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# SEC Regulatory Analysis: "A Long Way to Go and a Short Time to Get There"

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# SEC REGULATORY ANALYSIS: "A LONG WAY TO GO AND A SHORT TIME TO GET THERE"[1]

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## INTRODUCTION

The U.S. Securities and Exchange Commission (the SEC or Commission) 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 over 20,000 financial firms, including investment advisers, mutual funds and other exchange-traded funds, broker-dealers, national securities exchanges, credit-rating agencies, and a number of financial market utilities and quasi-governmental 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 the problem 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 analysis when it determines whether new rules are in the public interest. Federal appeals courts have vacated several 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 are expected to address in Regulatory Impact Analyses (RIAs) of major regulations.

Considering the controversy generated by recent court cases, an evaluation of economic analysis in SEC regulations is highly timely. This Article 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, as well as one major rule issued after the new guidance. We apply the Mercatus Center's Regulatory

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1. JERRY REED, EAST BOUND AND DOWN (RCA Records 1977).

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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 holds 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 (the CFTC), the Board of Governors of the Federal Reserve System, and the newly created Bureau of Consumer Financial Protection (the CFPB). 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 to prevent a future financial crisis. The Government Accountability Office recently identified inadequacies in economic analysis conducted by multiple financial regulatory agencies.[2] 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 analyses of their own rules. In addition, looking at how the SEC has interpreted its statutory rulemaking obligations can provide 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 33%. The highest score for use of analysis was just 5 out of 20 possible points, or 25%.
- **The SEC regulations we examined scored well below executive branch regulations proposed in 2010–11.** Executive branch regulations earned an average of 29.7 out of 60 possible points (50%), 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 (26%). Similar results occur when we

2. U.S. GOV'T ACCOUNTABILITY OFFICE, NO. GAO-13-101, DODD-FRANK ACT: AGENCIES' EFFORTS TO ANALYZE AND COORDINATE THEIR RULES 2 (2012), *available at* http://www.gao.gov/assets/660/650947.pdf.

compare 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. In addition, the SEC 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 be obvious to an expert agency.** The SEC's rulemaking to implement its new whistleblowing regime, for example, could have looked at alternatives based upon 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 on 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 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 into 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 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 is improved. The guidance represents an important milestone for the SEC, and as the agency gains more experience applying them, there is reason to be optimistic that its analysis will improve.

We begin in Part 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. Part II describes the rules that we have chosen to analyze. Part III reports the results of the evaluations of the rules using the Report Card and compares the regulatory analysis conducted by the SEC, an independent regulatory agency, with the analysis conducted by executive branch agencies. In Part IV, we suggest how the SEC could have improved its economic analysis using scholarly literature and data that should be readily available to the Commission. Part V analyzes one rule that was adopted after the SEC staff guidance took effect and considers other indicators of how the SEC's regulatory analysis has changed since the guidance's effective date. We conclude with a discussion of the implications of getting the analysis wrong and some suggestions for how the SEC can 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.[3] A series of executive orders has required executive agencies to perform regulatory analysis as part of their rulemaking process.[4] The Office of Management

3. *See* 44 U.S.C. § 3502(5) (2012) (listing independent regulatory agencies, including the SEC); Exec. Order No. 12,866, 3 C.F.R. 638, § 3(b) (1993–2000), *reprinted as amended in* 5 U.S.C. § 601 app. at 802–06 (2012) (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).

4. *See, e.g.*, Exec. Order No. 13,563, 3 C.F.R. 215 (2012), *reprinted as amended in* 5 U.S.C. § 601 app. at 816–17 (2012); Exec. Order No. 12,866, *supra* note 3; Exec. Order No. 12,291, 3 C.F.R. 127 (1982), *reprinted in* 5 U.S.C. § 601 app. at 431–34 (1982).

and Budget's Office of Information and Regulatory Affairs (OIRA) reviews these regulatory impact analyses.[5] The question of whether the President should and could 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.[6]

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 agency must "consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."[7] 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 explained, "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]."[8] Section 23(a)(2) of the Securities Exchange Act of 1934 (the 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."[9] In addition, a number of discrete statutory provisions require the SEC to consider economic effects of rules adopted pursuant to those provisions.[10] In fulfillment of these statutory obligations, the SEC typically

5. *See* Exec. Order No. 12,866, *supra* note 3, § 2(b) (directing OIRA to review executive agency rulemakings).

6. The former head of OIRA "encouraged" independent agencies "to give consideration to" President Obama's Executive Order 13,563. *See* Memorandum from Cass R. Sunstein, Adm'r, Office of Mgmt. & Budget, Exec. Office of the President, on Executive Order 13,563 (Feb. 2, 2011), *available at* http://www.whitehouse.gov/sites/default/files/omb/memoranda/2011/m11-10.pdf.

7. 15 U.S.C. §§ 77b, 78c(f), 80a-2(c) (2012). This requirement was added to these statutes by the National Securities Market Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416. The Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338, added the language to the Investment Advisers Act of 1940. *See* 15 U.S.C. § 80b-2.

8. PAUL ROSE & CHRISTOPHER J. WALKER, THE IMPORTANCE OF COST-BENEFIT ANALYSIS IN FINANCIAL REGULATION 27 (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, 956 F. Supp. 2d 43, 56 (D.D.C. 2013) (explaining that a mandatory analysis by the SEC of "various economic-related factors—efficiency, competition, and capital formation" or "some sort of broader, wide-ranging benefit analysis simply reads too much into this statutory language").

9. 15 U.S.C. § 78w(a)(2).

10. *See, e.g.*, *id.* § 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

includes an analysis section—the so-called "back-end"—in its notices of proposed and final rulemaking.

The quality and extent of the analysis have been called into question by academics, oversight bodies, and courts. Fraas and Lutter, in their examination of three major SEC rules, identified a number of flaws in the SEC's approach to economic analysis.[11] Aside from Paperwork Reduction Act estimates, discussions of costs and benefits were largely qualitative.[12] The SEC did not attempt to quantify costs such as "increased transaction costs or a reduction in market efficiency."[13] 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."[14]

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.[15] There was no attempt to quantify benefits or costs other than information collection costs.[16] The focus was on discretionary elements of the rulemaking and ignored the analysis of the elements of the rulemaking that were statutorily mandated.[17] "[T]he SEC sometimes used multiple baselines in its cost-benefit analyses that were ambiguous or internally inconsistent."[18] In some cases, the SEC did not clearly justify the regulatory action being undertaken.[19] For most rules, the SEC failed to take into account the SEC's administrative costs.[20] There was redundancy between the cost-benefit analysis and efficiency, competition, and capital formation sections of the releases.[21] The inspector general made six corresponding

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United States persons."); *id.* § 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.").

11. *See generally* Arthur Fraas & Randall Lutter, *On the Economic Analysis of Regulations at Independent Regulatory Commissions*, 63 ADMIN. L. REV. 213 (2011).

12. *Id.* at 232–33.

13. *Id.* at 233.

14. *Id.* at 234.

15. SEC OFFICE OF THE INSPECTOR GEN., NO. 499, FOLLOW-UP REVIEW OF COST-BENEFIT ANALYSES IN SELECTED SEC DODD-FRANK ACT RULEMAKINGS vi–vii (2012) [hereinafter SEC 2012 IG REPORT], *available at* http://www.sec.gov/about/offices/oig/reports/audits/2012/rpt499_followupreviewofd-f_costbenefitanalyses_508.pdf. This report was a follow-up to an earlier, less in-depth report on the same subject. *See* SEC OFFICE OF INSPECTOR GEN., REPORT OF REVIEW OF ECONOMIC ANALYSES PERFORMED BY THE SECURITIES AND EXCHANGE COMMISSION IN CONNECTION WITH DODD-FRANK ACT RULEMAKINGS (2011), *available at* http://www.sec.gov/about/offices/oig/reports/audits/2011/report_6_13_11.pdf.

16. SEC 2012 IG REPORT, *supra* note 15, at vi.

17. *Id.*

18. *Id.*

19. *Id.* at vii.

20. *See id.*

21. *Id.* at vi.

recommendations and urged the SEC to deepen economists' involvement in the process.[22]

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 PRA, but did not quantify any other costs.[23]

Courts have also weighed in. Over the past seven years, the SEC has lost several important court cases based on how it has carried out its analysis obligations.[24] 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.[25] The court held that the SEC had "violate[d] the APA by failing adequately to consider the costs mutual funds would incur . . . and by failing adequately to consider a proposed alternative to the independent chairman condition."[26] 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 faulted the SEC for not doing what it could to understand the costs of the rule.[27] 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.[28]

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22. *Id.* at vii–viii.
23. U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 2, at 16, 18. It should be noted that the GAO reviewed only one major SEC rule in depth. *Id.* at 4.
24. *See, e.g.*, Bus. Roundtable v. SEC, 647 F.3d 1144, 1156 (D.C. Cir. 2011); Am. Equity Inv. Life Ins. Co. v. SEC, 572 F.3d 923, 936 (D.C. Cir. 2009); Chamber of Commerce v. SEC, 443 F.3d 890, 909 (D.C. Cir. 2006); Chamber of Commerce v. SEC, 412 F.3d 133, 145 (D.C. Cir. 2005).
25. *Chamber of Commerce*, 412 F.3d at 137.
26. *Id.* at 136.
27. *Id.* at 142–44.
28. *Id.* at 144.

The court also held that the SEC was required to consider a reasonable alternative raised by the dissenting commissioners and commenters.[29]

On remand, the SEC upheld the rule after about a week of deliberation without reopening the comment period.[30] 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, together with publicly available information."[31] 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.[32] 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.[33] Moreover, the court found that, despite admitted gaps in cost data, the SEC had not considered actual cost data from funds that were already complying with the new requirements in anticipation of the rulemaking compliance date.[34]

The SEC's approach to assessing the effects on competition, efficiency, and capital formation was central to the court's holding in *American Equity Investment Life Insurance Co. v. SEC*.[35] The rule at issue in *American Equity* deemed fixed index annuities to be governed by the securities laws rather than solely by state insurance laws—which meant that the SEC would regulate these annuities.[36] The court held that the SEC's analysis of each of the three elements under section 2(b) of the Securities Act of 1933 (the Securities Act)[37]—competition, efficiency, and capital formation—was arbitrary and capricious.[38] The SEC had concluded that the rule would

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29. *Id.* at 145 ("[T]he disclosure alternative was neither frivolous nor out of bounds and the Commission therefore had an obligation to consider it.") (citing the standard set forth in *Laclede Gas Co. v. Fed. Energy Regulatory Comm'n*, 873 F.2d 1494, 1498 (D.C. Cir. 1989)).

30. Investment Company Governance, Investment Company Act Release No. 26,985, 70 Fed. Reg. 39,390, 39,390 (July 7, 2005).

31. *Id.* at 39,391.

32. Chamber of Commerce v. SEC, 443 F.3d 890, 906 (D.C. Cir. 2006).

33. *See, e.g.*, Circular A-4 from Office of Mgmt. and Budget to the Heads of Exec. Agencies & Establishments 17 (Sept. 17, 2003) [hereinafter Circular A-4], *available at* http://www.whitehouse.gov/sites/default/files/omb/assets/regulatory_matters_pdf/a-4.pdf (setting forth guidelines for transparency and reproducibility of RIAs and their underlying assumptions, methods, and data).

34. *Chamber of Commerce*, 443 F.3d at 906.

35. Am. Equity Inv. Life Ins. Co. v. SEC, 572 F.3d 923 (D.C. Cir. 2009).

36. *Id.* at 928 ("By redefining an 'annuity contract' to exclude [fixed index annuities], the Commission sought to ensure that purchasers of FIAs would be entitled to the full protection of the federal securities laws."); *see also* Baird Webel & Rena S. Miller, *Securities and Exchange Commission Rule 151A and Annuities: Issues and Legislation* 5 (Cong. Res. Serv. July 1, 2010), *available at* http://www.dtic.mil/cgi-bin/GetTRDoc?AD=ADA530625 ("The primary impact of this rule change is that many, if not most, of the practices related to the sale of indexed annuities of those companies and individuals selling indexed annuities will be regulated by both the SEC and the states.").

37. 15 U.S.C. § 77b(b) (2012).

38. *See Am. Equity Inv. Life Ins. Co.*, 572 F.3d at 934.

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.[39] The court also cited the SEC's failure to assess the existing level of competition under the state regulatory framework.[40] The SEC's efficiency analysis failed "to analyze the efficiency of the existing state law regime."[41] The capital formation analysis relied on the efficiency analysis, so it too was arbitrary and capricious.[42]

*Business Roundtable v. SEC* was a challenge to the SEC's first rulemaking under Dodd-Frank.[43] The rule at issue would have required public companies to include at company expense in their proxy materials 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.[44] 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.[45]

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 concerning costs.[46] Second, the SEC did not have sufficient empirical support for its prediction that the rule would enhance board performance and shareholder value.[47] Third, the SEC discounted the rule's costs by attributing them to the state law granting shareholders the right to elect directors, not the rule's requirement that companies pay for shareholder nominees to be included in the company's proxy materials.[48] Fourth, the rule did not take adequate

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39. *See id.* at 934–35.
40. *Id.* at 935.
41. *Id.* at 936.
42. *See id.*
43. 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, Comm'r, 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 ("[T]he 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 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.").
44. Bus. Roundtable v. SEC, 647 F.3d 1144, 1148 (D.C. Cir. 2011).
45. *Id.*
46. *Id.* at 1150.
47. *Id.* at 1151.
48. *Id.*

account of the possibility that the rule would be used to further the special interests of particular shareholders at the expense of the company.[49] 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).[50] Sixth, the SEC used different estimates about how often the rule would be used in calculating the costs and the benefits of the rule.[51] 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.[52]

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.[53] 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,[54] 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 about how to conduct economic analysis.[55] The guidance explains that "[h]igh-quality economic analysis . . . ensures that decisions to propose and

49. *Id.* at 1151–52.

50. *Id.* at 1153.

51. *Id.* at 1154.

52. *Id.* at 1154–56.

53. *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, *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 U. L. REV. 695, 712 (2013) (footnotes omitted) ("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."); 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, 793 (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).

54. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, 124 Stat. 1376 (2010). According to one count, the SEC has ninety-five rulemaking mandates under Dodd-Frank. DAVIS POLK & WARDWELL LLP, DODD-FRANK PROGRESS REPORT 5 (2012), *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.

55. Memorandum from the SEC Div. of Risk, Strategy, and Fin. Innovation and the Office of Gen. Counsel to the Staff of the Rulewriting Divs. and Offices (Mar. 16, 2012) [hereinafter SEC Guidance], *available at* http://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf.

adopt rules are informed by the best available information about a rule's likely economic consequences, and allows the Commission to meaningfully compare the proposed action with reasonable alternatives, including the alternative of not adopting a rule."[56]

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.[57] 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.[58]

The first two components of the SEC's guidance mirror the very first principle enunciated in Executive Order 12,866: "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 action) as well as assess the significance of that problem."[59] 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.[60]

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

56. *Id.* at 1.

57. *See* Exec. Order No. 13,563, *supra* note 4; Exec. Order No. 12,866, *supra* note 3; Circular A-4, *supra* note 33.

58. SEC Guidance, *supra* note 55, at 4–15.

59. *See* Exec. Order No. 12,866, *supra* note 3, § 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 (2d ed. 2012).

60. Circular A-4, *supra* note 33, at 4.

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 to determine not just 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 if 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 that "where 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."[61] On the other hand, the guidance also mentions that a statutory requirement for regulation counts as an independent justification for the regulation,[62] and chief economist Craig Lewis has said the justification for a regulation can be as basic as "Congress told us to."[63] 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 whether a new regulation is necessary or analyze how effectively different regulatory approaches will solve the problem.

The guidance also sets out an integrated role in the rulemaking process for economists—who SEC lawyers typically had brought in only at the end of the rulemaking process.[64] 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 "provid[es] general principles to guide staff . . . as to the substantive elements of a robust economic analysis."[65]

In addition to the new guidance regarding economic analysis, the SEC reversed an earlier structural change that had severed the chief economist's

61. *See* SEC Guidance, *supra* note 55, at 8.

62. *Id.* at 6.

63. *See* Craig M. Lewis, Chief Economist & Dir., Div. of Risk, Strategy & Fin. Innovation, SEC, Remarks before the SIFMA Compliance & Legal Society Luncheon: The Expanded Role of Economists in SEC Rulemaking (Oct. 16, 2012) [hereinafter Lewis Remarks], *available at* http://www.sec.gov/news/speech/2012/spch101612cml.htm ("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.'").

64. SEC Guidance, *supra* note 55, at 15–17.

65. Lewis Remarks, *supra* note 63.

direct reporting line to the SEC chairman.[66] The direct reporting line was restored by merging the positions of division director and chief economist, which once again ensured that the chief economist would have direct responsibility and accountability to the chairman for economic analysis at the SEC.[67]

In May 2011, Craig Lewis took over as chief economist and director of the SEC's Division of Risk, Strategy, and Financial Innovation,[68] which was subsequently renamed the Division of Economic and Risk Analysis.[69] In that capacity, the chief economist has a division reporting to him and 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.[70]

## 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 Article, through a detailed look at seven SEC rulemakings finalized before the SEC's staff issued its new memorandum guidance in March 2012,[71] 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 a subsequent section we also assess one rule finalized in November 2012.[72]

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66. *See, e.g.*, Jesse Westbrook, *SEC Economist Vacancies May Aid Legal Challenges of Dodd-Frank*, BLOOMBERG (Nov. 24, 2010, 6:00 AM), http://www.bloomberg.com/news/2010-11-24/sec-economist-vacancies-may-aid-legal-challenges-of-dodd-frank.html (reporting SEC Chairman Mary Schapiro's decision to end direct reporting of chief economist to her and implications of her decision).

67. Hester Peirce, *Economic Analysis by Federal Financial Regulators*, 9 GEO. MASON J.L. ECON. & POL'Y 569, 585 (2013).

68. Press Release, 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.

69. Press Release, 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.

70. *See* Peirce, *supra* note 67, at 585 (arguing that structural changes "should help give the SEC's economists a stronger voice in the agency's rulemaking and other matters").

71. 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 prior to and after July 2011.

72. Clearing Agency Standards, Exchange Act Release No. 68,080, 77 Fed. Reg. 66,220 (Nov. 2, 2012) (to be codified at 17 C.F.R. pt. 240) [hereinafter Clearing Agency Standards Release].

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, major rules adopted by the SEC were selected.[73] All of the rules are final rules adopted after a notice of proposed rulemaking and a comment period. We began the study in February 2012. We selected 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,[74] the Division of Investment Management,[75] and the Division of Trading and Markets.[76] 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.[77]

The purpose of selecting rules from each division was to ensure that we capture a broad view of rulemaking issues within the SEC's regulatory jurisdiction. Each rule is unique, and a complete analysis would require an assessment of every SEC rulemaking, but 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

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73. *GAO Federal Rules Database Search*, U.S. GOV'T ACCOUNTABILITY OFF., http://www.gao.gov/legal/congressact/fedrule.html (within "Agency," select "Independent Agencies and Govt Corporations; within "Subagency," select "United States Securities and Exchange Commission"; within "Rule Type," select "Major"; for "Date Published in Federal Register," leave start date unchanged and set "To" date at "02/01/2012" click on "Search"; from list, select first two rules for each rulemaking division, with the exception of the Division of Enforcement, for which there is only one rule and the Division of Investment Management, for which one of the two most recent rules is listed under "Subagency" "Commodity Futures Trading Commission"; to determine responsible Division, view final rule at https://www.federalregister.gov/articles/ and search within "For further information contact:" to identify Division of first listed contact person).

74. Net Worth Standard for Accredited Investors, Securities Act Release No. 9287, Investment Advisors Act Release No. 3341, 76 Fed. Reg. 81,793-02 (Dec. 29, 2011) (to be codified at 17 C.F.R. pts. 230, 239, 270, 275) [hereinafter Net Worth Standard Release]; Shareholder Approval of Executive Compensation and Golden Parachute Compensation, Securities Act Release No. 9178, Exchange Act Release No. 63,768, 76 Fed. Reg. 6010 (Feb. 2, 2011) (to be codified at 17 C.F.R. pts. 229, 240 and 249) [hereinafter Shareholder Approval Release].

75. Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, Investment Advisors Act Release No. 3308, 76 Fed. Reg. 71,128-01 (Nov. 16, 2011) [hereinafter Reporting by Investment Advisors Release]; Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisors Act Release No. 3221, 76 Fed. Reg. 42,950 (July 19, 2011) (to be codified at 17 C.F.R. pts. 275, 279) [hereinafter Rules Implementing Amendments Release].

76. Large Trader Reporting, Exchange Act Release No. 64,976, 76 Fed. Reg. 46,960 (Aug. 3, 2011) (to be codified 17 C.F.R. pts. 240 and 249) [hereinafter Large Trader Reporting]; Risk Management Controls for Brokers or Dealers with Market Access, Exchange Act Release No. 63,241, 75 Fed. Reg. 69,792 (Nov. 15, 2010) (to be codified 17 C.F.R. pt. 240) [hereinafter Risk Management Controls Release].

77. Securities Whistleblower Incentives and Protections, Exchange Act Release No. 64,545, 76 Fed. Reg. 34,300 (June 13, 2011) (to be codified 17 C.F.R. pts. 240, 249) [hereinafter Securities Whistleblower Incentives and Protections Release].

SEC's jurisdiction for which it is responsible.[78] The Office of General Counsel and Division of Economic and Risk Analysis assist the divisional rulewriting teams.[79] In addition, selecting rules from each division helps 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.[80] All of the rules predate the new guidance on economic analysis. All of these rules were finalized during a very busy period of SEC rulemaking in fulfillment of the SEC's mandates under Dodd-Frank.[81] The rules are summarized in Table 1 below.

**TABLE 1. RULES ANALYZED.**

| Rule | Summary of Rule |
|---|---|
| Risk Management Controls for Brokers or Dealers with Market Access<br><br>Division of Trading and Markets<br><br>Nov. 15, 2010 | New Rule 15c-3 under the Exchange Act requires brokers or dealers offering direct access to an exchange or alternative trading system (ATS):<br>• 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; and<br>• to craft controls reasonably designed to prevent the entry of orders that are erroneous, exceed certain credit and capital thresholds, or violate regulatory requirements. |

78. See SEC, FISCAL YEAR 2013 FINANCIAL REPORT 11 tbl.1.1 (2013), *available at* http://www.sec.gov/about/secpar/secafr2013.pdf (describing responsibilities of each SEC division).

79. *See id.* (describing responsibilities of the Division of Economic and Risk Analysis and Office of General Counsel).

80. Reporting by Investment Advisors Release, *supra* note 75.

81. *See Implementing Dodd-Frank Wall Street Reform and Consumer Protection Act—Accomplishments*, SEC, http://www.sec.gov/spotlight/dodd-frank/accomplishments.shtml (last modified Apr. 18, 2014) (listing rules SEC has proposed or adopted under Dodd-Frank and relevant Dodd-Frank sections).

| | |
|---|---|
| Large Trader Reporting<br><br>Division of Trading and Markets<br><br>Aug. 3, 2011 | New Rule 13h-1:<br>• requires large traders to self-identify to the SEC in order to receive an identification number;<br>• requires large traders to provide this identification number to broker-dealers that effect transactions on their behalf;<br>• requires broker-dealers to use the large trader identification number to maintain records and report transactions to the SEC; and<br>• requires monitoring by broker-dealers of activity that could trigger large trader requirements. |
| Securities Whistleblower Incentives and Protections<br><br>Division of Enforcement<br><br>June 13, 2011 | 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:<br>• the reporting of potential securities law violations to the SEC; and<br>• the determination and payment of an award of ten to thirty percent of the total amount collected by the SEC if the 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<br><br>Division of Investment Management<br><br>July 19, 2011 | 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:<br>• provide for the transition of medium-sized advisers to state registration from SEC registration;<br>• 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;<br>• implement Dodd-Frank registration exemptions for certain foreign advisers and advisers to venture capital funds and small private funds;<br>• require these "exempt reporting advisers" to file certain reports with the SEC; and<br>• 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<br><br>Division of Investment Management and CFTC<br><br>Nov. 16, 2011 | This joint SEC-CFTC rulemaking implements provisions of Title IV of Dodd-Frank. Specifically, the new rules:<br>• require investment advisers to one or more large private funds to file Form PF with the SEC; and<br>• 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. |

| | |
|---|---|
| Shareholder Approval of Executive Compensation and Golden Parachute Compensation<br><br>Division of Corporation Finance<br><br>Feb. 2, 2011 | This rulemaking, which implements section 951 of Dodd-Frank:<br>• requires companies to conduct a separate shareholder advisory vote to approve executive compensation;<br>• requires companies to conduct a vote to determine how often they will conduct a shareholder advisory vote on executive compensation;<br>• 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; and<br>• affords smaller companies an extended transition period to come into compliance with the new requirements. |
| Net Worth Standard for Accredited Investors<br><br>Division of Corporation Finance<br><br>Dec. 29, 2011 | This rulemaking, which implements section 413(a) of Dodd-Frank:<br>• 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; and<br>• makes a number of related technical corrections. |
| Clearing Agency Standards Rule<br><br>Division of Trading and Markets<br><br>Nov. 2, 2012 | This rulemaking, as required by Dodd-Frank, establishes minimum risk management and operational standards for registered clearing agencies, particularly those that act as central counterparties. |

## 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 qualitatively assessed the quality and use of regulatory analysis for proposed, economically significant regulations issued by executive branch agencies since 2008.[82] 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 twelve criteria grouped into three categories: Openness, Analysis, and Use. Table 2 lists the twelve criteria, which are derived from Executive Order 12,866 and OMB Circular A-4.

**TABLE 2. REGULATORY ANALYSIS ASSESSMENT CRITERIA.**

**Openness**

**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?

**Analysis**

**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?

**Use**

**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?

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82. The Report Card methodology is explained in Jerry Ellig & Patrick A. McLaughlin, *The Quality and Use of Regulatory Analysis in 2008*, 32 RISK ANALYSIS 855, 858–62 (2012). An explanation of the scoring method and all score data for the Mercatus Regulatory Report Card are available at *Regulatory Report Card*, MERCATUS CENTER GEO. MASON U., http://mercatus.org/reportcards (last visited Apr. 11, 2014).

The Report Card methodology is a middle ground between "checklist" systems for scoring regulatory analysis[83] and in-depth qualitative case studies.[84] Expert reviewers trained in the evaluation method assign each regulatory analysis a Likert Scale (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).[85] 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 the numbers should not be interpreted too literally; the analysis with double the score is 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.[86] Several articles using Report Card data have been published in scholarly journals.[87] Statistical tests show that the method produced consistent results from scorers trained in the evaluation method.[88] Report Card findings on the quality of agency

83. U.S. GOV'T ACCOUNTABILITY OFFICE, NO. GAO-97-38, AIR POLLUTION: INFORMATION CONTAINED IN EPA'S REGULATORY IMPACT ANALYSES CAN BE MADE CLEARER (1997); U.S. GOV'T ACCOUNTABILITY OFFICE, NO. GAO-98-142, REGULATORY REFORM: AGENCIES COULD IMPROVE DEVELOPMENT, DOCUMENTATION, AND CLARITY OF REGULATORY ECONOMIC ANALYSES (1998); 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); Robert W. Hahn et al., *Assessing Regulatory Impact Analyses: The Failure of Agencies to Comply with Executive Order 12,866*, 23 HARV. J.L. & PUB. POL'Y 859 (2000); Robert W. Hahn & Robert E. Litan, *How Well Does the Government Do Cost-Benefit Analysis?*, 1 REV. ENV. ECON. & POL'Y 192 (2007); Robert W. Hahn & Robert Litan, *Counting Regulatory Benefits and Costs: Lessons for the U.S. and Europe*, 8 J. INT'L ECON. L. 473 (2005); Stuart Shapiro & John F. Morrall, III, *The Triumph of Regulatory Politics: Benefit-Cost Analysis and Political Salience*, 6 REG. & GOVERNANCE 189 (2012).

84. ECONOMIC ANALYSIS AT EPA: ASSESSING REGULATORY IMPACT (Richard D. Morgenstern ed., 1997); THOMAS O. MCGARITY, REINVENTING RATIONALITY: THE ROLE OF REGULATORY ANALYSIS IN THE FEDERAL BUREACRACY (1991); RESOURCES FOR THE FUTURE, REFORMING REGULATORY IMPACT ANALYSIS (Winston Harrington et al. eds., 2009); Arthur Fraas, *The Role of Economic Analysis in Shaping Environmental Policy*, 54 L. & CONTEMP. PROBS. 113 (1991); Eric A. Posner, *Transfer Regulations and Cost-Effectiveness Analysis*, 53 DUKE L.J. 1067 (2003).

85. Ellig & McLaughlin, *supra* note 82, at 855–69 (providing an extensive explanation and justification of the evaluation method).

86. *See id.*

87. *See, e.g.*, Jerry Ellig et al., *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 Final Year of the Bush II Administration*, 63 ADMIN. L. REV. 179 (2011).

88. Ellig et al., *supra* note 87. An evaluation of inter-rater reliability is available at *Regulatory Report Card*, *supra* note 82.

regulatory analysis are generally consistent with the results of prior researchers' quantitative and qualitative evaluations of RIAs.[89]

Several trained Report Card scorers evaluated the SEC regulations that are the subject of this Article according to the method described above. These individuals have also evaluated executive branch regulations using the Report Card methodology.[90] We can thus use the score data to assess the quality and use of the SEC's economic analysis and compare it to the analysis produced by executive branch agencies.[91]

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 12,866, 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 26%). The highest-scoring regulation, Whistleblower Incentives and Protections, earned just 20 out of 60 possible points (33%). 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 regulations and analysis are easy to find online. The highest scores for the Analysis and Use categories were 5 points out of 20 possible points (25%).

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, but their average scores are approximately the same as the other regulations in the sample. Even if the SEC began initiating changes after July 2011, we suspect it is unlikely that significant effects of

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89. Ellig et al., *supra* note 87.

90. 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, senior research fellow at the Mercatus Center and one of the creators of the Report Card; and Todd Nesbit, assistant professor of economics at Ohio State University.

91. All of the executive branch regulations used for comparison in this Article were "prescriptive" regulations that contain mandates or prohibitions. 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. The "prescriptive" term originates from Posner, *supra* note 84, at 1073.

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** | 12/24/11 | 14 | 8 | 4 | 2 |

**FIGURE 1. OPENNESS, ANALYSIS, AND USE OF ECONOMIC ANALYSIS IN SEVEN SEC RULES**

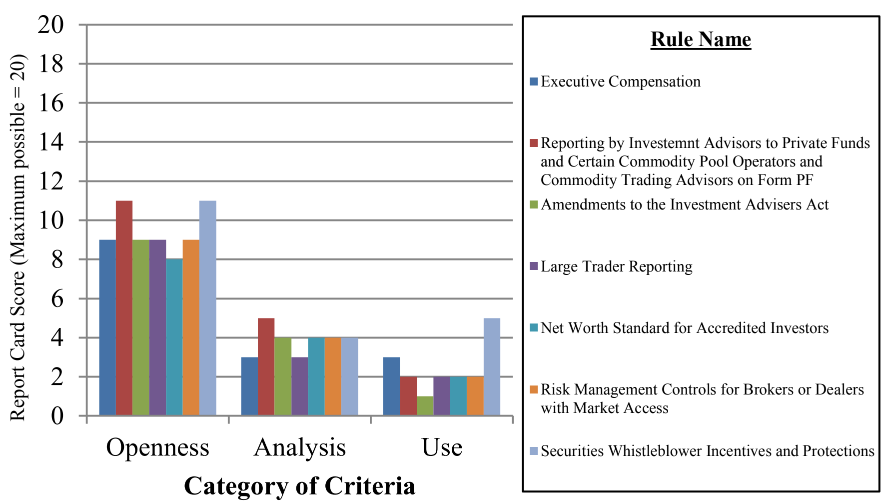


Figure 2 compares the scores for the SEC regulations with scores for executive branch regulations. Executive branch agencies often produce incomplete regulatory impact analysis, averaging just 29.7 out of a maximum possible 60 points for 2010–11. Nevertheless, this is almost double the average score for the seven SEC regulations.[92]

**FIGURE 2. COMPARISON OF SEC AND EXECUTIVE BRANCH RULE SCORES**

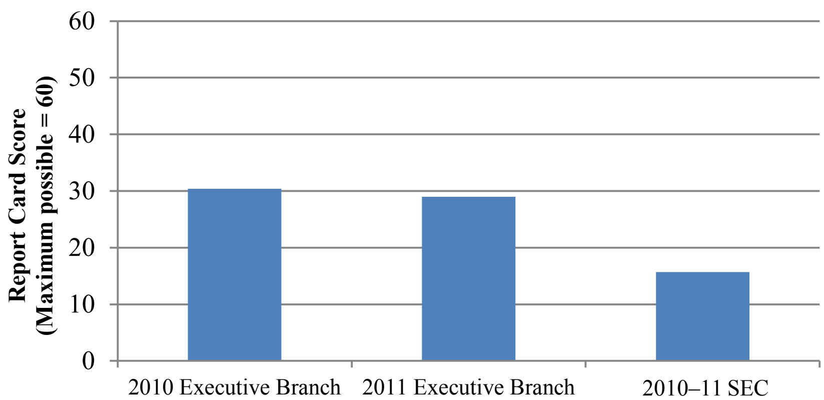
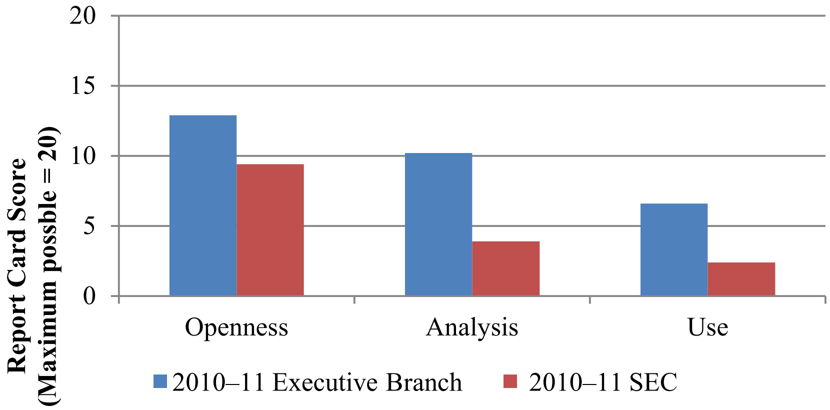



Figure 3 shows how the SEC regulations compare with executive branch regulations on the three major categories of criteria in the Report Card: openness, analysis, and use. The SEC regulations' scores for quality of analysis and use of analysis to inform decisions fall far short of both the maximum possible score and the average scores earned by executive branch agencies.[93] For both analysis and use of analysis, the executive agencies' average score was more than twice the SEC's average score.

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

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

**FIGURE 3. OPENNESS, ANALYSIS, AND USE COMPARISON**




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 following position:

> Analyzing 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."[94]

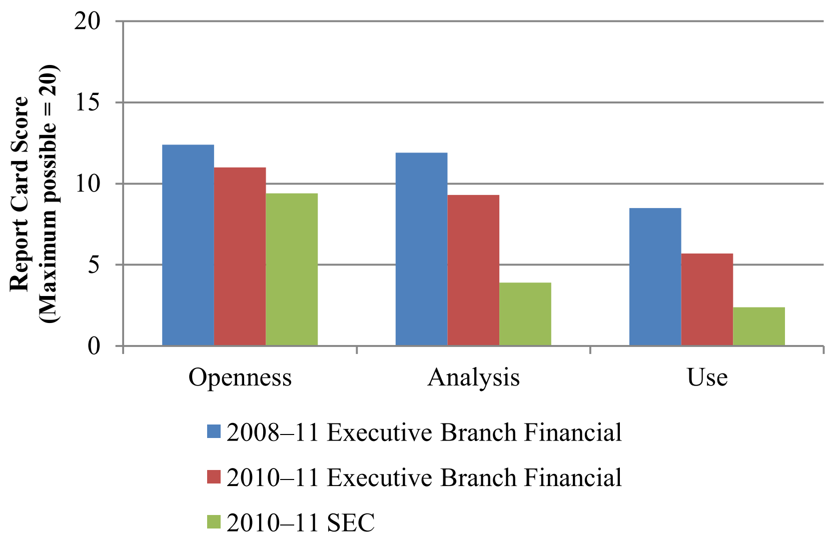
Figure 4 sheds some light on this argument by comparing the SEC regulations' average scores with the average scores executive branch agencies earned for their analysis of financial regulations. Several executive branch agencies issue regulations that address financial topics, such as the Department of Labor (pension and retirement savings plans), the Department of the Treasury (banking), and the Department of Housing and Urban Development (mortgage finance).[95] The Regulatory Report Card evaluated three executive branch financial regulations in 2010–11 and eight in 2008–11. We include scores from both time periods in Figure 4 to

94. *The SEC's Aversion to Cost-Benefit Analysis: Hearing Before the Subcomm. on TARP, Fin. Servs. And Bailouts of Pub. and Private Programs of the H. Comm. on Oversight and Gov't Reform*, 112th Cong. (2012) (statement of Mary L. Schapiro, Chairman, SEC), (quoting U.S. GOV'T ACCOUNTABILITY OFFICE, NO. GAO-12-151, DODD-FRANK ACT REGULATIONS: IMPLEMENTATION COULD BENEFIT FROM ADDITIONAL ANALYSES AND COORDINATION 19 (2011)); *see also* CURTIS W. COPELAND, ECONOMIC ANALYSIS AND INDEPENDENT REGULATORY AGENCIES 97 (2013), *available at* http://www.acus.gov/sites/default/files/documents/Copeland%20Final%20BCA%20Report%204-30-13.pdf (cataloguing the SEC's stated reasons for finding it "difficult to quantify certain regulatory costs and/or benefits," including the difficulties of understanding the effects when the SEC is regulating a new area and estimating the benefit of one rule that is part of an interrelated set of rules).

95. *See* Ellig & McLaughlin, *supra* note 82, at 864 tbl.IV (listing such regulations).

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.[96] In fact, executive branch agencies' average scores for financial regulations are about the same as the average scores for all executive branch regulations.[97] 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**




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

96. 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.

97. *See Regulatory Report Card*, *supra* note 82.

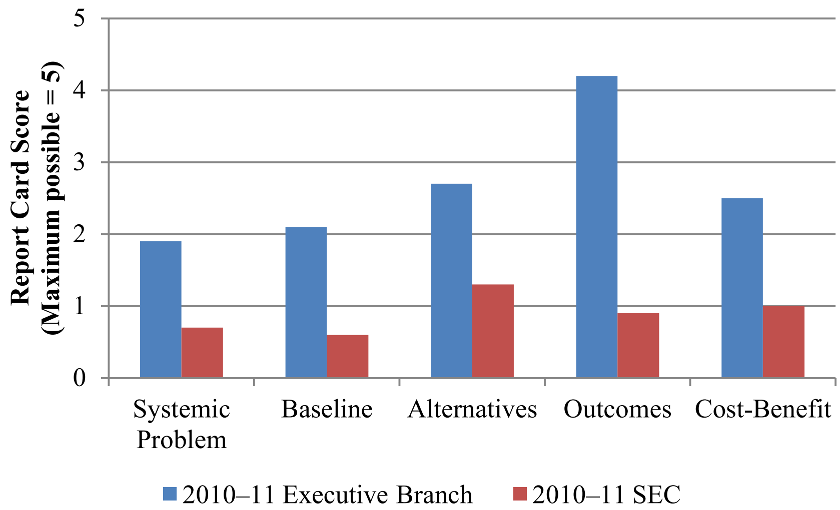
**TABLE 4. SUBSTANTIVE REQUIREMENTS FOR REGULATORY ANALYSIS IN SEC MEMORANDUM**

| 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?<br><br>**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 of 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 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 the SEC has identified as critical to sound economic analysis of rulemakings.[98]

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

**FIGURE 5. HOW SEC COMPARES WITH EXECUTIVE BRANCH ON ISSUES THE SEC IDENTIFIES AS IMPORTANT**




## 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 Article, in this Part 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 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 2010–11 executive branch regulations an average of ten times—and not at all in the NPRMs and RIAs for twenty-one executive branch regulations![99] While this tabulation may to some extent

99. In five of the seven SEC notices, the phrase "we believe" appears between thirty and ninety-three times.

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 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 and dealers offering 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 ensure compliance with regulatory requirements.[100] 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-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, exceed certain credit and capital thresholds, or violate regulatory requirements.[101] The rule also includes an annual review requirement and an annual chief executive officer certification requirement.[102]

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.

#### 1. 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" of May 6, 2010, as evidence that problems can spread quickly

100. Risk Management Controls Release, *supra* note 76, at 69,795.
101. *Id.* at 69,794.
102. *Id.* at 69,811.

through the securities markets and identified some high-level benefits that it anticipated as a result of the rule.[103] The notice[104] 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 does not explain what those risks are or attempt to quantify them.[105] The notice cites generally to the SEC's desire to prevent "potentially severe, widespread incidents that could arise as a result of inadequate risk controls on market access."[106] The notice also anticipates that "these financial and regulatory risk management controls should reduce risks associated with market access and thereby enhance market integrity and investor protection in the securities markets."[107] The SEC asserted—rather than established—the link between market access controls and investor confidence.[108]

To obtain a better understanding of the magnitude of the problem, the SEC could have undertaken a systematic search of erroneous trades and its 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."[109] In addition, the SEC easily could have obtained additional information about erroneous trades from the exchanges that 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.[110] 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

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103. *Id.* at 69,794. For a discussion of the flash crash, see STAFFS OF THE CFTC AND SEC, FINDINGS REGARDING THE MARKET EVENTS OF MAY 6, 2010: REPORT OF THE STAFFS OF THE CFTC AND SEC TO THE JOINT ADVISORY COMMITTEE ON EMERGING REGULATORY ISSUES (2010), *available at* http://www.sec.gov/news/studies/2010/marketevents-report.pdf.

104. Unless otherwise noted, "notice" refers to a notice of final rulemaking. The SEC typically uses the alternative term "release."

105. Risk Management Controls Release, *supra* note 76, at 69,794.

106. *Id.*

107. *Id.*

108. *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.").

109. *Id.* at 69,794 n.16.

110. *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").

(FINRA), the quasi-governmental regulatory organization that regulates broker-dealers.[111] Because the SEC regulates FINRA, it has access to FINRA data.

#### 2. 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 targeted at 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 experienced problems and did not have effective controls in place could be effective at motivating firms to improve their controls. In setting penalties in its enforcement cases, it is common for the SEC to consider whether firms made a good faith attempt to establish effective procedures to prevent illegal conduct.[112] 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, as well as whether adjustments in rules at the exchange/ATS level would suffice. The SEC recognized a role for other rule makers when it explained that the rule "is intended to complement and bolster existing rules and guidance issued by the exchanges and [FINRA]"[113] but 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

111. *See What We Do*, FINRA, http://www.finra.org/AboutFINRA/WhatWeDo/ (last visited Apr. 11, 2014) ("FINRA's mission is to safeguard the investing public against fraud and bad practices. We pursue that mission by writing and enforcing rules and regulations for every single brokerage firm and broker in the United States, and by examining broker-dealers for compliance with our own rules, federal securities laws and rules of the Municipal Securities Rulemaking Board.").

112. *See, e.g.*, Stephen L. Cohen, Assoc. Dir. of Enforcement, SEC, Remarks at SCCE's Annual Compliance & Ethics Institute (Oct. 7, 2013), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370539872783#.UwOI-NGYbmI ("You need to be armed with the knowledge of how law enforcement and regulatory agencies value the genuine efforts undertaken by companies to generate a culture of integrity and respect for the law. We care and we give credit for those efforts.").

113. Risk Management Controls Release, *supra* note 76, at 69,794.

broker-dealers.[114] The SEC dismissed this option without clearly explaining why it was inferior to the final rule.[115]

### 3. Economic Consequences

The SEC could have used the fact that there were two sets of firms—one with controls and one without—to assess the effects the rule would have. Controlling for other variables, it could have conducted a rigorous comparison of broker-dealers with and without controls. The results would have helped to establish not only whether there is a link between 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 Commission that forms the basis of successful enforcement actions.[116] In actions that generate monetary sanctions of more than $1 million, these whistleblowers must receive ten to thirty percent of the amount collected.[117] 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.[118]

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.[119] The volume, 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.[120] The SEC should be commended for looking to some of the relevant literature to guide its

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114. *See id.* at 69,799 (citing relevant comments).

115. *Id.*

116. Securities Whistleblower Incentives and Protections Release, *supra* note 77.

117. *Id.* at 34,300, 34,328.

118. *See id.* at 34,300.

119. *See, e.g.*, *id.* at nn.433, 436, 453, 457, 459.

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

thinking, but it missed many opportunities to make use of that literature in its analysis.[121]

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, which has been in existence since the Civil War; the whistleblower provision in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989;[122] and state false claims acts.[123] The SEC could have taken greater advantage of other government experiences with whistleblower programs to design and predict the effects of its program.[124] 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.[125]

121. The SEC's approach resulted in its failure to cite literature, even when it 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 "enhanc[ing] the quality of 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 525, 539, 545 (Ronald J. Daniels & Randall Morck eds., 1995). The notice cited this article for the point that tying the award to the penalty amount may provide an incentive for whistleblowers to delay. Securities Whistleblower Incentives and Protections Release, *supra* note 77, at 34,357 n.439. The article goes on later to present counterarguments on that point, but the SEC does not cite these counterarguments. Howse & Daniels, *supra*, at 535–36 (arguing that the risks that another whistleblower will emerge or that evidence will disappear works to counteract delay).

122. 12 U.S.C. § 1831k (2012) (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 a person who provides original information leading to recovery of criminal fine, restitution, or civil penalty under relevant banking statutes).

123. *See generally* Patrick A. Barthle II, *Whistling Rogues: A Comparative Analysis of the Dodd-Frank Whistleblower Bounty Program*, 69 WASH. & LEE L. REV. 1201 (2012) (discussing the 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 the history of whistleblower programs).

124. 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* Securities Whistleblower Incentives and Protections Release, *supra* note 77, at 34,327 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 . . . .").

125. *See, e.g.*, Troy A. Paredes, Comm'r, SEC, 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) [hereinafter Statement of Paredes at Opening Meeting to Adopt Final Rules], *available at* http://www.sec.gov/news/speech/2011/spch052511tap-item2.htm (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").

### 1. 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 was in effect, the SEC received many tips from whistleblowers,[126] 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 whistleblower compensation program was quite limited in scope,[127] 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, "In 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 some social costs for the whistle-blower herself."[128] In any case, thinking through the nature and extent of the problem would have helped the SEC to craft a more effective whistleblower program.

### 2. Alternatives

Assuming that the problem that the rule was designed to solve is that the SEC is not receiving adequate, 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 of 2002 (Sarbanes-Oxley) on whistleblowing—which included a new avenue for people with accounting and auditing complaints to raise them with the audit committee, as well as new protections for accounting whistleblowers against retaliation—and considered whether a preferable alternative to the rule would have been enhanced protections for whistleblowers.[129] The adopting release noted

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126. *See* Press Release, SEC, SEC Names New Specialized Unit Chiefs and Head of New Office of Market Intelligence (Jan. 13, 2010), *available at* http://www.sec.gov/news/press/2010/2010-5.htm (discussing the new Office of Market Intelligence, which was created to handle "the thousands of tips, complaints and referrals received by the SEC each year").

127. 15 U.S.C. § 78u-1(e) (permitting the SEC to pay bounties for insider trading tips); *see also* SEC OFFICE OF INSPECTOR GEN., NO. 474, ASSESSMENT OF THE SEC'S BOUNTY PROGRAM (2010), *available at* http://www.sec.gov/about/offices/oig/reports/audits/2010/474.pdf (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).

128. *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, 1204–05 (2010) (describing the social cost to the whistleblower as the social stigma associated with monetary awards).

129. One study that the SEC cited for another point looked at fraud cases before and after Sarbanes-Oxley and found that "SOX's protection for whistleblowers has not increased employees' incentives to come forward with cases of fraud" but noted, "This is not to say that the

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.[130]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.[131] Offering lower penalties to people involved in securities law violations who report them to the SEC might be another reasonable alternative to a whistleblower award program.

The SEC did consider some 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,[132] explicitly referred to the economic analysis section.[133] 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.[134] It is not clear if this economic analysis was done before the Commission made its decision, but it is difficult to see how the SEC 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 for this criterion.

Despite this relative strength, the whistleblower regulation's economic analysis failed to consider as an alternative mandatory internal reporting,

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legislation has not influenced employee whistleblowing by other measures." Alexander Dyck et al., *Who Blows the Whistle on Corporate Fraud?*, 65 J. FIN. 2213, 2250 (2010).

130. Securities Whistleblower Incentives and Protections Release, *supra* note 77, at 34,326 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.").

131. *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 B.U. 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 Professor Rapp's article).

132. 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 . . . ." Securities Whistleblower Incentives and Protections Release, *supra* note 77, at 34,331 n.274.

133. *Id.* at 34,326 n.225.

134. *Id.* at 34,361 n.459.

together with rewards for whistleblowers who report internally but not to the SEC. Such an approach might have been a way to minimize costs to the SEC, [135] whistleblowers, [136] and companies.[137] 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 did not address the specific issue of allowing rewards for whistleblowers who report only internally.[138] For insight in this area, the SEC could have looked at different state experiences.[139] The SEC also could have considered alternatives to mandated awards of ten to thirty percent of monetary sanctions.[140] Although the statute prescribed this range, considering

135. Kathleen L. Casey, Comm'r, SEC, Statement Regarding the Adoption of Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934 (May 25, 2011) [hereinafter Statement of Casey on Adoption of Rules], *available at* http://www.sec.gov/news/speech/2011/spch052511klc-item2.htm. ("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.").

136. *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: "In a society where one cannot distinguish between friends, neighbours 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. L. REV. 1107, 1142. Another article, 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. Callahan & Dworkin, *supra* note 123, at 335.

137. *See* Moberly, *supra* note 136, at 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).

138. *See* Securities Whistleblower Incentives and Protections Release, *supra* note 77, at 34,361 n.459 and accompanying text (citing Pamela H. Bucy, *Information as a Commodity in the Regulatory World*, 39 HOUS. L. REV. 905, 948–59 (2002); Luigi Zingales, *Want to Stop Corporate Fraud? Pay Off Those Whistle-Blowers*, WASH. POST, Jan. 18, 2004, at B2).

139. *See, e.g.*, Terry Morehead 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, 1668 (arguing for more flexibility, including allowing rewards to be made to whistleblowers who use either internal or external channels exclusively, based on an assessment of state whistleblower statutes).

140. 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

different formulations could have provided useful information to the SEC, the public, and Congress.

### 3. 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 experiences from other whistleblower programs. The SEC relied on staff expectation to determine some direct costs.[141] 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.[142]

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 non-monetary factors to contend that whistleblowers would continue to report internally, despite the availability of the SEC's whistleblower awards, yet also used literature on the importance of monetary awards to support the prediction that the SEC's rule—which takes internal reporting into account when determining award size—would encourage more internal reporting.[143] To justify this conflict, the SEC raised the possibility 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 in doing so the SEC did not

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floor on awards. David Ebersole, *Blowing the Whistle on Dodd-Frank Whistleblower Provisions*, 6 OHIO ST. ENTREPRENEURIAL BUS. L.J. 123, 143 (2011) ("[A]lthough whistleblower bounties are likely to be unnecessarily high with little marginal utility, they ironically may not provide certainty as intended.").

141. *See, e.g.*, Securities Whistleblower Incentives and Protections Release, *supra* note 77, at 34,354 n.422 ("This number is 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 34,355 n.427 (basing 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").

142. *See id.* at 34,360 n.457 (citing Callahan & Dworkin, *supra* note 123, at 284). Callahan and Dworkin found that the effectiveness of an award turns on the nature of the grantor and award. Callahan & Dworkin, *supra* note 123, at 296–97. They also noted that there are "practical costs associated with this privatization of the law enforcement function, in addition to the policy concerns." *Id.* at 336.

143. *Compare* Securities Whistleblower Incentives and Protections Release, *supra* note 77, at 34,360 & n.453 (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 34,360 & n.457 ("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.").

adequately explore the strength of its underlying assumptions about the existence and likely behavior of these two groups.[144]

The SEC goes so far as to suggest that the whistleblower rule will help companies, but the Commission 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.[145] 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."[146] 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 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."[147]

The SEC also failed to fully consider the implications that a whistleblowing program could have on the attorney-client relationship. Attorney-client privilege considerations led the SEC generally to preclude awards based on attorney-client information.[148] Nevertheless, the SEC did not consider the extent to which permitting attorneys to be paid for whistleblowing, albeit under limited circumstances, could "cloud their professional judgment."[149] As another example, the rules permit the SEC staff to communicate directly with whistleblowers rather than

144. *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").

145. *Id.* at 34,325–26.

146. *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," *id.*, 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.467 (citing Robert M. Bowen et al., *Whistle-Blowing Target Firm Characteristics and Economic Consequences*, 85 ACCT. REV. 1239, 1266 (2010).

147. Statement of Casey on Adoption of Rules, *supra* note 135.

148. *See* Whistleblower Incentives and Protections Release, *supra* note 77, at 34,313 n.117 (explaining general exclusion of "information received in breach of the attorney-client privilege" because "the attorney-client privilege stands apart because of the significance of attorney-client communications for achieving compliance with the Federal securities laws").

149. 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).

communicating through the attorney for the whistleblower's employer, as would normally be required.[150] The notice explains, "We 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."[151] 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.[152] 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 of lifting the prohibition in the whistleblower context.[153] 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, acknowledging that "whistleblowers might be paid with monies that otherwise could be distributed to victims" but making no effort to look at the resultant costs.[154] Commissioner Paredes, citing to the higher thresholds for submissions under the False Claims Act, expressed concern that the rule would impose costs on 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.[155] The government's resource commitment to sorting through and following up on complaints is likely to be large,[156] 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

150. 17 C.F.R. § 240.21F-17(b) (2014).

151. Securities Whistleblower Incentives and Protections Release, *supra* note 77, at 34,358.

152. *See* MODEL R. PROF'L CONDUCT 4.2 n.7, *available at* http://www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct/rule_4_2_communication_with_person_represented_by_counsel.html (explaining, "In 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.").

153. *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).

154. Securities Whistleblower Incentives and Protections Release, *supra* note 77, at 34,348.

155. Statement of Paredes at Opening Meeting to Adopt Final Rules, *supra* note 125.

156. Bucy, *supra* note 138, at 967; *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).

whistleblower programs.[157] 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. This failure could result in an ineffective whistleblower program or one that produces unintended negative consequences.[158]

### 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 Dodd-Frank.[159] 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.[160] Although the votes are nonbinding, the SEC added a requirement that companies disclose whether and how they have taken shareholder advisory votes into account.[161] Dodd-Frank permitted the Commission to exempt any "issuer or class of issuers" from these requirements.[162] 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.[163]

This rule received a Report Card score of 15 out of 60—close to the average for the seven pre-guidance rules we reviewed. The SEC's analysis was hampered by its reliance on the statutory mandate to justify the portions of the rulemaking that were not explicitly discretionary. The fact that Dodd-Frank 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

157. For a sampling of this literature, see *supra* notes 126–140.

158. *See, e.g.*, Feldman & Lobel, *supra* note 128, at 1154 ("Most strikingly, our findings suggest that legal incentives to report are frequently ill-designed and can in fact be inadvertently counterproductive.").

159. Shareholder Approval Release, *supra* note 74.

160. *Id.*

161. *See id.* at 6016 (discussing rationale for the 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").

162. 15 U.S.C. § 78n-1(e) (2012). The SEC also has general exemptive authority under the Securities Exchange Act. *Id.* § 78mm.

163. Shareholder Approval Release, *supra* note 74, at 6031 (discussing rationale for temporary exemption); *but see* Troy A. Paredes, Comm'r, SEC, Statement at Open Meeting to Adopt a Final Rule Regarding Shareholder Approval of Executive Compensation and Golden Parachute Compensation (Jan. 25, 2011), *available at* http://www.sec.gov/news/speech/2011/spch012511tap-3.htm (recommending permanent exemption for small and newly public companies).

Dodd-Frank 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,[164] 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 Dodd-Frank. Congress has the ability to veto agency rules under the Congressional Review Act,[165] 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 a large 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.[166] The SEC would have had to look at this literature in the context of its existing mandates, including extensive compensation disclosure requirements.

### 1. Systemic Problem

The notice explains that the rules will provide companies with clarity about how to comply with the statute and will facilitate investor decision-making[167] but does not explore whether there was a problem justifying 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."[168] Similarly, the SEC's conclusion 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" raises questions about the necessity for the new disclosure.[169]

In addition to looking at the adequacy of its existing executive compensation disclosure requirements, the SEC also ought to have looked beyond its regulatory framework to determine whether other private or

164. 15 U.S.C. § 78n-1(e).

165. 5 U.S.C. § 802.

166. For a general introduction to the literature, see ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932); Lucian A. Bebchuk & Michael S. Weisbach, *The State of Corporate Governance Research*, 23 REV. FIN. STUDS. 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. PERSP. 71 (2003); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 1 (1983); Andrei Shleifer & Robert Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737 (1997).

167. Shareholder Approval Release, *supra* note 74, at 6038–39.

168. *Id.* at 6039.

169. *Id.*

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.[170] 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 board and management activities.[171]

### 2. 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.[172] An alternative to a uniform rule would have been a rule scaled to size or limited to the biggest companies.[173] The SEC also could have considered the costs and benefits of modifying its existing disclosure requirements to provide any additional necessary information to investors without also requiring shareholder advisory votes.

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170. *See, e.g.*, Steven N. Kaplan, *Are U.S. CEOs Overpaid?*, ACAD. MGMT. PERSP., May 2008, at 15, *available at* http://faculty.chicagobooth.edu/steven.kaplan/research/kceo.pdf (arguing that market forces, board oversight, existing SEC disclosure rules, and existing avenues for shareholders to express discontent obviate the need for a mandatory, non-binding shareholder vote on executive compensation).

171. *See, e.g.*, Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV. 1779, 1809–10 (2011) (discussing the "immense" literature on whether executive compensation is properly linked with performance and concluding that a regulatory solution was not warranted because "[t]he core premise behind say-on-pay remains, at best, unproven"); 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 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. Most importantly, 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.").

172. *See, e.g.*, Jeffrey Gordon, *Executive Compensation and Corporate Governance in Financial Firms: The Case for Convertible Equity-Based Pay*, 2012 COLUM. BUS. L. REV. 834 (recommending an opt-in approach); Minor Myers, *The Perils of Shareholder Voting on Executive Compensation*, 36 DEL. J. CORP. L. 417 (2011) (recommending an opt-out approach).

173. *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).

### 3. Economic Consequences

The SEC's analysis of 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)[174] but are not sourced. Moreover, the SEC did not take into account non-paperwork costs, such as the costs of hiring outside consultants,[175] because those costs are attributable to the statutory mandate rather than the implementing rules.[176]

The discussion of costs largely ignores potential costs of the rule that are harder to quantify. The new advisory votes mandated by the rule are a step towards the federalization of corporate law, thus potentially imposing greater costs on corporations and their investors than would a state law regime.[177] 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.[178] The SEC does not consider whether the additional disclosures will impose costs on investors. Extraneous disclosures can distract investors' attention from more important items.[179] An item that receives great

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174. Shareholder Approval Release, *supra* note 74, at 6035.

175. 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 Exec. Officer, Ctr. for Capital Mkts. Competitiveness of the U.S. Chamber of Commerce, to Elizabeth M. Murphy, Sec'y, SEC (Nov. 18, 2010), *available at* https://www.sec.gov/comments/s7-31-10/s73110-47.pdf.

176. Shareholder Approval Release, *supra* note 74, 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.").

177. *See, e.g.*, Fisch, *supra* note 171, 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.").

178. *See, e.g.*, Steven M. Davidoff & Claire M. Hill, *Limits of Disclosure*, 36 SEATTLE U. 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"); 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, *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).

179. TSC Indus., 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

emphasis in SEC-mandated disclosures may figure more heavily into investment 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.[180] Proxy advisory firms, which provide voting recommendations, focus heavily on executive compensation issues,[181] so they could drive investors to pay even more attention to these items than they otherwise would.[182]

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."[183] Similarly, the SEC speculates, "By 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."[184] 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 if 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 U.S. capital markets."[185]

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). Entities with outstanding TARP funds were required to permit a separate shareholder vote on executive compensation.[186] The SEC noted the similarity of the requirement[187] but did not draw on companies' experience with TARP (albeit limited given that the TARP requirement had only recently been imposed) to better

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shareholders in an avalanche of trivial information—a result that is hardly conducive to informed decisionmaking.").

180. *See* Fisch, *supra* note 171, at 754–55 (discussing the role of proxy advisory firms in influencing say-on-pay advisory votes).

181. James K. Glassman & J. W. Verret, *How to Fix Our Broken Proxy Advisory System*, MERCATUS CENTER GEO. MASON U., 14–15 (Apr. 16, 2013), http://mercatus.org/sites/default/files/Glassman_ProxyAdvisorySystem_04152013.pdf (discussing proxy advisors' focus on say-on-pay issues).

182. For a discussion of reliance on proxy advisors, see Daniel M. Gallagher, Comm'r, SEC, Remarks at Society of Corporate Secretaries and Governance Professionals (July 11, 2013), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370539700301#.Uv-WwnmA2P8 (arguing, among other things, 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").

183. Shareholder Approval Release, *supra* note 74, at 6038.

184. *Id.*

185. *Id.* at 6040–41.

186. 12 U.S.C. § 5221(e) (2012).

187. Shareholder Approval Release, *supra* note 74, at 6023.

understand its implications. The SEC also could have looked at the United Kingdom's experience with say-on-pay.[188]

### 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.[189] The large trader must supply this identification number to its registered broker-dealers for use in their recordkeeping and reporting to the SEC.[190] The rulemaking also requires broker-dealers to monitor for unidentified large traders.[191] The rulemaking was authorized under section 13(h) of the Exchange Act[192] and motivated by the Commission's desire to have better information about market transactions.[193] The SEC adopted the rule—which had already been proposed—shortly after the "flash crash" of May 6, 2010, rattled the agency and markets and raised questions about the SEC's ability to reconstruct market events.[194] This rule received a Report Card score of 14 out of 60, which made it one of the lowest-scoring rules in our sample.

#### 1. 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.[195] Existing blue sheet data did not allow the SEC to trace a transaction to a particular trader or identify when it occurred.[196] Moreover, the SEC pointed to the fact that data were not required to be available to the SEC the day after a transaction occurs.[197] The SEC asserted that these shortcomings in the blue sheet data were the problem it was trying to solve but 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

188. *See* Gordon, *supra* note 173.
189. Large Trader Reporting Release, *supra* note 76.
190. *Id.* at 46,969–72 (describing duties of large traders).
191. *Id.* at 46,979 (summarizing monitoring requirements).
192. Market Reform Act of 1990, Pub. L. No. 101-432, § 3, 104 Stat. 963, 964–66 (codified as amended at 15 U.S.C. § 78m(h)).
193. Large Trader Reporting Release, *supra* note 76, at 46,960–61 (explaining that the rule will enhance the SEC's ability to collect information about active traders).
194. Securities Whistleblower Incentives and Protections Release, *supra* note 77, at 34,300, 34,328.
195. Large Trader Reporting Release, *supra* note 76, at 46,961.
196. *Id.*
197. *Id.*

investors should likewise benefit as a consequence of the Commission's enhanced access to information,"[198] 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 large trader information. Moreover, instead of simply pointing to the apparently "increasingly prominent role" of large traders,[199] the SEC should have considered more thoroughly what had changed to make the data necessary; Congress first gave the SEC authority to request the information in 1990,[200] 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.[201] The SEC mentioned the fact that the CFTC has a large trader reporting requirement[202] but did not look to the CFTC's long experience with this requirement to explain the SEC's need for a similar obligation.

#### 2. Alternatives

The SEC appears to have settled on its solution without giving even-handed consideration to alternatives. The Commission 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.[203] 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

198. *Id.* at 46,993–94.
199. *Id.* at 46,993.
200. *Id.* at 46,961 & n.9.
201. *See id.* 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, Assoc. Gen. Counsel, Inv. Advisers Ass'n, to Elizabeth M. Murphy, Sec'y, SEC 4 (June 22, 2010) ("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.").
202. Large Trader Reporting Release, *supra* note 76, at 46,978.
203. *See* Letter from Ann L. Vlcek, Managing Dir. and Assoc. Gen. Counsel, SIFMA, to Elizabeth M. Murphy, Sec'y, SEC 5–6 (June 24, 2010), *available at* http://www.sifma.org/issues/item.aspx?id=907.

order from origination or receipt through execution and/or cancellation."[204] This audit system might have been 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.[205] 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.[206] 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.[207]

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.[208] The adopting release did not take into account the potential costs associated with implementing two such closely related rules in quick succession.

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

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204. *Order Audit Trail System (OATS): OATS Basics*, FINRA, http://www.finra.org/Industry/Compliance/MarketTransparency/OATS/PhaseIII/p016184 (last visited Apr. 11, 2014) (slide 3).

205. Large Trader Reporting Release, *supra* note 76, at 46,990 (pointing out that the commenter who 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 203, at 6.

206. *See* Letter from Ann L. Vlcek, *supra* note 203, at 4 (arguing that, because future audit trail initiatives would be more likely to build upon OATS than upon 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).

207. Consolidated Audit Trail, Exchange Act Release No. 67,457, 77 Fed. Reg. 45,722 (Aug. 1, 2012) [hereinafter Consolidated Audit Trail Release]. 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.

208. Large Trader Reporting Release, *supra* note 76, at 46,963–64.

considered the option of obtaining the information it needed from their home country regulators.[209]

### 3. 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."[210] The SEC did make some accommodations in response to concerns about the rule's burdens outweighing its benefits. 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.[211] 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.[212] The SEC acknowledged that broker-dealers would be required to make certain information technology expenditures to comply with the rule[213] and estimated that initial implementation efforts would take firms an aggregate of 133,500 hours at a cost of $106,060 per broker-dealer.[214] 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.[215] One firm estimated that it would cost $3–4 million, but the SEC explained, without sufficient supporting data, that its own lower estimate was an average across firms.[216]

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209. This option was suggested in a comment letter on the proposed rule. *See* Letter from Guido Ravoet, Sec'y Gen., Eur. Banking Fed'n, and Claude-Alain Margelish, Chief Exec. Officer, Swiss Bankers Ass'n, to Elizabeth M. Murphy, Sec'y, SEC 2 (Oct. 21, 2010) [hereinafter Ravoet & Margelish Comment Letter], *available at* https://www.sec.gov/comments/s7-10-10/s71010-92.pdf.

210. Large Trader Reporting Release, *supra* note 76, at 46,982.

211. *Id.* at 46,974–75 (discussing why the SEC did not adopt the requirement to disclose account numbers).

212. *See id.* at 46,985–92 (noting at times that the Commission underestimated the burdens placed on large traders and broker-dealers).

213. *Id.* at 46,977.

214. *Id.* at 46,989–90 & n.320.

215. *See, e.g.*, Letter from Anne L. Vlcek, Managing Dir. and Assoc. Gen. Counsel, SIFMA, to David S. Shillman, Assoc. Dir., Div. of Trading and Mkts., SEC 5 (Mar. 29, 2012), *available at* http://www.sec.gov/comments/s7-10-10/s71010-100.pdf ("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.").

216. Large Trader Reporting Release, *supra* note 76, 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. 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, Exchange Act Release No. 66,839, 77 Fed. Reg. 25,007 (Apr. 26, 2012) [hereinafter Order Temporarily Exempting Broker-Dealers Release].

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.[217] 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 traders in order to ensure the covered broker-dealers' compliance.[218] The SEC attempted to limit the type of information that it required in order to avoid necessitating requests to other broker-dealers,[219] but it also required 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 to put protective measures in place; indeed, the rule's safe harbor is premised on strong policies and procedures. The SEC does not account for the costs of these measures.[220]

The SEC likewise may have underestimated the difficulty that parent companies would have, in light of information barriers, in obtaining information from subsidiaries.[221] The SEC concluded that if a parent company found too difficult the task of aggregating information to determine whether it qualifies as a large trader, the company "may elect to register voluntarily as a large trader."[222] Doing so would 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

217. Large Trader Reporting Release, *supra* note 76, at 46,960–61.

218. *See, e.g.*, Gregory J. Nowak & Matthew R. Silver, *Are You a 'Large Trader' Subject to the New SEC Reporting Rules?*, PEPPER HAMILTON LLP (Aug. 26, 2011), http://www.pepperlaw.com/publications_update.aspx?ArticleKey=2180 (anticipating that "many hedge fund managers and similar entities will implement programs to monitor their daily trading levels so as to avoid tripping the thresholds of the LT Reporting Rule"); *The SEC's New Large Trader Reporting Rule*, SIMPSON THACHER & BARTLETT LLP (Nov. 3, 2011), http://www.stblaw.com/google_file.cfm?TrackedFile=4B46116605D7EFD896B179&TrackedFolder=585C1D235281AED9B6A07D5F9F9478AB5A90188899 (recommending that broker-dealers "[c]onsider whether to modify your customer agreement and obtain representations from customers regarding large trader status").

219. Large Trader Reporting Release, *supra* note 76, at 46,991–92.

220. *Id.* at 46,998 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.").

221. *See id.* at 46,989 (arguing that firewalls will not be violated by information being shared by a subsidiary directly with its parent).

222. *Id.*

"protect[] the confidentiality of that information to the fullest extent permitted by applicable law,"[223] 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 so remote.[224] 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 might shift to securities not covered by the new regulation in order to avoid its burdens but did not offer data to support its counter-contention.[225]

### E. Net Worth Standard for Accredited Investors

The Net Worth Standard for Accredited Investors rulemaking implements section 413(a) of Dodd-Frank, which directed the SEC to adjust the net worth standard for accredited investors under the Securities Act to exclude the value of an investor's primary residence.[226] 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.[227] 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.[228] 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 the indebtedness does not exceed the value of the house.[229] 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 its rules without asking more fundamental questions about the standard.[230] The SEC did not look at the outcomes that standard

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223. *Id.* at 46,976.

224. SEC Office of Inspector Gen., No. OIG-557, Report of Investigation: Investigation into Misuse of Resources and Violations of Information Technology Security Policies Within the Division of Trading and Markets 25–26 (2012), *available at* http://www.sec.gov/foia/docs/oig-557.pdf (finding, among other things, that laptops used by SEC staff in inspections were left unattended, unencrypted, and unprotected).

225. Large Trader Reporting Release, *supra* note 76, at 46,982 (citing Ravoet & Margelish Comment Letter, *supra* note 209).

226. Net Worth Standard Release, *supra* note 74.

227. For a brief overview, see *Accredited Investors*, SEC, http://www.sec.gov/answers/accred.htm (last visited Apr. 11, 2014).

228. *See* 17 C.F.R. §§ 230.215(e), .501(a)(5) (2014).

229. *See id.* §§ 230.215(e)(1), .501(a)(5)(i).

230. Net Worth Standard Release, *supra* note 74, 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").

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.[231] 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."[232] The SEC declined to exercise that authority,[233] 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.

#### 1. 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 housing 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.

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 an investor who has

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231. *Id.* at 81,802–03.

232. Dodd-Frank Act, Pub. L. No. 111-203, § 413(b)(1)(A), 124 Stat. 1376, 1577–78 (2010). (codified as amended at 15 U.S.C. § 77b (2012) and 17 C.F.R. § 230.215 (2014)). 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. *Id.*

233. Net Worth Standard Release, *supra* note 74, 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).

become accredited largely because of a rapid increase in home prices is in need of greater protection than an investor who has become accredited due to a rapid increase in the price of gold or the value of his stock portfolio.

### 2. 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.[234] As a consequence, some have suggested non-wealth-based accredited investor standards.[235] The SEC could have considered whether shifting 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 buyer or his representative as a criterion under Rule 506, which permits securities to be sold to a small number of certain non-accredited investors.[236] 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.[237] 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.[238] 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

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234. *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).

235. *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").

236. Under Rule 506, an offering is not treated as a public offering if it is sold to no more than thirty-five purchasers. 17 C.F.R. § 230.506(b)(2)(ii) ("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.").

237. *Recommendations to Customers (Suitability)*, FINRA, http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3638 (retired NASD Rule 2310). FINRA subsequently replaced the rule with FINRA Rule 2111. *See* FINRA, FINRA MANUAL: OFFICIAL PUBLICATION OF THE FINANCIAL INDUSTRY REGULATORY AUTHORITY (2013), *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=8469.

238. Net Worth Standard Release, *supra* note 74, at 81,800 & n.65.

examination[239] may have made adjustments to the net worth standard unnecessary.

### 3. 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.[240] It also noted that its approach expanded the pool of potential purchasers and thus lowered costs to issuers by allowing for the exclusion from the calculation of mortgage debt along with the value of the home.[241] 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.[242] 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 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 with the SEC —Form PF—to provide information to regulators about the adviser and its private fund clients.[243] Form PF collects detailed information about the funds' types of investments, owners, and counterparties.[244] 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 under management.[245] Section 2 must be completed by large hedge fund advisers, meaning those with at least $1.5 billion in hedge fund assets under management.[246] Section

239. 15 U.S.C. § 80b-3(b), 80b-4 (2012).

240. *See* Net Worth Standard Release, *supra* note 74, at 81,803.

241. *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.").

242. *Id.* at 81,801 & n.72.

243. Reporting by Investment Advisers Release, *supra* note 75. Certain parts of the rulemaking pertain only to the SEC. Each agency performed its own economic analysis. We omit consideration of the CFTC's analysis from the discussion below.

244. *See id.* at 71,176–228.

245. *See id.* at 71,177–78 (describing in Instruction 3 which advisers have to complete which parts of Form PF).

246. *See id.*

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.[247] 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.[248] 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.[249]

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),"[250] and it directs the SEC and the CFTC to conduct a rulemaking.[251] 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."[252] 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.[253]

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 to ensure FSOC has adequate information to carry out its mission.[254] Dodd-Frank charged FSOC, a multi-regulator council that includes the chairmen of the SEC and CFTC, with "identify[ing] risks to the financial stability of the United States."[255] Among FSOC's responsibilities is the designation for additional regulatory supervision of nonbank financial companies that could pose risks to the financial system.[256] Nonbank financial companies include private funds.[257]

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247. *See id.*

248. *See id.*

249. *See id.* at 71,181–82 (describing in Instruction 9 when advisers must update Form PF).

250. 15 U.S.C. § 80b-4(b)(1)(A) (2012).

251. *Id.* § 80b-11.

252. Reporting by Investment Advisers Release, *supra* note 75, at 71,128–29.

253. *Id.* at 71,166.

254. *Id.* at 71,164.

255. 12 U.S.C. § 5322(a). FSOC's voting members are the Secretary of Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Director of the CFPB, 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. *Id.* § 5321(b)(1).

256. *Id.* § 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").

257. *FSOC Issues Final Rule on 'Systemically Significant' Nonbank Financial Companies*, ROTHSTEIN KASS, 1 (May 2012), http://www.rkco.com/getattachment/a7b9592c-210b-4358-b2cb-

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 primarily a response to the perceived needs of 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.[258]

In explaining why particular decisions were made, the notice of final rulemaking repeatedly refers to "our staffs' consultations with the staff representing the members of FSOC."[259] FSOC relies largely on staff drawn from the agencies that FSOC members head, presumably including staff of the SEC and CFTC.[260] 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.

#### 1. 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

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5326d44ad368/FSOC-Issues-Final-Rule-on-Systemically-Significant (explaining that "both fund managers and their private funds generally fall within the definition of a nonbank financial company").

258. Reporting by Investment Advisers Release, *supra* note 75, at 71,129–30 (footnotes omitted).

259. *See, e.g.*, *id.* at 71,129; *see also id.* at 71,131 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.").

260. *See Frequently Asked Questions*, FIN. STABILITY OVERSIGHT COUNCIL, http://www.treasury.gov/initiatives/fsoc/about/Pages/default.aspx (last visited Apr. 11, 2014) (Response to "How does FSOC operate?": "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.").

last financial crisis, it points out that having data about private funds could be useful in the next crisis.[261] 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.[262]

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.[263] The SEC seems to anticipate that Form PF may help to curb socially harmful risk-taking by imposing costs in a way that will force firms to internalize the costs of that risk-taking.[264] In citing as 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,[265] 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, that hedge funds are misallocating capital, or 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.[266] 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 where systemic risk exists but rather to provide empirical data to FSOC

261. Reporting by Investment Advisers Release, *supra* note 75, at 71,164 (citing S. REP. NO. 111–176, at 38 (2010)).

262. *Id.* at 71,165 (citing FIN. STABILITY OVERSIGHT COUNCIL, 2011 ANNUAL REPORT ii (2011), *available at* http://www.treasury.gov/initiatives/fsoc/Documents/FSOCAR2011.pdf) (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").

263. *Id.* at 71,116 (explaining that private fund investors and advisers stand to benefit from better risk management as a result of Form PF).

264. *Id.* at 71,171 ("[T]he 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 . . . .").

265. *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.").

266. *See, e.g.*, Jennifer Payne, *Private Equity and Its Regulation in Europe*, 12 EUR. BUS. ORG. L. REV. 559, 585 (2011) (arguing that private equity funds were being treated like hedge funds for European regulatory purposes although "the business models (and systemic risk implications) of private equity and hedge funds are quite distinct").

with which it may make a determination about the extent to which the activities of private equity funds or their advisers pose such risk.[267]

### 2. Alternatives

The notice identified five alternatives that were considered, but these reflected variations on the same regulatory approach rather than distinct alternatives.[268] 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.[269]

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267. Reporting by Investment Advisers Release, *supra* note 75, at 71,153 (citing 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*, (Eur. Corp. Governance Inst., Working Paper No. 176, 2011), *available at* http://ssrn.com/abstract=1762119 (supporting the proposition that one need not limit remedial measures taken in response to a crisis to the areas that caused the last crisis)). 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.

268. Reporting by Investment Advisers Release, *supra* note 75, 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.").

269. *See, e.g.*, Jón Daníelsson et al., *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); *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").

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 confidential information, since Form ADV is publicly available but 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 FSOC,[270] would be better suited to collect information relevant to assessing systemic risk of private funds.

### 3. 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."[271] 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 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."[272] 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."[273]

The economic analysis section states that the SEC made many changes to the original proposal intended to reduce cost burdens, in response to comments claiming that the estimated cost burdens in the proposal were too low. These 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.[274] It seems clear that these changes were made in response to comments, not because of anything the commissions learned from the benefit-cost analysis, and the analysis was then updated to reflect the revised regulation.

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270. 12 U.S.C. § 5343(a)(1) (2012) (describing the role of the Office of Financial Research in supporting FSOC by, among other things, "collecting data on behalf of the Council").
271. Reporting by Investment Advisers Release, *supra* note 75, at 71,166.
272. *Id.* at 71,159 n.395.
273. *Id.* at 71,163.
274. *Id.*

In some cases, the SEC concluded that 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."[275] Similarly, with regard to a requirement that certain data be reported on a monthly basis, the notice concludes:

> Based 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.[276]

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 potential indirect costs of having the government collect information about private funds. One potential cost is a decrease in private monitoring because of the market's reliance on increased government monitoring.[277] Less monitoring by private fund investors and counterparties could lead to heightened risk-taking. Decreased private sector monitoring might not be offset by government monitoring, particularly if the government is unable to use the information it collects effectively.

The SEC should have considered the cost to the government of processing and effectively using detailed information about private funds.

275. *Id.* at 71,145 (omitting a footnote that cited to the need for FSOC to understand "the extent to which the fund's value is determined using metrics other than market mechanisms").

276. *Id.* at 71,151.

277. *See, e.g.*, Ben Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Remarks at the Federal Reserve Bank of Atlanta's 2006 Financial Markets Conference: Hedge Funds and Systemic Risk (May 16, 2006), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20060516a.htm ("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?"); *see also* Houman B. Shadab, *Hedge Funds and the Financial Crisis*, MERCATUS ON POL'Y, Jan. 2009, at 3, *available at* http://mercatus.org/sites/default/files/publication/RSP_MOP34_Hedge_Funds_and_the_Financial_Crisis.pdf ("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.").

Some have suggested that academics could help analyze the information,[278] but confidentiality restrictions make it difficult to share information with academics. Including unnecessary items on Form PF could distract 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 FSOC, the SEC, and the CFTC.[279] This concern, however, seems not to have informed the rest of the analysis, which is infused with a more-is-better approach to information collection rather than a careful consideration of whether collecting particular information would be helpful.[280] As one example of information that might not be useful, Form PF requires data about funds that do not pose a systemic risk.[281]

Although the SEC acknowledged the importance of protecting the information submitted and discussed possible ways that it would do so,[282] 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 which Form PF information is provided.[283] 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

278. Leonard Nakamura, *Durable Financial Regulation: Monitoring Financial Instruments as a Counterpart to Regulating Financial Institutions* 7 (Nat'l Bureau of Econ. Research, Working Paper No. 17006, 2011), *available at* http://www.nber.org/papers/w17006.pdf ("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.").

279. Reporting by Investment Advisers Release, *supra* note 75, at 71,134.

280. *See, e.g*, COMM. ON CAPITAL MKTS. REGULATION, THE GLOBAL FINANCIAL CRISIS: A PLAN FOR REGULATORY REFORM ES-13 (2009), *available at* http://www.capmktsreg.org/pdfs/TGFC-CCMR_Report_(5-26-09).pdf ("[T]he regulator would bear the burden of demonstrating its need for the required information as well as its ability to use that information effectively."); Anne Rivière, *The Future of Hedge Fund Regulation: A Comparative Approach*, 10 RICH. J. GLOBAL L. & BUS. 263, 326 (2011) (arguing that the burden of proof should be on regulators to show that required data "is necessary to assess systemic risk").

281. Reporting by Investment Advisers Release, *supra* note 75, 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").

282. *Id.* at 71,156.

283. *See, e.g.*, 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 (2012), *available at* http://www.sec.gov/foia/docs/oig-557.pdf (discussing the unprotected status of certain SEC computers); *see also* Peter Schroeder, *Staff Data Leaks out of the SEC*, HILL (July 25, 2013), http://thehill.com/homenews/administration/313387-staff-data-leaks-out-of-the-sec (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).

positive externalities.[284] The SEC reasoned that performance fees are high enough relative to Form PF 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.[285] The SEC further opined that a private adviser that turned investors away would hurt its reputation with investors,[286] but hedge funds routinely turn away investors.[287] 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 to 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.[288] First, the rulemaking shifts a group of smaller, SEC-registered investment advisers—those with between $25 million and $100 million—to state registration.[289] Second, the rulemaking eliminates certain private fund adviser exemptions from registration and reporting requirements.[290] Third, the rulemaking requires

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284. *See, e.g.*, Houman B. Shadab, *The Challenge of Hedge Fund Regulation*, REGULATION, Spring 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. Carl 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." Reporting by Investment Advisers Release, *supra* note 75, at 71,171.

285. Reporting by Investment Advisers Release, *supra* note 75, 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").

286. *Id.* ("[W]e 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 . . . .").

287. Bernard Madoff reportedly enhanced his reputation as a money manager by turning investors away. *See, e.g.*, *The Madoff Affair: Con of the Century*, ECONOMIST, Dec. 20, 2008, at 119, *available at* http://www.economist.com/node/12818310 ("Turning away some investors and telling those he accepted not to talk to outsiders produced a sense of exclusivity."). 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.

288. Rules Implementing Amendments Release, *supra* note 75.

289. *Id.* at 42,951–61 (discussing the transition of mid-sized advisers from SEC to state registration).

290. *Id.* at 42,961–65 (discussing exempt reporting advisers); *id.* at 42,975 (discussing the narrowing of private adviser exemption).

private fund advisers that are exempt from registration—"exempt reporting advisers"—to fulfill certain reporting requirements.[291] Finally, 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.[292]

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[293] and did not conduct related analysis.[294] 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.[295] The SEC considered commenters' suggestions about particular registration and reporting items and made some changes in response[296] but did not carefully consider the implications for the SEC,

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291. Dodd-Frank exempted venture capital fund advisers and private fund advisers with less than $150 million in U.S. 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." Dodd-Frank Act, Pub. L. No. 111-203, §§ 407, 408, 124 Stat. 1376, 1574–75 (codified as amended at 15 U.S.C. § 80b-3(*l*), (m) (2012)) (adding Adviser Act subsections 203(*l*) and (m), respectively). 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), http://www.hblr.org/wp-content/uploads/2011/09/Schwartz-HedgeFundReg.pdf (arguing that "[t]he requirements for exempt advisers is likely the area where the SEC pushed its authority the furthest").

292. Rules Implementing Amendments Release, *supra* note 75, at 42,974–75 (discussing pay-to-play amendments).

293. Dodd-Frank Act § 410 (codified as amended at 15 U.S.C. § 80b-3A(a)(2)) (adding new section 203A(a)(2) of the Advisers Act to move mid-sized advisers—those required to register with and that are subject to examination by their home states, and that have $25–100 million in assets under management (or whatever higher threshold the SEC chooses)—to state registration from SEC registration); Dodd-Frank Act § 403 (codified as amended at 15 U.S.C. § 80b-3(b)) (amending section 203(b) of the Advisers Act by eliminating private adviser exemption from registration); Dodd-Frank Act §§ 407, 408 (codified as amended at 15 U.S.C. § 80b-3(*l*), (m)) (amending section 203 of the Advisers Act by exempting venture capital fund advisers and small private fund advisers from registration but authorizing the SEC to impose reporting requirements).

294. *See, e.g.*, Rules Implementing Amendments Release, *supra* note 75, 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 Dodd-Frank).

295. *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").

296. *See, e.g.*, *id.* 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

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.

### 1. 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[297] and the Commission's struggle to properly oversee such a large number of firms.[298] 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 smallest advisers.[299]

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 towards 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.[300] 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.[301] Moreover, these investors are presumed

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they manage."); *id.* at 42,937 (deciding, based on adverse comment, not to "accelerate the deadline for filing an annual updating amendment to an adviser's Form ADV filing").

297. *See, e.g.*, SEC STAFF OF DIV. OF INV. MGMT., STUDY ON ENHANCING INVESTMENT ADVISER EXAMINATIONS para. II.A (2011), *available at* http://www.sec.gov/news/studies/2011/914studyfinal.pdf (reporting that between October 1, 2004, and September 30, 2010, the number of registered investment advisers increased 38.5%, from 8581 to 11,888 advisers). It is surprising that the SEC does not appear to have employed the findings of this study in its analysis.

298. *See, e.g.*, SEC, FY 2014 CONGRESSIONAL BUDGET JUSTIFICATION AND ANNUAL PERFORMANCE PLAN AND FY 2012 ANNUAL PERFORMANCE REPORT 29 (2013) [hereinafter FY 2014 CONGRESSIONAL BUDGET JUSTIFICATION AND ANNUAL PERFORMANCE PLAN], *available at* http://www.sec.gov/about/reports/secfy14congbudgjust.pdf (finding that in fiscal year 2010, the SEC examined only nine percent of registered investment advisers.).

299. *See, e.g.*, Elisse B. Walter, Comm'r, SEC, Statement on Study Enhancing Investment Adviser Examinations (Required by Section 914 of Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act) (Jan. 2011), *available at* https://www.sec.gov/news/speech/2011/spch011911ebw.pdf ("Importantly, as a result of the Dodd-Frank Act, while there will be a near-term decrease in the number of registered investment advisers under the Commission's jurisdiction, the staff estimates that net assets under management will increase immediately as larger and more complex entities enter the Commission's oversight.").

300. *See supra* Part IV.E (discussing these changes).

301. *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.").

to be able to bear investment losses.[302] Accordingly, the SEC has traditionally played a less active investor protection role in the private fund area.[303] Instead it has allocated its resources to the protection of less wealthy retail investors.[304] As discussed above, concerns have been expressed about the use of wealth as a measure of financial sophistication.[305] 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.[306] 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."[307]

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 and due diligence that makes public disclosure valuable."[308] The SEC did not

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302. *See, e.g.*, Net Worth Standard Release, *supra* note 74, at 81,794 (explaining that "[o]ne 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 liquid) securities for an indefinite period and, if necessary, to afford a complete loss of such investment") (footnote omitted); *see also id.* at 81,794 n.17.

303. *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 (noting that "the 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.").

304. Paul S. Atkins, *Protecting Investors Through Hedge Fund Advisor Registration*, 25 ANN. REV. BANKING & FIN. L. 537, 551–52 (2006) (explaining that mandatory hedge fund registration requirement would shift resources from protecting retail to protecting wealthy investors).

305. *See* Rules Implementing Amendments Release, *supra* note 75, at 42,969; Karmel, *supra* note 301, at 683.

306. *See, e.g.*, Paredes, *supra* note 303, at 992–93 (discussing due diligence by hedge fund investors).

307. Rules Implementing Amendments Release, *supra* note 75, at 42,969.

308. *Id.* at 42,969, 42,964 ("[I]nvestors 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 (arguing that limiting the required information to "basic identifying data . . . would deny investors an opportunity to verify disclosures they receive directly from the adviser").

provide evidence, however, to support the proposition that inaccurate information is a significant problem.

### 2. 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, the SEC adopted Form PF, a form designed to provide information to FSOC, the SEC, and the CFTC about private funds.[309] As discussed in connection with that rulemaking, disclosure on Form ADV could serve as an alternative to disclosure on Form PF and vice versa.[310] The SEC also should have considered the degree to which the disclosure was unnecessary because it was already required elsewhere.[311] Rather than dismissing concerns about reporting that was duplicative with Form D reporting under the Securities Act, the SEC could have considered whether expanded Form D reporting could serve as an alternative to the rule's Form ADV disclosure.[312]

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.[313] 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

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309. *See supra* Part IV.G. As discussed in that section, some of the Form PF information might have been collected better 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.

310. 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.*, Rules Implementing Amendments Release, *supra* note 75, at 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.").

311. Even within Form ADV there is duplicative reporting. *Compare id.* at 42,965 (acknowledging "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"), *with id.* at 42,968 (noting elsewhere in Form ADV 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").

312. 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." Rules Implementing Amendments Release, *supra* note 75, at 42,966 n.230.

313. *Id.* at 42,962.

establish best practices for disclosure to investors and potential investors.[314] 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.[315]

### 3. 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 oversight."[316] Given that the SEC examined only nine percent of registered investment advisers in fiscal year 2010, such confidence may be misplaced.[317]

The SEC should also have taken into account the role that private funds play in the market, the economy and 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[318] and capital formation.[319] Imposing additional costs on

314. 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*, MANAGED FUNDS ASS'N, http://www.managedfunds.org/wp-content/uploads/2011/06/Due-Dilligence-Questionnaire.pdf (last visited Apr. 11, 2014).

315. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 201, 126 Stat. 306, 313–15 (2012); *see also* Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 9415, Exchange Act Release No. 69,959, Investment Advisers Act Release No. 3624, 78 Fed. Reg. 44,771 (July 24, 2013).

316. Rules Implementing Amendments Release, *supra* note 75, at 42,993.

317. *See* FY 2014 CONGRESSIONAL BUDGET JUSTIFICATION AND ANNUAL PERFORMANCE PLAN *supra* note 298, at 29.

318. *See, e.g.*, Darwin Choi et al., *Convertible Bond Arbitrage, Liquidity Externalities, and Bond Prices*, 91 J. FIN. ECON. 227 (2009), *available at* http://www.fdic.gov/bank/analytical/cfr/Choi_Getmansky_Tookes.pdf (finding that arbitrage in the convertible bond market, in which hedge funds are actively engaged, enhances liquidity in the underlying equity markets); Petri Jylhä et al., *Do Hedge Funds Supply or Demand Liquidity?*, 18 REV. FIN. (forthcoming) (manuscript at 13), *available at* http://efmaefm.org/0EFMSYMPOSIUM/Toronto-2011/papers/Rinne.pdf (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"); George Aragon & Philip Strahan, *Hedge Funds as Liquidity Providers: Evidence from Lehman Bankruptcy* (Nat'l Bureau of Econ. Research, Working Paper No. 15336 (2009), *available at* http://www.nber.org/papers/w15336.pdf (concluding, based on evidence from the Lehman bankruptcy, that hedge funds act as liquidity providers).

319. *See, e.g.*, David J. Brophy et al., *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").

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 of 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.[320]

The SEC did not fully consider the economic consequences of its mandatory disclosures. There are potential competitive implications of public disclosure.[321] 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.[322] More generally, the SEC could have considered the extensive literature discussing the costs and benefits of mandatory disclosure.[323]

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."[324]

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320. There is literature analyzing whether hedge funds outperform mutual funds and the market more generally. *See, e.g.*, Ackermann et al., *supra* note 284, at 854–55 (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").

321. Troy A. Paredes, Comm'r, 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) [hereinafter Statement to Adopt Final Rules Regarding Exemptions], *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.").

322. Rules Implementing Amendments Release, *supra* note 75, at 42,963.

323. *See, e.g.*, John C. Coffee, *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984) (making 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); Manne, *supra* note 178, at 511 (arguing that "[b]ehavioral 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."); Christian Leuz & Peter Wysocki, Economic Consequences of Financial Reporting and Disclosure Regulation: A Review and Suggestions for Future Research (Mar. 2008) (unpublished manuscript), *available at* http://ssrn.com/abstract=1105398 (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).

324. Rules Implementing Amendments Release, *supra* note 75, at 42,981. The SEC cites as benefits its receipt of "information as to whether these advisers or their activities might present

The SEC also anticipates that the new reporting requirements would have a positive effect on investor confidence and consequently on capital formation:

> 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.[325]

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. Such misplaced confidence can lead to inadequate monitoring by investors and inefficient capital allocation. As the reaction of Bernard Madoff investors illustrated, investors often believe that the SEC is watching advisers more closely than it is.[326]

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 does not provide a clear basis for this assumption.[327] 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.[328] 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."[329] The Commission faulted commenters for failing to "identify any specific costs associated with these concerns"[330] and concluded that the costs of developing a new system outweighed these

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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.* at 42,982. As noted above, the SEC did not establish the underlying problems before imposing these requirements.

325. *Id.* at 43,009.

326. *See, e.g.*, Peter Lattman, *Court Expresses Antipathy for S.E.C. in Handling of Madoff Case*, N.Y. TIMES DEALBOOK (Apr. 10, 2013, 1:37 PM), http://dealbook.nytimes.com/2013/04/10/court-expresses-antipathy-for-s-e-c-in-handling-of-madoff-case/.

327. Rules Implementing Amendments Release, *supra* note 75, 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 haircut from the one-hour estimate for registered advisers. *Id.*

328. *See, e.g.*, Letter from Seward & Kissel LLP to Elizabeth M. Murphy, Sec'y, SEC 10 (Jan. 31, 2011), *available at* http://www.sec.gov/comments/s7-37-10/s73710-112.pdf ("We believe that using the same form for both registered advisers and exempt reporting advisers will create confusion among investors.").

329. Statement to Adopt Final Rules Regarding Exemptions, *supra* note 321.

330. Rules Implementing Amendments Release, *supra* note 75, at 42,990.

concerns.[331] 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.[332]

## 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 restore the chief economist's direct reporting relationship to the chairman.[333] 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. Thus, although approximately two years have passed since the SEC staff released its guidance memorandum, it remains too early to determine definitively whether the guidance is improving analysis.

Preliminary evidence is 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 subsequent to the guidance.[334] 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.[335] In June 2013, in response to a congressional request, the SEC's inspector general 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.[336] However, the inspector general's report mostly assessed whether the SEC's analysis

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331. *Id.* at 42,962.

332. 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, Comm'r, SEC, 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.

333. *See supra* notes 55–70 and accompanying text.

334. Nat'l Ass'n of Mfrs. v. SEC, 956 F. Supp. 2d 43 (D.D.C. 2013).

335. *Id.* at 57 (noting that 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.") (footnote omitted).

336. SEC OFFICE OF INSPECTOR GEN., USE OF THE CURRENT GUIDANCE ON ECONOMIC ANALYSIS IN SEC RULEMAKINGS (2013) [hereinafter, SEC OIG POST-GUIDANCE REPORT].

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.

### A. 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 mandate to promulgate regulations requiring companies to make annual disclosures about the origin of conflict minerals "necessary to the functionality or production of a product" they manufacture.[337] The genesis for the rule was concern for victims of violence in the Democratic Republic of the Congo.[338]

The rule was challenged in court on a number of grounds, one of which was that the SEC's economic analysis was allegedly flawed.[339] The emphasis on economic analysis was not surprising given that one of the plaintiffs had estimated that the rule would cost $9–16 billion, in contrast to the SEC's estimate of $71.2 million.[340] The plaintiffs also faulted the SEC for failing to determine whether the rulemaking would have its intended benefits.[341] 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.

337. Dodd-Frank Act, Pub. L. No. 111-203, § 1502, 124 Stat. 1376, 2213.

338. *See, e.g.*, Letter from Richard J. Durbin, U.S. Senator, and Jim McDermott, U.S. Congressman, to Mary L. Schapiro, Chairman, SEC 1 (Oct. 4, 2010), *available at* http://www.sec.gov/comments/df-title-xv/specialized-disclosures/specializeddisclosures-22.pdf (explaining that Congress intended the conflict minerals provision to address the violence in the DRC that "has already claimed more than five million lives and continues to result in the death and rape of countless new victims").

339. Plaintiffs' Opening Brief at 26–34, Nat'l Ass'n of Mfrs. v. SEC, 956 F. Supp. 2d 43 (D.D.C. 2013) (No. 13-cv-635), *available at* http://www.nam.org/~/media/B5825277D7C144A48C2C4442054900D4/NAM_v_SEC_brief_only_01162013.pdf.

340. *Id.* at *16.

341. *Id.* at *27–31.

> Additionally, the social benefits are quite different from the economic or investor protection benefits that our rules ordinarily strive to achieve.[342]

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."[343] 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 to promote peace and security in the DRC," rather than the result of "the Commission having independently perceived a problem within its purview and having exercised its own judgment to craft a rule or regulation aimed at that problem."[344] 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."[345] 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.[346] 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.[347] The court also held that the SEC did not act arbitrarily or capriciously in reaching its cost estimates.[348]

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.

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342. Conflict Minerals, Exchange Act Release No. 67,716, 77 Fed. Reg. 56,273, 56,335 (Sept. 12, 2012) (to be codified at 17 C.F.R. pts. 240, 249(b)) [hereinafter Conflict Minerals Release]; Disclosure of Payments by Resource Extraction Issuers, Exchange Act Release No. 67,717, 77 Fed. Reg. 56,365 (Sept. 12, 2012) (to be codified at 17 C.F.R. pts. 240, 249).

343. Nat'l Ass'n of Mfrs. v. SEC, 956 F. Supp. 2d 43, 56 (D.D.C. 2013) (footnote omitted) (citing 15 U.S.C. § 78c(f)).

344. *Id.* at 58 (citations omitted).

345. *Id.*

346. *Id.* at 58 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).

347. *Id.* at 59.

348. *Id.* at 60–61.

### B. SEC INSPECTOR GENERAL'S POST-GUIDANCE ASSESSMENT OF SEC ECONOMIC ANALYSIS

The inspector general of the SEC conducted a post-guidance assessment of SEC economic analysis, which included the conflicts mineral rule and eleven other rules.[349] For eight of the twelve rules, the report found evidence that the SEC's economists and the rule-writing teams collaborated in assessing the economic effects of the rule.[350] However, some of the rules did not fully specify the baseline.[351] Almost all of the rules discussed benefits and costs qualitatively, but they offered little quantification of costs beyond paperwork costs.[352] Only one rule attempted to quantify benefits.[353] Only five of the twelve rules fully explained the reasons benefits and costs were not quantified.[354] Nevertheless, the inspector general concluded that the SEC's analysis "followed the spirit and intent" of the 2012 guidance.[355] 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."[356]

### C. REPORT CARD ANALYSIS OF A POST-GUIDANCE REGULATION

We suspect 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 the regulation or possible alternatives. 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.[357]

The Clearing Agency Standards rule is one of the rules included in the inspector general's report.[358] If the SEC's economic analysis improved by the end of 2012, we would expect to see signs of that in this rule. The Clearing Agency Standards Rule set forth risk management standards for

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349. SEC OIG POST-GUIDANCE REPORT, *supra* note 336, at 10 (explaining that the review covered twelve rules, seven of which were reviewed "more in depth").
350. *Id.* at 15.
351. *Id.* at 11.
352. *Id.* at 15.
353. *Id.*
354. *Id.* at 19.
355. *Id.* at i.
356. *Id.* at 34.
357. Clearing Agency Standards Release, *supra* note 72.
358. SEC OIG Post-Guidance Report, *supra* note 336, at app. VI (listing "Substantive Rules Examined").

SEC-registered clearing agencies, which are part of the plumbing of the securities markets.[359] Among other roles, clearing agencies serve as central counterparties, assuming the responsibilities of the seller to the buyer and vice versa.[360] 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.[361] 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 giving the SEC additional authority with respect to registered clearing agencies.[362]

The Clearing Agency Standards rule comes in response to the SEC's new Dodd-Frank authority. Registered clearing agencies are required to establish, implement, maintain, and enforce written policies and procedures governing their operations and risk management.[363] 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.[364] The rule includes minimum standards for credit exposure monitoring, margin requirements, financial resources, margin model validation, membership standards, recordkeeping, and financial disclosures.[365] The rule also requires registered clearing agencies to maintain written policies and procedures related to a number of other operational and risk management areas.[366]

359. Clearing Agency Standards Release, *supra* note 72, at 66,220 (explaining that clearing agencies "have become an essential part of the infrastructure of the U.S. securities markets" and that "[t]he new rule establishes minimum requirements regarding how registered clearing agencies must maintain effective risk management procedures and controls as well as meet the statutory requirements under the Exchange Act on an ongoing basis").

360. Press Release, SEC, SEC Adopts Standards for Risk Management and Operations of Clearing Agencies (Oct. 22, 2012) [hereinafter Risk Management and Operations Press Release], *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171485518#.UwWZ-84gv_Y ("Clearing agencies generally act as middlemen to the parties in a securities transaction.").

361. Clearing Agency Standards Release, *supra* 72, 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").

362. *See* Dodd-Frank Act, Pub. L. No. 111-203, §§ 701–814, 124 Stat. 1641–1822.

363. Clearing Agency Standards Release, *supra* note 72, at 66,228 (describing Rule 17Ad-22).

364. Risk Management and Operations Press Release, *supra* note 360 ("The rules would set standards with respect to measurement and management of credit exposures, margin requirements, financial resources and margin model validation. The rule also establishes certain recordkeeping and financial disclosure requirements for all registered clearing agencies as well as several new operational standards for these entities.").

365. Clearing Agency Standards Release, *supra* note 72, at 66,230, 66,243 (describing Rule 17Ad-22(b) and (c)).

366. *Id.* at 66,245 (describing Rule 17Ad-22(d)).

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 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.[367] 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.[368] 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, when we selected a post-guidance rule for review.[369]

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.

367. Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, Securities Act Release No. 9338, Exchange Act Release No. 67,453, 77 Fed. Reg. 48,208 (Aug. 13, 2012) (to be codified at 17 C.F.R. pts. 1, 230, 240, 241); Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," Exchange Act Release No. 66,868, 77 Fed. Reg. 30,596 (May 23, 2012) (to be codified at 17 C.F.R. pts. 1, 240).

368. 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 defers the related economic analysis. *See* Consolidated Audit Trail Release, *supra* note 207, at 45,726 ("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* Conflict Minerals Release, *supra* note 342.

369. *See, e.g.*, Purchase of Certain Debt Securities by Business and Industrial Development Companies Relying on Investment Company Act Exemption, Investment Company Act Release No. 30,268, 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 creditworthiness for entities relying on a single SEC exemption).

**TABLE 5. REPORT CARD EVALUATION OF THE CLEARING AGENCY STANDARDS RULE COMPARED TO SEVEN PRE-2012 SEC RULES**

| | Average for Seven Pre-2012 SEC Regulations | Clearing Agency Standards Rule |
|---|---|---|
| **Total** | 15.7 | 17 |
| **Openness** | 9.4 | 9 |
| **Analysis** | 3.9 | 5 |
| **Use** | 2.4 | 3 |
| **Systemic Problem** | 0.7 | 1 |
| **Baseline** | 0.6 | 2 |
| **Alternatives** | 1.3 | 2 |
| **Outcomes** | 0.9 | 1 |
| **Cost-Benefit** | 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.[370] 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 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.[371]

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

370. Clearing Agency Standards Release, *supra* note 72, at 66,266–71.
371. SEC Guidance, *supra* note 55, at 6–7.

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.[372]

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, which assesses the extent to which the regulatory agency claimed to use the analysis in its decisions. The rule received 3 points on this criterion; only one of the seven pre-2012 SEC rules scored as highly. This rule fared better than most others on use of analysis because it discussed, in a few paragraphs, the pros and cons of higher or lower net capital requirements for membership in a clearing agency.[373] The Commission clearly tried to balance 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.

## 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 trying 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 executive branch agencies 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

372. Ellig & McLaughlin, *supra* note 82, at 870.
373. *See* Clearing Agency Standards Release, *supra* note 72, at 66,278.

benefits of the proposed regulation and the 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 analysis. The SEC's 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 economic analyses explored here failed, beyond sporadic references, to take advantage of the academic literature that would help them to analyze the rulemakings. Oftentimes the analyses deferred to the statute rather than asking fundamental questions about the need for and objectives of the rulemaking at issue. 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-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 occurred in spite of 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 Commission's new economic analysis guidance. These 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 analysis, investors, regulated entities, Congress, and the Commission 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 more appropriately designed to satisfy a particular objective. Better analysis would also help to ensure that regulated entities target their compliance resources in the areas in which they would be most helpful at achieving the SEC's objectives. More thoughtful, comprehensive analysis will also help the SEC to 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 against which the SEC's rulemakings finalized after the SEC's most recent staff guidance on economic analysis took effect. Once 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 analyses compare with those of the SEC. As this Article demonstrates, an agency that is not committed to careful, well-supported, transparent economic analysis tends to base its rules on speculation and aspiration rather than 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 it may significantly increase the benefits or reduce the costs of the regulations 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.