank, but the SEC made a number of discretionary decisions about key program details.[103]

This rulemaking received the highest score among the pre-guidance rules we reviewed. It is also unique in its heavy citation to some of the relevant whistleblower literature. The volume,

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[99] *See id.* at 69,799 (citing relevant comments).
[100] *Id.*
[101] Securities Whistleblower Incentives and Protections, 76 Fed. Reg. 34,300 (June 13, 2011) (to be codified at 17 C.F.R. pts. 240 and 249).
[102] *Id.*
[103] *Id.*

breadth, and scope of academic whistleblower literature reflect the complexity of determining whether whistleblower programs provide the intended results and, if so, what characterizes effective whistleblower regimes. The effects of monetary incentives on a broad range of behaviors, including whistleblowing, have been widely studied.[104] The SEC should be commended for looking to some of the relevant literature to guide its thinking, but it missed many opportunities to make use of that literature in its analysis.[105]

Much of the available literature critically analyzes and draws lessons from other whistleblowing statutes. These include the IRS whistleblower program, which underwent some changes in 2006; the federal False Claims Act,[106] which has been in existence since the Civil War; the whistleblower provision in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989;[107] and state false claims acts.[108] The SEC could have taken greater advantage of other government experiences with whistleblower programs to design and predict

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[104] *See, e.g.*, Bruno S. Frey & Reto Jegen, *Motivation Crowding Theory*, 15 J. ECON. SURVEYS 589 (2001) (survey of empirical work on the effects of monetary incentives in a broad range of situations on intrinsic motivation); Edward Deci, Richard Koestner & Richard M. Ryan, *A Meta-Analytic Review of Experiments Examining the Effects of Extrinsic Rewards on Intrinsic Motivation*, 125 PSYCH. BULLETIN 627, 659 (1999) (analyzing 128 studies on effects of extrinsic rewards on intrinsic motivation across a wide variety of situations and concluding "that strategies that focus primarily on extrinsic rewards do, indeed, run a serious risk of diminishing rather than promoting intrinsic motivation").

[105] The SEC's approach resulted in its failure to cite literature even when that literature supported the SEC's analysis. For example, the SEC cited an article for a secondary point that it could have used to support its conclusions that monetary awards—even those paid to whistleblowers who are involved in the illegal conduct—are a useful mechanism for "enhance[ing] the regulatory system governing corporations." Robert Howse & Ronald J. Daniels, *Rewarding Whistleblowers: The Costs and Benefits of an Incentive-Based Compliance Strategy*, in DECISION-MAKING IN CANADA (Ronald J. Daniels & Randall Morck eds., 1995), at 539, 546. The notice cited this article for the point that tying the award to the penalty amount may provide an incentive for whistleblowers to delay. 76 Fed. Reg. at n. 439. The article goes on later to present counterarguments on that point, but the SEC does not cite these counterarguments. Howse & Daniels at 535–36 (arguing that the risks that another whistleblower will emerge or that evidence will disappear work to counteract delay).

[106] 31 U.S.C. §§ 3729–33 (2012).

[107] 12 U.S.C. § 1831k (permitting banking agencies to award up to "25 percent of the amount of the fine, penalty, restitution, or forfeiture or $100,000, whichever is less" to person who provides original information leading to recovery of criminal fine, restitution, or civil penalty under relevant banking statutes).

[108] *See generally* Patrick A. Barthle II, *Whistling Rogues: A Comparative Analysis of the Dodd-Frank Whistleblower Bounty Program*, 69 WASH. & LEE L. REV. 1201 (Spring 2012) (discussing history of whistleblower programs); Elletta Sangrey Callahan & Terry Morehead Dworkin, *Do Good and Get Rich: Financial Incentives for Whistleblowing and the False Claims Act*, 37 VILL. L. REV. 273, 275–83 (1992) (discussing history of whistleblower programs).

the effects of its program.[109] Where the SEC's program is different from its forerunners—for example, the barriers for SEC whistleblowers are comparatively low—the analysis should have explored the implications of these differences.[110]

Systemic problem. The whistleblower rule was mandated by Congress, and the SEC did not analyze the problem it was trying to solve. Even before the whistleblower rule went into effect, the SEC had been receiving many tips from whistleblowers, so the problem might have been the SEC's inability to effectively identify tips worth pursuing. Encouraging more tips through a whistleblower program would not solve that problem and could make it worse. The SEC's pre–Dodd-Frank Act whistleblower compensation program was quite limited in scope,[111] so the SEC could have compared the volume, timeliness, and quality of its own tips to the volume, timeliness, and quality of tips received by other agencies with more generous whistleblower programs to assess whether there was a problem that needed to be solved. One experimental study found, for example, that the need for awards falls with the perceived severity of the wrongdoing and concluded that "[i]n areas where the misconduct is likely to be viewed, at least by some of the people, as severe, there is less need to use rewards that carry both monetary costs for the state and

[109] The SEC, for example, downplayed the relevance of data generated under the False Claims Act by pointing to the relative lenience of the SEC's program. *See* 76 Fed. Reg. at n. 232 ("It is not clear that data about whistleblower behavior under the False Claims Act necessarily will be an accurate predictor of behavior under our program. The barriers to participation as a False Claims Act whistleblower are appreciably higher than in our program . . . .").
[110] *See, e.g.*, Troy A. Paredes, Commissioner, SEC, Speech by SEC Commissioner: Statement at Open Meeting to Adopt Final Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934 (May 25, 2011) (arguing that the fact that the SEC's program is more lenient than the False Claims Act should have served as a warning "that the final rule does not do enough to efficiently filter out lower-quality submissions"), *available at* http://www.sec.gov/news/speech/2011/spch052511tap-item2.htm.
[111] 15 U.S.C. § 78u–1(e) (permitting the SEC to pay bounties for insider trading tips). *See also* SEC OFFICE OF INSPECTOR GEN., ASSESSMENT OF THE SEC'S BOUNTY PROGRAM (Mar. 29, 2010) (assessing the effectiveness of the SEC's pre-Dodd-Frank whistleblower program in light of other government agencies' programs and making recommendations for improving it), *available at* http://www.sec-oig.gov/reports/auditsinspections/2010/474.pdf.

social costs for the whistle-blower herself."[112] In any case, thinking through the nature and extent of the problem would have helped the SEC craft a more effective whistleblower program.

Alternatives. Assuming that the problem that the rule was designed to solve is that the SEC is not receiving adequately high-quality tips, there are alternatives to monetary whistleblower awards. For example, the SEC could have looked at the effects of the Sarbanes-Oxley Act on whistleblowing.[113] This act includes a new avenue for people with accounting and auditing complaints to raise them with the company's audit committee and new protections against retaliation for accounting whistleblowers. The SEC could then have considered whether a preferable alternative to the proposed rule would have been enhanced protections for whistleblowers.[114] The adopting release noted Sarbanes-Oxley's emphasis on effective internal whistleblowing frameworks but stopped short of exploring the degree to which prior government efforts to encourage whistleblowing had been successful.[115] Another alternative to whistleblowing that has been suggested in the literature and should have been considered by the SEC is permitting insider trading on information about corporate misconduct.[116] Offering lower

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[112] *See, e.g.*, Yuval Feldman & Orly Lobel, *The Incentives Matrix: The Comparative Effectiveness of Rewards, Liabilities, Duties, and Protections for Reporting Illegality*, 88 TEX. L. REV. 1151, 1204 (2010). The social cost to the whistleblower is the social stigma associated with monetary awards. *Id.* at 1205.

[113] Pub. L. No. 107-204, 116 Stat. 745 (July 30, 2002).

[114] One study that the SEC cited for another point looked at fraud cases before and after Sarbanes-Oxley and found that Sarbanes-Oxley "protections for whistleblowers [have] not increased employees' incentives to come forward with cases of fraud," but noted that "[t]his is not to say that the legislation has not influenced employee whistleblowing by other measures." Alexander Dyck et al., *Who Blows the Whistle on Corporate Fraud?*, 65 J. OF FIN. 2213, 2250 (2010).

[115] 76 Fed. Reg. at n. 230 (discussing the Sarbanes-Oxley requirements, but noting that, in Dodd-Frank, "Congress chose a wholly different model—one that provides financial incentives for employees and others to report violations directly to the Commission").

[116] *See* Jonathan Macey, *Getting the Word Out About Fraud: A Theoretical Analysis of Whistleblowing and Insider Trading*, 105 MICH. L. REV. 1899, 1921 (2007) ("Insider trading can accomplish the same socially desirable results as whistleblowing."); Geoffrey Christopher Rapp, *Beyond Protection: Invigorating Incentives for Sarbanes-Oxley Corporate and Securities Fraud Whistleblowers*, 87 BOSTON UNIV. L. REV. 91, 151–53 (2007) (discussing the possibility of permitting whistleblowers to engage in insider trading as one way of motivating whistleblowers—the point for which the SEC cited this article).

penalties to people involved in securities law violations if they report them to the SEC might be another reasonable alternative to a whistleblower award program.

The SEC did consider different ways of crafting whistleblower awards. For example, the SEC, in explaining its decision not to mandate that whistleblowers report to internal compliance programs before or at the same time as they report to the SEC,[117] explicitly referred to the economic analysis section.[118] In the rules we reviewed, this is one of the few instances in which economic analysis seems to have played an explicit role in the decision-making process. The economic analysis suggested that mandatory internal reporting could discourage some whistleblowers who might be willing to report to the SEC but fear reprisal or other harassment if they report internally.[119] It is not clear whether this economic analysis was done before the commission made its decision, but it is difficult to see how the commission could have made the decision without employing logic similar to the economic analysis. For this use of economic reasoning in one facet of the regulation, the whistleblower regulation received a score of 3 points on the Report Card criterion that assesses whether the commission claimed to use the economic analysis in any decisions. This is the highest score any of the SEC regulations achieved on this criterion.

Despite this relative strength, the whistleblower regulation's economic analysis failed to consider an alternative that stipulated mandatory internal reporting, together with rewards for whistleblowers who report internally but not to the SEC. Such an approach might have been a

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[117] The SEC explained that "the final rule relies on whistleblowers to determine whether reporting potential securities violations internally would be appropriate or desirable at their entity . . . ." 76 Fed. Reg. at n.274.
[118] *Id.* at n. 225.
[119] *Id.* at 34,361.

way to minimize costs to the SEC,[120] whistleblowers,[121] and companies.[122] In support of its decision not to require mandatory internal reporting, the SEC relied on articles that argued generally in favor of monetary awards as a means for compensating whistleblowers for the adverse consequences of whistleblowing, but it did not address the specific issue of allowing for rewards to whistleblowers who report only internally.[123] For insight in this area, the SEC could have looked at different state experiences.[124] The SEC also could have considered alternatives to mandated awards of ten to thirty percent of the monetary sanctions.[125] Although the statute

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[120] Kathleen L. Casey, Commissioner, SEC, Statement by SEC Commissioner: Adoption of Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934 (May 25, 2011) ("Unlike a company engaged in the act of self-policing, the Division must observe numerous legal formalities that are required of government actors. As a consequence, the public investigative process can be substantially more ponderous and time-consuming than private investigative processes. And there is a danger in not addressing matters quickly and decisively. By diverting tips and complaints from private channels to the Commission, we may end up permitting violations to last longer and grow more serious."), *available at* http://www.sec.gov/news/speech/2011/spch 052511klc-item2.htm.

[121] *See, e.g.*, James Gobert & Maurice Punch, *Whistleblowers, the Public Interest, and the Public Interest Disclosure Act 1998*, 63 MOD. L. REV. 25, 53 (2000) (looking at benefits and drawbacks of whistleblowing in the context of a British whistleblower protection statute and noting one potential drawback of governmental encouragement of whistleblowing is that "[i]n a society where one cannot distinguish between friends, neighbors, and co-workers, on the one hand, and government informers, on the other, social cohesion and trust are likely to become the victims"). An article cited several times in the notice discusses that many whistleblowers, "likely driven by their sense of loyalty," may prefer internal whistleblowing to external whistleblowing. *See* Richard E. Moberly, *Sarbanes-Oxley: Structural Model to Encourage Corporate Whistleblowers*, 2006 B.Y.U. LAW REV. 1107, 1142. Another article, which was cited by the SEC in support of another point, suggests that companies could mitigate the "conflict of interest" that monetary awards pose for the employee motivated by loyalty to his company by offering monetary awards to internal whistleblowers. Elletta Sangrey Callahan & Terry Morehead Dworkin, *Do Good and Get Rich: Financial Incentives for Whistleblowing and the False Claims Act*, 37 VILL. L. REV. 273, 335 (1992).

[122] *See* Richard E. Moberly, *Sarbanes-Oxley: Structural Model to Encourage Corporate Whistleblowers*, 2006 B.Y.U. LAW REV. 1107, 1156–57 (explaining that whistleblower error, which may be intentional or unintentional, is a cost of whistleblowing, but that the cost may be lower for companies if the erroneous tip is handled internally).

[123] *See* 76 Fed. Reg. at n. 459 and accompanying text (citing, *inter alia*, Pamela H. Bucy, *Information as a Commodity in the Regulatory World*, 39 HOUS. L. REV. 905, 948–59 (2002) and Luigi Zingales, *Want to Stop Corporate Fraud? Pay Off Those Whistle-Blowers*, AEI-Brookings Joint Center Policy Matters (Jan. 18, 2004)).

[124] *See, e.g.*, Terry M. Dworkin & Janet P. Near, *Whistleblowing Statutes: Are They Working?*, 25 AM. BUS. L. J. 241, 262–63 (arguing, based on an assessment of state laws, that provisions requiring internal mandatory reporting, if "balanced by more liberal remedies for whistleblowers who suffer retaliation when they proceed internally," "would be approaching a well-balanced and useful whistleblowing statute"); Gerard Sinzdak, *Whistleblower Laws: Defending a More Flexible Approach to Reporting Requirements*, 96 CAL. L. REV. 1633, 1698 (based on an assessment of state whistleblower statutes, arguing for more flexibility, including allowing rewards to be made to whistleblowers who use either internal or external channels exclusively).

[125] The SEC does not, for example, appear to have considered the arguments made in a lengthy comment by David Ebersole, which was later published in a law review. He addressed many aspects of the statute and proposed rules. Among the concerns he raised was the ten percent floor on awards. David Ebersole, Comment on SEC Whistleblower Proposal (Dec. 19, 2010), at 19 ("although whistleblower bounties are likely to be unnecessarily high

prescribed this range, considering different formulations could have provided useful information to the SEC, the public, and Congress.

Economic consequences. The notice does not include a thorough, supported analysis of the rule's costs and benefits. Its statements about costs and benefits appear to be based largely on conjecture, rather than on academic literature or on experiences from other whistleblower programs. The SEC relied on staff expectation to determine some direct costs.[126] To gain a better understanding of indirect costs, the SEC could have drawn from insights about costs and benefits from a well-researched study that it cited for the proposition that monetary awards would increase the whistleblower pool.[127]

An important indirect cost of the rule could be the effect on companies' internal compliance programs. The SEC used literature arguing that whistleblowers are motivated by nonmonetary factors to contend that whistleblowers would continue to report internally despite the availability of the SEC's whistleblower awards; yet the SEC also used literature on the importance of monetary awards to support the prediction that the SEC's rule—which takes internal reporting into account in determining the award size—would encourage more internal

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with little marginal utility, they ironically might not provide certainty as intended"), *available at* http://www.sec.gov/comments/s7-33-10/s73310-220.pdf. *See also* David Ebersole, *Blowing the Whistle on Dodd-Frank Whistleblower Provisions*, 6 OHIO ST. ENTREPRENEURIAL BUS. L.J. 123 (2011).

[126] *See, e.g.*, 76 Fed. Reg. at n. 422 ("This number is based on a staff estimate based upon the expectation that roughly 10 percent of all tips received by the Commission will be submitted in hard copy . . . ."). *Id.* at n. 427 (the SEC based its estimate that five percent or fewer whistleblowers would pay their lawyers hourly fees rather than contingency fees "in part, on the Commission's belief that most whistleblowers likely will not retain counsel to assist them in preparing the forms").

[127] *See id.* at 34,361, n. 457 (citing Elletta Sangrey Callahan & Terry Morehead Dworkin, *Do Good and Get Rich: Financial Incentives for Whistleblowing and the False Claims Act*, 37 VILL. L. REV. 273, 335 (1992)). They find that the effectiveness of an award turns on the nature of both the grantor and the award. *Id.* at 336. They also note that there are "practical costs associated with this privatization of the law enforcement function, in addition to the policy concerns." *Id.* at 296–97.

reporting.[128] To justify this conflict, the SEC raised the possibility that that there are two sets of whistleblowers—one that is motivated by money and one that is not—and explained that the rule would work for both groups, but the SEC did not adequately explore the strength of its underlying assumptions about the existence and likely behavior of these two groups.[129]

The SEC goes so far as to suggest that the whistleblower rule will help companies, but does not offer support for this expectation. The agency anticipated, for example, that the rule's monetary awards "should increase the likelihood that individuals will report misconduct to effective internal reporting programs" and hence the likelihood that companies would invest more in improving their compliance programs.[130] The notice asserts that companies that "may previously have underinvested in internal compliance programs may respond by . . . strengthening their internal compliance programs," which "will involve costs on companies," but "there should be an overall increased efficiency from the perspective of investors to the extent that these companies achieve a more optimal investment in these programs."[131] The SEC does not provide evidence that companies are underinvesting now in internal compliance or that the existence of the whistleblower program will incentivize the optimal amount of investment in internal compliance at underinvesting companies. Although the SEC could get access to

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[128] Compare 76 Fed. Reg. at 34,361, n. 453 and accompanying text (citing literature finding that whistleblowers are not financially motivated in support of the conclusion that whistleblowers would not be induced by financial incentives to report to the SEC rather than internally) with *id.* at 34,361, n. 457 and accompanying text ("The financial incentives offered by the final rules to report internally should induce individuals to report who, absent any financial incentive, would never have reported either internally or to the Commission.").

[129] *See id.* at 34,360 (explaining that "we have tailored the final rules to provide whistleblowers who are otherwise pre-disposed to report internally, but who may also be affected by financial incentives, with additional economic incentives to continue to report internally").

[130] 76 Fed. Reg. at 34,325–56.

[131] *Id.* at 34,362. The notice cites an article in support of the possibility that its rules would cause issuers that had underinvested in corporate governance to make "improvements in corporate governance generally," but that article found that governance improvements only occurred in the firms that were "exposed in the press," which is not a component of the SEC's whistleblowing program. *Id.* at 34,362, n. 466 and accompanying text (citing Robert M. Bowen et al., *Whistle-Blowing Target Firm Characteristics and Economic Consequences*, working paper (2009), at 29, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=890750).

information about typical defense costs, it instead "makes no effort to quantify with specificity the impact of" "the defense costs of companies . . . as they are forced to hire outside counsel to represent them before the Division of Enforcement."[132]

The SEC also failed to fully consider the implications that a whistleblowing program could have for the attorney-client relationship. Attorney-client privilege considerations led the SEC generally to preclude awards based on attorney-client information. Nevertheless, the SEC did not consider the extent to which permitting, albeit under limited circumstances, attorneys to be paid for whistleblowing could "cloud their professional judgment."[133] As another example, the rules permit the SEC staff to communicate directly with whistleblowers rather than through the attorney for the company by which the whistleblower is employed, as would normally be required.[134] The notice explains that "[w]e believe that these rules provide benefits by ensuring that whistleblowers are able to work with the Commission as it takes actions in response to possible securities law violations, and thus justify any costs on companies."[135] The so-called no-contact rule—the prohibition on going around a company's counsel and speaking directly with a company employee—is a fundamental rule governing attorney conduct.[136] The SEC should have drawn on the literature exploring that prohibition and the experiences of other government agencies to better understand the costs and benefits

[132] Kathleen L. Casey, Commissioner, SEC, Statement by SEC Commissioner: Adoption of Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934 (May 25, 2011), *available at* http://www.sec.gov/news/speech/2011/spch052511klc-item2.htm.
[133] Barry R. Temkin & Ben Moskovits, *Lawyers as Whistleblowers Under the Dodd-Frank Wall Street Reform Act: Ethical Conflicts Under the Rules of Professional Conduct and SEC Rules*, 84 N.Y. ST. B.J. 10, 12 (2012).
[134] 17 C.F.R. § 240.21F-17(b).
[135] 76 Fed. Reg. at 34,358.
[136] *See* Model Rule of Professional Conduct Rule 4.2 (2013). Note 7 to the rule explains that "[i]n the case of a represented organization, this Rule prohibits communications with a constituent of the organization who supervises, directs or regularly consults with the organization's lawyer concerning the matter or has authority to obligate the organization with respect to the matter or whose act or omission in connection with the matter may be imputed to the organization for purposes of civil or criminal liability." *Id.*

of lifting the prohibition in the whistleblower context.[137] In addition, the commission should have considered the effect that the rule's provisions related to whistleblower lawyers would have on the efficacy and cost of the rule.

The SEC did not adequately consider the potential costs of the whistleblower program to investors and the government. The SEC acknowledges that "whistleblowers might be paid with monies that otherwise could be distributed to victims" but makes no effort to look at the resultant costs.[138] Commissioner Paredes, citing the higher thresholds for submissions under the False Claims Act, expressed concern that the rule would impose costs to the SEC in the form of "an excessive flow of lower-quality tips to the Commission" which could then divert the SEC's time and resources from more important matters.[139] The government's resource commitment to sorting through and following up on complaints is likely to be large,[140] and the SEC did not fully analyze this commitment.

The SEC's failure to conduct a thorough regulatory analysis for the whistleblower rule is especially notable because of the broad availability of academic work in this area, much of which is based on evaluations of other whistleblower programs. Although the adopting release cited much of this work, it did not use it to form the basis of a comprehensive look at the need for a whistleblower program and the elements that should be included in the design of such a program.

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[137] *See, e.g.*, Alafair S. R. Burke, *Reconciling Professional Ethics and Prosecutorial Power: The No-Contact Rule Debate*, 46 STAN. L. REV. 1635 (1994); Joan Colson, *Comment: Rule of Ethics or Substantive Law: Who Controls an Individual's Right to Choose a Lawyer in Today's Corporate Environment*, 38 J. MARSHALL L. REV. 1265 (2005).
[138] 76 Fed. Reg. at 34,348.
[139] Troy A. Paredes, Commissioner, SEC, Speech by SEC Commissioner: Statement at Open Meeting to Adopt Final Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934 (May 25, 2011), *available at* http://www.sec.gov/news/speech/2011/spch052511tap-item2.htm.
[140] Pamela H. Bucy, *Information as a Commodity in the Regulatory World*, 39 HOUS. L. REV. 905, 967 (2002) (verifying whistleblowers' tips "takes significant resources that are uniquely available to public regulators"). *See also* Anthony Heyes & Sandeep Kapur, *An Economic Model of Whistleblower Policy*, 25 J.L. ECON. & ORG. 157 (2009) (demonstrating the importance of understanding whistleblower motives in shaping the appropriate governmental response to tips).

This failure could result in an ineffective whistleblower program or one that produces unintended negative consequences.[141]

C. Shareholder Approval of Executive Compensation and Golden Parachute Compensation

The Shareholder Approval of Executive Compensation and Golden Parachute Compensation rulemaking was mandated by section 951 of the Dodd-Frank Act.[142] The rule requires companies to conduct shareholder advisory votes on (1) executive compensation, (2) the frequency of this executive compensation vote, and (3) golden parachute agreements in connection with mergers and acquisitions.[143] Although the votes are nonbinding, the SEC added a requirement that companies disclose whether and how they have taken shareholder advisory votes into account.[144] Dodd-Frank permitted the SEC to exempt any "issuer or class of issuers" from these requirements.[145] The SEC provided only a temporary exemption for small companies (which Dodd-Frank explicitly mentioned as potential candidates for exemption) with respect to one portion of the rule.[146]

This rule received a Report Card score of 15 out of 60—close to the average for the seven pre-guidance rules we reviewed but still low when compared to rules from executive agencies. The SEC's analysis was hampered by its reliance on the statutory mandate to justify the portions

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[141] *See, e.g.*, Yuval Feldman & Orly Lobel, *The Incentives Matrix: The Comparative Effectiveness of Rewards, Liabilities, Duties, and Protections for Reporting Illegality*, 88 TEX. L. REV. 1151, 1154 (2010) ("Most strikingly, our findings suggest that legal incentives to report are frequently ill-designed and can in fact be inadvertently counterproductive.").
[142] Shareholder Approval of Executive Compensation and Golden Parachute Compensation, 76 Fed. Reg. 6010 (Feb. 2, 2011) (to be codified at 17 C.F.R. pts. 229, 240, and 249).
[143] *Id.*
[144] *See id.* at 6016 (discussing rationale for requirement that companies disclose "whether and, if so, how their compensation policies and decisions have taken into account the results of the most recent shareholder advisory vote on executive compensation").
[145] Dodd-Frank § 951 (adding 15 U.S.C. § 78n–1(e)). The SEC also has general exemptive authority under the Securities Exchange Act. 15 U.S.C. § 78mm.
[146] *Id.* at 6031 (discussing rationale for temporary exemption). *But see* Troy A. Paredes, Commissioner, SEC, Statement at Open Meeting to Adopt a Final Rule Regarding Shareholder Approval of Executive Compensation and Golden Parachute Compensation (Jan. 25, 2011) (recommending permanent exemption for small and newly public companies), *available at* http://www.sec.gov/news/speech/2011/spch012511tap-3.htm.

of the rulemaking that were not explicitly discretionary. The fact that the Dodd-Frank Act mandated a particular course of action for the SEC does not alter the need for the SEC to understand the problem it is trying to solve. An understanding of the nature of the problem is essential in order to determine whether a proposed solution will work. Likewise, the fact that the Dodd-Frank Act mandated a particular solution to the problem does not alter the need to look at alternatives. The SEC has exemptive authority that allows it some leeway to depart from the mandate, but, even if it were not to exercise that authority, the agency, Congress, and the public should know whether there is a preferable alternative to the one set forth in the Dodd-Frank Act. Congress has the ability to veto agency rules under the Congressional Review Act,[147] and one obvious thing legislators may want to know in order to decide whether to use that veto power is whether there is a better alternative available.

In a more thorough consideration, the SEC could have taken advantage of the copious literature on executive compensation and corporate governance. Among other things, academics have looked extensively at issues related to agency problems and asymmetric information in the governance of publicly held corporations.[148] The SEC would have had to look at this literature in the context of its existing mandates—including extensive compensation disclosure requirements.

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[147] 5 U.S.C. §§ 801–8 (2012).

[148] For a general introduction to the literature, *see* Lucian A. Bebchuk & Michael S. Weisbach, *The State of Corporate Governance Research*, 23 REV. OF FIN. STUDIES 939 (2010). *See also* Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972); Lucian A. Bebchuk & Jesse Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON. PERSPECTIVES 71 (2003); ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J. LAW & ECON. 1 (1983); Andrei Shleifer & Robert Vishny, *A Survey of Corporate Governance*, 52 J. OF FINANCE 737 (1997).

Systemic problem. The notice explains that the rules will provide companies with clarity about how to comply with the statute and will facilitate investors' decision-making,[149] but it does not explore whether there was a problem that justified the rule's voting and disclosure mandates. To the contrary, some of the SEC's analysis suggests there may not have been a problem. For example, with respect to golden parachute disclosure, the SEC acknowledged that "our existing disclosure requirements include much of this disclosure."[150] Similarly, the SEC concluded that new tabular disclosure requirements for executive compensation would impose only "limited" costs since the same information "is currently required to be disclosed in narrative format," thus raising questions about the necessity for the new disclosure.[151]

In addition to looking at the adequacy of its existing executive compensation disclosure requirements, the SEC ought also to have looked beyond its regulatory framework to determine whether other private or government solutions were effectively at work. If boards of directors set executive compensation in light of market factors, there may not be a need for the government to take further steps such as those taken in this rulemaking.[152] As part of understanding whether there was a problem to be solved, the SEC also would have needed to look at the efficacy of existing mechanisms—including state law and exchange listing requirements—for shareholders to monitor and control the activities of boards and management.[153]

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[149] 76 Fed. Reg. at 6038–39.
[150] *Id.* at 6039.
[151] *Id.*
[152] *See, e.g.*, Steven N. Kaplan, *Are U.S. CEOs Overpaid?*, EXCHANGE, May 2008, at 15 (arguing that market forces, board oversight, existing SEC disclosure rules, and existing avenues for shareholders to express discontent obviate the need for a mandatory nonbinding shareholder vote on executive compensation), *available at* http://faculty.chicagobooth.edu/steven.kaplan/research/kceo.pdf.
[153] *See, e.g.*, Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. LAW REV. 1779, 1809–10 (2011) (discussing "immense" literature on whether executive compensation is properly linked with performance and concluding that a regulatory solution was not warranted because "the core premise behind say-on-pay remains, at best, unproven") (a prior version of the article was published in September 2010 at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1673575); Jill E. Fisch, *Leave It to Delaware: Why Congress Should Stay Out of Corporate Governance*, 37 DEL. J. CORP. L. 731, 758 (2013) (arguing that, with respect to Dodd-Frank's

Alternatives. The adopting release did not consider viable alternatives to the rule. The SEC could have looked at ways to foster improved corporate governance through internal corporate mechanisms, which would have allowed for better tailoring to individual company characteristics. As an alternative to mandatory votes, the SEC could have considered opt-in or opt-out procedures to allow for more flexible implementation.[154] An alternative to a uniform rule would have been a rule scaled to size or limited to the biggest companies.[155] The SEC also could have considered the costs and benefits of modifying its existing disclosure requirements to provide any additional information necessary to investors, without also requiring shareholder advisory votes.

Economic consequences. The SEC's analysis of the costs and benefits of the rulemaking is not thorough because it focuses largely on the elements of the rules over which the SEC had discretion. In some cases, the SEC's burden estimates are quite precise (*e.g.*, $400 per hour for "outside professionals" to prepare disclosures),[156] but they are not sourced. Moreover, the SEC did not take into account non-paperwork costs, such as the costs of hiring outside

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say-on-pay provision, "[f]ederalism thus directly interferes with Delaware's private ordering approach"). *See generally* Lucian A. Bebchuk & Assaf Hamdani, *Federal Corporate Law: Lessons from History*, 106 COLUM. L. REV. 1793, 1834–35 (2006) (recommending that on an issue-by-issue basis, "federal policymakers should examine whether: (1) the existing state law arrangement is optimal, and (2) any of the tools that are now unavailable at the state level—rules, agency involvement, public enforcement, criminalization, duties on agents not subject to the jurisdiction of the state of incorporation—would be superior," and stating that "this review should not proceed under the prevailing strong presumption that corporate affairs should normally be left to state law absent compelling reasons to intervene").

[154] *See, e.g.*, Jeffrey Gordon, *Executive Compensation and Corporate Governance in Financial Firms: The Case for Convertible Equity-Based Pay*, Working Paper No. 373 (SSRN, July 9, 2010) (recommending opt-in approach); Minor Myers, *The Perils of Shareholder Voting on Executive Compensation*, 36 DEL. J. CORP. LAW 417 (2011) (recommending opt-out approach).

[155] *See* Jeffrey N. Gordon, *"Say on Pay": Cautionary Notes on the UK Experience and the Case for Shareholder Opt-In*, 46 HARV. J. LEGIS. 323 (2009) (discussing differences between small and large firms that could affect the benefits generated by particular compensation rules).

[156] 76 Fed. Reg. at 6035.

consultants,[157] because those costs are attributable to the statutory mandate rather than the implementing rules.[158]

The discussion of costs largely ignores those potential costs of the rule that are harder to quantify. The new advisory votes mandated by the rule are a step toward the federalization of corporate law, thus potentially imposing greater costs on corporations and their investors than would a state law regime.[159] The SEC's analysis omits any discussion of the fact that more disclosure is not always preferable for investors and could be harmful to them.[160] The SEC does not consider whether the additional disclosures will impose costs on investors. Extraneous disclosures can distract investors' attention from more important items.[161] An item that receives great emphasis in an SEC-mandated disclosure may figure more heavily into investment

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[157] The Chamber of Commerce's Center for Capital Markets Competitiveness raised some of these additional costs in its comment letter. Letter from David T. Hirschmann, President and Chief Executive Officer, Center for Capital Markets Competitiveness of the United States Chamber of Commerce, to Elizabeth M. Murphy, Secretary, SEC (Nov. 18, 2010).

[158] 76 Fed. Reg. at 6039 ("Our analysis of the costs of the amendments we are adopting today relates to the incremental direct and indirect costs arising from the requirements in our rule amendments. The analysis below does not reflect any additional direct or indirect costs arising from new Exchange Act Section 14A, including the shareholder advisory votes on say-on-pay, frequency, and golden parachute compensation, and any likely additional costs which would be incurred because of these votes.").

[159] *See, e.g.*, Fisch, *supra* note 153, at 782 ("State regulation of corporate governance and Delaware corporate law in particular offer substantive and structural advantages over federal regulation. These advantages include specialized lawmaking structures with expertise in business law issues, the capacity to respond to market and legal developments, and the ability to tailor governance structures to firm-specific needs and characteristics.").

[160] *See, e.g.*, Geoffrey A. Manne, *The Hydraulic Theory of Disclosure Regulation and Other Costs of Disclosure*, 58 ALA. L. REV. 473, 511 (2007) (arguing that disclosure mandates impose costs, including "unintended behavioral responses [that] may whittle away the value of increased disclosure"); Troy A. Paredes, *F. Hodge O'Neil Corporate and Securities Law Symposium: Blinded by the Light: Information Overload and its Consequences for Securities Regulation*, 81 WASH. U. L.Q. 417 (2003) (arguing that disclosure mandates should not be imposed without thinking about the users of the information, who may suffer from information overload); Steven M. Davidoff & Claire M. Hill, *The Future of Financial and Securities Markets: The Fourth Annual Symposium of the Adolf A. Berle Jr. Center on Corporations, Law & Society: Limits of Disclosure*, 36 SEATTLE UNIV. L. REV. 599, 624 (2013) (arguing that, rather than informing investors, executive compensation disclosure may benefit executives, who "can use fuller access to the details about compensation of their peers in negotiations to ratchet up their pay").

[161] TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 448–49 (1976) ("Some information is of such dubious significance that insistence on its disclosure may accomplish more harm than good. . . . [I]f the standard of materiality is unnecessarily low, not only may the corporation and its management be subjected to liability for insignificant omissions or misstatements, but also management's fear of exposing itself to substantial liability may cause it simply to bury the shareholders in an avalanche of trivial information—a result that is hardly conducive to informed decisionmaking.").

decisions than it would have absent the disclosure emphasis. This phenomenon is intensified in the area of corporate disclosures because of the involvement of proxy advisory firms.[162] Proxy advisory firms, which provide voting recommendations, focus heavily on executive compensation issues,[163] so they could drive investors to pay even more attention to these items than they otherwise would.[164]

The SEC's discussion of benefits is largely speculative. The notice states, for example, that the rulemaking "will benefit shareholders and other market participants by providing potentially useful information for voting and investment decisions."[165] Similarly, the SEC speculates that "[b]y providing disclosure of the full scope of golden parachute compensation, we believe issuers will provide more detailed, comprehensive, and useful information to shareholders to consider when making their voting or investment decisions."[166] As noted above, this discussion assumes that existing disclosures are inadequate, without explaining why that is the case. Without more information, it is not clear whether the SEC is correct in concluding that "the amendments we are adopting should improve the ability of investors to make informed voting and investment decisions, and, therefore lead to increased efficiency and competitiveness of the US capital markets."[167]

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[162] *See* Fisch, *supra* note 153, at 754–55 (discussing role of proxy advisory firms in influencing say-on-pay advisory votes).
[163] James K. Glassman & J. W. Verret, *How to Fix Our Broken Proxy Advisory System* (Mercatus Center at George Mason University Apr. 16, 2013), at 14–15 (discussing proxy advisors' focus on say-on-pay issues), *available at* http://mercatus.org/publication/how-fix-our-broken-proxy-advisory-system.
[164] For a discussion of reliance on proxy advisors, *see* Daniel M. Gallagher, Commissioner, SEC, Remarks at Society of Corporate Secretaries and Governance Professionals (July 11, 2013). Among other things, he argues that "[a]nother unintended consequence of the increase in mandated disclosure is the rise of proxy advisory firms and the increasing willingness of investment advisers and large institutional investors to rely on such firms in order to ostensibly carry out their fiduciary duties."
[165] 76 Fed. Reg. at 6038.
[166] *Id.*
[167] 76 Fed. Reg. at 6040–41.

With respect to both costs and benefits, the SEC could have looked to the experiences of companies that obtained government funding through the Troubled Asset Relief Program (TARP).[168] Entities with outstanding TARP funds were required to permit a separate shareholder vote on executive compensation.[169] The SEC noted the similarity of the requirement[170] but did not draw on companies' experiences with it (albeit limited given that the TARP requirement had only recently been imposed) to better understand its implications. The SEC also could have looked at the United Kingdom's experience with say-on-pay.[171]

D. Large Trader Reporting

The Large Trader Reporting rulemaking requires large traders, as measured by the volume or value of their trading, to identify themselves to the SEC, provide extensive information to the SEC, and obtain from the SEC an identification number.[172] The large trader must supply this identification number to its registered broker-dealers for use in their recordkeeping and reporting to the SEC.[173] The rulemaking also requires broker-dealers to monitor for unidentified large traders.[174] The rulemaking was authorized under section 13(h) of the Exchange Act[175] and motivated by the SEC's desire to have better information about market transactions.[176] The SEC adopted the rule—which had already been proposed—shortly after the flash crash of May 6, 2010, rattled the agency and the markets and raised questions about the SEC's ability to

[168] TARP was established by the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (Oct. 3, 2008).
[169] 12 U.S.C. § 5221(e).
[170] 76 Fed. Reg. at 6023.
[171] *See* Gordon, *supra* note 155.
[172] Large Trader Reporting, 76 Fed. Reg. 46,960 (Aug. 3, 2011) (to be codified at 17 C.F.R. pts. 240 and 249).
[173] *Id.* at 46,969–72 (describing duties of large traders).
[174] *Id.* at 46,979 (summarizing monitoring requirements).
[175] 15 U.S.C. 78m(h), as adopted in the Market Reform Act of 1990, P.L. 101-432 (1990).
[176] 76 Fed. Reg. at 46,960–61 (explaining that rule will enhance the SEC's ability to collect information about active traders).

reconstruct market events.[177] This rule received a Report Card score of 14 out of 60, which made it one of the lowest-scoring rules in our sample.

Systemic problem. The SEC, in its notice, made an attempt to outline a problem by pointing to gaps in its current information collection system, the electronic blue sheets.[178] Existing blue sheet data did not allow the SEC to trace a transaction to a particular trader or identify when the transaction occurred.[179] Moreover, the SEC pointed to the fact that data were not required to be available to the SEC the day after a transaction occurred.[180] The SEC asserted that these shortcomings in the blue sheet data were the problem it was trying to solve, but it did not take the analysis to the necessary next step and explain how having the data would solve a problem in market function. If mere lack of access to information were the type of problem the SEC needed to solve through rulemaking, the SEC could cite that as the basis for an infinite number of rulemakings. Rather than simply expressing an expectation "that investors should likewise benefit as a consequence of the Commission's enhanced access to information,"[181] the SEC should have explored how having the missing information would enhance the SEC's ability to facilitate well-functioning markets. The SEC could have analyzed, for example, how its response to the flash crash would have been different with access to the large trader information. Moreover, instead of simply pointing to the apparently "increasingly prominent role" of large traders,[182] the SEC should have more thoroughly considered what had changed to make the data

[177] *See supra* note 90.
[178] 76 Fed. Reg. at 46,961.
[179] *Id.*
[180] *Id.*
[181] 76 Fed. Reg. at 46,993–94.
[182] *Id.* at 46,993.

necessary; Congress first gave the SEC authority to request the information in 1990,[183] but the SEC waited until 2011 to finalize a rule.

The SEC's failure to pinpoint the problem it was attempting to solve made the development of an effective solution more difficult. For example, the SEC's decision to require aggregation among companies with a common parent regardless of whether there is coordination of investment discretion could undermine the value of the information for purposes of reconstructing market events.[184] The SEC mentioned the fact that the CFTC has a large trader reporting requirement,[185] but did not look to the CFTC's long experience with this requirement to explain the SEC's need for a similar requirement.

Alternatives. The SEC appears to have settled on its solution without giving even-handed consideration to alternatives. The SEC could have looked at modifying other SEC or FINRA information collection requirements. The SEC also could have considered a coordinated approach with international regulators interested in the same type of information. One commenter suggested relying on changes to FINRA's Order Audit Trail System (OATS) instead of making changes to the SEC's electronic blue sheets.[186] FINRA, which is the frontline regulator of brokers, maintains an audit trail system that "is designed to capture all of the events in the lifecycle of an

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[183] *See supra* note 175.

[184] *See* 76 Fed. Reg. at 46,965 (explaining decision to apply at the parent level regardless of where the investment discretion lies). *See also* Letter from Jennifer S. Choi, Associate General Counsel, Investment Advisers Association, to Elizabeth M. Murphy, Secretary, SEC (June 22, 2010), at 4 ("Transaction data that consolidate trading activity of affiliates that do not coordinate investment decisions or trading strategies or even share information about investment decisions would present at best an inaccurate, and at worst a misleading, picture to the Commission of the trading activity of a large trader.").

[185] 76 Fed. Reg. at 46,982.

[186] *See* Letter from Ann L. Vlcek, Managing Director and Associate General Counsel, SIFMA, to Elizabeth M. Murphy, Secretary, SEC (June 24, 2010), at 5–6, *available at* http://www.sifma.org/issues/item.aspx?id=907.

order from origination or receipt through execution and/or cancellation."[187] This audit system could be modified to obtain the information sought by the SEC with respect to large traders. Instead of giving that option due consideration in response to a commenter's suggestion, the SEC took the commenter's cost estimates out of context and concluded that the commenter's letter did not support the OATS alternative.[188] The commenter preferred OATS because it anticipated that OATS investments would generate greater benefits in the long term and reduce future expenditures in connection with the anticipated consolidated audit trail rulemaking.[189] The consolidated audit trail rulemaking, then under consideration and subsequently adopted by the SEC, is an initiative intended to provide for the collection of comprehensive trade data across market venues and is thus related to the large trader reporting rule.[190]

Alternatively, the SEC could have considered the option of deferring its large trader information requests and incorporating them directly into the consolidated audit trail rulemaking. The notice included a brief discussion of the consolidated audit trail rulemaking, but argued that the large trader rule was a necessary near-term way to get the SEC the information it needed.[191] The adopting release did not take into account the potential costs associated with implementing two such closely related rules in quick succession.

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[187] FINRA, *OATS Basics* at 2 (last visited July 2, 2013), *available at* http://www.finra.org/Industry/Compliance/MarketTransparency/OATS/PhaseIII/p016184.

[188] 76 Fed. Reg. at 46,990 (pointing out that commenter that had suggested the OATS alternative had also provided an estimate from a firm that indicated the OATS alternative would be more expensive). That commenter explained that "using the electronic blue sheets would require only slightly less investment and time to implement, but that investment and time would be of limited benefit to the SEC's larger goal of the consolidated audit trail and firms' build-out for the consolidated audit trail." Letter from Ann L. Vlcek, *supra* note 186, at 6.

[189] *See id.* at 4 (arguing that, because future audit trail initiatives would be more likely to build on OATS than on the SEC's electronic blue sheets, it would be more cost effective to achieve the SEC's objectives for this rulemaking through modifications to OATS).

[190] SEC, Consolidated Audit Trail, 77 Fed. Reg. 45,722 (Aug. 1, 2012). The SEC noted in that rulemaking that certain aspects of the large trader rule could be rendered superfluous by the consolidated audit trail rule. *Id.* at 45,734.

[191] 76 Fed. Reg. at 46,963–64.

The SEC also could have considered adopting a more limited form of the rule. For example, it could have required large traders to identify themselves only after they had established a pattern of engaging in large trades. The SEC could have considered other ways to limit the reach of the definition of large trader to better capture the types of traders in which it was interested. With respect to foreign large traders, the SEC could have considered the option of obtaining the information it needed from their home country regulators.[192]

Economic consequences. The adopting release states that "the Commission has designed the proposed [*sic*] rule to minimize the burdens of the large trader reporting requirements on both large traders and registered broker-dealers."[193] The SEC did make some accommodations in response to concerns about burden outweighing benefit. For example, the SEC eliminated the requirement that large traders report their account numbers in response to concerns from commenters about the burden and impracticability of reporting account numbers.[194]

More broadly, however, it is unclear that the SEC did the requisite work to understand those burdens. The adopting release includes baseline work to estimate the number of affected large traders and broker-dealers and the burdens, but the basis for those estimates is uncertain.[195] The SEC acknowledged that broker-dealers would be required to make certain information technology expenditures to comply with the rule,[196] and estimated that initial implementation efforts would take firms an aggregate of 133,500 hours at a cost of $106,060

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[192] This option was suggested in a comment letter on the proposed rule. *See* Letter from Guido Ravoet, Secretary General, European Banking Federation, and Claude-Alain Margelish, Chief Executive Officer, Swiss Bankers Association, to Elizabeth M. Murphy, Secretary, SEC (Oct. 21, 2010), at 2.
[193] 76 Fed. Reg. at 46,982.
[194] *Id.* at 46,974–75 (discussing why SEC did not adopt the requirement to disclose account numbers).
[195] *Id.* at 46,985–92.
[196] *Id.* at 46,977.

per broker-dealer.[197] In reaching this estimate, the SEC looked to the number of new disclosure items—two—rather than to the complex nature of one of the two new items—transaction execution time.[198] One firm estimated that it would cost $3 to $4 million, but the SEC explained, without sufficient supporting data, that its own lower estimate was an average across firms.[199]

The SEC's analysis omitted serious consideration of certain costs. The rule requires broker-dealers to monitor for unidentified large traders and affords a safe harbor to broker-dealers that set up policies and procedures reasonably designed to detect unidentified large traders.[200] Thus, even a broker-dealer that is unlikely to have large trader customers might decide—out of an abundance of caution—to avail itself of the safe harbor, which would entail costs that the SEC does not take into account. Also relevant are downstream costs—the costs that broker-dealers covered by the rule will impose on other broker-dealers in the transaction chain and on traders in order to ensure the covered broker-dealers' compliance. The SEC attempted to limit the type of information that it required in order to avoid necessitating requests to other broker-dealers,[201] but it also requires broker-dealers to treat customers as large traders if they have "actual knowledge" that they are. This obligation is likely to inspire broker-dealers to take protective steps to avoid violating the rule—including requiring entities with which they interact

[197] *Id.* at 46,989, n. 320 and accompanying text.
[198] *See, e.g.*, Letter from Anne L. Vlcek, Managing Director and Associate General Counsel, SIFMA, to David S. Shillman, Associate Director, Division of Trading and Markets, SEC (Mar. 29, 2012), at 5 ("Under current market structure, reporting brokers in many circumstances face overwhelming challenges in obtaining execution times for large traders because of the complexities that exist in processing and settling trades."), *available at* http://www.sec .gov/comments/s7-10-10/s71010-100.pdf.
[199] 76 Fed. Reg. at 46,996–97. Perhaps suggesting that the SEC underestimated the amount of work necessary, subsequent to adoption, the SEC extended the compliance date for broker-dealers under the rule. SEC, Order Temporarily Exempting Broker-Dealers from the Recordkeeping, Reporting, and Monitoring Requirements of Rule 13h-1 under the Securities Exchange Act of 1934 and Granting an Exemption for Certain Securities Transactions, 77 Fed. Reg. 25,007 (Apr. 26, 2012).
[200] 17 C.F.R. § 240.13h–1(f).
[201] 76 Fed. Reg. at 46,991–92.

to put protective measures in place—and indeed the rule's safe harbor is premised on strong policies and procedures. The SEC does not account for the costs of these measures.[202]

The SEC likewise may have underestimated the difficulty that parent companies would have, in light of information barriers, in obtaining information from subsidiaries.[203] The SEC concluded that if a parent company found it too difficult to aggregate information to determine whether it qualifies as a large trader, the company "may elect to register voluntarily as a large trader."[204] Doing so would, of course, require the parent company to obtain even more—albeit different—information from affiliated entities.

The SEC did not give serious consideration to less easily quantifiable costs of the rulemaking, such as the possibility that the extensive information provided by large traders to the SEC could be compromised to the competitive detriment of the large traders. The SEC promised to "protect[] the confidentiality of that information to the fullest extent permitted by applicable law,"[205] but a recent data breach by staff in an SEC office charged with market monitoring suggests that the possibility of information being compromised is not remote.[206] The notice also did not give much consideration to the rule's potential to shift trading. The adopting release remonstrated a commenter for failing to provide data to support its contention that large traders

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[202] *Id.* at 46,989, n. 408 ("To the extent that a broker-dealer that is subject to the monitoring requirements requires, by contract or otherwise, an entity that is not otherwise subject to the Rule's monitoring requirements to nevertheless perform a monitoring function, the Commission's estimate does not account for that situation.").
[203] *Id.* at 46,989 (arguing that firewalls will not be violated by information being shared by a subsidiary directly with its parent).
[204] *Id.* at 46,989.
[205] *Id.* at 46,976.
[206] SEC OFFICE OF INSPECTOR GEN., REPORT OF INVESTIGATION: INVESTIGATION INTO MISUSE OF RESOURCES AND VIOLATIONS OF INFORMATION TECHNOLOGY SECURITY POLICIES WITHIN THE DIVISION OF TRADING AND MARKETS 25–26 (Aug. 30, 2012) (finding, among other things, that laptops used by SEC staff in inspections were left unattended, unencrypted, and unprotected), *available at* http://www.sec-oig.gov/Reports/OOI/2012/OIG-557.pdf.

might shift to securities not covered by the new regulation in order to avoid its burdens, but it did not offer data to support its countercontention.[207]

E. Net Worth Standard for Accredited Investors

The Net Worth Standard for Accredited Investors rulemaking implements section 413(a) of the Dodd-Frank Act, which directed the SEC to adjust the net worth standard for accredited investors under the Securities Act of 1933 to exclude the value of an investor's primary residence.[208] Generally, under the securities laws, issuers (such as companies, hedge funds, and private equity funds) are able to offer and sell securities to accredited investors without triggering costly SEC registration requirements.[209] One type of accredited investor—the one addressed in this rulemaking—is an individual or couple that qualifies by virtue of having a net worth greater than $1 million. The SEC's new net worth standard calculation excludes the value of the primary residence and indebtedness associated with the primary residence to the extent that the indebtedness does not exceed the value of the house. The rulemaking also includes some related technical amendments.

This rule received a Report Card score of 14 out of 60, which made it one of the lowest-scoring rules in our sample. The exclusion of the value of primary residences from the net worth calculation was immediately effective upon enactment of Dodd-Frank, and the SEC's rulemaking reflected that change in the SEC's rules without asking more fundamental questions

[207] 76 Fed. Reg. at 46,982 (citing European Banking Federation and Swiss Bankers Association comment letter).
[208] Net Worth Standard for Accredited Investors, 76 Fed. Reg. 81,793 (Dec. 29, 2011) (to be codified at 17 C.F.R. pts. 230, 239, 270, and 275).
[209] For a brief overview, *see* SEC, *Accredited Investors*, *available at* http://www.sec.gov/answers/accred.htm.

about the standard.[210] The SEC did not look at the outcomes that the standard was trying to achieve, the problems that stood in the way of achieving them, or whether there might have been a better way to solve those problems. The rulemaking analyzed only the costs and benefits of its specific amendments, such as whether it should grandfather existing investors and whether and to what degree it should exclude from the net worth calculation mortgage debt along with the value of the home. Dodd-Frank, however, gave the SEC leeway—after conducting analysis—to make adjustments to the statutory definition as it "may deem appropriate for the protection of investors, in the public interest, and in light of the economy."[211] The SEC declined to exercise that authority,[212] but the existence of the authority underscores congressional interest in understanding the effects of the standard. Conducting an analysis of the statutory standard would have helped to elucidate those effects.

Systemic problem. The problem the statutory mandate and the rulemaking were seeking to address was presumably tied to the fact that the rapid increase in house prices before the financial crisis enabled people who had not previously qualified as accredited investors to meet the accredited investor threshold. The adopting release does not mention this issue or look at whether the broadening of the accredited investor category through the increase in home values resulted in investor harm.

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[210] 76 Fed. Reg. at 81,793 (noting that the "change to the net worth standard was effective upon enactment by operation of the Dodd-Frank Act, but it also requires us to revise our current Securities Act rules to conform to the new standard").

[211] Dodd-Frank § 413(b)(1)(A). This discretionary provision allows for an "initial review and adjustment" of the term. A separate provision *requires* a review of the definition of "accredited investor" "in its entirety" at least every four years beginning four years from the enactment of Dodd-Frank. Dodd-Frank § 413(b)(2).

[212] 76 Fed. Reg. at 81,795 (explaining the commission's decision to wait until the Government Accountability Office completes a related study before considering whether to modify the statutory definition).

The fact that a new set of individuals generally not previously able to purchase private securities were able to purchase them because of the increase in home values provided the SEC with a useful natural experiment. The SEC could have looked at whether these newly qualified investors took advantage of their ability to buy securities previously off limits to them and, if so, whether and how these investors were harmed. It would also have been useful to look at whether sellers of these securities targeted this newly qualified group of investors aggressively or, of their own volition, excluded investors who would have qualified as accredited solely by virtue of their home equity. These inquiries, which the SEC could have conducted with the assistance of FINRA and state securities administrators, would have helped the SEC, Congress, and the public to assess the reasonableness of limiting access to investments based on wealth. An inquiry of this sort might also have shed light on the extent to which investors who have become accredited largely because of a rapid increase in home prices are in need of greater protection than investors who have become accredited due to a rapid increase in the price of gold or the value of their stock portfolios.

Alternatives. The accredited investor standard, which is primarily rooted in wealth or income rather than financial sophistication, has long been controversial, as it excludes most individual investors from a whole set of investments.[213] As a consequence, some have suggested non-wealth-based accredited investor standards.[214] The SEC could have considered whether shifting

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[213] *See, e.g.*, Houman B. Shadab, *Fending for Themselves: Creating a U.S. Hedge Fund Market for Retail Investors*, 11 N.Y.U.J. LEGIS. & PUB. POL'Y 251, 308 (2008) (discussing problems with wealth as proxy for financial sophistication in the hedge fund context).

[214] *See, e.g.*, Wallace K. Finger, *Note*: *Unsophisticated Wealth: Reconsidering the SEC's "Accredited Investor" Definition under the 1933 Act*, 86 WASH. U. L. REV. 733, 760 (2009) (recommending supplementing wealth standard with a licensing examination for investors); So-Yeon Lee, *Note*: *Why the "Accredited Investor" Standard Fails the Average Investor*, 31 REV. BANKING & FIN. L. 987, 1011 (2012) (arguing that "criteria for evaluating whether a particular investor can afford to take risks should be based on whether the investor has discretionary income, not on whether he or she is worth an arbitrary amount of money, or makes some arbitrary amount of income").

to an explicit financial sophistication standard or an investment diversification requirement would be a better way to protect investors. The SEC already uses the financial sophistication of the buyers or their representatives as a criterion under Rule 506, which permits securities to be sold to a small number of certain non-accredited investors.[215] Alternatively, the SEC could have considered whether the existing FINRA suitability rule, pursuant to which broker-dealer representatives selling securities must make only suitable recommendations to their customers, was sufficient to protect investors or whether it could be amended to require heightened care when the bulk of an investor's wealth was made up of home equity.[216] The SEC did consider the suitability rule in determining whether to require mortgage debt to be included if the proceeds were used to purchase securities.[217] The SEC also did not consider whether additional provisions of Dodd-Frank that require private fund advisers to register with the SEC and be subject to SEC examination may have made adjustments to the net worth standard unnecessary.

Economic consequences. The SEC's analysis of the economic consequences of the rulemaking was limited to the clarifications that it made. The SEC asserted that its clarifying rules promote efficiency and reduce the cost of raising capital.[218] It also noted that its approach expanded the pool of potential purchasers and thus lowered costs to issuers by allowing for the exclusion of mortgage

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[215] Under Rule 506, an offering is not treated as a public offering if it is sold to no more than 35 purchasers. 17 C.F.R. § 230.506. "Each purchaser who is not an accredited investor either alone or with his purchaser representative(s) has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description." 17 C.F.R. § 230.506(b)(2)(ii).
[216] Financial Industry Regulatory Authority, NASD Rule 2310, Recommendations to Customers. FINRA subsequently replaced the rule with FINRA Rule 2111, Suitability.
[217] 76 Fed. Reg. at 81,800, n. 65 and accompanying text.
[218] *Id.* at 81,803.

debt from the calculation, along with the value of the home.[219] The SEC looked at the difference between excluding all mortgage debt and excluding only the debt up to the value of the home and found that there was "no material difference" in the number of affected households.[220] The SEC could have used the same data source—the Federal Reserve Board Survey of Consumer Finances—to look more broadly at the question of how many fewer households would qualify under the new net worth standard. It could have used that information to consider whether issuers would face heightened costs as a result of the decreased pool of investors.

F. Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF

In a joint rulemaking, the SEC and the CFTC adopted rules under the Investment Advisers Act of 1940 and the Commodity Exchange Act that would require SEC-registered investment advisers managing $150 million or more in private fund assets to file a new form—Form PF—with the SEC to provide information to regulators about the adviser and its private fund clients.[221] Form PF collects detailed information about the types of investments made by the funds, the owners of the funds, and the counterparties to the funds.[222] Form PF comprises four sections, the first of which must be completed by any SEC-registered adviser that manages one or more private funds and has—together with its related persons—at least $150 million in assets

[219] *Id.* at 81,801 ("The amendments will result in a larger pool of accredited investors than the first alternative method of implementation, under which all indebtedness secured by the primary residence would be included as a liability in the net worth calculation.").
[220] *Id.* at 81,801, n. 72 and accompanying text.
[221] Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, 76 Fed. Reg. 71,128 (Nov. 16, 2011). Certain parts of the rulemaking pertain only to the SEC. Each agency performed its own economic analysis. We omit from the discussion below consideration of the CFTC's analysis.
[222] *See* 76 Fed Reg. at 71,176–228.

under management.[223] Section 2 must be completed by large hedge fund advisers, meaning those with at least $1.5 billion in hedge fund assets under management.[224] Section 3 must be completed by large liquidity fund advisers, meaning those with at least $1 billion in money market and liquidity fund assets under management.[225] The fourth section must be completed by large private equity fund advisers, meaning those with at least $2 billion in private equity fund assets under management.[226] Large hedge fund and liquidity fund advisers are required to update Form PF quarterly and smaller advisers and private equity fund advisers must file annually.[227]

Form PF responds to a Dodd-Frank provision that authorizes the SEC to collect information from investment advisers to private funds "as necessary and appropriate in the public interest and for the protection of investors, or for the assessment of systemic risk by the Financial Stability Oversight Council (FSOC)"[228] and directs the SEC and the CFTC to conduct a rulemaking.[229] Form PF is intended to "provide FSOC and the Commissions with important information about the basic operations and strategies of private funds and help establish a baseline picture of potential systemic risk in the private fund industry."[230] In addition, the CFTC and SEC anticipate that Form PF will provide them with the information they need to devise further regulations for, and better target examinations of, private funds.[231]

As the notice explains, FSOC is "at the center of a framework" designed to prevent another costly financial crisis, and Form PF's primary purpose is to help ensure that the FSOC

[223] *See id.* at 71,177–78 (Instruction 3 to Form PF describing which advisers have to complete which parts of Form PF).
[224] *See id.*
[225] *See id.*
[226] *See id.*
[227] *See id.* at 71,181–82 (Instruction 9 to Form PF describing when advisers must update Form PF).
[228] Dodd-Frank § 404 (amending 15 U.S.C. § 80b–4).
[229] Dodd-Frank § 406(e) (adding 15 U.S.C. § 80b–11).
[230] 76 Fed. Reg. at 71,128–29.
[231] *Id.* at 71,166.

has adequate information to carry out its mission.[232] Dodd-Frank charged the FSOC, a multi-regulator council that includes the chairmen of the SEC and the CFTC, with "identify[ing] risks to the financial stability of the United States."[233] Among the FSOC's responsibilities is the designation for additional regulatory supervision of nonbank financial companies, which includes private funds that could pose risks to the financial system.[234]

Performing the analysis for a rule that is primarily designed to serve another agency is a difficult task, and the Report Card score for this rulemaking—18 out of 60—reflects this difficulty. As the following excerpt from the notice suggests, the rule seems to be primarily a response to the perceived needs of the FSOC rather than a solution to a clearly identified problem:

> The policy judgments implicit in the information required to be reported on Form PF reflect FSOC's role as the primary user of the reported information for the purpose of monitoring systemic risk. The SEC would not necessarily have required the same scope of reporting if the information reported on Form PF were intended solely for the SEC's use. We expect the information collected on Form PF and provided to FSOC will be an important part of FSOC's systemic risk monitoring in the private fund industry. . . . In its most recent release on this subject, FSOC confirmed that the information reported on Form PF is important not only to conducting an assessment of systemic risk among private fund advisers but also to determining how that assessment should be made.[235]

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[232] *Id.* at 71,164.

[233] Dodd-Frank § 112(a) [12 U.S.C. § 5322(a)]. The FSOC's voting members are the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Director of the Consumer Financial Protection Bureau, the Chairman of the SEC, the Chairman of the CFTC, the Chairman of the Federal Deposit Insurance Corporation, the Director of the Federal Housing Finance Administration, the Chairman of the National Credit Union Administration Board, and an independent insurance expert. Dodd-Frank § 111(b)(1) [12 U.S.C. § 5321(b)(1)].

[234] Dodd-Frank § 113 [12 U.S.C. § 5323] (authorizing FSOC to designate any financial company that through "material financial distress" or "the nature, scope, size, scale, concentration, interconnectedness, or mix" of its activities "could pose a threat to the financial stability of the United States").

[235] 76 Fed. Reg. at 71,129–30 (footnotes omitted).

In explaining why particular decisions were made, the notice of final rulemaking repeatedly refers to "our staffs' consultations with the staff representing FSOC's members."[236] The FSOC relies largely on staff drawn from the agencies that FSOC members head, presumably including staff of the SEC and the CFTC.[237] Because the nature of the staff-level conversations is typically not discussed in any detail, the rationale for the collection of particular types of information remains unclear.

Systemic problem. The notice does not clearly identify a systemic problem that the rule is intended to solve. Rather, while acknowledging Congress's recognition that private funds are not generally believed to have played a major role in the last financial crisis, it points out that having data about private funds could be useful in the next crisis.[238] To the extent that systemic risk is the problem driving the rule, the SEC acknowledges that Form PF is not, in and of itself, an antidote to systemic risk.[239]

Elsewhere, the notice suggests that the rule might be aimed at solving other problems—excessive risk-taking by hedge funds that imposes negative externalities and improper capital allocation. The SEC seems to anticipate that Form PF may help to curb socially harmful risk-

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[236] *See, e.g.*, *id.* at 71,131. *See also id.* at n. 243 ("[B]ased on our consultation with staff representing FSOC's members, we believe that turnover will provide important insight into the role of hedge funds in providing trading liquidity in certain markets.").

[237] *See* Financial Stability Oversight Council, Frequently Asked Questions, Response to "How does the FSOC operate?" (last visited Mar. 28, 2013) ("The Council operates under a committee structure to promote shared responsibility among the member agencies and to leverage the expertise that already exists at each agency. . . . The Council also maintains a small, independent staff to provide advice on statutory authorities and obligations, and to manage its document flow, records retention, and public records disclosure. This staff also includes policy experts to help coordinate the work of the committees and, where appropriate, complex inter-agency rule makings, to support Council functions such as designations, and to draft reports to Congress."), *available at* http://www.treasury.gov /initiatives/fsoc/about/Pages/default.aspx.

[238] 76 Fed. Reg. at 71,164 (citing S. Rep. No. 111–176, at 38 (2010)).

[239] 76 Fed. Reg. at 71,165 (noting that "although collecting information on Form PF will increase the transparency of the private fund industry to regulators (an important prerequisite to understanding and monitoring systemic risk), transparency alone may not be sufficient to address systemic risk") (citing FSOC 2011 Annual Report, at ii).

taking by imposing costs in a way that will force firms to internalize the costs of that risk-taking.[240] In citing a potential benefit of the rule—the allocation of "capital to investments with a higher value to the economy as a whole" flowing from improved risk management[241]—the SEC seems to be identifying improper allocation of capital as a problem. The SEC does not provide the information necessary to demonstrate that hedge fund risk-taking is imposing externalities or that hedge funds are misallocating capital. Nor does it demonstrate that Form PF is the appropriate solution to those problems.

The analysis of the underlying problem should have distinguished among different types of funds. Private equity funds, for example, are very different from hedge funds and do not pose the same types of risks.[242] Although the "SEC acknowledges that several potentially mitigating factors suggest that private equity funds may have less potential to pose systemic risk than some other types of private funds," it goes on to state that such differences are not relevant because "[t]he design of Form PF . . . is not intended to reflect a determination as to whether systemic risk exists but rather to provide empirical data to FSOC with which it may make a determination about the extent to which the activities of private equity funds or their advisers pose such risk."[243]

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[240] 76 Fed. Reg. at 71,171 ("the uneven distribution of the benefits and costs of Form PF reflects the potential for an uneven distribution of the costs and benefits of engaging in risky financial activities that may impose negative externalities").

[241] *Id.* at 71,166 ("The SEC believes that private fund advisers may, as a result, assess more carefully the risks associated with particular investments and, in the aggregate, allocate capital to investments with a higher value to the economy as a whole.").

[242] *See, e.g.*, Jennifer Payne, *Private Equity and Its Regulation in Europe*, University of Oxford Legal Research Series 40 (July 2011), at 24 (arguing that private equity funds were being treated like hedge funds for European regulatory purposes "although the business models (and systemic risk implications) are quite distinct").

[243] 76 Fed. Reg. at 71,153 (footnote omitted). The omitted footnote cites an article in support of the proposition that one need not limit remedial measures taken in response to a crisis to the areas that caused the last crisis. Eilís Ferran, *The Regulation of Hedge Funds and Private Equity: A Case Study in the Development of the EU's Regulatory Response to the Financial Crisis* (University of Cambridge and European Corporate Governance Institute Feb. 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1762119. That article went on to acknowledge, however, that a proper balance needs to be struck; compliance costs must be taken into account. *Id.* at 29. Citing the proposed Form PF, the article noted that "the EU's approach may not fare too badly when it becomes

Alternatives. The notice identified five alternatives that were considered, but these reflected variations on the same regulatory approach rather than distinct alternatives.[244] More distinct approaches exist and could have been considered. For example, if private funds' interactions with other financial institutions are the area of greatest concern, then obtaining information from private funds' counterparties—many of which already provide a lot of information to the government—about their exposure to private funds could provide regulators with more relevant information at a lower cost. As others have suggested, an alternative approach could rely on private monitoring through hedge funds' prime brokers—typically large, heavily regulated financial institutions:

> There is, however, an alternative mechanism for using private information about hedge fund positions for the purpose of measuring systemic risk, i.e. via prime brokers. They observe the whole trading activity of client hedge funds, and often run its risk engines. Given their involvement in counterparty risk, they have a strong incentive to monitor fund exposures closely. Such continuous monitoring can provide early warning signs for systemic risk. While this is essentially a market solution, supervisors, who already regulate the prime brokers, could require that prime brokers fulfill such a function.[245]

The SEC also could have looked at other possible avenues for obtaining data. One option would be to expand the existing investment adviser registration form, Form ADV, to capture additional information about private funds. This alternative would have required protection of

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possible to view it in context as part of an international trend." *Id.* at 30.While that is correct, the SEC still needs to identify the problem it is trying to solve in order to determine how to solve it.

[244] 76 Fed. Reg. at 71,163 ("Among the alternatives that we considered were requirements that varied along the following five dimensions: (1) Requiring more or less information; (2) requiring more or fewer advisers to complete the Form; (3) allowing advisers to rely more on their existing methodologies and recordkeeping practices in completing the Form (or, alternatively, requiring more standardized responses); (4) requiring more or less frequent reporting; and (5) allowing advisers more or less time to complete and file the Form.").

[245] *See, e.g.*, Jón Daníelsson, Ashley Taylor & Jean-Pierre Zigrand, *Highwaymen or Heroes: Should Hedge Funds Be Regulated; A Survey*, 1 J. FIN. STABILITY 522, 537 (2005) (discussing benefits and costs of different approaches to hedge fund regulation), *available at* http://www.ashleytaylor.org/hf_jfs2005.pdf. *See also* Michael R. King & Philipp Maier, *Hedge Funds and Financial Stability: Regulating Prime Brokers Will Mitigate Systemic Risks*, 5 J. FIN. STABILITY 283, 296 (2000) (pointing to the effectiveness of "[i]ndirect regulation by prime brokers and market discipline by creditors, counterparties, and investors" and arguing "that direct regulation of hedge funds may not be feasible and is not likely to be effective, due to the delays with reporting and processing the information"), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1297188.

confidential information, since Form ADV is publicly available, but it would have streamlined advisers' reporting obligations. Alternatively, the SEC could have considered whether the Office of Financial Research, a new Dodd-Frank agency established to collect data on behalf of the FSOC, would be better suited to collect information relevant to assessing systemic risk of, and related to, private funds.

Economic consequences. The rule's benefits are described in sweeping, imprecise terms. For example, the economic analysis section explained that "if this information helps to avoid even a small portion of the costs of a financial crisis like the most recent one, the benefits of Form PF will be very significant."[246] A more precise linkage of the information being collected to its usefulness in minimizing the costs of a financial crisis would have been more helpful to the commissions as they decided what information to collect.

The discussions of direct costs are likewise too imprecise to be of use in commission decision making. For example, the notice acknowledges that "particular advisers may, based on their circumstances, incur burdens substantially greater than or less than the estimated averages," but it anticipates with imprecision that "the *average* burden of completing Form PF is very unlikely to be in the thousands or tens of thousands of hours."[247] Similarly, the SEC's estimates for hardware costs were imprecise, ranging from an aggregate industry cost of "$0 to $25,000,000 for the first year, though the actual cost is likely to fall in between these two end-points."[248]

The economic analysis section states that the SEC made many changes to the original proposal that were intended to reduce cost burdens, in response to comments claiming that the

[246] 76 Fed. Reg. at 71,166.
[247] *Id.* at 71,159, n. 395 (emphasis in original).
[248] *Id.* at 71,163.

estimated cost burdens in the proposal were too low. These changes include extending compliance dates, allowing some firms to report annually rather than quarterly, increasing size thresholds for firms that need to file, and allowing advisers to use existing data-tracking methodologies to a greater extent.[249] It seems clear that the commissions made these changes in response to comments (not because of anything they had learned from the benefit-cost analysis), and they then updated the analysis to reflect the revised regulation.

In some cases, the SEC concluded that the FSOC's perceived information needs obviated the need to estimate costs. For example, in considering whether to require a fair value breakdown of assets and liabilities, the SEC concluded that advisers that do not already prepare such a breakdown may "incur additional costs to complete this question, and we are sensitive to their costs. We believe, however, that this question will provide valuable information for FSOC's systemic risk-monitoring activities and our investor protection mission and that the associated burden is warranted."[250] Similarly, with regard to a requirement that certain data be reported on a monthly basis, the notice concludes that "[b]ased on our staffs' consultations with staff representing FSOC's members, we agree with commenters who argued that rapidly changing markets and portfolios merit collecting certain information more often than on a quarterly basis, and we are not persuaded that the large hedge fund and large liquidity fund advisers required to respond to these questions will be overwhelmed by this reporting."[251]

In order to fully understand the consequences of the rule, the economic analysis should have included more than cursory consideration of indirect costs. For example, the notice does not take adequate account of the potential indirect costs of having the government collect

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[249] *Id.* at 71,163.
[250] *Id.* at 71,145 (omitting footnote that cited the need for the FSOC to understand "the extent to which the fund's value is determined using metrics other than market mechanisms").
[251] *Id.* at 71,151.

information about private funds. One potential cost is the new systemic instabilities resulting from decreased private monitoring because of the market's reliance on increased government monitoring.[252] Less monitoring by private fund investors and counterparties, which may have better and more current information than government regulators, could lead to heightened risk-taking. Decreased private sector monitoring might not be offset by government monitoring, particularly if the government is unable to effectively use the information it collects.

The SEC should have considered the cost to the government of processing and effectively using detailed information about private funds. Some have suggested that academics could help analyze the information,[253] but confidentiality restrictions make it difficult to share information with academics. Including unnecessary items on Form PF could distract the FSOC from information that would be more relevant to systemic risk assessments. The SEC acknowledged that information overload was a possibility when it explained, in connection with a decision to separate data by fund strategy, that excluding "extraneous information" would enhance the utility of the information for the FSOC, SEC, and CFTC.[254] This concern, however, seems not to have informed the rest of the analysis, which is infused with a more-is-better approach to information

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[252] *See, e.g.*, Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, Hedge Funds and Systemic Risk, Remarks at the Federal Reserve Bank of Atlanta's 2006 Financial Markets Conference (May 16, 2006) ("As a practical matter, could the authorities collect such an enormous quantity of highly sensitive information in sufficient detail and with sufficient frequency (daily, at least) to be effectively informed about liquidity risk in particular market segments? . . . Perhaps most important, would counterparties relax their vigilance if they thought the authorities were monitoring and constraining hedge funds' risk-taking?"), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20060516a.htm. *See also* Houman B. Shadab, *Hedge Funds and the Financial Crisis*, MERCATUS ON POLICY (Jan. 2009), at 3 ("Moreover, additional government oversight may increase complacency, undermine ongoing private efforts to improve best practices, and overwhelm regulators with duties beyond their resources and abilities."), *available at* http://mercatus.org/sites/default/files/publication/RSP_MOP34_Hedge_Funds_and_the_Financial_Crisis.pdf.

[253] Leonard Nakamura, *Durable Financial Regulation: Monitoring Financial Instruments as a Counterpart to Regulating Financial Institutions*, NATIONAL BUREAU OF ECONOMIC RESEARCH (May 2011), at 7 ("To the extent consistent with privacy considerations, permitting academics and investment advisors to access and analyze the financial database would enhance the capacity to identify cyclic and systemic risks within the U.S. financial structure.").

[254] 76 Fed. Reg. at 71,134.

collection rather than a careful consideration of whether collecting particular information would be helpful.[255] As one example of information that might not be useful, Form PF requires data about funds that do not pose a systemic risk.[256]

Although the SEC acknowledged the importance of protecting the information submitted and discussed possible ways that it would do so,[257] potential compromises to the confidentiality of private adviser information were not considered as a potential cost. No matter how carefully the SEC's policies are crafted, there is likely to be a security breach at some point by staff or computer systems at the SEC, CFTC, FSOC, FINRA (which administers the Form PF filing system), or one of the other regulators to whom Form PF information is provided.[258] Accordingly, this cost should have been taken into account. The SEC also did not undertake to determine whether the rule would reduce hedge fund activities and their attendant positive externalities.[259] The SEC reasoned that performance fees are high enough relative to Form PF

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[255] *See, e.g.*, Committee on Capital Markets Regulation, *The Global Financial Crisis: A Plan for Regulatory Reform*, Recommendation No.17, at 13 (May 2009) ("the regulator would bear the burden of demonstrating its need for the required information as well as its ability to use that information effectively"), *available at* http://www.capmktsreg.org/pdfs/TGFC-CCMR_Report_(5-26-09).pdf; Anne C. Rivière, *The Future of Hedge Fund Regulation: A Comparative Approach* (Apr. 2010), at 74–75 [later published in 10 RICH J. GLOBAL L. & BUS. 263] (summer 2011) (arguing that the burden of proof should be on regulators to show that required data "are necessary to assess systemic risk").

[256] 76 Fed. Reg. at 71,137 (explaining that "FSOC would benefit from access to data about funds that, on an individual basis, may not be a source of systemic risk").

[257] *Id.* at 71,156.

[258] *See, e.g.*, OFFICE OF INSPECTOR GENERAL, SEC, REPORT OF INVESTIGATION: INVESTIGATION INTO MISUSE OF RESOURCES AND VIOLATIONS OF INFORMATION TECHNOLOGY SECURITY POLICIES WITHIN THE DIVISION OF TRADING AND MARKETS (Aug. 30, 2012) (discussing the unprotected status of certain SEC computers), *available at* http://www.sec-oig.gov/Reports/OOI/2012/OIG-557.pdf. *See also* Peter Schroeder, *Staff Data Leaks Out of the SEC*, THE HILL, July 25, 2013 (discussing how personally identifiable information of SEC staff was transferred unwittingly to an employee's thumb drive and then to the servers of another government agency), *available at* http://thehill.com/homenews/administration/313387-staff-data-leaks-out-of-the-sec.

[259] *See, e.g.*, Houman B. Shadab, *The Challenge of Hedge Fund Regulation*, REGULATION (2007), at 36 ("Academics, industry professionals, and regulatory authorities overwhelmingly agree that hedge funds benefit the economy by mitigating price downturns, bearing risks that others will not, making securities more liquid, and ferreting out inefficiencies."). Additional regulation, even disclosure regulation will undermine hedge funds' traditional "latitude and flexibility with respect to investment strategies" that derives from their relative lack of regulation. Ackermann et al., *The Performance of Hedge Funds: Risk, Return, and Incentives*, 54 J. FIN. 833, 870 (1999). The SEC did acknowledge that "to the extent that capital available for investment is reduced, the companies in which private funds would otherwise invest may also bear costs." 76 Fed. Reg. 71,171.

costs to ensure that private advisers will not shut private funds down or attempt to keep them below registration thresholds in response to the compliance costs.[260] The SEC further opined that a private adviser that turned investors away would hurt its reputation with investors, but hedge funds routinely turn away investors.[261] To better assess how additional costs would affect the size and number of private funds and returns to private fund advisers, the SEC would have to consider factors such as how competitive the private fund market is. A better understanding of the competitive landscape would have helped the commissions anticipate whether Form PF would affect hedge fund investment levels.

G. Rules Implementing Amendments to the Investment Advisers Act of 1940

Pursuant to authority granted in Dodd-Frank, the SEC adopted new rules and amendments under the Advisers Act.[262] First, the rulemaking shifts a group of smaller SEC-registered investment advisers—those with between $25 million and $100 million—to state registration. Second, the rulemaking eliminates certain private fund adviser exemptions from registration and reporting requirements. Third, the rulemaking requires private fund advisers that are exempt from registration—"exempt reporting advisers"—to fulfill certain reporting requirements.[263] Finally,

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[260] *Id.* at 71,170 (noting that the agency "believes, however, that substantial economic incentives will likely counter such behavior, including private fund performance fees that incentivize the private fund adviser to continue advising its funds and maximize fund appreciation and return").

[261] *Id.* ("we anticipate that business relations with investors that may be damaged if the adviser turns away investor assets may also motivate advisers to continue to permit the size of their funds to increase as a result of new investment"). Bernard Madoff reportedly enhanced his reputation as a money manager by turning investors away. *See, e.g.*, *The Madoff Affair: Con of the Century*, THE ECONOMIST, Dec. 18, 2008 ("Turning away some investors and telling those he accepted not to talk to outsiders produced a sense of exclusivity."), *available at* http://www.economist.com/node/12818310. Although hindsight shows us that Madoff was perpetrating a fraud, the ease with which he attracted investor money suggests that turning potential investors away can bolster an adviser's reputation.

[262] SEC, Rules Implementing Amendments to the Investment Advisers Act of 1940, 76 Fed. Reg. 42,950 (July 19, 2011) (amending 17 C.F.R. pts. 275 and 279).

[263] Dodd-Frank exempted venture capital fund advisers and private fund advisers with less than $150 million in US assets under management from registration, but permitted the SEC to impose reporting and recordkeeping requirements on them "as the Commission deems necessary or appropriate in the public interest or for the protection of investors."

the rulemaking applies the SEC's pay-to-play rules to exempt reporting advisers and foreign private advisers, and makes a number of technical amendments.

This rule received a Report Card score of 14 out of 60, which made it one of the lowest-scoring rules in our sample. The SEC's analysis suffered from a lack of precision with respect to objectives and an absence of critical assessment of potential consequences of the rulemaking. Rather than identifying problems, the SEC relied on Dodd-Frank mandates to justify the key pieces of the rulemaking[264] and did not conduct related analysis.[265] Even the SEC's decisions that extended beyond the clear statutory mandates were supported only with general references to enhancing the SEC's knowledge base.[266] The SEC considered commenters' suggestions about particular registration and reporting items and made some changes in response,[267] but it did not carefully consider the implications for the SEC, the investors, and the market of adding substantial numbers of registered and reporting private fund advisers to the SEC's ranks and moving smaller advisers to state oversight.

Dodd-Frank §§ 407 (adding Adviser Act § 203(l) & 408 (adding Advisers Act § 203(m))). Traditionally, unregistered advisers have not been subject to extensive reporting requirements, but the SEC imposed substantial reporting requirements in this rulemaking. *See* Jeff Schwartz, *The Crystallization of Hedge Fund Regulation*, 2 HARV. BUS. L. REV. ONLINE 73, 77 (2011) (arguing that "[t]he requirements for exempt advisers is likely the area where the SEC pushed its authority the furthest"), *available at* http://www.hblr.org/2011/09/hedgefund-reg/.

[264] Dodd-Frank § 410 (adding new section 203A(a)(2) of the Advisers Act to move mid-sized advisers—those required to register with and subject to examination by their home states and with between $25 million and $100 million assets under management (or whatever higher threshold the SEC chooses)—to state registration from SEC registration); Dodd-Frank § 403 (amending section 203(b) of the Advisers Act) (eliminating private adviser exemption from registration); Dodd-Frank §§ 407 & 408 (amending section 203 of the Advisers Act) (exempting venture capital fund advisers and small private fund advisers from registration, but authorizing the SEC to impose reporting requirements).

[265] *See, e.g.*, 76 Fed. Reg. at 42,977 (explaining that "[b]ecause many of the new rules and rule amendments will implement or clarify provisions of the Dodd-Frank Act, they will not create benefits and costs separate from the benefits and costs considered by Congress in passing the Dodd-Frank Act," and limiting consideration of costs and benefits to those not generated by the Act).

[266] *See, e.g.*, *id.* at 42,983 (explaining that Form ADV "changes will give us a more complete picture of an adviser's practices, help us better understand an adviser's operations, business and services, and provide us with more information to determine an adviser's risk profile and prepare for examinations").

[267] *See, e.g.*, 76 Fed. Reg. at 42,958 ("We are persuaded by these comments that a buffer may prevent costs and disruption to advisers that otherwise may have to switch between federal and state registration frequently because of, for example, the volatility of the market values of the assets they manage."); *id.* at 42,937 (based on adverse comment, deciding not to "accelerate the deadline for filing an annual updating amendment to an adviser's Form ADV filing").

Systemic problem. The SEC did not identify the problems this rulemaking is intended to solve. One potential problem that could lead to the decision to shift investment advisers to state oversight is the increase in the number of investment advisers registered with the SEC[268] and the SEC's struggle to properly oversee such a large number of firms.[269] However, another part of the rulemaking—the new registration and reporting schemes for private fund advisers that were previously exempt—would exacerbate the SEC's oversight burden, particularly because these advisers are more complex than the smaller advisers.

A thorough assessment of the problems underlying the rulemaking would have been particularly helpful, given that the rulemaking marks a substantial shift of emphasis for the SEC away from the protection of retail investors and toward the protection of private fund investors. Access to hedge funds and other private funds is limited to investors who meet certain wealth thresholds, thresholds that were increased by Dodd-Frank.[270] These accreditation requirements are intended to restrict private funds to investors who are adequately sophisticated or able to afford knowledgeable advisers to find suitable funds for them.[271] Moreover, these investors are presumed to be able to bear investment losses.[272] Accordingly, the SEC has traditionally played a

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[268] *See, e.g.*, Staff of the Division of Investment Management, Securities and Exchange Commission, Study on Enhancing Investment Adviser Examinations 8 (Jan. 2011) (between October 1, 2004 and September 30, 2010, the number of registered investment advisers increased by 38.5%, from 8,581 advisers to 11,888 advisers), *available at* http://www.sec.gov/news/studies/2011/914studyfinal.pdf. It is surprising that the SEC does not appear to have employed the findings of this study in its analysis.

[269] *See, e.g.*, Securities and Exchange Commission, FY 2014 Congressional Budget Justification and Annual Performance Plan and FY 2012 Annual Performance Report, at 29 (Apr. 2013) (in fiscal year 2010, the SEC examined only nine percent of registered investment advisers), *available at* http://www.sec.gov/about/reports/secfy 14congbudgjust.pdf.

[270] *See supra* section E for a discussion of these changes.

[271] *See, e.g.*, Roberta S. Karmel, *Regulation by Exemption: The Changing Definition of an Accredited Investor*, 39 RUTGERS L.J. 681, 683 (2008) ("Very generally, an accredited investor is an investor who is sufficiently sophisticated so as not to need the protections of the federal securities laws, but such an investor generally is defined in terms of wealth, on the theory that an accredited investor can hire knowledgeable and sophisticated advisors.").

[272] *See, e.g.*, SEC, Net Worth Standard for Accredited Investors, 76 Fed. Reg. 81,793 at text accompanying note 17 (Dec. 29, 2011) ("One purpose of the accredited investor concept is to identify persons who can bear the economic risk of an investment in unregistered securities, including the ability to hold unregistered (and therefore

less active investor protection role in the private fund area.[273] Instead it has allocated its resources to the protection of less wealthy retail investors. As discussed above, concerns have been expressed about the use of wealth as a measure of financial sophistication.[274] The SEC could have included consideration of these concerns in its assessment of the problem the rulemaking was intended to solve.

With respect to the portion of the rulemaking that requires increased public disclosures by private fund advisers, the underlying problem is not obvious. Prospective private fund investors typically demand information from private fund advisers or enlist the assistance of a third party to obtain information for them.[275] The SEC did not identify the barriers that were preventing investors from obtaining the information directly from advisers, as one would expect investors to be able to do in a competitive market. Indeed, the SEC acknowledges that the information required by this rulemaking "is similar to, and at times less extensive than, the information that investors in hedge funds and other private funds commonly receive in response to due diligence questionnaires or in offering documents."[276]

The SEC hinted that the problem could be the unreliability of the information investors are getting when it noted that "it is precisely the ability of these [sophisticated] investors to compare Form ADV information to the information they have received in offering documents

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less liquid) securities for an indefinite period and, if necessary, to afford a complete loss of such investment.") (footnote omitted).

[273] *See, e.g.*, Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975, 990 (2006) ("[T]he SEC traditionally has not stepped in to protect the kinds of wealthy investors and institutions who typically invest in hedge funds. Instead, the SEC has deferred to such well-heeled investors to protect themselves through market discipline.").

[274] *See supra* note 214 and accompanying text.

[275] *See, e.g.*, Paredes, *On the Decision to Regulate Hedge Funds*, *supra* note 273, at 992–93 (discussing due diligence by hedge fund investors).

[276] 76 Fed. Reg. at 42,969.

and due diligence that makes public disclosure valuable."[277] The SEC did not provide evidence, however, to support the proposition that inaccurate information is a significant problem.

Alternatives. The SEC did not analyze reasonable alternatives to the different components of the rule. In a separate Dodd-Frank rulemaking, which was discussed above,[278] the SEC adopted Form PF, a form designed to provide information to the FSOC, SEC, and CFTC about private funds. As discussed in connection with that rulemaking, disclosure on Form ADV could serve as an alternative to disclosure on Form PF, and vice versa.[279] The SEC also should have considered the degree to which the disclosure was unnecessary because it was already required elsewhere.[280] Rather than dismissing concerns about reporting that was duplicative with Form D reporting under the Securities Act as part of the Regulation D registration exemption,[281] the SEC could have considered whether expanded Form D reporting could serve as an alternative to the rule's Form ADV disclosure.[282]

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[277] *Id.* at 42,969. *See also id.* at 42,964 ("investors will be able to compare Form ADV information to the information they receive in offering documents and due diligence to identify potential misrepresentations"); *See also id.* at 42,963 (limiting the required information to "basic identifying data" "would deny investors an opportunity to verify disclosures they receive directly from the adviser").

[278] *See supra* section F. As discussed in that section, some of the Form PF information might better have been collected on Form ADV. The decision about which information should be publicly disclosed (Form ADV) versus disclosed only to regulators (Form PF) turns on its business sensitivity and usefulness to the general public.

[279] The SEC acknowledged the connection when it stated that it considered comments made in connection with this rulemaking in the Form PF rulemaking. *See, e.g.*, 76 Fed. Reg. 42,967 ("We have considered these comments in the context of this rulemaking and have determined to make several changes. We will also consider these comments in the context of the Form PF release.").

[280] Even within Form ADV there is duplicative reporting. *See id.* at 42,965 (acknowledging that "the new information requirements we proposed to Part 1A of Form ADV overlap in some respects with the new brochure requirements (Part 2 of Form ADV), but noting "that the overlap may be necessary as the two parts of Form ADV serve very different purposes"). *But see id.* at 42,968 (noting that "[b]y requiring [information about auditors] in question 23 [of Form ADV], we are able to relieve advisers from the burden of reporting similar information" elsewhere in Form ADV).

[281] 17 C.F.R. § 230.501–230.508 (2013).

[282] The SEC was "not persuaded that providing this [duplicative] information will significantly increase the reporting burden, and the information will assist both the Commission and the public in quickly and accurately locating additional relevant information regarding the fund." 76 Fed. Reg. at 42,967, n. 230.

The notice explains that reporting by exempt reporting advisers could be useful in determining "whether these advisers or their activities might present sufficient concerns to warrant our further attention" for investor protection reasons.[283] As an alternative way to achieve that objective, the SEC could have considered relying on tips generated by the new Dodd-Frank whistleblower program. The whistleblower program could also be another route for addressing concerns about misinformation being provided to private fund investors.

To the extent adequate information is not being provided, the SEC could have considered working with the industry on a voluntary effort to establish best practices for disclosure to investors and potential investors.[284] To the extent the SEC wanted to encourage more *public* disclosures, it could have considered lifting its own prohibition on advertising—a change that Congress later directed the SEC to make under the JOBS Act.[285]

Economic consequences. The SEC should have broadened its consideration of the economic consequences beyond direct compliance costs. For example, the SEC could have considered whether the shift in resource allocation from retail funds to private funds would prompt sophisticated investors to rely excessively on SEC oversight instead of doing their own homework. If SEC registration is perceived to be a seal of government approval on an adviser or a fund, investors may curtail their due diligence. The SEC noted that "clients and investors may have greater confidence in advisers that provide more fulsome disclosure and are subject to our

[283] *Id.* at 42,962.
[284] The Managed Funds Association, for example, publishes a model due diligence questionnaire for hedge fund investors. *See* Model Due Diligence Questionnaire for Hedge Fund Investors, *available at* http://www.managedfunds.org/wp-content/uploads/2011/06/Due-Dilligence-Questionnaire.pdf.
[285] Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (Apr. 5, 2012), at § 201. *See also* SEC, Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. 44,771 (July 24, 2013).

oversight."[286] Given that, in fiscal year 2010, the SEC examined only nine percent of registered investment advisers, such confidence may be misplaced.[287]

The SEC should also have taken into account the role that private funds play in the market, in the economy, and in investors' portfolios, as well as the effect that the rulemaking would have on those roles. The Commission should have looked at the degree to which private funds contribute to market liquidity[288] and capital formation.[289] Imposing additional costs on advisers to these funds could materially affect these roles. The SEC also should have looked at whether the rulemaking might cause advisers to relocate outside the United States and refuse U.S. investors. As a corollary, the SEC could have looked at whether limiting the number of private fund opportunities available to U.S. investors would hamper their ability to deploy their money effectively.[290]

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[286] 76 Fed. Reg. at 42,993.

[287] *See* Securities and Exchange Commission, FY 2014 Congressional Budget Justification and Annual Performance Plan and FY 2012 Annual Performance Report, at 29 (Apr. 2013), *available at* http://www.sec.gov/about/reports /secfy14congbudgjust.pdf.

[288] *See, e.g.*, George Aragon & Philip Strahan, *Hedge Funds as Liquidity Providers: Evidence from Lehman Bankruptcy*, NBER Working Paper Series No. 15336 (Sept. 2009) (concluding, based on evidence from Lehman bankruptcy, that hedge funds act as liquidity providers), *available at* http://www.nber.org/papers/w15336.pdf?new _window=1; Darwin Choi, Mila Getmansky & Heather Tookes, *Convertible Bond Arbitrage, Liquidity Externalities, and Bond Prices* (2007) (finding that arbitrage in the convertible bond market, in which hedge funds are actively engaged, enhances liquidity in the underlying equity markets), *available at* http://www.fdic.gov/bank/analytical/cfr /Choi_Getmansky_Tookes.pdf; Petri Jylhä, Kalle Rinne & Matti Suominen, *Do Hedge Funds Supply or Demand Liquidity?* (Sept. 17, 2010), at 13 (finding "that hedge funds seem to supply liquidity when markets are illiquid and use liquidity when the markets are liquid so the cost of using liquidity is low"), *available at* http://efmaefm.org /0EFMSYMPOSIUM/Toronto-2011/papers/Rinne.pdf.

[289] *See, e.g.*, David J. Brophy, Paige P. Ouimet & Clemens Sialm, *Hedge Funds as Investors of Last Resort?*, 22 REV. FIN STUD. 541, 569 (2006) (finding that companies "that obtain equity financing from hedge funds tend to be smaller and riskier and are less likely to have analyst coverage compared to firms that obtain financing from other investor classes").

[290] There is literature analyzing whether hedge funds outperform mutual funds and the market more generally. *See, e.g.*, Ackermann et al., *The Performance of Hedge Funds: Risk, Return, and Incentives*, 54 J. FIN. 833, 854–55 & 870 (1999) (concluding that, even though hedge funds do not outperform market indices on a risk-adjusted basis, "the low beta values on hedge funds make them a potentially valuable addition to many investors' portfolios").

The SEC did not fully consider the economic consequences of its mandatory disclosures. There are potential competitive implications of public disclosure.[291] The SEC gave only brief consideration to these concerns in response to commenters, who "did not persuade" the SEC that it could make the requisite finding to overcome the public disclosure presumption for reports filed with the SEC.[292] More generally, the SEC could have considered the extensive literature discussing the costs and benefits of mandatory disclosure.[293]

The SEC should have given greater consideration to the implications of its reporting requirements for exempt reporting advisers. Without a clear basis, the SEC concludes that although "difficult to quantify," the benefits of the exempt reporting adviser reporting requirements "are substantial."[294] The SEC also anticipates that the new reporting requirements would have a positive effect on investor confidence and consequently on capital formation:

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[291] Troy A. Paredes, Commissioner, SEC, Statement at Open Meeting to Adopt Final Rules Regarding Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less Than $150 Million in Assets Under Management, and Foreign Private Advisers and Final Rules Implementing Amendments to the Investment Advisers Act of 1940 (June 22, 2011), *available at* http://www.sec.gov/news/speech/2011/spch062211tap-items-1-2.htm ("[I]t is difficult to identify any appreciable marginal investor protection benefit from the public disclosure that the final rule dictates. To the contrary, there is reason to worry that at least some of the information might be competitively sensitive and that mandating its public disclosure could harm [venture capital] funds and the very investors that the rule purports to protect.").

[292] 76 Fed. Reg. at 42,963.

[293] *See, e.g.*, John C. Coffee, *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984) (making, *inter alia*, an efficiency argument for mandatory disclosure); Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669 (1984) (assessing arguments in favor of mandatory disclosure regulation and arguing that benefits and costs of disclosure regulation should be compared with costs and benefits of alternative forms of regulation); Christian Leuz & Peter Wysocki, Economic Consequences of Financial Reporting and Disclosure Regulation: A Review and Suggestions for Future Research, Working Paper (Mar. 2008) (reviewing disclosure literature, discussing firm-specific and macro-economic costs and benefits of voluntary disclosure, and discussing costs and benefits of financial reporting and disclosure regulations); Geoffrey A. Manne, *The Hydraulic Theory of Disclosure Regulation and Other Costs of Disclosure*, 58 ALA. L. REV. 473, 511 (2007) ("Behavioral responses to regulation, even via mere disclosure, can be costly. Firms and managers will endeavor to circumvent costly regulations, regulations will have unintended consequences, and dynamic market shifts may undermine much of the regulations' force. That these effects eradicate the benefits of mandatory disclosure is not itself inevitable; that they exist, however, is.").

[294] *Id.* at 42,981. The SEC cites as benefits the SEC's receipt of "information as to whether these advisers or their activities might present concerns sufficient to warrant our further attention in order to protect their clients, investors, and other market participants" and assistance to "investors and prospective investors in conducting due diligence and . . . protect[ing] against fraud." *Id.* As noted above, the SEC did not establish the underlying problems before imposing these requirements.

> Access to the information we are requiring exempt reporting advisers to report may also increase clients' and prospective clients' trust in investment advisers, which may encourage them to seek professional investment advice and encourage them to invest their financial assets. This may enhance capital formation by making more assets available for investment and enhancing the allocation of capital generally.[295]

As part of the analysis, the SEC should have considered whether some of the anticipated greater confidence might result from a misperception about the SEC's role in verifying the information. As the reaction of Madoff investors illustrated, investors often believe that the SEC is watching advisers more closely than it is.[296] Such misplaced confidence can lead to inadequate monitoring by investors and inefficient capital allocation.

With respect to costs, the SEC estimated that the amortized paperwork burden over three years for exempt reporting advisers would be 2.67 hours, but it does not provide a clear basis for this assumption.[297] More significantly, however, the SEC failed to seriously assess potential indirect costs of the exempt reporting adviser requirements. One of these, which commenters raised, was investor confusion resulting from exempt reporting advisers' use of Form ADV, which has traditionally only been used by registered advisers. By imposing extensive reporting requirements and pledging to conduct routine examinations of these advisers, the SEC "collaps[ed] the distinction between what it means to be unregistered versus registered as an investment adviser."[298] The SEC faulted commenters for failing to "identify any specific costs

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[295] *Id.* at 43,009.
[296] *See, e.g.*, Peter Lattman, *Court Expresses Antipathy for S.E.C. in Handling of Madoff Case*, N.Y. TIMES, Apr. 10, 2013, *available at* http://dealbook.nytimes.com/2013/04/10/court-expresses-antipathy-for-s-e-c-in-handling-of-madoff-case/?_r=0.
[297] 76 Fed. Reg. at 43,000. As one example, the SEC bases its estimate for annual updates to Form ADV by taking an apparently arbitrary eighty-five percent cut from the one-hour estimate for registered advisers. *Id.*
[298] Troy A. Paredes, Commissioner, SEC, Statement at Open Meeting to Adopt Final Rules Regarding Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less Than $150 Million in Assets Under Management, and Foreign Private Advisers and Final Rules Implementing Amendments to the Investment Advisers Act of 1940 (June 22, 2011), *available at* http://www.sec.gov/news/speech/2011/spch062211tap-items-1-2.htm.

associated with these concerns"[299] and concluded that the costs of developing a new system outweighed these concerns.[300] The SEC also should have considered the opportunity cost of the resources that exempt reporting advisers would spend in order to comply with these requirements.[301]

V. The SEC's Post-Guidance Performance

Court decisions striking down SEC regulations due to poor quality or insufficient use of economic analysis motivated the commission staff to promulgate new guidance for analysis and to restore the chief economist's direct reporting relationship to the chairman. It may take time, however, for economists to gain full control over the analysis and for the commission to develop experience in using the analysis to make decisions. In this section, we review three early pieces of evidence: a 2013 court decision upholding the SEC's economic analysis, a 2013 report from the SEC's inspector general on the quality of the SEC's economic analysis, and a Regulatory Report Card evaluation of one major regulation issued after the staff guidance went into effect.

This preliminary evidence is decidedly mixed. Although without specific consideration of the elements in the staff guidance memorandum, a federal district court deemed sufficient the SEC's analysis in connection with the conflict minerals rule—one of the major rules adopted

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[299] 76 Fed. Reg. at 42,990.
[300] *Id.* at 42,962.
[301] Dissenting Commissioner Casey explained this cost as follows:

> Every dollar that is spent by a venture capital fund to satisfy the Commission's newly imposed regulatory requirements is a dollar that cannot be invested in the next Google, Apple, or Amazon. These dollars will never reach nascent companies that are developing green tech, cutting-edge biotechnology, or products that are even beyond our dreams today.

Kathleen L. Casey, Statement at SEC Open Meeting—Rules Implementing Amendments to the Investment Advisers Act of 1940; Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less Than $150 Million in Assets Under Management, and Foreign Private Advisers (June 22, 2011), *available at* http://www.sec.gov/news/speech/2011/spch062211klc-items1-2.htm.

subsequent to the guidance.[302] As the judge noted, however, the humanitarian objectives of the rule at issue distinguished it from other rules that had been invalidated in the past.[303] In June 2013 the SEC's inspector general, in response to a congressional request, issued a report that concluded the SEC's analysis largely followed the guidance, based on a review of twelve regulations proposed or finalized after the guidance was issued.[304] However, the inspector general's report mostly assessed whether the SEC's analysis covered specified topics; it did not extensively assess the quality of the analysis. To see whether the quality of the SEC's analysis may have improved, we reviewed an important regulation in the inspector general's sample using the Report Card methodology. This preliminary review of one regulation suggests that there may be much more room for improvement than the inspector general's report indicates. Once the SEC has finalized more major rules, it will be possible to rigorously assess the SEC's progress.

Thus, although more than a year and a half have passed since the SEC staff released its guidance memorandum, it remains too early to state definitively whether the guidance is improving analysis.

Judicial Consideration of SEC Post-Guidance Economic Analysis

One of the major rules adopted after the SEC staff guidance took effect implemented the Dodd-Frank Act mandate to promulgate regulations requiring companies to make annual disclosures about the origin of conflict minerals (such as tantalum, tin, tungsten, and gold) "necessary to the

[302] Nat'l Ass'n of Mfrs. v. Sec. and Exch. Comm'n, 2013 U.S. Dist. LEXIS 102616 (July 23, 2013).
[303] *Id.* at *39 (Prior cases in which the SEC's economic analysis had been found deficient "involved shortcomings on the Commission's part with respect to the economic implications of its actions—*economic* implications of its actions . . . . By contrast, none of those decisions lends support to Plaintiff's theory that the Conflict Minerals Rule must be invalidated because the SEC failed to consider whether the Rule would actually achieve the *humanitarian* benefits identified by Congress.") (emphasis in original) (footnote omitted).
[304] Office of Inspector General, SEC, USE OF THE CURRENT GUIDANCE ON ECONOMIC ANALYSIS IN SEC RULEMAKINGS (June 6, 2013) [hereinafter SEC OIG POST-GUIDANCE REPORT].

functionality or production of a product" they manufacture.[305] The genesis for the rule was concern for victims of violence in the Democratic Republic of the Congo (DRC).

The rule was challenged in court on a number of grounds, one of which was that the SEC's economic analysis was allegedly flawed.[306] The emphasis on economic analysis was not surprising given that one of the plaintiffs had estimated that the rule would cost between $9 billion and $16 billion, in contrast to the SEC's estimate of $71.2 million.[307] The plaintiffs also faulted the SEC for failing to determine whether the rulemaking would have its intended benefits.[308] The SEC explained that it was unable to do so, given the atypical nature of the rule's objectives:

> The statute therefore aims to achieve compelling social benefits, which we are unable to readily quantify with any precision, both because we do not have the data to quantify the benefits and because we are not able to assess how effective Section 1502 will be in achieving those benefits. Additionally, the social benefits are quite different from the economic or investor protection benefits that our rules ordinarily strive to achieve.[309]

The court, taking a narrow view of the Exchange Act's requirement to "consider . . . whether the action will promote efficiency, competition, and capital formation," held that the SEC did not have to consider whether the conflict minerals rule "would actually achieve the social benefits Congress envisioned."[310] The court placed great weight on the fact that the regulation was the product of "*Congress's determination* that the due diligence and disclosure requirements it enacted would help promote peace and security in the DRC," rather than the result of "the Commission having independently perceived a problem within its purview and

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[305] Dodd-Frank § 1502 [15 U.S.C. 78m note].
[306] Plaintiffs' Opening Brief at 26–34, Nat'l Ass'n of Mfrs. v. Sec. and Exch. Comm'n, 2013 U.S. Dist. LEXIS 102616 (July 23, 2013), *available at* http://www.nam.org/~/media/B5825277D7C144A48C2C4442054900D4/NAM_v_SEC_brief_only_01162013.pdf.
[307] *Id.* at 16.
[308] *Id.* at 27–31.
[309] 77 Fed. Reg. at 56,335.
[310] Nat'l Ass'n of Mfrs. v. Sec. and Exch. Comm'n, 2013 U.S. Dist. LEXIS 102616, *35–*36 (July 23, 2013) (footnote omitted) (citing 15 U.S.C. § 78c(f)).

having exercised its own judgment to craft a rule or regulation aimed at that problem."[311] The SEC, the court held, "rightly maintains that its role was not to 'second-guess' Congress's judgment as to the benefits of the disclosure."[312] The court went on to suggest that, with respect to this particular rule, the SEC may not have even been subject to the statutory requirement to consider efficiency, competition, and capital formation.[313] To the extent statutory analysis requirements applied, the court held that the SEC had fulfilled them, even though it had not considered whether the rule would achieve the intended humanitarian benefits.[314] The court also held that the SEC did not act arbitrarily or capriciously in reaching its cost estimates.[315]

Regardless of whether it was a statutory violation, the SEC's failure to evaluate benefits in connection with this rulemaking runs directly counter to the guidance in the staff's memorandum. However, because the rule's humanitarian objective makes it atypical of SEC rules, the analysis employed with respect to that rulemaking may not shed much light on the SEC's progress on economic analysis under the staff guidance.

SEC Inspector General's Post-guidance Assessment of SEC Economic Analysis

In June 2013 the inspector general of the SEC conducted a post-guidance assessment of SEC economic analysis in response to a congressional request. The inspector general's report included the conflict minerals rule and eleven other rules.[316] For eight of the twelve rules, the report found evidence that the SEC's economists and the rulewriting teams collaborated in assessing the

[311] *Id.* at *40–*41 (emphasis in original) (citations omitted).
[312] *Id.* at *41.
[313] *Id.* at *42–*44, n. 15 (arguing that, because Congress had already made a public interest determination, the SEC did not have to and that, absent an obligation to make a public interest finding, the SEC does not have an obligation to consider efficiency, competition, and capital formation).
[314] *Id.* at *46.
[315] *Id.* at *50.
[316] SEC OIG POST-GUIDANCE REPORT, *supra* note 304, at 10 (explaining that the review covered twelve rules, seven of which were reviewed "more indepth").

economic effects of the rule.[317] However, some of the rules did not fully specify the baseline.[318] Almost all of the rules discussed benefits and costs qualitatively, but they offered little quantification of costs beyond paperwork costs.[319] Only one rule attempted to quantify benefits.[320] Only five of the twelve rules fully explained the reasons benefits and costs were not quantified.[321] Nevertheless, the inspector general concluded that the SEC's analysis "followed the spirit and intent" of the 2012 guidance.[322] The inspector general did make some recommendations for improvements in the SEC's analysis, including "further incorporating specific elements in OMB Circular A-4 or practices that Federal administrative agencies have adopted."[323]

Regulatory Report Card Analysis of a Post-guidance Regulation

We suspect that there may have been less improvement in the SEC's economic analysis than the inspector general's broad conclusion suggests. It is one thing to offer some discussion of the topics listed in the SEC's guidance, such as potential justifications for a regulation or possible alternatives to it. It is quite another thing to offer a thorough, evidence-based analysis of the problem the regulation is supposed to solve or to assess the benefits and costs of a wide range of different alternatives. To illustrate these differences, we used the Report Card methodology to assess the analysis accompanying the SEC's Clearing Agency Standards rule, finalized in November 2012.[324]

[317] *Id.* at 15.
[318] *Id.* at 11.
[319] *Id.* at 15.
[320] *Id.*
[321] *Id.* at 19.
[322] *Id.* at i.
[323] *Id.* at 34.
[324] SEC, Clearing Agency Standards: Final Rule, 77 Fed. Reg. 66,220 (Nov. 2, 2012) (to be codified at 17 C.F.R. pt. 240).

The Clearing Agency Standards rule, promulgated in response to the SEC's new Dodd-Frank authority, is one of the rules included in the inspector general's report mentioned above. If the SEC's economic analysis improved by the end of 2012, we would expect to see signs of that improvement in this rule. The Clearing Agency Standards rule sets forth risk management standards for SEC-registered clearing agencies, which are part of the plumbing of the securities markets. Among other roles, clearing agencies serve as central counterparties, assuming the responsibilities of the seller to the buyer and vice versa. Because of the fundamental role of clearing agencies in the securities markets, the manner in which they are managed is particularly important and has long been a core SEC responsibility.[325] Dodd-Frank only underscored the importance of this responsibility by mandating that many security-based swaps, which previously were cleared bilaterally, be cleared through a registered clearing agency and by giving the SEC additional authority with respect to registered clearing agencies.[326]

Registered clearing agencies are required to establish, implement, maintain, and enforce written policies and procedures governing their operations and risk management.[327] The rule sets forth minimum standards for clearing agencies that act as central counterparties (and thus are exposed to risk of financial loss if participants default on their obligations) in a number of areas including risk management, standards for membership, and recordkeeping and financial disclosure. The rule includes minimum standards for credit exposure monitoring, margin requirements, financial resources, margin model validation, membership standards,

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[325] 77 Fed. Reg. at 66,200 (describing the SEC's nearly four decades of responsibility for facilitating securities clearance and settlement and noting that "[o]ver the years clearing agencies registered with the Commission have become an essential part of the infrastructure of the U.S. securities markets").
[326] *See* Titles VII and VIII of Dodd-Frank.
[327] 17 C.F.R. § 240.17Ad-22.

recordkeeping, and financial disclosures.[328] The rule also requires registered clearing agencies to maintain written policies and procedures related to a number of other operational and risk management areas.[329]

We chose to assess this particular rule, even though it is not a major rule, for several reasons. First, it was adopted long enough after the staff's guidance memorandum on economic analysis took effect to reflect the memorandum's principles for economic analysis. Second, two of the major rules adopted after the guidance went into effect were joint rules with the CFTC;[330] they are not therefore the sole work of the SEC. The other three major rules adopted after the guidance took effect and at the time we undertook this analysis all have unique features that would have complicated the SEC's analysis.[331] By contrast, the Clearing Agency Standards rule is well within the agency's area of expertise and is a more routine SEC rulemaking. Finally, this rule is one of the more substantial rules finalized from June 2012 through mid-2013.[332]

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[328] 17 C.F.R. § 240.17Ad-22(b) and (c).
[329] 17 C.F.R. § 240.17Ad-22(d).
[330] SEC and CFTC, Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48,207 (Aug. 13, 2012) (to be codified at 17 C.F.R. pts. 1, 230, 240, and 241); SEC and CFTC, Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 77 Fed. Reg. 30,595 (May 23, 2012) (to be codified at 17 C.F.R. pts. 1 and 240).
[331] The first major rule related to the planned consolidated audit trail, a project that involves active participation by self-regulatory organizations, such as the stock exchanges. The SEC directed these entities to develop a proposal and deferred the related economic analysis. *See* SEC, Consolidated Audit Trail, 77 Fed. Reg. 45,722, 45,726 (Aug. 1, 2012) (to be codified at 17 C.F.R. pt. 242) ("A robust economic analysis of the next step—the actual creation and implementation of a consolidated audit trail itself—requires information on the plan's detailed features (and their associated cost estimates) that will not be known until the SROs submit their [National Market System] plan to the Commission for its consideration. Accordingly, the Commission is deferring this analysis until such time as it may approve any NMS plan—that is, after the NMS plan, together with its detailed information and analysis, has been submitted by the SROs and there has been an opportunity for public comment."). The other two major rules, one of which was discussed above, were Dodd-Frank rulemakings related to conflict minerals and companies engaged in resource extraction. Both of these rules are atypical of SEC rulemakings in terms of subject matter and degree of interest from affected entities and interest groups. *See* SEC, Conflict Minerals, 77 Fed. Reg. 56,273 (Sept, 12, 2012) (to be codified at 17 C.F.R. pts. 240 and 249); SEC, Disclosure of Payments by Resource Extraction Issuers, 77 Fed. Reg. 56,365 (Sept. 12, 2012) (to be codified at 17 C.F.R. pts. 240 and 249).
[332] Compare, for example, SEC, Purchase of Certain Debt Securities by Business and Industrial Development Companies Relying on Investment Company Act Exemption, 77 Fed. Reg. 70,117 (Nov. 23, 2012) (to be codified at 17 C.F.R. pt. 270) (replacing credit ratings with alternative standards of credit worthiness for entities relying on a single SEC exemption).

The Report Card evaluation of the Clearing Agency Standards rule reveals little improvement in the quality of analysis. Table 5 shows that this rule achieved about the same total, openness, analysis, and use scores as the seven pre-2012 SEC rules assessed above. Turning to the five factors in the SEC guidance, the Clearing Agency Standards rule scored slightly better than the average pre-2012 SEC rule for analysis of the baseline and alternatives.

Table 5. Regulatory Report Card Evaluation of the SEC Clearing Agency Standards Rule Compared to Seven Pre-2012 SEC Rules

	Total	Openness	Analysis	Use	Systemic problem	Baseline	Alternatives	Outcomes	Cost-benefit
Average for 7 pre-2012 SEC regulations	15.7	9.4	3.9	2.4	0.7	0.6	1.3	0.9	1
Clearing Agency Standards Rule	17	9	5	3	1	2	2	1	1

The Clearing Agency Standards rule scored better than average for analysis of the baseline because, unlike most of the other rules, it actually mentioned some baseline conditions relevant to one important aspect of the rule. In its discussion of clearing agencies' risk management practices, the analysis provides a detailed description of current practices, which the SEC contends are largely consistent with the international standards on which the proposed regulation is based.[333] This may be a case in which the regulatory analysis (identification of baseline practices and international standards) may have influenced the form of the rule.

However, the SEC's treatment of current industry *practices* (which it appears to regard as the baseline behavior that would continue in the absence of the new regulation) should only be

[333] 77 Fed. Reg. at 66,266–71.

the first step toward a projection of the practices the SEC expects to occur in the absence of new regulation and *outcomes* the SEC expects those practices to produce. The SEC's own economic analysis guidance notes:

> An economic analysis of a proposed regulatory action compares the current state of the world, including the problem the rule is designed to address, to the expected state of the world with the proposed regulation (or regulatory alternatives) in effect. Economic impacts of proposed regulations are measured as the differences between these two scenarios.[334]

The Clearing Agency Standards notice offers little insight into how current practices might change in the absence of the new regulation or into the baseline level of risk associated with current practices. Thus, although the analysis offers somewhat more discussion of baseline conditions than the pre-2012 regulations, the baseline analysis is far from complete.

This rule scored higher than average for analysis of alternatives solely due to its discussion of the baseline. In the Regulatory Report Card, analysis of the baseline is one component of the analysis of alternatives, because the baseline should describe the outcomes expected under the "no new regulatory action" alternative.[335]

The Clearing Agency Standards rule also received a noticeably higher score than most of the other SEC regulations that we reviewed on Report Card Criterion 9 (see table 2 above), which assesses the extent to which the regulatory agency claimed to use the analysis in its decisions. The rule received three points on this criterion; only one of the seven pre-2012 SEC rules scored as high. This rule fared better than most others on use of analysis because it discussed the pros and cons of higher or lower net capital requirements for membership in a clearing agency (albeit in only a few paragraphs).[336] The commission clearly tried to balance

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[334] SEC Guidance, *supra* note 53, at 6–7.
[335] Ellig & McLaughlin, *supra* note 73, at 870.
[336] 77 Fed. Reg. at 66,278.

market power concerns against risk management, opting to set minimum net capital requirements at a level it hoped would encourage new entrants to become clearing agency members. Although the economic logic is clear, it is not clear how any economic calculation led the SEC to conclude that the specific figure chosen ($50 million) is optimal. This is about the only instance in which the economic analysis appears to be used to make decisions about this rule.

These very modest improvements in the baseline discussion and use of analysis may be harbingers of better things to come, or they may be random variations. Given that major federal rules and their accompanying analysis often take several years to develop, we believe any conclusions about the effects of the SEC's 2012 economic analysis guidance would be premature at this early date.

VI. Conclusions and Recommendations

In March 2012, the SEC pledged to improve its economic analysis in line with the principles enunciated in the executive orders that govern regulatory analysis by executive branch agencies. This is a positive and significant step for three reasons. First, the SEC opted to adopt the tried-and-true analytical criteria that have guided diverse executive branch agencies for decades rather than attempting to invent a new set of criteria from scratch. This means there are substantial opportunities to learn from "best practices" employed by executive branch agencies—including those that regulate financial markets. Second, the SEC's guidance emphasizes the most fundamental aspects of regulatory impact analysis: assessment of the need for the regulation, identification of a baseline against which to measure the effects of the regulation, identification of reasonable alternatives, and an evaluation of the costs and benefits of the proposed regulation and any alternatives. Third, the SEC also pledged to involve its economists throughout the rule-

development process rather than expecting them to produce an analysis after the major decisions on the rule have already been made.

Evidence from pre-2012 rulemakings suggests that these were wise decisions. This article has identified significant weaknesses in the SEC's pre-2012 economic analyses. Those analyses read more like justifications of the final rule than careful analyses of the underlying problems and the various ways that those problems could be addressed. The analyses failed, beyond sporadic references, to take advantage of the academic literature that would help them analyze the rulemaking. The analyses often deferred to the statute rather than asking fundamental questions about the need for it and what its objectives would be. In designing many of these rules, the SEC did not appear to have a clear picture of what it was trying to achieve. The absence of a clear objective may be largely to blame for the haphazard nature of the economic analyses in these rules. The SEC often based cost and benefit estimates on speculation and failed altogether to seriously contend with potential indirect costs of the regulation.

Our evaluation using the Mercatus Regulatory Report Card methodology found that the quality and use of regulatory analysis at the SEC prior to 2012 was significantly inferior to the quality and use of regulatory analysis by executive branch agencies. This was true despite the fact that executive branch agencies themselves usually fall far short of the standards articulated in the executive orders. Most tellingly, executive branch agencies outscored the SEC on the Report Card criteria most directly relevant to the topics in the SEC's new economic analysis guidance. These Report Card results suggest that the new guidance addresses significant problems in SEC economic analysis, and improvement should be a major priority.

Were the SEC to conduct more thorough analyses, investors, regulated entities, Congress, and the SEC itself would benefit. Investors, who ultimately bear the costs of many regulations,

would benefit from regulations that are more likely to be effective in solving real problems and are more appropriately designed to satisfy a particular objective. Better analysis would also help ensure that regulated entities target their compliance resources in the areas in which they would be most helpful in achieving the SEC's objectives. More thoughtful, comprehensive analysis will also help the SEC demonstrate to Congress the costs and benefits of the choices that Congress has made and thus provide Congress with the necessary information to make decisions about potential changes to legislative mandates. The SEC routinely contends that it does not have adequate resources to carry out its responsibilities. Better analysis will help it make better choices about how to spend the resources it has.

Our analysis provides a baseline for the SEC's rulemakings that were finalized after the SEC's most recent staff guidance on economic analysis took effect. When more regulations have been finalized pursuant to the memorandum's guidance, examining whether and how the SEC's analysis has improved will be a fruitful area for future research.

Another fruitful area for research would be to examine how other independent regulatory agencies' economic analysis compares with that of the SEC. As this paper demonstrates, an agency that is not committed to careful, well-supported, and transparent economic analysis tends to base its rules on speculation and aspiration rather than on a concrete understanding of the circumstances in which its rule will have to function. A more comprehensive economic analysis may be more costly to the agency in the short run, but in the long run such analysis should significantly increase the benefits or reduce the costs of the regulations that the commission adopts. We anticipate that, as the SEC's much-needed decision to retool its regulatory analysis takes hold, the agency, markets, and investors will reap the rewards.