THE COST-BENEFIT ANALYSIS OF FINANCIAL REGULATION:
WHAT THE SEC IGNORES IN THE RULEMAKING PROCESS,
WHY IT MATTERS, AND WHAT TO DO ABOUT IT

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I. INTRODUCTION

Over the last twenty-five years, under both Republican and Democratic presidents, no analytical tool has become more fundamental to the modern administrative state than cost-benefit analysis ("CBA"). As commonly used, CBA helps regulators reach informed decisions on

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Government agencies now routinely use CBA. This was not always the case. Before the 1980s, agencies did not systematically rely on CBA when evaluating regulations and other projects. But executive orders issued by the Reagan and Clinton administrations have since made the use of CBA by agencies common, and Congress has enacted numerous statutes requiring agencies to perform cost-benefit analyses.

policy matters, but does not dictate regulatory outcomes.\(^2\) When applied properly, CBA has assisted many agencies and members of the public in deciding whether a proposed rulemaking would be better than the status quo, choosing between alternative regulations, and determining whether any regulation would be preferable to no regulation whatsoever. As the technicalities and complexities of government regulation have further escaped the grasp of legislators and the lay public, CBA has become the focus of efforts to produce optimal regulatory results through rational decision-making procedures.

However, cost-benefit analysis has not been utilized consistently across the different sectors of government regulation. In particular, the nation’s financial regulators have failed to perform the rigorous analysis required of most other government agencies, especially those in the fields of health, safety, and environmental regulation. This shortcoming is peculiar at best, and troubling at worst. Financial institutions regulated by the federal government are central to the health of the U.S. economy, and much of this country’s wealth is held in regulated financial instruments, such as bank accounts, stocks, bonds, mutual funds, and futures contracts. In light of the corporate scandals of the late 1990s and early 2000s, effective financial regulation has taken on increased political importance.\(^3\) Surely, as much as any other sphere of regulation, the

\(^2\) See Richard A. Posner, *Cost-Benefit Analysis: Definition, Justification, and Comment on Conference Papers*, 29 J. LEGAL STUD. 1153, 1175 (2000) (“Collecting… information is what is meant by cost-benefit analysis as an evaluative tool, indeed as anything less than the exclusive decision rule. It is not the equality or inequality sign that marks analysis as cost-benefit but the collection and display of costs and benefits.”).

\(^3\) See, e.g., Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002). Passed in the wake of accounting scandals at companies like Enron, WorldCom, and Global Crossing, Sarbanes-Oxley created the Public Company Accounting Oversight Board, a new regulatory body to oversee the accounting industry. *Id.* § 101. The Act also required the Securities and Exchange Commission (“SEC”) to undertake several specific rulemakings. *Id.* §§ 208(a), 301, 302(a), 303(a), 306(a)(3), 307, 401(a), 401(b), 404(a), 406(a), 406(b), 407(a), and 501(a). The SEC was also given the authority to “promulgate such rules and regulations, as may be necessary or appropriate in the public interest or for the protection of investors, and in furtherance of this Act.” *Id.* § 3(a), (codified at 15 U.S.C.S. § 7202(a) (Supp. IV 2004)). Between Aug. 27, 2002, and Mar. 16, 2004, the SEC promulgated nineteen final rulemakings pursuant to its authority under the Act. *See* Securities & Exchange Commission, *Spotlight on
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government’s policies toward financial institutions are both susceptible to and deserving of
comprehensive reviews of costs and benefits.4 And yet, there has been no effort by agencies to
justify their regulations to Congress, regulated parties, and the general public on the simple
principle that the benefits of such regulations ought to exceed the costs they impose. This is true
not only of the U.S. Securities and Exchange Commission (“SEC,” or the “Commission”), the
subject of this Article, but also the Commodity Futures Trading Commission (“CFTC”), the
Federal Deposit Insurance Corporation (“FDIC”), the Federal Reserve Board, and the Federal
Trade Commission (“FTC”).5 This Article argues that the use of cost-benefit analysis by
financial regulators, in particular the SEC, has been inadequate and led to an overall reduction in
the quality of rulemaking.

Until recently, the government’s near-total failure to articulate and apply cost-benefit
principles in the context of financial regulation has escaped the attention of regulators,
coordinate branches of government, and the public.6 However, the SEC’s use—or lack thereof—
of CBA in a controversial recent rulemaking on the governance of the mutual fund industry

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4 Nobel Laureate George Stigler made this point more than forty years ago in his review of a special study of the
SEC’s regulation of U.S. securities markets. “[I]t is possible,” he wrote, “to study the effects of public policies, and
not merely to assume they exist and are beneficial, and... grave doubts exist whether... account is taken of costs of
proceeded to critique the SEC for failing to consider all of the costs of its securities registration regulations. He
noted that, in his judgment, “[t]he costs of the program... probably exceed even a reasonably optimistic estimate of
the benefits.” Id. at 124 n.9.

5 Robert W. Hahn & Cass R. Sunstein, A New Executive Order for Improving Federal Regulation? Deeper and
REGULATORY REFORM: A GLOBAL PERSPECTIVE 62 tbl. 3-11 (2000)). That these agencies do not estimate the future
benefits and costs of their regulatory activities owes principally to their status as “independent” (as opposed to
“executive”) agencies. See infra Section II.D.

6 See ROBERT W. HAHN, AN ANALYSIS OF THE FIRST GOVERNMENT REPORT ON THE BENEFITS AND COSTS OF
about the benefits and costs of antitrust, banking and security [sic] regulation,... Those gaps in our knowledge
should help serve as a wakeup call to those in the academic community wishing to produce useful knowledge for
policymakers.”).
shone light on the issue for perhaps the first time.\footnote{See Investment Company Governance, 69 Fed. Reg. 46378 (Aug. 2, 2004) (to be codified at 17 C.F.R. pt. 270). For a complete discussion of this rulemaking, see \textit{infra} Section IV.C.1.a.} Given the size of the mutual fund industry—which had $8.1 trillion of assets under management as of the end of 2004\footnote{Investment Company Institute, \textit{Trends in Mutual Fund Investing} (Jan. 28, 2005), available at http://www.ici.org/stats/mf/trends_12_04.html.}—the gravity of this conflict cannot be ignored. Two of the SEC’s five commissioners dissented from the rulemaking, explicitly relying on the fact that the Commission failed to consider the costs imposed by the regulation. Congress, in turn, passed legislation demanding that the SEC justify its position on cost-benefit grounds. A major business lobby petitioned for judicial review of the SEC action, and in a landmark ruling in June 2005, the D.C. Circuit struck down the regulation for failing to satisfy “its statutory obligation to determine as best it can the economic implications of the rule it has proposed.”\footnote{Chamber of Commerce of the United States of America v. SEC, 412 F.3d 133, 143 (D.C. Cir. 2005). For a complete discussion of this case, see \textit{infra} Section IV.C.1.C.} While mutual fund governance has drawn the most significant attention to how financial regulators ignore the use of CBA, it is far from the only topic on which rulemaking would benefit from a healthy dose of regulatory analysis.

It is not altogether surprising that the cost-benefit analysis of financial regulation has received so little attention.\footnote{At least in the United States. Due to the cost-benefit requirements imposed on the United Kingdom’s Financial Services Authority, see \textit{infra} Section III.B. British scholars have begun to address the role of CBA in financial regulation. \textit{See} DAVID SIMPSON ET AL., SOME COST-BENEFIT ISSUES IN FINANCIAL REGULATION (Financial Services Authority, Occasional Paper Series No. 12, 2000) [hereinafter COST-BENEFIT ISSUES]; ISAAC ALFON & PETER ANDREWS, \textsc{Cost-Benefit Analysis in Financial Regulation: How To Do It and How It Adds Value} (Financial Services Authority, Occasional Paper Series No. 3, 1999). Some authors have addressed the overall cost of financial regulation without addressing the specific costs of individual regulations. \textit{See}, e.g., Julian R. Franks et al., \textit{The Direct and Compliance Costs of Financial Regulation}, 21 J. BANKING & FIN. 1547 (1998).} First, administrative law scholars who tend to study CBA are rarely experts on financial regulation, and vice versa, and there has been little cross-pollination between the two disciplines. Second, because agencies responsible for health, safety, and the environment perform cost-benefit analyses of their proposed rulemakings, they tend to draw a lot
of scrutiny. On the other hand, financial regulators, shunning the use of CBA, provide scholars with little to study.

Third, and perhaps most significantly, the issues that make CBA so interesting to administrative law scholars are generally absent or of lesser importance in financial regulation. Over the last two decades, CBA has generated a substantial body of literature with respect to health, safety, and environmental regulation. In these realms, CBA generates many questions of concern to philosophers, economists, lawyers, lobbyists, and government officials: How much is a human life worth? What trade-offs should be made between product or workplace safety and economic cost? And what is the value of clean air and water, an unspoiled mountain vista, or the survival of an endangered species? Government agencies such as the Environmental Protection Agency (“EPA”) and the Occupational Safety and Health Administration (“OSHA”) must routinely answer such questions in the course of performing CBA. Moreover, the answers—no less the fact that such questions are even asked—continue to produce heated debates. While financial regulation boasts its own set of cost-benefit issues, they are not so literally the matters of life and death that other scholars have studied.

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This Article will attempt to fill this gap in the literature by addressing the theory and practice of CBA in the context of financial regulation. Part II will lay the groundwork for this discussion by defining CBA, addressing its critiques and defenses, and noting how its historical development in the U.S. administrative state has separated those agencies that use CBA from those that do not. As the literature on CBA is quite extensive, this Part will not be exhaustive, but instead will focus on issues relevant to financial regulation. Part III will look at how CBA is practiced by financial regulators, contrasting its limited use by the SEC with the much more significant experience of the United Kingdom’s Financial Services Authority (“FSA”). Part IV will take an in-depth look at several recent SEC proposals with respect to the scandal-plagued mutual fund industry and evaluate the Commission’s use of cost-benefit analysis therein. Given the importance of mutual funds to the overall securities market, the number and variety of rules proposed in a short period in 2003 and 2004, and the controversy generated by those rules, the mutual fund reforms present a particularly fertile area in which to study the role of CBA in financial regulation. This Article is agnostic on the merits of those regulations, but instead is concerned with the means by which the SEC justified these significant rulemakings. Finally, Part V will offer and evaluate several suggestions for deepening and broadening the use of CBA by financial regulators in order to improve the quality and presentation of their rulemakings.
II. COST-BENEFIT ANALYSIS IN ADMINISTRATIVE RULEMAKING

A. Varieties of Cost-Benefit Analysis

Not surprisingly, given its widespread use in the social sciences, CBA is open to a variety of definitions. These definitions will vary according to the generality or specificity of the analysis and the manner in which the results are used. Richard Posner writes:

At the highest level of generality, ... [CBA] is virtually synonymous with welfare economics, that is, economics used normatively—used, that is, to provide guidance for the formation of policy, either public (the more common domain of the term) or private. At the other end of the scale of generality, the term denotes the use of the Kaldor-Hicks (wealth maximization rather than utility maximization) concept of efficiency to evaluate government projects... and government regulations, including not only administrative regulations dealing with health, the environment, and other heavily regulated activities but also statutes and common-law doctrines and decisions.

Along a different axis of definition, the term cost-benefit analysis can refer to a method of pure evaluation, conducted wholly without regard to the possible use of its results in a decision; or to an input into decision, with the decision maker free to reject the results of the analysis on the basis of other considerations; or to the exclusive method of decision.

While it can be put to different uses, the goal of CBA always remains the same: wealth maximization. However, in practice, that end goal is ideally tempered by human judgment and common sense. As defenders of the practice insist, “[i]t is best taken as pragmatic instrument, agnostic on the deep issues and designed to assist people in making complex judgments where multiple goods are involved.”

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13 See Amartya Sen, The Discipline of Cost-Benefit Analysis, 29 J. LEGAL STUD. 931, 932–33 (2000) (“[T]he term ‘cost-benefit analysis’ has considerable plasticity and various specific procedures have been called by that name (by the protagonists and by others).”).
14 Posner, supra note 2, at 1153–54.
15 See W. Kip Viscusi et al., Economics of Regulation and Antitrust (3d ed. 2000). Viscusi writes: At a very minimum, it seems reasonable that society should not pursue policies that do not advance our interests. If the benefits of a policy are not in excess of the costs, then clearly it should not be pursued, because such effects do more harm than good. Ideally we want to maximize the net gain that policies produce. This net gain is the discrepancy of between benefits and costs, so our objective should be to maximize the benefit-minus-cost difference.
Cost-benefit analysis may also be defined, in part, by what it is not. It differs from financial analysis, which “is used primarily in the private sector to determine which outcomes are best from the perspective of private interests.”\textsuperscript{17} While the two procedures may include similar calculations of costs and benefits, CBA looks at society as a whole rather than a particular individual or firm.\textsuperscript{18} It differs, too, from risk-risk analysis, which compares the risks posed by the status quo with new, substitute risks that may be created by regulation. Under risk-risk analysis, a regulation whose benefits exceed its costs may nonetheless be unwise if in mitigating one risk, it creates a new, more substantial risk.\textsuperscript{19} CBA is also unlike feasibility analysis; that procedure requires an agency to ask whether a significant risk exists, and if it does, to promulgate regulations reducing that risk to the lowest level feasible under current technologies. This may result in regulatory costs far in excess of benefits, as is often the case where environmental rules impose billions of dollars of costs to save a single statistical life.\textsuperscript{20} CBA is also distinguishable from comparative risk assessment (“CRA”), which ranks risks in order of their severity to ensure that the most serious risks are addressed first.\textsuperscript{21}

CBA is also different from, though closely related to, cost-effectiveness analysis (“CEA”). CEA is “the evaluation of alternatives according to both their costs and their effects with regard to producing some outcome or set of outcomes.”\textsuperscript{22} This, while CBA looks at a given regulation and asks what costs and benefits it will produce, CEA begins with a given regulatory outcome and asks what regulation will produce it at the lowest cost. CEA does not ask inquire into the monetary value of benefits, and thus does not ask, from a cost-benefit perspective, if the

\textsuperscript{17} TEVFIK F. NAS, COST-BENEFIT ANALYSIS: THEORY AND APPLICATION 2 (1996).
\textsuperscript{18} Id. See also E.J. MISHAN, COST-BENEFIT ANALYSIS: AN INFORMAL INTRODUCTION xxix (4th ed. 1988).
\textsuperscript{19} See Calandrillo, supra note 11, at 996–98.
\textsuperscript{21} Pildes & Sunstein, supra note 1, at 43–45.
\textsuperscript{22} HENRY M. LEVIN, COST-EFFECTIVENESS: A PRIMER 17 (1983).
status quo or no regulation at all might be preferable to even the “best” regulatory alternative. CBA is also more flexible, as it allows regulators to consider both the relative and absolute relationships between regulatory costs and benefits. CEA, however, may be superior when benefits are hard to quantify or where political considerations demand a regulatory outcome and the only issue is how to achieve it. Nevertheless, CBA and CEA utilize many of the same analytical approaches and are often used in tandem. As we will see, CEA is often treated as a component of CBA in guidelines requiring agencies to consider alternatives to a proposed rule.

B. Critiques of Cost-Benefit Analysis

Even as its use has grown, CBA has come under withering criticism for producing incorrect or politically skewed results. Many of these criticisms reflect a general unease with consequentialist ethics, which when fused with CBA’s utilitarian bent holds that the best policy is that which produces the highest total utility. This discomfort is most commonly expressed when the economic benefits of a policy or program are weighed against costs measured in human life. The valuation of human life is common in analysis of health and environmental legislation, but the very act itself—of saying that a priceless human life is worth the finite sum of $6.1 million—is thought to devalue human dignity. Fortunately, this critique is not applicable to the cost-benefit analysis of financial regulation, which rarely, if ever, presents such matters of life.

23 Id. at 25.
24 Id. at 25–26.
25 NAS, supra note 17, at 64.
27 Frank, supra note 12, at 915. This unease reflects a difference between the ways in which experts and lay persons evaluate risks. Experts “use[] probabilistic, quantitative techniques that treat risk in aggregate terms—as the expected number of injuries, deaths, or other adverse consequences over a given time. It emphasizes the end states that policies produce, not the processes by which harms are imposed or through which policy is made.” Pildes & Sunstein, supra note 1, at 55. Lay persons, on the other hand, tend to assess risks in light of normative values, such as personal responsibility, and tend to be more concerned with low-probability catastrophic risks than those of lesser harm but greater certainty. See id. at 55–64. See also Henry S. Richardson, The Stupidity of the Cost-Benefit Standard, 29 J. LEGAL STUD. 971, 972 (decriyng the absence of “practical intelligence” in the use of CBA).
28 ACKERMAN & HEINZERLING, supra note 26, at 66–71.
and death. However, CBA is prone to several other common and occasionally interrelated critiques, each of which may be applied to financial regulation as well as that affecting health, safety, and the environment.

1. Incommensurability

One common argument against CBA is that by reducing disparate costs and benefits to dollar terms, and then weighing them against each other, practitioners of CBA are comparing apples and oranges. This problem, known as incommensurability, “occurs when the relevant goods cannot be aligned along a single metric without doing violence to our considered judgments about how these goods are best characterized.”

It is particularly acute in non-market situations, where CBA takes advantage of the human respect for money to assign values to things that cannot easily be valued or which most people do not value in monetary terms. This has the effect of putting the costs and benefits of an action on common ground, perhaps misleadingly. For example, those critics will protest “that when a power plant pollutes the air, our gains from the cheap power thus obtained simply cannot be compared with the pristine view of the Grand Canyon we sacrifice.”

Likewise, in financial regulation, critics might object that the benefits of a measure intended to protect the investing public will be weighed against the costs to those institutions whose conduct is at issue. In short, not all benefits are fungible, nor are all costs.

2. Indeterminacy

The criticism that CBA may not produce clear outcomes derives from one of the major methods used to assign values to goods not traded in the marketplace and there are no objective data to reveal individual preferences. The contingent valuation method uses survey techniques to

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31 Frank, *supra* note 12, at 914.
32 Pildes & Sunstein, *supra* note 1, at 65.
find out what individuals might be willing to pay for a benefit of regulation or how much they would be willing to accept for the loss of such a benefit. The problem arises from the endowment effect, the well-documented fact that people will assign greater values to goods they possess than to those they do not. Given a certain allocation of entitlements, a change from the status quo to a newly regulated state may produce a net benefit, and thus be worthwhile. However, given the new arrangement of entitlements, a switch back to the previous state may then, too, be worthwhile. Thus, CBA cannot be applied absent a prior decision about the distribution of entitlements, which requires a political or value judgment independent of and antecedent to any economic analysis. And where there is more than one economically efficient outcome, as under these circumstances, CBA gives no basis for choosing between results.

3. Bias

Many of the charges against CBA contend that it is inherently biased. This bias can usually takes one of two forms: bias in favor of the wealthy or bias in favor of the status quo.

The contingent valuation method is responsible for the first of these biases. As benefits are often calculated based on the beneficiaries’ willingness to pay for those benefits, and willingness to pay is based on income, CBA unjustifiably favors high-income earners. Some critics take umbrage with the principles of economic efficiency underlying CBA precisely because of its lack of concern for distributional impact. This bias will have the effect of undervaluing benefits that accrue principally to the poor.

33 NAS, supra note 17, at 110.
35 This is known as the Scitovsky paradox. See Adler & Posner, supra note 1, at 185–86.
37 Frank, supra note 12, at 916.
A related charge is that CBA is biased toward the status quo. In light of the endowment effect, respondents to surveys used in the contingent valuation method “are often willing to pay more, by several orders of magnitude, to prevent a harmful effect than to undo a harmful effect that has already occurred.” This as a result, where people lack a social entitlement—whether clean air and water or a securities market free of self-dealing—they are often not willing to pay a lot for it, and the calculated benefits are lower than the costs. Bias toward the status quo also arises from difficulties in the calculation of costs and benefits:

Opposition to cost-benefit analysis may also stem from the fact that the costs of a policy change are often far easier to quantify than its benefits, especially in the domains of environmental policy and health and safety policy. In both fields, consensus about how to measure benefits has proved especially elusive. The upshot is that policy decisions in these arenas tend to be driven primarily by cost considerations, resulting in a bias in favor of the status quo. This bias may help explain why advocates of change are overrepresented among opponents of cost-benefit analysis.

Finally, critics contend CBA is biased toward the status quo because costs are frequently overstated, thus making many regulations appear unwise. This occurs because cost estimates are often based on surveys of the entities that would bear the cost of regulation; where an industry opposes regulation, these estimates can be self-servingly high. Even when not consciously distorted, these estimates will fail to account for cost-reducing advances in technology. When a regulation imposes a cost on some party, it will seek to reduce that cost; but only when that regulation survives cost-benefit analysis will the regulated parties have an incentive to develop new, cost-reducing technologies. This would be as true for financial

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39 See supra note 34 and accompanying text.
40 Frank, supra note 12, at 918.
41 Id. at 928.
44 See Ackerman & Heinzerling, supra note 26, at 35–40.
institutions facing costly new information-gathering requirements as it has been proven to be for industries forced to adopt new pollution-control technologies.\(^{45}\)

4. Flawed Data

Another line of criticism holds that CBA is inherently a doomed enterprise because of the poor quality of the data used to create estimates of the costs and benefits. Essentially, this argument reduces to the old computer-science axiom, “Garbage in, garbage out.” Scientific uncertainty may make it impossible to provide reliable estimates of costs or benefits, and in reality much of what passes for CBA is learned guesswork.\(^{46}\) Likewise, some statistics cited as talismanic truths may have very little basis in reality. For instance, the conclusion that a human life is worth $6.1 million is widely used in cost-benefit analyses of health and safety regulations.\(^{47}\) However, as no one would actually give up his or her life for $6.1 million, findings premised on that figure is flawed.\(^{48}\) In short, the argument goes, quantitative CBA is only as good as the data available, and the available data are not very good.

A more precise concern is that while cost-benefit analysis is static—a snapshot of data at a particular time—consumer preferences and other data used in CBA are dynamic.\(^{49}\)

Considering the impact of financial regulation on competition, one economist wrote:

\(^{45}\) Id. at 38 (noting that the cost of reducing sulfur emissions under the Clean Air Act declined 90 percent from 1990 to 2000).

\(^{46}\) Pildes & Sunstein, supra note 1, at 47. See also Douglas MacLean, The Ethics of Cost-Benefit Analysis, in DEMOCRACY, SOCIAL VALUES, AND PUBLIC POLICY 107, 120–21 (Milton M. Carrow et al. eds., 1998) (criticizing the contingent valuation method).

\(^{47}\) ACKERMAN & HEINZERLING, supra note 26, at 61. The wage-risk method asks what increase in income workers require to take a job that has an increased mortality rate. Thus, if a job that had a 1-in-10,000 annual risk of death paid 30 more cents per hour than a completely risk-free job, then a worker who took the risky job would accept $600 more per year in exchange for a 1-in-10,000 chance of dying. Statistically, that is taken to imply that the worker values his life at $600 x 10,000 = $6 million. Id. at 76.

\(^{48}\) See generally id. at 61–90. Another objection to this valuation is that it assumes linearity in worker preferences. While an individual might rationally accept $600 in exchange for a 1-in-10,000 chance of dying in a given year, far fewer people would accept $3 million in exchange for a 50 percent chance of dying. See MISHAN, supra note 18, at 334 n.10.

\(^{49}\) ALFON & ANDREWS, supra note 10, at 10.
If one accepts that competition is a nonlinear process, then it is not possible to analyse by the linear technique of cost-benefit analysis the consequences of adding or removing one regulation. The “before” and “after” approach of comparative static analysis ignores what may happen along the way. A proper impact analysis would not only have to discover the future responses of buyers and sellers to their changing incentives, but also would have to take account of the interaction of the specified regulation with other regulations influencing these incentives.\(^{50}\)

Even some defenders of CBA admit that the failure to account for dynamic valuations is a problem with CBA.\(^{51}\) This is also widely regarded as a problem in environmental studies.\(^{52}\)

5. Poor Track Record

The final major critique of cost-benefit analysis is a practical one: No matter how useful it may be in theory, government agencies do a very poor job of cost-benefit analysis in practice. The research and writing in this area is most closely identified with Robert W. Hahn, the director of the AEI-Brookings Joint Center for Regulatory Studies. Hahn has concluded that agencies generally usually fail to assess fundamental economic information about proposed regulations.\(^{53}\) He has found that while agencies have customarily estimated the costs of regulations to producers, they have more often than not failed to estimate the costs to the federal government or state or local governments.\(^{54}\) They also regularly fail to quantify the expected benefits of


\(^{52}\) Kysar, *supra* note 11, at 568.


Notwithstanding his criticism of the conduct of CBA by government agencies, Hahn defends the practice and believes that “economic analysis ha[s] made important contributions to the study of social regulation.” Robert W. Hahn, *In Defense of the Economic Analysis of Regulation* 56 (2005).

\(^{54}\) Hahn & Dudley, *supra* note 53, at 10.
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regulation or compare costs and benefits.\(^{55}\) Hahn has also found that most analyses do not consider the costs and benefits of regulatory alternatives.\(^{56}\) Overall, Hahn describes agencies’ compliance with CBA requirements as “superficial.”\(^{57}\) As a result, where agencies have failed to conduct adequate CBA, they often promulgate rules whose costs greatly exceed their benefits.\(^{58}\)

C. Defenses of Cost-Benefit Analysis

Proponents of cost-benefit analysis will concede that CBA has its weaknesses, but they are not fatal. First, whatever flaws CBA has, no one has suggested a serious alternative that would better help agencies evaluate public policies.\(^{59}\) Second, as economists have refined their toolkits, the practice of CBA has also improved, yielding better and more consistent results.\(^{60}\) Third, CBA is in some sense inescapable. No one would argue that government should be arbitrary in its decision-making, yet the weighing of costs and benefits is only mere rationality cloaked in another name.\(^{61}\) Several more detailed responses to CBA’s critics are given below.

\(^{55}\) Id. at 10–12.

\(^{56}\) Id. at 12.

\(^{57}\) HAHN, REGULATORY REFORM, supra note 53, at 5.


\(^{59}\) See Calandrillo, supra note 11, at 1023–24; Posner, supra note 2, at 1158.

\(^{60}\) See Pildes & Sunstein, supra note 1, at 46 (noting that techniques like contingent valuation are “more advanced” than “first-generation CBA” and have improved the quantification of intangible benefits that critics had charged were undervalued).

\(^{61}\) See EDWARD M. GRAMLICH, BENEFIT-COST ANALYSIS OF GOVERNMENT PROGRAMS 3 (1981) (“Ultimately, it is nothing more than a logical attempt to weigh the pros and cons of a decision. And ultimately, something like it must necessarily be employed in any rational decision.”). See also Frank, supra note 12, at 914 (“Notwithstanding their public pronouncements about incommensurability, even the fiercest critics of cost-benefit analysis cannot escape such tradeoffs.”).
1. CBA Is a Decision Procedure, Not a Moral Standard

Many critics of cost-benefit analysis fail to appreciate its application in the real world. Often, they treat it as if it were a moral standard under which an agency could take regulatory action if and only if the regulation satisfies some cold-hearted, impersonal calculus. However, CBA is not a categorical imperative or mandatory rule of decision. Rather, it is a tool used by humans for making decisions, or even justifying decisions already made. The individuals who use CBA may entertain other considerations in their judgments besides costs and benefits. As a decision procedure, CBA is intended to inform those judgments, not overrule or preclude them.

2. CBA May Account for Redistributive Concerns

Wealth maximization, the economic principle underlying cost-benefit analysis, is often criticized for failing to consider the distributional impacts of regulations it would justify. In light of these principals, traditional CBA ignores the distribution impacts of regulations. For instance, wealth-maximization principles would justify a regulation that resulted in benefits of $1 million, all to wealthy individuals, and costs of $500,000, all to poor individuals.

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62 See, e.g., Richardson, supra note 27, at 973 (arguing that CBA “fail[s] to make room for practical intelligence”); id. at 978 (“[I]t would be letting the tail wag the dog to allow the possibilities of convenient data collection sharply to delimit our conception of intelligent practical reasoning.”).

63 Adler & Posner, supra note 1, at 172.

64 As noted earlier, see supra Section II.B.5, many government decisions are not justified on the cost-benefit standard. This, however, does not mean they are incorrect or illegitimate, only unsupported by the tools of economic analysis.

65 Pearce, supra note 30, at 3:

What CBA produces, and what is morally correct, may coincide if, and only if, we adopt a further rule, namely that some aggregated set of preferences of individuals is the correct way of making decisions. In some circumstances the two may well coincide. In others, government will often reserve the right to “overrule” group preferences. In still others, and these are surely the majority, governments will at least wish to know what the preferences of the individuals who make up society are. It is in this sense that CBA is an “input,” an “aid,” an “ingredient” of decision-making. It does not supplant political judgment. (emphasis in original). See also GRAHAWE WALSHE & PETER DAFFERN, MANAGING COST-BENEFIT ANALYSIS 271 (1990) (“It has been emphasised that political and other judgmental forces will also be at work, even where we are happy that the costs and benefits of all relevant options have been properly evaluated.”).

66 See Mishan, supra note 18, at 200–02. See also JAMES T. CAMPEN, BENEFIT, COST, AND BEYOND 41–42 (1986); Pearce, supra note 30, at 60–64.
However, cost-benefit methods are increasingly being tailored to reflect concerns about distributional fairness. The most common method is to weigh benefits and costs based on the marginal utility of income to different groups. For instance, in the example above, an extra dollar of income may be given a weight of 0.5 for the wealthy individuals and 1.5 to the poor individuals. In that case, the regulation would have benefits of only $500,000 and costs of $750,000 in weighted dollars, causing it to fail under cost-benefit principles. Alternatively, regulators may supplement CBA with a separate analysis of a regulation’s distributional impact.

Some economists criticize the weighting method because of a lack of social consensus over what weights would be appropriate and because the goal of CBA should be to maximize wealth, with redistribution taking place on budget through the tax and welfare systems. However, other economists favor an integrative approach for fear that a separate statement on distributive impacts would either be ignored or over-emphasized by regulators.

The executive order requiring most government agencies to conduct cost-benefit analysis for major rulemakings includes “distributive impacts” and “equity” among the factors that agencies must consider in the course of CBA. However, the order does not specify which analytical method to use. Current regulations favor separate distributional impacts. Any criticism of this approach would be best considered in light of political choices as to how CBA is conducted, not whether CBA itself is inherently biased against distributional concerns.

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67 NAS, supra note 17, at 151–55; CAMPEN, supra note 66, at 41.
68 Pildes & Sunstein, supra note 1, at 47.
69 See, e.g., Mishan, supra note 18, at 201. See also Frank, supra note 12, at 917 (“We can employ unweighted willingness-to-pay measures without apology, and use the welfare and tax system to compensate low-income families ex ante for the resulting injury.”).
70 CAMPEN, supra note 66, at 41.
71 Exec. Order No. 12,866, 58 Fed. Reg. 51735 (Oct. 4, 1993) [hereinafter E.O. 12,866]. Section 1(a) of the order includes “distributive impacts” and “equity” as two examples of net benefits that agencies should maximize in choosing among regulatory alternatives. Regulators are also instructed to consider distributive impacts and equity in choosing the most cost-effective from among available regulatory alternatives. Id. § 1(b)(5).
72 See supra Section II.E.
3. CBA Helps Cabin Agency Discretion

Over the last two years, the SEC has come under significant criticism for “overreacting” to the scandals in the mutual fund industry with “an extravaganza of rule-making.” While this Article is agnostic on the wisdom of those regulations, this controversy highlights one other important benefit of cost-benefit analysis—its ability to constrain agencies that may be prone to over-regulation. In theory, this should be of greatest use with respect to independent agencies, like the SEC, that are not subject to normal political controls.

Eric Posner has written that CBA is beneficial not because it forces regulators to consider normative principles of cost-effectiveness in the rulemaking process. Rather, he argues that its primary virtue is that it disciplines agencies and increases the control of elected officials in the executive and legislative branches. Tackling the question from the perspective of the principal-agent problem, Posner finds that CBA is a useful tool for ensuring that agencies implement the policies of the principals, whether the President or Congress. Cost-benefit analysis produces information that the principal can use to monitor the agency, and thereafter sanction the agency when it acts contrary to the principal’s wishes. Knowing this, agencies should promulgate regulations with which the political branches of the government will agree, thereby upholding the normative principle that policy ought to be made through democratic processes.

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73 *Risk at the SEC*, Editorial, WALL ST. J., May 10, 2004, at A16. See also Peter H. Stone, *Mutual Fund Morass*, NAT’L J., Nov. 15, 2003, available at www.lexis.com (quoting William McLucas, the former director of enforcement at the SEC, as saying “We have some problems in the industry that need to be addressed... but I’m not sure that the hysteria surrounding this right now is warranted.”).


75 *Id.* at 1186–89. Mark Seidenfeld makes a similar argument when he contends that agencies will promulgate rules in line with the stated preferences of the White House when they know that the rulemakings will be subject to OMB review. *See* Mark Seidenfeld, *The Psychology of Accountability and Political Review of Agency Rules*, 51 DUKE L.J. 1059, 1091 (2001).

76 Posner, *supra* note 74, at 1197.
CBA can also discipline agencies by creating information by which the public can evaluate agencies and hold them politically accountable. Adler and Posner call this “regulatory transparency.”\(^{77}\) Under this theory, an agency’s statement as to the effect of a regulation will alert interested parties, who may then criticize the agency and its cost or benefit estimates. In the absence of a clear, detailed analysis, the agency will presumably engage in an implicit balancing of a regulation’s costs and benefits, but the general public will not be able to discern the logic (or lack thereof) behind the agency’s decisions.\(^{78}\) Publicly available regulatory analyses should also reduce the influence that powerful interest groups have over regulatory agencies by reducing their informational advantage.\(^{79}\) This, in turn, should result in better regulation whose benefits are not so heavily weighted toward those interest groups.

4. CBA Corrects Regulators’ Cognitive Biases

While Posner looks to CBA to constrain agency officials in the exercise of their conscious discretion, others justify CBA as corrective to those officials’ unconscious biases. Insights from cognitive psychology and behavioral law and economics have shown that people’s beliefs regarding risk are often highly inaccurate and that regulatory responses will often depart from what would be expected under conventional decision-making processes.\(^{80}\) Cost-benefit analysis, notwithstanding any biases it might embody, may compensate by forcing regulators to confront rational objections to their decisions.

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\(^{77}\) Adler & Posner, supra note 1, at 175.

\(^{78}\) Id. at 175–76.


This theory has been best articulated by Cass Sunstein, who makes the simple observation that just as humans are prone to error, so too are governments. The result in some cases will be too much regulation, and in others too little.\textsuperscript{81} He elaborates:

My basic suggestion is that cost-benefit analysis is best defended as a means of overcoming predictable problems in individual and social cognition. Most of these problems might be collected under the general heading of selective attention. Cost-benefit analysis should be understood as a method for putting “on screen” important social facts that might otherwise escape private and public attention. Thus understood, cost-benefit analysis is a way of ensuring better priority setting and of overcoming predictable obstacles to desirable regulation, whatever may be our criteria for deciding the hardest questions about that topic.\textsuperscript{82}

According to Sunstein, people and groups suffer from several cognitive biases that cause them to misjudge risks and ignore or fail to collect relevant information.\textsuperscript{83} As a result, many people will demand regulation based on irrational premises, which interest groups seeking to create fear or reduce public concern may then exploit. Sunstein describes CBA as a useful “filter” on these demands.\textsuperscript{84} For instance, by converting non-monetary values like human lives into dollar figures, regulators need not suggest that a statistical life is worth any discrete amount of money. However, they will promote coherent decision-making and sensible regulatory priorities.\textsuperscript{85}

Stephen J. Choi and A.C. Pritchard have catalogued these cognitive biases as they affect regulators at the SEC.\textsuperscript{86} They identify seven such behaviors.\textsuperscript{87} Most importantly, the phenomena of “bounded search” tends to “blind regulators to possible alternatives to regulation,”\textsuperscript{88} and the “availability bias” causes agency staff to pay too much attention to the most recent information, rendering them prone to see a pattern—such as a corporate governance

\textsuperscript{81} Sunstein, supra note 1, at 139.
\textsuperscript{82} Sunstein, supra note 16, at 1060.
\textsuperscript{83} See id. at 1065–1072.
\textsuperscript{84} Id. at 1072.
\textsuperscript{85} Id. at 1094.
\textsuperscript{87} Id. at 20–36.
\textsuperscript{88} Id. at 21.
COST-BENEFIT ANALYSIS OF FINANCIAL REGULATION

crisis—in a series of random and unconnected events. Overconfidence is another problem. Given their expertise, “SEC regulators may be overconfident in their policy prescriptions, leading to errors and regulatory overreaching.” This hubris will lead agency officials to ignore contrary empirical data (or the absence of empirical data) regarding their regulations and attempt to extend the reach of their regulatory schemes into territory occupied by other regulators.

While Choi and Pritchard do not identify cost-benefit analysis as a corrective to these biases, CBA fits comfortably within their other proposals. They suggest that an internal review process in which agency staff members are forced to justify their decisions can ameliorate some biases. Naturally, CBA is one of the tools by which staff would justify their proposals. The authors also propose more thorough judicial review: “Regulators who anticipate review by an unknown audience will tend to take greater care in arriving at their decisions…. Being forced to consider alternatives and counterarguments is a useful antidote to overconfidence.”

Likewise, Stephanie Stern argues that notice-and-comment rulemaking encourages agency “lock-in,” a cognitive bias in which agencies become committed to and are reluctant to change the terms of proposed rulemakings. This is common where the rulemaking implicates the agency’s “self-image”—such as the SEC’s role as the guarantor of investors’ rights. She recommends “[r]eview processes that encourage counterargument” to counteract the lock-in phenomenon. Given their focus on alternative regulatory approaches, cost-benefit and cost-effective analysis certainly appear to meet this criterion.

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89 Id. at 25.
90 Id. at 28.
91 Id. at 28–29.
92 Id. at 36–37.
93 Id. at 38.
94 Id. at 38.
96 Id. at 626.
D. A Brief History of CBA in the Administrative State

The use of cost-benefit analysis as a tool for assessing government regulation dates back nearly as far as the modern administrative state. Adler and Posner identify three trends that facilitated widespread use of CBA: the growth of centralized government in the United States; the rise of Progressivism, which sought to promote good governance based on administrative expertise and scientific principles; and the invention of modern welfare economics, which provided those scientific principles. 97 The first government agency to make widespread use of CBA was the Army Corps of Engineers, and the first legislation to command that projects be undertaken on the cost-benefit standard was directed toward the Corps. 98 With the maturation of the administrative state in the 1950s and 1960s, CBA came to enjoy wider popularity. It became standard practice for water resource planners, gaining wider adherence with the Defense Department’s adoption of the Planning, Programming, and Budgeting System in the 1960s. 99 It also made political sense: “Applied economists and agency officials believed that, whatever its problems, CBA was superior to the alternatives. When the government proposed a project, taxpayers and critics demanded a justification, and the most obvious justification was that the project would produce gains that exceeded its costs.” 100 However, CBA’s popularity waned in the 1970s due to both practical and ideological objections. On the one hand, faced with a number of new statutes and agencies directed toward the protection of health, safety, and the environment, government economists had a hard time collecting useful data or valuing goods like human life or environmental resources. On the other hand, the utilitarian nature of CBA fell

97 Adler & Posner, supra note 1, at 169.
99 NAS, supra note 17, at 4.
100 Adler & Posner, supra note 1, at 170.
out of favor during an era of increasing political populism.\textsuperscript{101} This was particularly true with respect to the burgeoning environmental movement. Then as now, many activists thought natural resources should not be valued in base economic terms and that the government should protect the human health and the environment without regard to cost.\textsuperscript{102}

1. Congressional Action

Like the Army Corps of Engineers, many government agencies first performed some version of cost-benefit analysis at the behest of Congress. Johnston places these cost-benefit statutes in two categories: substantive and procedural. Substantive cost-benefit statutes require agencies to “balance the costs and benefits of alternative standards for reducing environmental or health risks, and to set the standard at a ‘reasonable’ level.”\textsuperscript{103} Procedural cost-benefit statutes, on the other hand, instruct agencies to strike a cost-benefit balance without saying how they should do so. Regulators usually satisfy these statutes by preparing impact statements evidencing a “good faith” attempt to balance the costs and benefits of a federal program.\textsuperscript{104} Congress utilized statutes of both varieties in the major health, safety, and environmental legislation of the 1960s and 1970s. In at least one noteworthy case, a court has struck down a rulemaking where the agency’s required cost-benefit analysis was found to be inadequate.\textsuperscript{105}

On the other hand, several statutes have been held to prohibit or limit the use of CBA in agency rulemaking. Instead, these statutes generally require the agency to promulgate rules in

\textsuperscript{101} \textit{Id.} at 170–71.
\textsuperscript{102} \textit{PEARCE, supra} note 30, at 18–19.
\textsuperscript{105} Corrosion Proof Fittings v. Environmental Protection Agency, 947 F.2d 1201 (5th Cir. 1991) (vacating EPA’s asbestos ban under the Toxic Substances Control Act).
the public interest without regard to costs or economic consequences. In 1981, the Supreme Court held that the Occupational Health and Safety Act does not allow OSHA to use CBA in setting health standards.106 Likewise, the Court has held that the EPA is precluded from considering costs in promulgating national ambient air quality standards pursuant to the Clean Air Act.107 At the same time, the D.C. Circuit has held that even where statutes do not require CBA, agencies may still use it.108 An agency that conducts CBA even when it is not required may be better able to set priorities, evaluate existing regulations, design alternative regulatory strategies, and persuade Congress and the public of the desirability of a particular regulation.109

Alarmed by reports of the costs of government regulation, Congress showed a renewed interest in “procedural” cost-benefit analysis after the Republican Party took both houses in the 1994 elections.110 The Unfunded Mandates Reform Act (“UMRA”),111 one of the first acts of the 104th Congress, ushered in much greater congressional oversight of the regulatory review process. UMRA requires each agency to prepare a “written statement” containing, *inter alia*, “a qualitative and quantitative assessment of the anticipated costs and benefits of the Federal mandate” for each notice of proposed rulemaking or final rule likely to result in public or private

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107 Whitman v. American Trucking Ass’ns, 531 U.S. 457, 471 (2001) (“The text of § 109(b), interpreted in its statutory and historical context and with appreciation for its importance to the CAA as a whole, unambiguously bars cost considerations from the NAAQS-setting process, and thus ends the matter for us as well as the EPA.”).
108 Michigan v. Environmental Protection Agency, 213 F.3d 663, 678 (D.C. Cir. 2000) (“It is only where there is ‘clear congressional intent to preclude consideration of cost’ that we find agencies barred from considering costs.”) (citations omitted). While the Supreme Court has never specifically addressed the issue, Justice Breyer has written: In order to better achieve regulatory goals,... regulators must often take account of all of a proposed regulation’s adverse effects, at least where those effects clearly threaten serious and disproportionate public harm. Hence, I believe that, other things being equal, we should read silences or ambiguities in the language of regulatory statutes as permitting, not forbidding, this type of rational regulation. *American Trucking Ass’ns*, 531 U.S. at 490 (Breyer, J., concurring in part and concurring in the judgment).
109 McGarity, supra note 1, at 162–63. *But see American Trucking Ass’ns*, 531 U.S. at 471 n.4 (suggesting, in dictum, that if it could be proved that an agency “secretly consider[ed] the costs of attainment without telling anyone,” it would be grounds for the Court to vacate the rulemaking at issue).
sector expenditures of $100 million or more in a single year.\textsuperscript{112} For those same rules, UMRA also requires agencies to “identify and consider a reasonable number of regulatory alternatives” and choose from among them “the least costly, most cost-effective or least burdensome alternative that achieves the objectives of the rule.”\textsuperscript{113} While nothing in the statutory text appears to demand such a result, independent agencies are exempt from UMRA.\textsuperscript{114}

A year later, the Contract with America Advancement Act\textsuperscript{115} broadened Congress’ role in the regulatory process. One subtitle of the Act, known as the Congressional Review Act,\textsuperscript{116} imposed additional reporting requirements and instituted a “wait and see” version of the legislative veto. Before any rule promulgated by a federal agency can take effect, the agency must submit to the Comptroller General and make available to Congress a full copy of any cost-benefit analysis it prepared, along with reports prepared pursuant to the Regulatory Flexibility Act\textsuperscript{117} and the Unfunded Mandates Reform Act.\textsuperscript{118} The Comptroller General, in turn, must submit a report on each major rule to the appropriate committees in the House and the Senate within 15 days; the report must include an assessment of the agency’s compliance with the above-mentioned reporting requirement.\textsuperscript{119} Congress may then prevent a rule from taking effect through a joint resolution of disapproval.\textsuperscript{120} Unlike UMRA, this legislation applies to the independent regulatory agencies, including the SEC; only the Federal Reserve Board’s rules

\textsuperscript{113} 2 U.S.C. § 1535(a) (2000).
concerning monetary policy are exempt from oversight. Since the beginning of 2000, the Government Accountability Office (“GAO”) has issued seventeen reports on SEC rulemakings to the relevant congressional committees.

In recent years, Congress has passed other legislation intended to promote the use of CBA in regulatory analysis. The Truth in Regulating Act, for instance, created a three-year pilot program under which the GAO, when requested by Congress, would independently evaluate an agency’s analysis of the costs, benefits, and alternatives to a proposed regulation. However, Congress has also failed in several instances to pass significant regulatory legislation requiring expanded use of CBA across the regulatory spectrum. The Comprehensive Regulatory Reform Act of 1995 would have created a “supermandate” that all new major federal regulations be justified by CBA. The bill also would have authorized individuals to petition government agencies or the President to conduct a cost-benefit analysis of any rulemaking to which they were subject; denials of petition would also be subject to judicial review. With slight variations, other proposed legislation would have imposed similar obligations on government agencies to analyze the costs and benefits of major rulemakings.

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124 Id. § 4(a)(3).
125 See S. 343, 104th Cong., 1st sess. (Feb. 2). The legislation applied to “major” rules, defined in the bill as those rules that “the agency proposing the rule or the President reasonably determines is likely to have a gross annual effect on the economy of $50,000,000 or more in reasonably quantifiable increased direct and indirect costs, or has a significant impact on a sector of the economy.” Id. § 621(4)(A)(i). The term “supermandate” belongs to Cass Sunstein, Congress, Constitutional Moments, and the Cost-Benefit State, 48 Stan. L. Rev. 247, 270 (1996).
126 Comprehensive Regulatory Reform Act, supra note 125, § 625.
2. Presidential Action

With all due respect to Congress, CBA only emerged as the dominant analytical tool of the modern administrative state because of a series of executive orders dating back to 1981. Early in his administration, President Ronald Reagan issued Executive Order 12,291, which required agencies to consider costs and benefits in their rulemakings and choose the regulatory approach that imposed the least cost on society.\textsuperscript{128} Reagan supplemented this order with Executive Order 12,498, which required agencies to submit draft regulatory agendas—consisting of the agency’s policies, goals, and planned rulemakings—once a year to the Office of Management and Budget (“OMB”), part of the Executive Office of the President.\textsuperscript{129} Both orders were superseded by President Bill Clinton in Executive Order 12,866, which remains in force and guides the regulatory planning process to this day.\textsuperscript{130} The Clinton order observes that “[t]he American people deserve a regulatory system that... protects and improves their health, safety, environment, and well-being and improves the performance of the economy without imposing unacceptable or unreasonable costs on society.”\textsuperscript{131} Among twelve overarching principles of regulation, the order obliges government agencies to abide by cost-benefit principles: “Each agency shall assess both the costs and the benefits of the intended regulation and, recognizing that some costs and benefits are difficult to quantify, propose or adopt a regulation only upon a reasoned determination that the benefits of the intended regulation justify its costs.”\textsuperscript{132} It also requires agencies to choose the most cost-effective of competing regulatory alternatives.\textsuperscript{133}

\textsuperscript{130} E.O. 12,866, \textit{supra} note 71. President George W. Bush amended the Clinton executive order to remove any official role for the Vice President in the regulatory review process, Exec. Order No. 13,258, 67 Fed. Reg. 9385 (Feb. 28, 2002). Otherwise, Executive Order 12,866 remains in force and will be referred to throughout the remainder of this Article.
\textsuperscript{131} E.O. 12,866, \textit{supra} note 71, pmbl.
\textsuperscript{132} \textit{Id.} § 1(b)(6).
\textsuperscript{133} \textit{Id.} § 1(b)(5).
Cost-Benefit Analysis of Financial Regulation

Executive Order 12,866 imposes several obligations on government agencies with respect to cost-benefit analysis. For each “significant regulatory action,” the agency must provide OMB’s Office of Information and Regulatory Affairs (“OIRA”) with an assessment of the potential costs and benefits of the proposal. When a significant regulatory action is likely to have an economic impact of $100 million or more, the agency must provide assessments of the costs and benefits anticipated from the regulation, including the underlying analysis. The benefits to be considered include “the promotion of the efficient functioning of the economy and private markets, the enhancement of health and safety, the protection of the natural environment, and the elimination or reduction of discrimination or bias.” The costs include “the direct cost both to the government in administering the regulation and to businesses and others in complying with the regulation, and any adverse effects on the efficient functioning of the economy, private markets (including productivity, employment, and competitiveness), health, safety, and the natural environment.” To the extent possible, costs and benefits should be quantified. The agency also must provide an assessment of the costs and benefits of alternatives to the proposed regulation, including non-regulatory alternatives, along with an explanation “why the planned

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134 The order defines “significant regulatory action” as “any regulatory action that is likely to result in a rule that
may:

(1) Have an annual effect on the economy of $100 million or more or adversely affect in a material way the economy, a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or State, local, or tribal governments or communities;

(2) Create a serious inconsistency or otherwise interfere with an action taken or planned by another agency;

(3) Materially alter the budgetary impact of entitlements, grants, user fees, or loan programs or the rights and obligations of recipients thereof; or

(4) Raise novel legal or policy issues arising out of legal mandates, the President’s priorities, or the principles set forth in this Executive order.

Id. § 3(f).
135 Id. § 6(a)(3)(B)(ii).
136 Id. § 6(a)(3)(C)(i).
137 Id. § 6(a)(3)(C)(ii).
138 Id. § 6(a)(3)(C)(i)–(ii).
regulatory action is preferable to the identified potential alternatives."

Once a proposed regulation is published in the Federal Register, the agency must make those materials available to the public. The agency may not, however, publish the proposed regulation until it and its accompanying analyses have been reviewed by OIRA, unless OIRA first waives review or fails to notify the agency of the need for review within a specified period of time. The last two decades have seen significant debate over the wisdom and propriety of these procedures.

Independent regulatory agencies are exempt from the major provisions of both the Reagan and Clinton executive orders. The current executive order defines “agency,” as used in the order, to exclude those agencies included in the definition of “independent regulatory agency” found in the Paperwork Reduction Act of 1980. Among the agencies excluded from OMB oversight were many of the nation’s financial regulators: the Board of Governors of the Federal Reserve Board, the CFTC, the FDIC, the FTC, and the SEC. The history surrounding this exemption is unclear. Some authority holds that President Reagan thought that he could not

139 Id. § 6(a)(3)(C)(iii).
140 Id. § 6(a)(3)(E)(i).
141 Id. §§ 6(b), 8.
143 E.O. 12,291, supra note 128, § 1(d); E.O. 12,866, supra note 71, § 3(b).

[T]he term “independent regulatory agency” means the Board of Governors of the Federal Reserve System, the Commodity Futures Trading Commission, the Consumer Product Safety Commission, the Federal Communications Commission, the Federal Deposit Insurance Corporation, the Federal Energy Regulatory Commission, the Federal Housing Finance Board, the Federal Maritime Commission, the Federal Trade Commission, the Interstate Commerce Commission, the Mine Enforcement Safety and Health Review Commission, the National Labor Relations Board, the Nuclear Regulatory Commission, the Occupational Safety and Health Review Commission, the Postal Rate Commission, the Securities and Exchange Commission, and any other similar agency designated by statute as a Federal independent regulatory agency or commission.

compel these agencies to comply with the order in light of their formally independent status.\footnote{BARRY D. FRIEDMAN, \textit{REGULATION IN THE REAGAN-BUSH ERA: THE ERUPTION OF PRESIDENTIAL INFLUENCE} 78 (1995).} (In fact, the White House had received a memorandum from the Office of Legal Counsel in the Justice Department concluding that the executive order could be legally applied to the independent agencies.\footnote{See Memorandum for the Honorable David Stockman, Director, Office of Management and Budget, from Larry L. Simms, Acting Assistant Attorney General, Office of Legal Counsel (Feb. 12, 1981), \textit{reprinted in part in} PETER M. SHANE & HAROLD H. BRUFF, \textit{THE LAW OF PRESIDENTIAL POWER: CASES AND MATERIALS} 355–58 (1988) [hereinafter OLC Memo].} Other sources argue that this was primarily a political decision intended to prevent a hostile reaction from Congress.\footnote{See Pildes & Sunstein, supra note 1, at 15; Peter L. Strauss, \textit{The Place of Agencies in Government: Separation of Powers and the Fourth Branch}, 84 COLUM. L. REV. 573, 592–93 (1984).} In any event, in March 1981, Vice President George H.W. Bush sent a letter to the independent agencies asking them to comply with the sections of the order regarding principles of cost-benefit analysis and the preparation of regulatory impact analyses.\footnote{Strauss, supra note 147, at 593 n.78. \textit{See also} FRIEDMAN, supra note 145, at 78 (citing \textit{Hearing on Role of OMB in Regulation Before House Comm. on Energy and Commerce, Subcomm. on Oversight and Investigations}, 97th Cong., 1st sess. 101 (June 18, 1981)).} Seven agencies, including the SEC, agreed to do so.\footnote{See FRIEDMAN, supra note 145, at 78; Strauss, supra note 147, at 593 n.78. \textit{But see} Pildes & Sunstein, supra note 1, at 15 (“The independent agencies were asked voluntarily to comply with Executive Order 12291, but not one of them formally acknowledged their willingness to do so.”).} However, their commitment and cooperation were short-lived,\footnote{See FRIEDMAN, supra note 145, at 78.} and OMB has never exercised the authority to review rules promulgated by the independent agencies.

Specifically, the independent agencies do not have to produce the assessments of the costs and benefits of and the possible alternatives to each proposed regulation. Consequently, OMB does not have the power to delay, review, or prevent promulgation of rulemakings by these agencies. However, Executive Order 12,866 contains two sections that explicitly cover the independent agencies otherwise exempt from the order and, at the very least, serve to keep OMB apprised of these agencies’ activities. Under the order, each independent agency must prepare a regulatory agenda for the OIRA administrator listing all regulations under development or
Twice a year, each agency is also required to submit a regulatory plan listing the most important “significant regulatory actions that the agency reasonably expects to issue in proposed or final form in that fiscal year or thereafter.” The purpose of these requirements is to allow the White House to identify whether any agency’s plans conflict with the President’s priorities or policies or actions of another agency, and thereafter to resolve any differences. Among other things, this regulatory plan must include “[a] summary of each planned significant regulatory action including, to the extent possible, alternatives to be considered and preliminary estimates of the anticipated costs and benefits.” However, a review of the SEC’s most recent submissions to OIRA indicates that the agency does not report separately on the costs and benefits of these regulations under consideration. Instead, these reports refer OIRA to the analyses published in the Federal Register, which will be the subject of Part IV of this Article.

E. Economic Analysis Under Executive Order 12,866

OMB has prescribed guidelines for agencies to follow in performing regulatory analysis under Executive Order 12,866. (Given the similarities between the requirements imposed by the order and the Congressional Review Act, the same methodologies are employed for both executive and congressional review of agency rulemakings.) The most recent guidelines, found in OMB’s Circular A-4, were issued in 2003 after a period of public comment and peer review. They replace but draw substantially from guidelines issued during the Clinton

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151 E.O. 12,866, supra note 71, at § 4(b).
152 Id. § 4(c)(1).
153 Id. §§ 4(c)(4)–(5).
154 Id. § 7.
155 Id. § 4(c)(1)(B).
administration. Circular A-4 never speaks directly to financial regulation, as it does to health, safety, and environmental regulation, but many of its instructions are of general applicability.

The guidelines explain that it is important that federal agencies engage in regulatory analysis in order to ascertain whether the benefits of regulation justify the costs, help agencies decide which of various regulatory alternatives would be most cost-effective, inform the public of the effects of government regulation, and demonstrate when a proposal may be ill-advised. A good regulatory analysis should have three components: a “statement of the need for the proposed action,” “an examination of alternative approaches,” and “an evaluation of the benefits and costs—quantitative and qualitative—of the proposed action and the main alternatives identified by the analysis.” The evaluation of costs and benefits should demonstrate how the proposed action would yield the expected benefits, identify the baseline against which the benefits and costs will be measured, and point out any expected side effects. The circular explains that both CBA and CEA should be used to support any major rulemaking.

The OMB guidelines embody a set of presumptions about the regulatory process and regulatory review. Chief among them is that regulation should not be the rule, but the exception to the rule, and that agencies should exercise their discretion to regulate only where there is a “compelling need” to do so. A corollary to this presumption is that regulations creating

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159 Circular A-4, supra note 157, at 1–2.
160 Id. at 2.
161 Id. at 2–3.
162 Id. at 9.
163 Id. at 3–4 (quoting E.O. 12,866, supra note 71, at § 1). See also id. at 6 (“Government action can be unintentionally harmful, and even useful regulations can impede market efficiency. For this reason, there is a presumption against certain types of regulatory action.”).
incentives for behavior are preferred to those prescribing what individuals should do.\textsuperscript{164} Second, government regulations should “do more good than harm”—that is, they should produce net benefits for society.\textsuperscript{165} Third, and perhaps most importantly for the purpose of this Article, agencies can best show that their regulations will do more good than harm by presenting the expected costs and benefits of those regulations in numerical form.\textsuperscript{166} Thus, quantitative data are preferred to qualitative data, and quantitative data expressed in monetary terms are preferred to quantitative data expressed in other units of measurement. Fourth, this quantitative analysis should be transparent to the public; to that end, the agencies should disclose the sources of the data used in their analyses and describe all of the assumptions built into their models.\textsuperscript{167} Finally, to ensure they address all relevant issues and have all necessary data, agencies should consult with interested members of the public at the earliest stages of the analytical process.\textsuperscript{168}

Most of Circular A-4 concerns the means by which agencies should produce their regulatory analyses. The process begins with a baseline, which is “the best assessment of the way the world would look absent the proposed regulation.”\textsuperscript{169} To create a baseline for the analysis of a particular regulation, an agency should consider a number of factors, including changes in the market, external factors affecting costs and benefits, the effects of other regulations promulgated by the agency or other agencies, and the extent to which those regulations are complied with; where more than one baseline is reasonable, the agency should

\textsuperscript{164} Id. at 15.
\textsuperscript{165} Id. at 4.
\textsuperscript{166} Id. at 3 (“[Y]ou should be able to assess quantitatively the benefits and costs of the proposed rule and its alternatives.”); id. at 26 (“Sounds quantitative estimates of benefits and costs, where feasible, are preferable to qualitative descriptions of benefits and costs because they help decision makers understand the magnitudes of the effects of alternative actions.”).
\textsuperscript{167} Id. at 17.
\textsuperscript{168} Id. at 3.
\textsuperscript{169} Id. at 15.
evaluate costs and benefits with respect to those alternative baselines.\textsuperscript{170} Next, the agency should identify the available regulatory alternatives. For instance, where the agency is considering a rule requiring certain behavior of regulatory parties to correct a market failure, it should look into whether the problem could be fixed by greater information disclosure or through a market-oriented solution; likewise, the agency should consider the effects of different compliance dates, enforcement methods, and degrees of stringency.\textsuperscript{171} While an agency has discretion to choose which alternatives it will consider, it should consider all reasonably appropriate alternatives to the contemplated regulatory action.\textsuperscript{172} The agency should choose the alternative that produces the greatest net benefits, not the one that has the best ratio of benefits to costs.\textsuperscript{173}

The OMB circular states that the proper measure for valuing both costs and benefits is opportunity cost, as measured by individuals’ willingness to pay (“WTP”) for a particular benefit.\textsuperscript{174} These data are easily expressed in dollar terms. The best basis for determining WTP is market prices for the goods and services affected by the regulation. Failing that, regulator should look to “revealed preferences” derived from market data.\textsuperscript{175} For goods and services not easily valued in market transactions, OMB recommends “stated preference methods” relying on survey data, including the contingent valuation method.\textsuperscript{176} Other important measures of a regulatory action’s costs and benefits include private sector compliance costs (or savings), government administrative costs (or savings), gains or losses in consumer’ or producers’ surplus, discomfort or inconvenience, and expenditures of time.\textsuperscript{177}

\textsuperscript{170} Id.
\textsuperscript{171} Id. at 7–9.
\textsuperscript{172} Id. at 16.
\textsuperscript{173} Id. at 10.
\textsuperscript{174} Id. at 18. In some situations, “willingness to accept”—what individuals would accept as compensation for not receiving a particular benefit—might also be a valid measure for opportunity cost. Id.
\textsuperscript{175} Id. at 20–22.
\textsuperscript{176} Id. at 22–24.
\textsuperscript{177} Id. at 37.
Where costs and benefits cannot be quantified, the agency must conduct a rigorous analysis of these “intangible” costs and benefits.\textsuperscript{178} For benefits and costs that can be quantified but not monetized, the agency should explain why monetization is not possible and express its data in quantitative form. For estimates that cannot be quantified, much less monetized, the analysis should present any relevant quantitative data; describe all of the non-quantified costs and benefits, listed in order of importance; discuss the strengths and limitations of the qualitative information; explain why the costs and benefits could not be quantified; and describe the connection between the qualitative costs and benefits and the agency’s policy choice.\textsuperscript{179} The guidelines contemplate that there will be instances where non-quantified costs and benefits are so crucial to the decision that no meaningful comparison can be made between the quantified costs and benefits. In those circumstances, the agency should carry out a “threshold” analysis to determine how small the value of non-quantified benefits (or how large the value of non-quantified costs) could be to yield zero net benefits.\textsuperscript{180}

The OMB guidelines warn agencies to be careful to distinguish transfer payments from costs or benefits, as one party’s loss is offset by the other’s gain.\textsuperscript{181} Nevertheless, agencies should still consider the distributional effects of their policies. (This was one of the major differences between Executive Order 12,291 and Executive Order 12,866.) However, rather than weight costs or benefits based on the economic status of the groups or individuals affected in the main body of their cost-benefit analyses, agencies should provide a separate discussion of distributional effects. This analysis should be quantitative to the extent possible.\textsuperscript{182}

\textsuperscript{178} Id. at 27.
\textsuperscript{179} Id.
\textsuperscript{180} Id. at 2.
\textsuperscript{181} Id. at 38.
\textsuperscript{182} Id. at 14.
Regulatory analysis should also be sensitive to the fact that many estimates of costs and benefits are uncertain. Such predictions are often speculative, and agencies should take care to consider different future scenarios. The OMB guidelines expect that agencies will produce quantitative and qualitative analysis of this uncertainty and explain in those terms how costs and benefits would compare with the baseline under different circumstances. Furthermore, when the uncertainty results from a lack of data, agencies should consider deferring regulatory decisions pending further study to acquire that data.

OMB puts a strong emphasis on ensuring that the regulatory analysis is robust and rigorous and open to public scrutiny. It writes:

> Because of its influential nature and its special role in the rulemaking process, it is appropriate to set minimum quality standards for regulatory analysis. You should provide documentation that the analysis is based on the best reasonably obtainable scientific, technical, and economic information available. To achieve this, you should rely on peer-reviewed literature, where available, and provide the source for all original information.

> A good analysis should be transparent and your results must be reproducible. You should clearly set out the basic assumptions, methods, and data underlying the analysis and discuss the uncertainties associated with the estimates. A qualified third party reading the analysis should be able to understand the basic elements of your analysis and the way in which you developed your estimates.

> To provide greater access to your analysis, you should generally post it, with all the supporting documents, on the internet so the public can review the findings. You should also disclose the use of outside consultants, their qualifications, and history of contracts and employment with the agency.

Finally, OMB guidelines describe how the results of a regulatory analysis should be presented. The analysis should include a schedule of the monetized costs and benefits, a list of the benefits and costs that can be quantified but not monetized, a description of the costs and benefits that cannot be quantified, and references to the data or studies on which any estimates are based.
The specific guidelines contained in Circular A-4 did not go into effect until Jan. 1, 2004, for proposed rules received by OMB, and Jan. 1, 2005, for final rules. However, the document draws heavily from previous guidelines, which embodied similar presumptions in favor of quantification of data, consideration of regulatory alternatives, transparency, and disclosure. By and large these guidelines present an ideal case of what CBA should look like in the administrative state—and ideal, of course, more honored in the breach than in the observance.  

III. COST-BENEFIT ANALYSIS OF FINANCIAL REGULATION

This section looks at the practice of cost-benefit analysis by two national financial regulators: the U.S. Securities and Exchange Commission and the U.K. Financial Services Authority. Specific instances of CBA by the SEC will be considered later in Section IV.C.

A. SEC Practice

The SEC has no official program for cost-benefit analysis, but it does conduct CBA on several levels. However, none of its practices demonstrate the analytical rigor contemplated by Executive Order 12,866 or the policy guidelines regarding its implementation. The first level of analysis is the informal—or at least non-public—consideration of costs and benefits by SEC staff members in the course of crafting regulations. This stage of analysis leaves no visible evidence, and it is impossible to discern what level of inquiry is undertaken.

The second level consists of reports submitted to the Comptroller General pursuant to the Congressional Review Act. The Act requires each agency, including independent agencies like the SEC, to submit to the GAO a report containing, among other things, its cost-benefit analysis of each proposed rule. In turn, the Comptroller General must submit a report to

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187 See supra Section II.B.5.
188 See supra Section II.D.1.
Congress for each major rulemaking assessing the agency’s compliance with the reporting requirement. Since the beginning of 2000, the Comptroller General has submitted eighteen reports to Congress regarding SEC rulemakings. These reports, however, provide little useful information on the agency’s conduct of cost-benefit analysis. All of these reports consist of a pro forma cover letter from an SEC attorney to the chairmen and ranking members of the relevant House and Senate committees indicating, among other things, that the SEC complied with its statutory obligations. That letter is followed by a short analysis, no longer than two pages, of the rulemaking. The first part of this analysis concerns the agency’s CBA, but it is invariably brief and perfunctory. In most cases, the analysis states, without explanation or support, the monetary value of certain costs. However, it often ignores the existence of benefits or dismisses them as hard to quantify. In at least one case where the costs and benefits reported to Congress were quantified, the costs actually exceeded the benefits.

The SEC’s most public demonstrations of regulatory cost-benefit analysis are found in the Federal Register notices of proposed and final rulemakings. Three of these rulemakings will be discussed in greater depth in Section IV.C. The Federal Register notices generally begin with an introduction, background materials on the issues relevant to the rulemaking, and a discussion of the new rules. In order, the notice then includes a statement of the regulation’s information-collection requirements pursuant to the Paperwork Reduction Act; a cost-benefit analysis; a

discussion of the regulation’s impacts on competition, efficiency, and capital formation as required by the Securities Exchange Act; a regulatory flexibility analysis addressing the rule’s effects on “small entities,” as required by the Regulatory Flexibility Act of 1980; and a statement of the statutory authority under which the Commission is promulgating the rule. For the purposes of this Article and the later discussion of the SEC’s attempts to regulate the mutual fund industry, the most important of these sections is the cost-benefit analysis. However, as will be shown, these analyses tend to be rather short and qualitative, lacking the depth and analytical rigor required of other agencies pursuant to Executive Order 12,866 and Circular A-4. The Paperwork Reduction Act analysis is also sometimes relevant, as in cases where the agency estimates the compliance costs of new information-collection requirements.\footnote{\textit{\textsuperscript{192}}}

The last way in which the SEC discloses the costs and benefits of its rulemakings is through ad hoc ex post analyses. Reports of this type, however, are written by economists on the Commission’s staff in their private capacity and typically include a disclaimer noting that they do not reflect the opinion of the SEC.\footnote{\textit{\textsuperscript{193}}} It is more common for papers of this sort to be produced outside the Commission than from the inside.\footnote{\textit{\textsuperscript{194}}}

\textbf{B. FSA Practice}

The SEC’s experience may be contrasted with the more formal requirements for cost-benefit analysis existing at its British counterpart, the FSA. While the Chancellor of the Exchequer created the FSA (originally the Securities and Investment Board) in 1997, it was

\footnote{\textit{\textsuperscript{192}} See, \textit{e.g.}, \textit{infra} notes 321–328 and accompanying text.}
\footnote{\textit{\textsuperscript{193}} See, \textit{e.g.}, LORI WALSH, \textbf{THE COSTS AND BENEFITS TO FUND SHAREHOLDERS OF 12B-1 PLANS: AN EXAMINATION OF FUND FLOWS, EXPENSES AND RETURNS}, available at www.sec.gov/rules/proposed/s70904/lfwals042604.pdf.}
rapidly enlarged with the passage of the Financial Services and Markets Act of 2000 (“FSMA”). The FSMA, which went into effect in December 2001, transferred the responsibilities of several other agencies to the FSA, giving it control over most aspects of financial regulation. Unlike the SEC, the FSA is an independent, non-governmental body financed by the financial services industry, though the government appoints board members. Also unlike the SEC, the FSA is required to evaluate the costs and benefits of its regulations. Naturally, given the complexities of CBA, the FSA has had some difficulties implementing its statutory mandate, but its experience over the last few years has hinted at the potential for CBA in the realm of financial regulation.

1. Statutory Requirements

The FSMA imposes on the FSA a broad obligation to conduct a cost-benefit analysis for each rule. In its rulemaking function, the FSA is required to consider the principle that “a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction.”¹⁹⁵ To that end, the Act requires the FSA to publish a draft of every proposed rule, which must be accompanied by a cost-benefit analysis.¹⁹⁶ The Act differs from Executive Order 12,866 and its other American counterparts in not requiring monetization of both costs and benefits. Instead, it requires “an estimate of the costs together with an analysis of the benefits” for all proposed rules and those final rules that differ significantly from the initial proposals.¹⁹⁷

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¹⁹⁵ Financial Services and Markets Act of 2000, c. 8, § 2(3)(c) (Eng.) [hereinafter FSMA]. The FSA considers this idea of “proportionality” as one of its “principles of good regulation.” See Financial Service Authority, Principles of Good Regulation, at http://www.fsa.gov.uk/Pages/About/Aims/Principles/index.shtml (“In making judgements in this area, we take into account the costs to firms and consumers. One of the main techniques we use is cost benefit analysis of proposed regulatory requirements.”).

¹⁹⁶ FSMA, supra note 195, § 155(1)-(2).

¹⁹⁷ Id. § 155(10).
2. Methodology

Just as OMB issued rules by which U.S. agencies should evaluate the costs and benefits of federal regulations, the FSA has created a set of guidelines for its staff on how to perform cost-benefit analysis. In keeping with the FMSA, the guidelines put an emphasis on ex ante CBA rather than ex post analysis. The FSA’s recommendations are also intended to integrate CBA into the policy-making process, rather than have regulators merely conduct an analysis to justify an already settled-upon course of conduct. To that end, the FSA guidelines prescribe a four-stage process of regulatory analysis.

In the first stage, regulators “set the stage” for the CBA by deciding which policy options they will consider. To do so, they must specify their policy goals and consider how the broader policy context might impose external constraints. For example, the agency may want to increase investor protection, but might not be able to do so in a manner that increases compliance costs on small businesses. Having done so, the regulators should create a list of “must satisfy” constraints and reject policy options that do not meet those requirements; other constraints can be treated as “factors to consider” and integrated into the CBA.

In the second stage, regulators must decide on the scope and depth of the analysis they will undertake. Beginning with this stage, regulators must consider the importance of the policy goal under review in order to best use the FSA’s limited resources. As a general rule, the FSA should conduct a broader analysis for more important rules. However, staff members are encouraged “to err on the side of caution, to ensure the adequacy of the policy making

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199 See id. at 6 n.1, 7–8.
200 Id. at 10.
201 Id. at 11.
202 Id. at 9.
process.\footnote{Id. at 12.} With respect to the depth of analysis required, the FSA advises that the primary goal of CBA is to choose among regulatory options (including doing nothing), not to consider policies individually and in the abstract. “Consequently, one should generally evaluate the options included in the analysis to the point needed to establish the relative magnitude of their net benefits or the qualitative trade-offs involved rather than to the point of being able to estimate precisely and accurately the net benefits produced by each one.”\footnote{Id.} At this stage, regulators should also recognize that they will have to present their findings to the public in a manner consistent with the requirements of the FSMA.\footnote{Id. at 12–13.}

Stage 3 is the heart of the process where regulators assess the costs and benefits of the regulatory alternatives under consideration. While the FSMA appears to require quantification of costs but not of benefits, the FSA recommends quantifying both columns. The purpose of this is to determine whether any particular regulation yields net benefits and to rank the alternatives on that basis.\footnote{Id. at 13.} While the guidelines expect that the analysis will be “as specific and concrete as possible,” they also recognize that CBA is plagued with uncertainty and that where necessary, regulators should offer upper and/or lower bounds on their estimates of costs and benefits.\footnote{Id. at 18–19.}

The FSA is more specific than OMB in advising regulators with respect to what they should measure in doing a cost-benefit analysis. Though particular regulations may demand further analysis, the FSA recommends that regulators focus on six “impact categories”:

1. Direct costs: These are the costs to the public authorities of designing, monitoring, and enforcing regulations. These costs, which include personnel and information technology, should be easy to measure given that they are incurred by regulatory bodies, not market
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actors. Direct costs should be low for most new regulations, but may be considerable when a regulator extends its authority into a new area or regulation.208

2. Compliance costs: The costs to regulated parties will usually be much greater than those to the regulator. While it is relatively straightforward to measure those parties’ expenditures in the market, it is harder to measure the costs incurred through an internal re-allocation of resources. Generally, the revealed preference method or a measure of valuing opportunity cost will provide useful estimates for CBA purposes.209

3. Quantity of goods sold: Where regulations increase the costs of doing business, production will decrease and/or costs will increase. Over a large number of market transactions, this will usually have a measurable and quantifiable effect on overall consumer surplus, the difference between what consumers are willing to pay for a good and its retail cost. Likewise, a regulation that increases production or reduces costs will increase consumer surplus.210

4. Quality of goods offered: Where regulations lead to improvements in the quality of goods offered, regulators can arrive at a rough estimate of the benefit through the contingent valuation method. Where regulations lead consumers to purchase more suitable products—for instance, increase disclosure by financial intermediaries may direct consumers to purchase those products best meeting their financial objectives—consumer surplus will again increase. However, quantitative estimates for this category may prove elusive, requiring qualitative assessments.211

5. Variety of products offered: An increase in consumer choices is presumed to create a benefit, but this is often difficult to quantify. As a result, this category is usually considered as a “tie breaker” between regulatory alternatives.212

6. Efficiency of competition: Market competition will maximize social welfare where consumers have the information to make good buying decisions. Under such conditions, sellers will compete on the basis of price and quality and will avoid excess advertising intended to “fool” consumers into giving them greater market share. While the benefit of efficient competition can be difficult to estimate, the FSA cited an example in which regulators found the cost savings of a life insurance disclosure regulation to be £800 million annually.213

During the Stage 3 evaluation, regulators should also usually calculate the distributional effects of their policies and, where possible, estimate the costs and benefits as they may affect different

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208 Id. at 28–29.
209 Id. at 29–30.
210 Id. at 31–34.
211 Id. at 35–38.
212 Id. at 38.
213 Id. at 38–39.
groups or market participants.\footnote{Id. at 14. See also id. at 40.} The FSA guidelines also expect regulators to separately evaluate the impact of alternative regulatory schemes on small businesses and on consumers.\footnote{Id. at 18.}

In Stage 4 of the CBA process, regulators should “provide an output” of their results that connects with the broader regulatory process. This presentation should include a statement of the problem to be addressed through regulation, descriptions of the regulatory alternatives under consideration, an appraisal of the costs and benefits of those alternatives, and a statement of the tradeoffs between the different alternatives. The regulators should also state the assumptions on which their estimates are based in order to allow policymakers and the public to evaluate the quality of their analysis.\footnote{Id. at 19.}


3. Evaluation

The FSA has hired outside experts to evaluate its use of CBA. These analyses shed light on the difficulty of performing cost-benefit analysis of financial regulation and the institutional impediments to imposing a CBA requirement on regulators. NERA Economic Consulting, a private consultancy, found that FSA’s methodology was basically sound, but that, some
policymakers have treated CBA as a final step to obtain authorization for a regulation, rather than as an integral step in the regulatory process. They have also found instances in which CBA was thought not to be useful or where the FSA’s Economics of Financial Regulation team thought that the analysis was of insufficient quality. NERA also found that the analyses focused too heavily on compliance costs, with too little attention paid to other market costs.

A companion report by John Howell & Co. found that the agency had made substantial strides in implementing its cost-benefit mandate, as more than 90 percent of “consultation papers” included analysis of costs and benefits in 2002 and 2003. However, the Howell report indicated that there was a significant gap between the senior management’s commitment to effective CBA and that of the staff. The report also noted that the FSA was a young agency and lacked many resources, such as a large staff of trained economists, necessary to performing the large number of analyses required of it.

IV. CASE STUDY: THE REGULATION OF MUTUAL FUNDS

This Section will take a deeper look at the SEC’s use of cost-benefit analysis. Section A discusses the source of the SEC’s rulemaking authority with respect to the mutual fund industry. Section B gives a brief overview of the recent scandals that gave rise to a remarkable number of rulemakings, and Section C discusses three significant rulemakings and their accompanying cost-

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222 Id. at 3.
223 Id. at 16. More recently, the FSA has undertaken a new study on the costs of financial regulation in hopes of “identify[ing] where there may be discretionary elements of regulation that are costly to firms but which are not matched by corresponding benefits.” It expects to complete the study toward the end of 2005. Press Release, FSA Begins Costs of Regulations Study (Mar. 3, 2005), available at http://www.fsa.gov.uk/Pages/Library/Communication/PR/2005/027.shtml.
225 Id. at 5.
226 Id. at 5, 16.
benefit analyses in greater depth. Section D evaluates the SEC’s use of CBA in light of the principles set forth by OMB and the FSA for its use.

A. SEC Authority over Mutual Funds

The SEC has regulatory authority over the mutual fund industry pursuant to the Investment Company Act of 1940 (“ICA”). The primary purposes of the Act were “the protection of individuals who purchase the security issued by the investment company,” “to provide a comprehensive regulatory scheme to correct and prevent certain abusive practices in the management of investment companies,” and “to prevent self-dealing on the part of those managing and controlling investment companies and to protect shareholders in the funds from dishonest and self-dealing advisers.” Under Section 38, of the Act, “[t]he Commission shall have authority from time to time to make, issue, amend, and rescind such rules and regulations and such orders as are necessary or appropriate to the exercise of the powers conferred upon the Commission elsewhere in this title.” In exercising this regulatory authority, the Commission is required by statute to “consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.”

B. Mutual Fund Scandals

The SEC’s usually cooperative relationship with the mutual fund industry was shaken to its foundation by a series of scandals implicating both fund management and trading practices. In fact, as with similar controversies roiling the securities and insurance industries, many of these abuses were not discovered by the SEC, but by New York State Attorney General Eliot Spitzer, a

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228 Greater Iowa Corp. v. McLendon, 378 F.2d 783, 794 (8th Cir. 1967).
229 Herpich v. Wallace, 430 F.2d 792, 816 (5th Cir. 1970).
233 See generally Paul Dwyer, Breach of Trust, BUS. WEEK, Dec. 15, 2003, at 98 (describing how the industry’s close relationship with regulators created an environment in which abuses were long condoned).
fact that forced the SEC to play catch-up with state regulators.234 The most widespread scandals concerned two practices known as “market timing” and “late trading,” though there were also problems with selective disclosure of portfolio holdings to favored investors, directed brokerage commissions, failure to disclose breakpoint discounts, prohibited sales contests, employee trading, and violations of suitability rules. As many of these practices were orchestrated or condoned by the senior management of mutual fund companies, they gave rise to serious questions about the governance of these operations as well.

Market timing is the practice of making frequent purchases and redemptions of mutual fund shares in order to take advantage of minor discrepancies between the actual and book value of fund shares. Market timing is very common in, and most easily illustrated by, funds that invest in international equities. Under existing rules, mutual funds must value their portfolios at least each day.235 Typically, funds do so at 4 p.m. Eastern Standard Time, at the closing of New York markets. However, by this time markets in Europe and Asia may have been closed for hours, resulting in “stale” prices. Market timers can then use news and information obtained after the close of international markets to predict price changes in the securities owned by the mutual fund. However, the net asset value (“NAV”) of fund shares calculated at 4 p.m. will not reflect those developments, which will not be factored into the prices of its foreign stocks until trading markets open for business overseas. For example, imagine the NAV of a U.S.-based international equities fund is $10.00 per share at 4 p.m., but after-market news points to a strong day ahead for international stocks. Under those conditions, a market timer can place his purchase order at 3 p.m., get that day’s stale price, and redeem those shares the next day for $10.50 a share based on the strong performance of those foreign stocks. Arbitrageurs pursuing

market-timing strategies might generate excess returns up to 70 percent annually. Market timing imposes many costs on long-term fund shareholders. It dilutes the value of other investors’ holdings, disrupts management of a fund’s portfolio, forces managers to hold excess cash reserves or sell holdings to meet frequent redemptions, and increases trading and administrative expenses. Many of the biggest names in the mutual fund industry—Alliance Capital Management, Bank of America, Invesco Funds, Janus Capital Management, and Strong Capital Management—have been subject to SEC enforcement actions for facilitating market-timing activity in order to attract more business from customers in the hedge fund industry. Fund managers would have an incentive to facilitate this behavior among sophisticated investors at the expense of unsuspecting long-term shareholders because their management fees increase in proportion to their assets under management. There have also been cases where employees of mutual fund companies have engaged in excessive short-term trading for their personal accounts.

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Nevertheless, the behavior of the market timers is not clearly illegal. However, it also could have easily been prevented by changes to the rules regarding NAV calculations. SEC rules require “fair value pricing” of fund securities.\footnote{\textsuperscript{244} Rule 2a-4, 17 C.F.R. 270.2a-4(a)(1) (“Portfolio securities with respect to which market quotations are readily available shall be valued at current market value, and other securities and assets shall be valued at fair value as determined in good faith by the board of directors of the registered company.”)} It is not difficult to value domestic securities in which trading ended at 4 p.m. However, it is more difficult for international securities with stale, hours-old prices that may have been affected by more recent developments. In both 1999 and 2001, the SEC issued interpretive letters to the Investment Company Institute—the trade association for the mutual industry—emphasizing the requirement that funds to use a fair-pricing methodology where there had been a “significant event” likely to affect the prices of securities for which there is no recent market price.\footnote{\textsuperscript{245} See Letter from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management, Securities and Exchange Commission, to Craig S. Tyle, General Counsel, Investment Company Institute, 2001 SEC No-Act. LEXIS 543 (Apr. 30, 2001); Letter from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management, Securities and Exchange Commission, to Craig S. Tyle, General Counsel, Investment Company Institute, 1999 SEC No-Act. LEXIS 958 (Dec. 8, 1999).} However, the SEC has never defined what constitutes a “significant event,”\footnote{\textsuperscript{246} Coffee, supra note 236.} thereby allowing funds to regularly use stale prices for international securities in their 4 p.m. NAV calculations.\footnote{\textsuperscript{247} Reuters, \textit{SEC: Many Funds Don’t Use ‘Fair Value’ Pricing}, \textit{L.A. Times}, Mar. 25, 2004, at C4 (reporting that nearly a third of mutual funds had not used fair value pricing over the previous twenty months and that half had used it five times or fewer).} Many commentators have pointed to mandatory fair value pricing as the best way to prevent market timing.\footnote{\textsuperscript{248} See, e.g., Peter Mauthe & Jerry Wagner, Editorial, \textit{Proposed “Reforms” for Mutual Funds Would Hurt Individual Investors}, \textit{The Hill}, Feb. 5, 2004, at 14; Diana B. Henriques, \textit{A Band-Aid for the Fund Industry’s Broken Leg?}, \textit{N.Y. Times}, Nov. 21, 2003, at C1 (reporting the opinion of several leading academics that fair value pricing is the best method to combat market timing).}

Late trading, however, is a clear illegal violation of the SEC’s forward pricing rules. Under these rules, a shareholder may purchase or redeem shares at the next NAV calculated by the mutual fund.\footnote{\textsuperscript{249} SEC Rule 22c-1, 17 C.F.R. 270.22c-1(a). The forward pricing rule states:} Thus, an investor wishing to buy or sell shares at that day’s price must
submit his or her order by 4 p.m.; any order submitted afterward would be priced at the next

day’s calculated NAV. The rationale for this rule is clear: If shareholders could trade on the
basis of a past NAV, then they could take advantage of market movements or new information to
purchase or redeem shares at prices not reflective of the shares’ actual value. For many years,
such backward pricing was the norm in the mutual fund industry:

From the passage of the 1940 Act until 1968, the pricing norm was to calculate a NAV
that remained in effect for the next twenty-four hours. Thus, most funds calculated NAV
prior to the point in time when they offered investors the ability to purchase or redeem
shares. Backward pricing, as it was known, created stale prices. Backward pricing
presented investors (or their aggressive brokers) with the opportunity to make large
speculative profits by purchasing large blocks of fund shares during a rising market and
selling the shares quickly after the NAV was recalculated to reflect the market’s rise.
Successful implementation of this strategy resulted in dilution for the fund's buy-and-hold
shareholders.250

This situation was not corrected until the passage of Rule 22c-1, which clearly barred the
practice. However, the practice continued, usually as broker-dealers acting as intermediaries
between the shareholder and the fund accepted orders from favored customers after the 4 p.m.
deadline or permitted them to cancel orders on the basis of post-4 p.m. events.251

These scandals have prompted concerns about the management of investment companies
and the oversight provided by their boards. Much of this attention has been directed toward the
funds’ independent directors. Given their formal separation from management, those directors
have been charged with special authority to act in the interests of shareholders. The Supreme

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No registered investment company issuing any redeemable security... shall sell, redeem, or repurchase any
such security except at a price based on the current net asset value of such security which is next computed after
receipt of a tender of such security for redemption or of an order to purchase or sell such security.

Id. (emphasis added).

250 Conrad Ciccotello et al., Trading at Stale Prices with Modern Technology: Policy Options for Mutual Funds in
the Internet Age, 7 VA. J.L. & TECH. 6, at *12 (2002).

available at http://www.sec.gov/litigation/admin/33-8520.htm; In the Matter of Steven B. Markovitz, Investment
the Matter of Theodore Charles Siphol III, Administrative Proceeding File No. 3-11261 (Sept. 16, 2003), available
Court has described mutual funds’ independent directors as “independent watchdogs” whose role is “to supply an independent check on management and to provide a means for the representation of shareholder interests in investment company affairs.” However, as evidence of these scandals came to light, regulators found their efforts lacking. As SEC Commissioner Harvey Goldschmid said, “[T]oo often, as demonstrated by cases that the Commission has brought since September, and other cases that are currently in the SEC’s enforcement process, independent directors have been the ‘last to know’ about fund conflicts and wrongdoing.”

C. The SEC’s Response

The SEC responded to the scandals in the mutual fund industry with a flurry of rulemakings. These regulations concerned both the overall governance of mutual funds, whose shortcomings may have allowed some of the abuses to occur, as well as specific fund operations. Since the beginning of 2003, the Commission has issued at least ten final rules and at least five proposed rules that have not yet been finalized. The three rules discussed below were chosen because they were likely to generate the greatest economic impact. In order to shed the most light on the SEC’s use of CBA, two of the rulemakings are discussed in their proposed—not final—form. Due to a lack of data, it is not clear in each case whether the rule would generate $100 million in costs, thus making it a “significant regulatory action” subject to OMB review if promulgated by a different agency. However, each regards important aspects of the industry and therefore merits the scrutiny afforded by cost-benefit analysis.

252 Burks v. Lasker, 441 U.S. 471, 484 (1979) (internal quotes and citations omitted).
1. Investment Company Governance

   a. The SEC Rulemaking

   The most controversial of these rules, proposed in January 2004 and published in final form that August, was intended to strengthen investment company governance.\(^{255}\) The rule dramatically increased the independence requirement for the boards of mutual funds seeking to take advantage of ten commonly used exemptive rules, which allowed transactions otherwise prohibited by the ICA. The SEC acknowledged that this rule was motivated by the recent scandals in the industry:

   We proposed these rule amendments, along with a number of other initiatives, in the wake of a troubling series of enforcement actions involving late trading of mutual fund shares, inappropriate market timing activities, and misuse of nonpublic information about fund portfolios. When we proposed these amendments, we expressed concern that the enforcement actions in many cases reflected a serious breakdown in management controls. We observed that, in some cases, the fund was used for the benefit of fund insiders, often the management company or its employees,... The proposed fund governance standards would complement that rule by placing fund boards in a better position to demand that management adhere to the highest of compliance standards.\(^{256}\)

   Among other changes, the rulemaking required that independent directors comprise at least three quarters of the fund’s board of directors;\(^{257}\) that the chairman of the board be an independent director;\(^{258}\) that boards conduct annual self-assessments of their performance;\(^{259}\) that the independent directors meet at least once quarterly in a separate session.\(^{260}\) The first two rule changes—the increased independence requirement and the independent chairman requirement—provoked the greatest discussion.

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\(^{255}\) Investment Company Governance, supra note 7.
\(^{256}\) Id. at 46378–79.
\(^{257}\) Id. at 46381.
\(^{258}\) Id. at 46382.
\(^{259}\) Id. at 46384.
\(^{260}\) Id.
The Commission’s published cost-benefit analysis was almost entirely non-quantitative.\textsuperscript{261} The Commission’s rule requiring that 75 percent of fund directors be independent was found to have several benefits: “A fund board whose independent directors constitute at least 75 percent of the fund board should strengthen the hand of the independent directors when dealing with fund management, and may assure that independent directors maintain control of the board and its agenda.”\textsuperscript{262} The SEC staff also said that a heightened independence requirement would prevent problems such as late trading and market timing, thereby improving investor confidence.\textsuperscript{263} The staff declined to provide any quantitative assessments, noting that “[w]hile these benefits are not easily quantifiable in terms of dollars, we believe they are real.”\textsuperscript{264}

Discussion of the costs of the 75 percent requirement focused entirely on compliance costs. The staff noted that a mutual fund not currently in compliance with the rule could choose one of three options: decreasing the size of the board and allowing interested directors to resign, replacing some interested directors with independent directors, or adding independent directors to an enlarged board.\textsuperscript{265} The only costs identified were those of finding new independent directors, compensating those directors, and preparing proxy statements.\textsuperscript{266} None of those costs were quantified, as the SEC asserted that it was without a “reliable basis for determining how funds would choose to satisfy the [new requirement] and therefore it [was] difficult to determine the costs associated with electing independent directors.”\textsuperscript{267} Moreover, the discussion did not

\textsuperscript{261} The only dollar figure concerned a rule amendment unrelated to the board composition changes, which require boards to “retain copies of materials considered by the board in approving advisory contracts.” The Commission’s analysis pegged the cost of this requirement at $9.46 per fund per year. \textit{id.} at 46387.

\textsuperscript{262} \textit{id.} at 46382.

\textsuperscript{263} \textit{id.} at 46386.

\textsuperscript{264} \textit{id.}

\textsuperscript{265} \textit{id.} at 46387.

\textsuperscript{266} \textit{id.}

\textsuperscript{267} \textit{id.}
COST-BENEFIT ANALYSIS OF FINANCIAL REGULATION

consider other sorts of costs, such as the effects on fund performance of replacing experienced, knowledgeable “insider” directors with potentially less knowledgeable and less experienced “outside” directors, particularly as the demand for independent directors grows.

The Commission’s cost-benefit analysis of the independent-chairman requirement proceeded along similar lines. The Commission wrote that having an independent chairman free of conflicts of interest should benefit fund shareholders:

The board chairman can play an important role in setting the agenda of the board, and in establishing a boardroom culture that can foster the type of meaningful dialogue between fund management and independent directors that is critical for healthy fund governance. The chairman can play an important role in providing a check on the adviser, in negotiating the best deal for shareholders when considering the advisory contract, and in providing leadership to the board that focuses on the long-term interests of investors. We believe that a fund chairman is in the best position to fulfill these responsibilities when his loyalty is not divided between the fund and its investment adviser.268

None of these putative benefits were quantified. The Commission said that it could not identify any out-of-pocket costs resulting from this regulation.269

Two dissenting commissioners and many commentators have questioned the value of the majority’s cost-benefit analysis. Instead, they insisted, the rulemaking will impose significant costs while failing to yield any certain benefits. In an unusually blunt dissent, Commissioners Cynthia A. Glassman and Paul S. Atkins argued that the new rule would result in “a substantial cost to fund shareholders” and that existing controls provided adequate oversight by independent directors.270 Taking the Commission to task for inadequate analysis, they wrote that despite the existence of empirical data that could have been analyzed to evaluate potential benefits, the proponents [of the rule] provided no such analysis. Moreover, the majority speculates sanguinely that the benefits of these amendments will come at “minimal” cost to funds. Positing that empirical evidence is unnecessary, the majority dismisses pleas for more deliberate action.271

268 Id. at 46383.
269 Id. at 46387.
270 Id. at 46390.
271 Id.
With regard to the independent chairman requirement, the two dissenting commissioners requested that the SEC conduct a more thorough analysis, but it failed to do so despite the existence of empirical data suggesting that the proposed rule might have harmful effects.\textsuperscript{272} Noting some glaring omissions from the SEC’s published cost-benefit analysis, the two dissenters concluded that “[u]nder the cover of ‘good atmospherics’ and the shroud of ‘investor protection,’ the majority has decided to adopt measures the benefits of which are illusory, but the costs of which are real.”\textsuperscript{273}

Glassman, in particular, criticized the Commission for failing to consider the compliance costs of the independent-chairman rule. In a speech shortly before adoption of the final rule, she noted that an independent chairman will likely be less-well-informed than an executive chairman, requiring the hiring of a staff at additional cost to shareholders.\textsuperscript{274}

The proposed rule prompted nearly 200 comments,\textsuperscript{275} several of which dealt with the Commission’s failure to address the costs of the regulation. With respect to indirect costs—not the costs of compliance, but those associated with the regulation’s overall effect on the market—one party commissioned its own study, which found a negative correlation between the independence of a fund’s chairman and a fund’s returns to shareholders.\textsuperscript{276} The Commission dismissed this concern, noting that “independent chairmen can provide benefits and serve other purposes apart from achieving high performance for the fund.”\textsuperscript{277} Other comments argued that requiring an independent chairman would be less cost-effective than the deterrent of prosecution

\textsuperscript{272} \textit{Id.} at 46391–92.
\textsuperscript{273} \textit{Id.} at 46393.
\textsuperscript{275} Investment Company Governance, supra note 7, at 46379.
\textsuperscript{277} Investment Company Governance, supra note 7, at 46384.
of directors who violate their fiduciary duty. Still other comments focused on the relatively higher costs to smaller mutual funds, which were not addressed in the Commission’s cost-benefit analysis. To that end, the chairman of one small mutual fund estimated that his compliance costs of $108,000 would equal 16 percent of expected shareholder dividends.

b. Congressional Criticism

After the rule was promulgated, other critics seized on the failures of the Commission’s cost-benefit analysis in their efforts to undermine the rulemaking. Opponents of the SEC’s measure also won a victory on Capitol Hill. At the behest of Fidelity, Sen. Judd Gregg (R-N.H.) inserted a provision into an omnibus spending bill requiring the SEC to justify the need for an independent chairman. The bill required the SEC to submit a report to the Senate Appropriations Committee by May 1, 2005, “analyz[ing] whether mutual funds chaired by disinterested directors perform better, have lower expenses, or have better compliance records than mutual funds chaired by interested directors.” The Gregg amendment also requires the SEC to act on the recommendations of the report by Jan. 1, 2006.

The Commission’s response, while lengthy, sheds very little new light on the empirical issue of whether the independent-chairman requirement is justified under cost-benefit principles. Most of the report is devoted to an explanation of the various mutual fund scandals and a qualitative explanation of how mutual funds would benefit from independent chairmen and

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283 Id.
increased representation of independent directors. Toward the end of the paper, its authors noted that the SEC had considered alternatives, quoting language to that effect from its release adopting the rulemaking.\textsuperscript{284} The SEC also said that it undertaken a review of the new rule’s costs and benefits, but found the costs to be “wholly within [the] discretion” of individual funds.\textsuperscript{285} It added: “In any event, the additional costs, if any, are speculative at this point, and the Commission has no reliable basis for estimating those costs.”\textsuperscript{286}

Only in Part V of the report did the SEC attempt to explain the relationship between independent chairs and fund performance and expenses, the heart of the cost-benefit issue in this rulemaking. The Commission concluded that “the analyses based on data currently available on performance and expenses are inconclusive – there is insufficient evidence to conclude that management-chaired funds have better performance or lower fees.”\textsuperscript{287} In other words, the SEC would not attempt to justify its rulemaking on the basis of cost-benefit analysis; nor did the report at any point present any data which Congress or the public might use to evaluate the wisdom of the rulemaking.

With respect to the SEC’s use of cost-benefit analysis, three aspects of this report stand out. First, the Commission discussed its methodology at some length, giving Congress some basis on which to consider the validity of the staff’s conclusions.\textsuperscript{288} Second, much of the discussion related to the SEC’s analysis is reactive, not proactive. The report discusses at length the flaws of the Bobroff-Mack report published in March 2004 by Fidelity Investments in


\textsuperscript{285} Id. at 60.

\textsuperscript{286} Id.

\textsuperscript{287} Id. at 64.

\textsuperscript{288} Id. at 65–70.
response to the notice of proposed rulemaking two months earlier, but reveals little of the analysis undertaken within the SEC before it published the proposed rule. In fact, given the numerous references to the Bobroff-Mack report within the SEC’s own analysis, it is unclear from the report whether the SEC conducted its analysis prior to undertaking the rulemaking or whether the study represents a post hoc rationalization produced only after the rider to the appropriations bill forced the Commission into action. For that reason, the report sheds little insight into what procedures the SEC undertakes to analyze a proposed rule before offering it for public consumption in the Federal Register. Third, nowhere in the report does the report point the reader to where it might see, and therefore evaluate, the empirical data on which the SEC based its conclusions.

Finally, the Gregg Amendment required the SEC to act on the results of its report by Jan. 1, 2006. At the end of the report, the Commission’s recommendations did not deviate from the status quo. The report did not recommend that the SEC revise or rescind the rule, only that it “continue to monitor how the presence of an independent chair on the board changes the independence and effectiveness of the board.”

c. Judicial Intervention

The battle over this regulation also moved to the courts. The U.S. Chamber of Commerce (the “Chamber,” or “petitioner”) filed a lawsuit in the U.S. District Court for the District of Columbia to prevent the independent-chairman regulation from going into effect. In its complaint, the Chamber discussed the Commission’s failure to consider many of the costs of
the regulation and cited the Bobroff-Mack report\textsuperscript{291} as evidence of the rule’s harmful economic consequences.\textsuperscript{292}

In a landmark ruling, the D.C. Circuit Court of Appeals struck down the rulemaking and remanded the matter to the SEC.\textsuperscript{293} After conducting a threshold inquiry into the petitioner’s standing to bring suit, the court considered two separate arguments advanced by the petitioner. First, rejecting the Chamber’s argument that the regulation amounted to an impermissible intrusion on matters of corporate governance traditionally governed by state law, the court upheld the Commission’s authority to issue the rule. The court found that the Investment Company Act “confers upon the Commission broad authority to exempt transactions from rules promulgated under the ICA, subject only to the public interest and the purposes of the ICA.”\textsuperscript{294}

In light of this “broad authority,” the court also dismissed the Chamber’s argument that the ICA—which requires mutual fund boards to be composed of at least 40 percent independent directors—limited the SEC’s ability to impose by rule more stringent conditions than those found in the statute on those funds wishing to engage in exempt transactions.\textsuperscript{295}

In the second merits-based section of the opinion, the court turned its attention to the Chamber’s argument that the Commission’s rulemaking violated the Administrative Procedure Act (“APA”),\textsuperscript{296} which allows a reviewing court to set aside any agency action that is “arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law.”\textsuperscript{297} The petitioner advanced three separate arguments pursuant to which the SEC’s action was unlawful: (1) The SEC “failed to show the connection between the abuses that prompted the rulemaking” and the

\textsuperscript{291} See Bobroff & Mack, supra note 276.
\textsuperscript{293} Chamber of Commerce of the United States of America v. SEC, 412 F.3d 133, 145 (D.C. Cir. 2005).
\textsuperscript{294} Id. at 139.
\textsuperscript{295} Id. at 140.
new conditions; (2) it “did not comply with its obligation under the ICA to consider whether those conditions ‘will promote efficiency, competition, and capital formation’”; and (3) it “did not consider reasonable alternatives to the independent chairman condition.”

The court rejected the Chamber’s first argument. It found that the SEC had adequately stated its reasoning for the new requirements. Even though none of the improper behavior cited by the SEC involved exempt transactions, they brought to light a broader problem of conflicts of interest within the industry that might result in further abuses if not addressed. The court found that it was not arbitrary or capricious for the Commission to promulgate prophylactic regulations intended to strengthen the hand of independent directors and thereby discourage the sort of environments in which improper behavior might flourish. Deferring to the agency’s expertise, the court said it had “no basis upon which to second-guess that judgment.”

The Chamber’s second argument was that the SEC violated the APA by failing (1) “to develop new, and to consider extant, empirical data comparing the performance of funds” with and without independent chairmen; and (2) “to consider the costs of the conditions it was imposing” that would, in turn, impede efficiency, competition, and capital formation. With respect to the first point, the court noted the limits of formal cost-benefit analysis in agency rulemaking: “[W]e are acutely aware that an agency need not—indeed cannot—base its every action upon empirical data; depending on the nature of the problem, an agency may be ‘entitled to conduct… a general analysis based on informed conjecture.’” To that end, the court did not

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298 412 F.3d at 140 (quoting 15 U.S.C. § 80a-2(c) (2000)). The internally quoted language requiring the SEC to consider whether its rulemakings will promote “efficiency, competition, and capital formation” appears not only in the ICA but also in the Securities Act of 1933 and the Securities Exchange Act of 1934, the two other major sources of the Commission’s rulemaking authority. See 15 U.S.C. § 77b(b) (2000); 15 U.S.C. § 78c(f) (2000). Thus, the court’s analysis with respect to how the costs of regulation would affect efficiency, competition, and capital formation applies broadly, and not just in the context of mutual fund regulation.

299 412 F.3d at 141.

300 Id. at 142.

301 Id. (quoting Melcher v. FCC, 134 F.3d 1143, 1158 (D.C. Cir. 1998)).
find an APA violation in the Commission’s decision not to do its own empirical study or in its cursory, though reasoned, dismissal of the Bobroff-Mack study findings.\footnote{Id. at 142–43.}

However, the court did find that the SEC violated the APA in not giving adequate attention to the costs imposed by the new regulation. It first noted that the SEC has admitted the difficulty in predicting costs in light of the different ways in which funds could satisfy the independence requirements and uncertainty over whether funds would choose to hire more staff in order to serve the new independent directors. Nevertheless, the court held, “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.”\footnote{Id. at 144.} In short, the Commission’s attempts to skirt the issue—by pretending that data which it did not have could not be obtained or depended on the independent decision-making of the regulated mutual fund—rendered its rulemaking arbitrary. While recognizing that economic analysis of regulation is difficult and not always precise, the court still demanded that the agency undertake some effort to quantify the costs of the rules it promulgated. It is clear from this context that even an informal survey of a cross-section of funds would have revealed their preferences with respect to how they would satisfy the new independence requirement and their resulting staffing needs, giving the Commission the data it needed in order to estimate costs. The Commission’s failure to engage in that limited undertaking rendered its action in violation of the APA.

The court also largely accepted the Chamber’s third argument, i.e., that the Commission violated the APA when it failed to adequately consider alternatives to the proposed regulation.
Setting some limits, the court observed that the SEC need not consider “‘every alternative… conceivable by the mind of man… regardless of how uncommon or unknown that alternative’ may be.”\(^{304}\) Nevertheless, the court found unconvincing the Commission’s argument that disclosure-based alternatives endorsed by Commissions Atkins and Glassman were inconsistent with the ICA. While Congress rejected a purely disclosure-based regulatory approach in the ICA, disclosure is still a key component of and consistent with the Act; moreover, the SEC was adding to the ICA’s disclosure requirements in other rulemakings even as it rejected the possibility of disclosure-based regulation with respect to fund governance. As a result, “the disclosure alternative was neither frivolous nor out of bounds and the Commission therefore had an obligation to consider it.”\(^{305}\)

The D.C. Circuit’s opinion represents a qualified, but unprecedented, statement in favor of the SEC’s use of cost-benefit principles in the rulemaking process. While the Commission is not required to undertake its own detailed empirical analysis of every rulemaking, it must still make an effort to determine the costs of the rules it proposed and give due consideration to non-frivolous alternatives that may achieve the same goals while imposing fewer burdens on regulated entities and, in turn, consumers. Given the relevant similarities between and among the ICA, the Securities Act of 1933, and the Securities Exchange Act of 1934,\(^{306}\) there is no reason why this case should not apply broadly to most of the areas regulated by the SEC. As shown in the next two subsections, the concerns over the quality of analysis employed by the Commission in its regulation of mutual fund governance are not confined to that particular rulemaking.

\(^{304}\) Id. (quoting Motor Vehicles Mfrs. Ass’n v. State Farm Mutual Auto Ins. Co., 463 U.S. 29, 51 (1983)).

\(^{305}\) Id. at 145.

\(^{306}\) See supra note 298.
2. Mandatory Redemption Fees

The SEC had a two-prong response to the controversy over market timing. First, with relative speed and little controversy, the Commission promulgated a final rule requiring mutual fund companies to disclose in their fund prospectuses the risks to investors of short-term purchases and redemptions of mutual fund shares and the fund’s policies with respect to such frequent purchases and redemptions.\(^\text{307}\) Second, it proposed new regulation, Rule 22c-2, imposing a mandatory 2 percent redemption fee on mutual fund shareholders who redeem their shares within five days of purchase.\(^\text{308}\) This proposal anticipated a much greater economic impact, and thus generated significant controversy.

Such a fee would serve two main purposes. It would reimburse the fund—and by extension, its long-term shareholders—for the administrative costs of redeeming shares, which funds have generally estimated at about 2 percent.\(^\text{309}\) It would also discourage market timing by making short-term trading more expensive and therefore less profitable.\(^\text{310}\) Even before the market-timing scandals erupted, the Commission had allowed funds to voluntarily impose a fee of up to 2 percent on frequent traders; however, now it proposed making this fee mandatory and uniform. This, the Commission wrote, would make it easier for funds to administer the rule and create a level playing field for smaller funds that might feel compelled to waive such fees in order to remain competitive with larger funds.\(^\text{311}\) The fee would kick in only on the redemption of shares held fewer than five days, though funds would have the option of requiring a longer

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\(^{307}\) See Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, 69 Fed. Reg. 22300 (Apr. 23, 2004) (to be codified at 17 C.F.R. pts. 239 & 274). Since the economic effect of the disclosure rule will be minimal, this Section focuses on the fee rule, which has a significant economic impact.


\(^{309}\) Id. at 11763.

\(^{310}\) Id.

\(^{311}\) Id. at 11764.
holding period.\textsuperscript{312} In the event an investor only sold a portion of his or her holdings, the Commission proposed adopting the “first in, first out” method, which would treat the longest-held shares as being sold first for the purposes of determining whether the fund must charge a redemption fee.\textsuperscript{313} The purpose of this provision was to protect smaller investors who might need to quickly redeem their investments in the event of a financial emergency.\textsuperscript{314}

The Commission acknowledged that many individual investors do not trade with mutual funds directly, but hold their shares through intermediaries—such as banks, broker-dealers, and retirement plans—that purchase and redeem fund shares through omnibus accounts. The Commission also noted, however, that many mutual funds that already charged redemption fees did not do so to omnibus accounts, and that many successful market-timing abuses took advantage of that fact.\textsuperscript{315} Consequently, the Commission offered funds three options for compliance: First, the intermediaries could transmit shareholders’ account numbers to the fund during each transaction so that the fund could determine whether a redemption fee was required. Second, the fund and the intermediary could enter into an agreement whereby the latter would determine whether the redemption fee was required and submit each short-term shareholder’s account information to the fund. Finally, the fund and the intermediary could enter into an agreement whereby the intermediary would impose the redemption fee on the fund shareholders and then remit the proceeds to the fund.\textsuperscript{316} Regardless of which option is chosen, each week the intermediaries would also have to provide the fund with the Taxpayer Identification Number (“TIN”) and transaction information for each shareholder who buys or sells fund shares during the previous week. The purpose of this requirement is to help the fund ensure that redemption

\begin{footnotes}
\item[312] \textit{Id.} at 11764–65.
\item[313] \textit{Id.} at 11765.
\item[314] \textit{Id.}
\item[315] \textit{Id.} at 11766.
\item[316] \textit{Id.}
\end{footnotes}
fees are being properly assessed and to help detect short-term traders operating through multiple accounts with intermediaries.\footnote{Id. at 11766–67.}

The cost-benefit analysis published with the proposed rule was brief and entirely qualitative, not quantitative. However, other material included in the rulemaking pointed to the intriguing possibility that the Commission could have conducted and presented a more meaningful analysis.

The Commission identified several benefits of imposing a mandatory redemption fee. By discouraging market-timing activity, the fee would lower funds’ transaction costs, prevent fund shareholders from experiencing unwanted taxable capital gains, and stop short-term traders from diluting the positions of long-term shareholders. As a consequence, fund performance would improve and investors would have more confidence in the market in general and mutual funds in particular, benefiting both the investor and the fund itself.\footnote{Id. at 11768–69.} On the cost side, the Commission expected the rule to impose only minimal fees on funds, whether or not they already imposed fees on redemptions of short-term purchases.\footnote{Id. at 11769.} However, without providing any monetary estimates in this section of the rulemaking, the Commission noted that there might be costs to financial intermediaries who held fund shares for investors. These costs would include software and other technologies to store shareholder information and track their trading activity. The analysis also predicted that increased costs might cause investors to put their money in other financial products.\footnote{Id. at 11769.}
Intriguingly, the Commission did attempt to quantify some regulatory compliance costs in its discussion under the Paperwork Reduction Act.\(^{321}\) In this section, the Commission considered the costs associated with the three options for the assessment and collection of the redemption fee when shares are traded through intermediaries like banks and broker-dealers.\(^{322}\) Without revealing the source of its estimates, the Commission forecast that 15 percent of the estimated 3,100 registered open-ended mutual funds would use the first compliance option, 35 percent would utilize the second option, and the remaining 50 percent would take advantage of the third. The first option would require funds to develop or upgrade their information systems in order to receive account information from intermediaries, match individual shareholders’ purchases with their redemptions, and assess redemption fees. Based on information obtained from the funds, the Commission estimated that initial start-up costs would be $560,000 per fund (or $260.4 million total) and annual operation and maintenance costs would be $6,640 per fund (or slightly less than $3.1 million total). The second option would require funds to make similar investments in information technology, resulting in total start-up costs of $607.6 million and annual operation and maintenance costs of $7.2 million. The third option, in which the intermediaries collected and remitted the redemption fee, would not impose any significant costs on the funds themselves.\(^{323}\)

The Paperwork Reduction Act analysis also evaluated the costs to the estimated 6,800 financial intermediaries whose responsibilities would be increased under all three options. The Commission found that under the first option, intermediaries would have average start-up costs of $100,000 (or $102 million total) and annual operation and maintenance costs also of $100,000

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\(^{321}\) *Id.* at 11769–72. These analyses include estimates for both the number of employee-hours required as well as monetary costs, though it is not clear whether the monetary costs include the cost of the employees’ time.

\(^{322}\) See supra note 316 and accompanying text.

\(^{323}\) *Mandatory Redemption Fees, supra* note 308, at 11770.
(or $102 million total). Under the second option, intermediaries would have start-up costs of $10,000 (or $23.8 million total) and operation and maintenance costs of $10,000 (or $23.8 million total). The Commission did not estimate any costs for intermediaries under the third option, which requires no collection of account information or disclosures to the fund. However, the last part of this analysis is flawed, as under the third option the intermediaries are responsible for determining when to charge a redemption fee and for remitting those fees to the mutual funds; that requirement would certainly impose some costs on intermediaries, at least in terms of software technology and added personnel.

The Commission also estimated the costs associated with the weekly reporting requirement applicable under all three options. For the mutual funds, the Commission estimated aggregate initial capital costs at $310 million and annual operation and maintenance costs of nearly $21 million. For the intermediaries, these figures were $1.02 billion and $680 million, respectively. Altogether, for the first three years of implementation, the Commission estimated that the average annual cost of the regulation to be slightly more than $1.05 billion.

While the Commission quantified many of the compliance costs in its Paperwork Reduction Act analysis, it did not attempt to monetize the benefits of a mandatory redemption fee, inasmuch as it would reduce market timing by short-term shareholders. This omission is noteworthy in light of several studies—some acknowledged in the proposed rule release—

324 Id.
325 Id.
326 Id. at 11771.
327 Id.
328 Id. Actually, however, the Commission’s math here appears to be wrong. As demonstrated in one comment letter, the Commission failed to include all of the named costs in its calculations, see id. at 1171 n.102, and the true cost would be upwards of $1.33 billion a year for three years. Comment Letter of Delta Data Software, Inc. (Mar. 9, 2004), available at http://www.sec.gov/rules/proposed/s71104/lbkeller030904.htm. Even that estimate may be inaccurate, for two reasons. First, it may be low to the extent that the calculations do not include any operation or maintenance costs for the first year of operation; such costs were considered only for the second and third years. Second, though less convincingly, it may be deceptively high to the extent that start-up costs should be amortized over a period longer than three years.
quantifying the costs of such activity. One study cited in the redemption-fee proposal estimated that among a sample of 109 international open-end mutual funds representing about 20 percent of the international fund sector, market-timing activity caused a transfer of $420 million over twenty-six months from passive investors to market timers.\textsuperscript{329} Another, not cited by the SEC, estimated the cost of dilution from market timing at $4 billion a year, and growing.\textsuperscript{330} Nevertheless, the Commission failed to incorporate these figures into an analysis demonstrating what benefits might be obtained from a mandatory redemption fee that would deter much of that harmful trading activity.

Not surprisingly, reaction to the proposed rule was strong and sharply divided. Some funds voluntarily added redemption fees, particularly for international funds most susceptible to market timing.\textsuperscript{331} The ICI backed making such fees mandatory,\textsuperscript{332} as did the Securities Industry Association, which represents many of the financial intermediaries affected by the proposed rule.\textsuperscript{333} However, many comments were critical. These views often focused not so much on the principle of imposing a 2 percent redemption fee, but on the large compliance costs associated with the rule’s information-reporting requirements.\textsuperscript{334} One of these comment letters estimated

\begin{thebibliography}{99}
\bibitem{332} Fink Testimony, supra note 237.
\end{thebibliography}
that actual costs would actually be more than double what the Commission estimated in its Paperwork Reduction Act analysis. Some comments also noted that the Commission failed to give adequate consideration to fair value pricing as an alternative to redemption fees. Commissioner Atkins dissented from the proposed rulemaking on this basis.

Ultimately, the SEC retreated from its proposed rule, voting unanimously not to require redemption fees. Instead, it kept such fees optional while requiring funds to enter into agreements with intermediaries to share information about transactions by fund shareholders. The final rule made neither requested comments on nor made any mention of a stronger fair-value pricing requirement. The CBA accompanying the final rule was similar to that in the proposed rulemaking. Again, the SEC made no attempt to monetize the benefit of the rule. As for costs, the Commission estimated overall start-up costs of $162 million for funds and $949.5 million for intermediaries and ongoing annual costs of $10.8 million and $379.8 million, respectively. Thus, while the cost of a mandatory redemption fee (and associated information-sharing requirements) would have been slightly above $1 billion, the average annual cost for the first three years of the implementation of the information-sharing requirement (accompanying the status quo, under which redemption fees are optional) would be still be $630 million. In short, even when effectively gutted, the rulemaking will impose significant costs on funds and

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335 Comment Letter of First Trust Corp. 10 (May 10, 2004), available at http://www.sec.gov/rules/proposed/s71104/1strustcor051004.pdf (estimating actual compliance costs of more than $2.6 billion annually).
339 Id. at 13330.
340 Id. at 13337, 13339.
intermediaries—and thus on fund shareholders—even as the SEC makes no explicit effort to justify the rulemaking under cost-benefit principles.

3. The 4 P.M. Hard Close

In response to widespread late trading in the mutual fund industry, much of it facilitated by fund insiders, the SEC proposed amendments to Rule 22c-1.\footnote{Amendments to Rules Governing Pricing of Mutual Fund Shares: Proposed Rule, 68 Fed. Reg. 70388 (Dec. 17, 2003) (to be codified at 17 C.F.R. pt. 270) [hereinafter Share Pricing Amendments]. The SEC also promulgated a final rule requiring funds to have policies and procedures designed to prevent fund personnel from facilitating late trading, among other prohibited activities. See Compliance Programs of Investment Companies and Investment Advisors, 68 Fed. Reg. 74714 (Dec. 24, 2003) (to be codified at 17 C.F.R. pts. 270, 275 & 279).} Previously, in order to purchase or redeem shares at that day’s closing price, investors would have to submit their orders—most of which went through retail dealers and other intermediaries—by 4 p.m. Then, sometime after 4 p.m., the dealer would submit a single consolidated purchase or redemption order to the fund’s primary transfer agent, which kept records of how many shares were sold and how many were redeemed, and by whom. Many orders are routed to primary transfer agents through the National Securities Clearing Corporation (“NSCC”), which operates Fund/SERV, an automated system for processing those orders to funds. Typically, the intermediaries process orders received from their retail customers in the early evening hours before submitting them Fund/SERV, and the process is not completed until the middle of the night.\footnote{Share Pricing Amendments, supra note 341, at 70388–89.}

The new rule would require that all purchase and redemption orders be received by the mutual fund, its designated transfer agent (“DTA”), or a registered clearing agency (such as Fund/SERV) by 4 p.m. in order to obtain the current day’s price. As a result, intermediaries would have to submit omnibus purchase and redemption orders before 4 p.m. in order for their customers to receive that day’s price. Those intermediaries, in turn, would have to set some deadline even earlier in the day for their customers to submit orders so that those orders could be
processed, consolidated, and submitted before the “hard” 4 p.m. deadline. The new rule is expected to have other consequences. DTAs would be required to record the date and time they receive orders in order to prevent any violations of the rule. Intermediaries would have to invest in more technology and personnel to handle the same number of transactions in a shorter period of time. Also, some intermediaries, such as 401(k) plan administrators, indicated that they would likely not be able to process purchase or share requests on the same day they are made, thereby reducing the ability of individual shareholders to quickly trade in or out of funds.  

The published cost-benefit analysis accompanying the rule probed a considerable number of the likely costs and benefits of the proposal. However, the discussion was almost entirely qualitative, even where it may have been possible through surveys or other techniques to create monetary estimates for some of these data.

The Commission identified several key benefits of the rule. It would prevent dilution of share value caused when late traders purchase mutual fund shares at a price below the NAV or redeem shares for a price below the NAV. It would increase investor confidence, particularly among long-term investors who are harmed the most by late trading. The rule would also reduce the transaction costs, such as commissions on the purchase and sale of securities, incurred by funds as a result of higher trading volume caused by late trading. The Commission did not attempt to quantify any of these benefits, but did cite to one study estimating the loss to shareholders from late trading at $400 million a year. The cited paper uses a simple regression analysis to measure the correlation between daily mutual fund flows and post-4 p.m. market

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343 Id. at 70389–91.
344 Id. at 70392.
345 Id. at 70392 n.42 (citing Eric Zitzewitz, How Widespread is Late Trading in Mutual Funds? (Sept. 2003), available at http://gobi.standord.edu/ResearchPapers/Library/RP1817.pdf.
activity for 75 percent of mutual funds representing 48 percent of assets.\footnote{Eric Zitzewitz, How Widespread is Late Trading in Mutual Funds? (Nov. 2004), at 8–10, available at http://faculty-gsb.stanford.edu/zitzewitz/Research/latetrading.pdf. This paper is a revision of the first draft of the paper cited in the SEC’s rulemaking proposal.} The author found a statistical likelihood of late trading in more than half of the fund families surveyed\footnote{Id. at 15.} and estimated shareholder losses at $400 million.\footnote{Id. at 17.} However, outside of this footnote, the SEC did not attempt to draw any connection between the costs imposed on society by late traders with the benefits that would accrue from a regulation aimed at stopping the practice.

On the other side of the ledger, the SEC identified a large number of costs imposed by the regulation but only monetized two of the least significant. The Commission noted that the rule would require intermediaries and individuals to submit their orders earlier in the day, but specifically declined to quantify how many fewer trades would be executed as a result.\footnote{Share Pricing Amendments, supra note 341, at 70392 (“The Commission, however, has no reasonable basis for determining the number of customers or potential customers that intermediaries might lose or the costs associated with the potential lost customer orders.”).} Likewise, it noted that intermediaries would have to upgrade their computer systems to handle a more concentrated order flow but declined to give a monetary estimate of that cost.\footnote{Id. (“The Commission, however, has no reasonable basis for determining the costs of the technological upgrades intermediaries might incur as a result of the proposed amendments, because each intermediary could upgrade in a way that it deem best for its particular computer system.”).} The Commission also did not estimate how much it would cost the NSCC to upgrade Fund/SERV in order to handle the high number of orders expected to come in shortly before 4 p.m.\footnote{Id. at 70392–93. The NSCC estimated these start-up costs at $5 million. See Comment Letter of National Securities Clearing Corp. (Feb. 6, 2004), available at http://www.sec.gov/rules/proposed/s72703/nscc020604.htm.}

Further, the Commission described many costs that the funds and their DTAs would bear. It observed that if intermediaries find it too expensive to upgrade their computer systems, some investors might look to alternative financial products. Alternatively, some investors might choose to bypass intermediaries and execute purchase or redemption orders with the funds directly or through DTAs. In that event, the funds and DTAs will have to increase capacity in
order to accommodate a larger number of individual orders. Also, small funds may be hurt because, lacking the advertising budgets of large fund families, they would have difficulty reaching individual investors who bypassed intermediaries. Finally, the regulation imposed a record-keeping function on DTAs, for which the Commission did estimate costs pursuant to the Paperwork Reduction Act. The Commission found that it would cost about $1.1 million for funds to modify their contracts with the DTAs to reflect this new obligation, and less than $400,000 for the DTAs to comply with it.

Comments on the proposed regulation principally expressed concern about the effects of this regulation on certain classes of investors and indicated support for alternative measures briefly mentioned in the rulemaking. Specifically, many of the comments were concerned that small, unsophisticated investors and beneficiaries of retirement plans would be forced to meet impossibly early deadlines; investors on the West Coast would be particularly harmed. Meanwhile, more sophisticated shareholders with the ability to rapidly process their orders would have the advantage of trading later in the day, and thus, with better information. As a result, many if not most of the proposals received by the SEC favored an alternative to the 4 p.m. hard close. While the details vary, the thrust of these proposals is the creation of a verified

352 Share Pricing Amendments, supra note 341, at 70393.
353 Id. at 70393–94.
order processing system with tamper-proof electronic or physical time stamps. Many of these proposals would also require intermediaries to register with the SEC, annual audits, certification procedures, compliance programs, and the approval of fund boards. The SEC requested comments on this sort of regulatory option\textsuperscript{356} but proceeded with the 4 p.m. hard close proposal despite this alternative. To date, the SEC has not issued a final rule, but it is thought to be considering replacing the 4 p.m. hard close with a verified order processing system.\textsuperscript{357}

D. Evaluation of the SEC’s Cost-Benefit Analyses

This Section evaluates the SEC’s cost-benefit analysis of the three mutual fund regulations discussed above in terms of four metrics: identification of costs and benefits, quantification, consideration of regulatory alternatives, and presentation of results.

1. Identification of Costs and Benefits

The SEC did the best job in identifying the costs and benefits of its proposed regulations, though its performance was generally inconsistent. In this respect, the Commission’s identification of the costs associated with the 4 p.m. hard close regulation provides a good example of what it should do as a first step in conducting cost-benefit analysis of proposed regulations. The CBA for that regulation noted the effects of a hard trading deadline on shareholders, funds, intermediaries, and the firms that process orders. The CBA noted that the regulation would impose result in a reduction in customer orders, a possible shift to alternative financial products, and significant compliance costs, particularly with respect to the information technology and personnel needed to process customer orders in a condensed period of time.

\textsuperscript{356} Share Pricing Amendments, \textit{supra} note 341, at 70390.

\textsuperscript{357} See Brooke A. Masters, \textit{New Byword for Funds is Disclosure}, WASH. POST, Jan. 9, 2005, at F1 (“Paul Roye, who heads the SEC’s division of investment management, said the commission is considering some kind of electronic time stamp as an alternative to the hard close.”).
However, on most other counts, the SEC did a poor job in identifying the costs and benefits of its proposed regulations. First, it focused heavily on compliance costs and ignored most other factors. The investment company governance regulation identified compliance costs, but avoided any independent analysis of whether the proposed regulations would result in weaker fund performance. The analyses also avoided discussion of many of the other factors—including the regulation’s effect on the quantity, quality, and variety of goods offered, and its effect on competition—identified by the FSA as central to the cost-benefit analysis of financial regulation.\footnote{358 See supra notes 210–213 and accompanying text.} Cost-benefit analyses conducted by or for the FSA typically use the FSA’s six-category taxonomy in order to classify costs and benefits.\footnote{359 See, e.g., FSA, LLOYD’S CONSULTATION PAPER, supra note 218, annex 3, at 11; OXFORD ECONOMIC RESEARCH ASSOCIATES, COST-BENEFIT ANALYSIS OF THE FSA’S PROPOSITIONS ON SOFT COMMISSIONS AND BUNDLING iv–vii (April 2003), available at http://www.fsa.gov.uk/pubs/cp/cp176_oxera_cba.pdf [hereinafter OXERA, SOFT COMMISSIONS].} The SEC’s analyses also failed to discuss what costs, if any, the regulation would have imposed on the agency itself.

Second, with respect to benefits, the SEC in each case pointed to the vague and uninformative benefit of “investor confidence.” The Commission’s reliance on this common catchphrase may reflect a sense of groupthink at an agency devoted, after all, to the protection of investors.\footnote{360 See Choi & Pritchard, supra note 86, at 33–36.} However, without more, investor confidence is a benefit devoid of any substantive content. As two proponents of cost-benefit analysis of financial regulation have written:

> It is unfortunate that the benefits of regulatory measures have often been described as “an increase in consumer protection.” This is vague and might have contributed to a climate in which some believe that the economic benefits of financial regulation are almost impossible to estimate and that, therefore, CBA is unlikely to be successful.\footnote{361 ALFON & ANDREWS, supra note 10, at 20.}

In the alternative, benefits to investors could have been described in a variety of forms susceptible to better definition and analysis: increased fund returns, lower fund fees, increased consumer surplus, or better investment options. Nevertheless, with the old crutch of “investor...
confidence,” the SEC chose not to undertake a more specific analysis of what benefits would arise from these regulations.

2. Quantification

Undoubtedly, quantification of costs and benefits, where possible, is one of the most crucial aspects of cost-benefit analysis.\textsuperscript{362} The SEC’s failure to express the costs and benefits of its proposed rulemakings in numerical terms represents a significant shortcoming in its analysis. Moreover, as the D.C. Circuit observed in the mutual fund governance case, that so few data were expressed monetarily makes it difficult for policymakers or the general public to compare the costs and benefits of the regulations and their alternatives.\textsuperscript{363}

With one major exception, the SEC’s analyses were almost entirely qualitative. The agency did not estimate the costs or benefits of the governance regulation, the benefits of the redemption fee regulation, or the costs or benefits of the 4 p.m. hard close regulation. Some of these omissions were quite glaring. The CBA accompanying the hard close regulation explicitly declined to estimate how much it would cost the NSCC to comply with the new regulation, but such information might have been obtained by merely asking; in its comment letter, the NSCC

\textsuperscript{362} CBA contemplates that costs and benefits will be quantified, when possible, so a regulatory agency bears some obligation to attempt to quantify those data. As the Fifth Circuit wrote in invalidating an EPA regulation promulgated pursuant to a faulty cost-benefit analysis:

While [the Toxic Substances Control Act] contemplates a useful place for unquantified benefits beyond the EPA’s calculation, unquantified benefits never were intended as a trump card allowing the EPA to justify any cost calculus, no matter how high.

The concept of unquantified benefits, rather, is intended to allow the EPA to provide a rightful place for any remaining benefits that are impossible to quantify after the EPA’s best attempt, but which still are of some concern. But the allowance for unquantified costs is not intended to allow the EPA to perform its calculations over an arbitrarily short period so as to preserve a large unquantified portion.

Unquantified benefits can, at times, permissibly tip the balance in close cases. They cannot, however, be used to effect a wholesale shift on the balance beam. Such a use makes a mockery of the requirements of TSCA that the EPA weigh the costs of its actions before it chooses the least burdensome alternative.


\textsuperscript{363} Chamber of Commerce, 412 F.3d at 144.
reported its likely compliance costs as $5 million.\textsuperscript{364} Furthermore, many of the costs for new technology and personnel might have been ascertained by consulting with the regulated parties. The absence of estimates here is noteworthy in light of the fact that similar costs were estimated for the redemption fee regulation. Likewise, with respect to the independent director requirement, the agency’s staff could have surveyed funds to find out how they would comply with the rule. Many of the compliance costs—money spent to locate and hire new directors, directors’ fees, and increased staffing to serve these non-executive directors—are common in the industry and might have been factored into the analysis.

The one major exception to this finding is the SEC’s estimation of compliance costs for the mandatory redemption fee proposal. These costs were estimated pursuant to the requirements of the Paperwork Reduction Act but were not included in any formal cost-benefit analysis.\textsuperscript{365} In this instance, the SEC provided a significant number of specific quantitative data. Three facts about this analysis are noteworthy. First, the SEC’s analysis contains basic math errors, which may be cause for concern.\textsuperscript{366} Second, the Commission did not indicate its sources of data, thereby making it impossible for members of the interested public to evaluate the quality of the agency’s analysis.\textsuperscript{367} Third, the SEC estimated that this regulation would require three-year compliance costs in excess of $1 \textit{billion}, most of which would be incurred in the first year.

\textsuperscript{364} See supra note 351.

\textsuperscript{365} See supra note 321–328 and accompanying text.

\textsuperscript{366} See supra note 328.

\textsuperscript{367} In other rulemakings, the SEC has provided more complete information about the source of its data with respect to some types of compliance costs. See, e.g., Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, 69 Fed. Reg. 11244, 11257–60 (Mar. 9, 2004) (providing sources of information for estimates of labor-cost savings and indicating some of the assumptions behind its calculations regarding the costs of producing and distributing shareholder reports).

In other settings, however, agencies have been accused of withholding data in order to skew the results of the regulation for political purposes. For instance, the EPA deleted references to a Harvard University study it commissioned from its recent rulemaking limiting mercury emissions from power plants. The Harvard study found monetized benefits 100 times greater than those cited in the agency’s CBA. Critics contend that the Harvard results were omitted in order to avoid providing support to proponents of stricter emissions standards. See Shankar Vedantam, \textit{New EPA Mercury Rule Omits Conflicting Data}, WASH. POST, Mar. 22, 2005, at A1.
Given that the threshold for a “significant regulatory action” prompting OMB review is only $100 million in costs, this is truly a staggering amount. The fact that the SEC would contemplate imposing such costs on the mutual fund industry—which would then pass such costs onto shareholders—without undertaking a full cost-benefit analysis should give us pause.

With respect to the benefits and distributional consequences of these regulations, the SEC had access to data that may have been used to justify those large costs. It is well established that both market timing and late trading impose certain costs on mutual funds and long-term investors, among them dilution and higher administrative expenses. Regulations to combat those practices would redistribute funds from market timers and late traders back to fund managers and long-term investors. Given the availability of academic studies estimating the costs of these practices—not to mention the SEC’s institutional capacity to study those issues on its own—it stands to reason that the SEC could have provided an estimate of how regulations targeting these practices would create beneficial distributional consequences.

Of course, not every cost or benefit can be quantified, and qualitative assessments of costs and benefits are important to regulatory analysis. However, the OMB guidelines offer two suggestions to regulators in circumstances when the major costs and benefits are not easily quantified. First, if the non-quantified costs and benefits are considered important, agencies are supposed to conduct a “threshold” analysis. This type of examination answers the question, “How small could the value of the non-quantified benefits be (or how large would the value of the non-quantified cost need to be) before the rule would yield zero net benefits?” This practice is intended to allow as meaningful a comparison as possible between costs and benefits.

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368 E.O. 12,866, supra note 71, at § 3(f)(1).
369 Cf. supra note 193 and accompanying text (indicating that SEC staff members occasionally prepare economic analyses of agency rulemakings in their individual capacities).
370 Circular A-4, supra note 157, at 2. In addition to the threshold analysis, the agency is also supposed to indicate which of the non-quantified costs and benefits are the most significant, and why. Id.
by putting the non-quantified costs (or benefits) in opposition to monetized net benefits (or costs). Second, if there is significant uncertainty in the cost-benefit analysis—as there is in each case here—then agencies are told to “consider deferring the decision... pending further study to obtain sufficient data.” In light of the number of costs and benefits that might have been quantified but were not, further study—including consultation with affected parties—may have led to better quantitative analysis.

3. Consideration of Regulatory Alternatives

Both the OMB and FSA guidelines require agencies to consider the costs and benefits of regulatory alternatives and to choose among them based on some form of cost-effectiveness analysis. By way of illustration, the Department of Agriculture calculated the net benefits of two alternatives to its regulation banning the importation of Canadian beef products in response to an outbreak of mad-cow disease north of the border. By contrast, the SEC has failed in this aspiration. Instead, its conduct of cost-benefit analysis better resembles an appendage to an already-determined course of action than an integral part of the policy-making process.

In none of its analyses does the SEC consider the costs and benefits of alternatives to the chosen regulation. In the investment company governance regulation, the SEC did not demonstrably consider any number of alternatives—prosecuting directors for violations of their fiduciary duties, a larger SEC enforcement budget, or a certification requirement akin to § 302 of the Sarbanes-Oxley Act—that might have promoted better governance at a lower cost. The

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371 Id. at 39.
373 The FSA considers CBA an important part of the process of policy development. Under this model, alternatives are submitted to rigors of regulatory analysis and only once the costs and benefits are known does the favored policy emerge. The alternative poses significant problems, as “[d]elayed CBA might reveal that the favoured policy option would yield an excess of costs over benefits. That would be a significant problem, absent countervailing non-economic impacts.” FSA, PRACTICAL COST-BENEFIT ANALYSIS, supra note 198, at 8. However, as a practical matter, the FSA’s analyses do not consistently consider the costs and benefits of regulatory alternatives.
further failure to consider disclosure-based alternatives supported by the two dissenting commissioners was one of the two bases on which the D.C. Circuit struck down the regulation as being in violation of the APA.\(^{374}\) Further, it bears noting that in the two proposed (as opposed to final) rulemakings discussed earlier, the Commission solicited comments on alternative proposals. In the rulemaking requiring a mandatory redemption fee, the SEC asked whether the alternative of fair value pricing would better prevent market timing based on stale pricing. Likewise, in the rulemaking imposing a 4 p.m. hard close, the agency asked for comments on whether a tamper-proof time stamp—part of a verified order processing system—would thwart illegal late trading. These citations beg the question of what constitutes adequate consideration of regulatory alternatives.

The SEC’s solicitation of comments on fair value pricing and time stamps was inadequate because the agency did not seek information on these alternatives until it issued the notices of proposed rulemaking in the Federal Register. There are strong arguments that because of the agency’s investments of time, money, and political capital in a proposed rulemaking, this is too late in the process for any consultation to be meaningful:

> After agency members have devoted months, or even years, to preparing a proposed rule and made highly visible public commitments endorsing that proposal, the attitude maintenance bias suggests suboptimal processing of later public inputs. This is not to suggest that agencies never change a proposed rule—they routinely alter rules in response to public feedback, particularly from powerful interest groups, or complete multiple rounds of notice and comment. The effect of cognitive consistency is to decrease the frequency of these position changes compared to an optimal model of information-processing.\(^{375}\)

The fact that agency staff will be biased in favor of a proposed rule even while soliciting comments on alternatives demonstrates the need for early consultation with interested parties and

\(^{374}\) Chamber of Commerce, 412 F.3d at 144-45.

\(^{375}\) Stern, supra note 94, at 591.
early consideration of regulatory alternatives. Commissioner Atkins made a similar point in dissenting from the SEC’s proposed rulemaking on market timing. While the proposed rule imposing mandatory redemption fees mentioned the possibility of fair value pricing, Atkins said that issuing the proposed rule would preclude consideration of that alternative. The GAO has also urged the SEC to revisit its rule aimed at late trading and consider less costly alternatives.

As it turned out, the SEC appears to have retreated from these two proposed rules. It backtracked from the mandatory redemption fee in favor of continued voluntary fees and greater information-collection requirements. It has also not issued the 4 p.m. hard close regulation in final form and may replace it with some form of verified order processing. The fact that the agency reconsidered its published proposals might belie the argument that notices of proposed rulemakings create “agency lock-in” and stifle debate on regulatory alternatives. That argument clearly has some merit, but it is ultimately unconvincing. By issuing proposed regulations while soliciting comments on alternatives, the SEC has unnecessarily postponed final decision-making. Had the agency solicited comments on and analyzed the costs and benefits of regulatory alternatives before issuing its notices of proposed rulemaking, the proposals it ultimately put forward would have been better supported and less controversial. That might have enabled the agency to promulgate its rules with less delay and better protect mutual fund shareholders from

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376 See id. at 621–27 (noting that the bulk of agency decision-making occurs in during the pre-notice period). Stern added:

A published notice in the Federal Register is a widely visible public commitment that encourages agency lock-in. A commitment, according to the consistency research, encompasses statements of opinion and behavior as well as promises. Although the proposed notice of rulemaking is not a legally binding commitment, it is a psychological commitment to the agency’s “best thinking” about a regulatory problem.

Id. at 629.

377 See supra note 337 and accompanying text.

continued dilution and expenses. The consideration of regulatory alternatives during the early, consultative phases of rulemaking is preferred to late-stage consultation.\textsuperscript{379}

4. Presentation of Results

The presentation of an agency’s findings regarding the costs and benefits of a proposed rulemaking is important. On the one hand, the results should be disclosed in a manner that enables citizens to understand and evaluate the rulemaking.\textsuperscript{380} On the other hand, the agency can present the results in such a manner as to convince the public that its recommendations would best solve the problem of malfeasance in the mutual fund industry.\textsuperscript{381} The SEC’s analyses meet neither of these objectives.

First, the published cost-benefit analyses did not clearly articulate either the benefits or the costs of the new regulations. For instance, with respect to both the market timing and late trading regulations, the agency used footnotes to note academic studies that purported to show that those practices harmed innocent investors to the tune of hundreds of millions or billions of dollars a year. Had those findings been more fully presented and the sums of money involved been contrasted with the expected costs of those regulations, the benefits of the proposed rulemakings may have been more readily apparent. The SEC’s analysis also did not articulate how the proposed measures would increase investor confidence or prove that they would have such an effect, thereby diminishing the importance of that putative benefit. Likewise, having failed to monetize most of the costs of the regulations—even easily calculated compliance

\textsuperscript{379} See E.O. 12,866, \textit{supra} note 71, § 6(a)(1) (“Before issuing a notice of proposed rulemaking, each agency should, where appropriate, seek the involvement of those who are intended to benefit from and those expected to be burdened by any regulation.”). \textit{See also} Circular A-4, \textit{supra} note 157, at 3 (“Early consultation can be especially helpful. You should not limit consultation to the final stages of your analytical effort.”).

\textsuperscript{380} Pildes & Sunstein, \textit{supra} note 1, at 108.

\textsuperscript{381} See WALSHE & DAFFERN, \textit{supra} note 65, at 30 (“In seeking to influence decisions about the allocation of resources the importance of a clear and well-argued presentation cannot be over-emphasised.”).
costs—the rulemakings did not present a readily understood picture as to what costs shareholders would ultimately bear in exchange for these added protections.

Second, the SEC could have used cost-benefit analysis to challenge arguments that its proposals were not justified by the scandals that prompted their promulgation. For instance, the agency argued that if 75 percent of mutual fund directors (including all board chairmen) were independent, shareholders would receive enhanced protection. That conclusion may have carried greater weight had it shown that a significant number of funds implicated in enforcement actions in 2003 and 2004 did not meet this enhanced independence requirement. The Commission could also have won support by demonstrating how transfers from market timers and late traders to long-term shareholders and the mutual funds themselves might pay for the additional costs of preventing abusive trading activity. Third, the presentation of the cost-benefit analysis would have been considerably improved has the SEC included any meaningful comparison of regulatory alternatives and disclosed the assumptions and sources of data underlying its analysis.

With regard to presentation, the SEC’s lackluster performance stands in stark contrast to the FSA’s successful effort to make its findings accessible and transparent. Its reports will often explain the sources of information on which its estimates are based and describe the underlying market dynamics that informed its analysis.\(^{382}\) The FSA also makes ample use of charts and graphs in order to permit comparisons between the costs and benefits with respect to each of the FSA’s six cost-benefit categories,\(^{383}\) separate one-time implementation costs from ongoing

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\(^{382}\) See, e.g., OXERA, SOFT COMMISSIONS, supra note 359, at 3–4 (explaining that the report relies on interviews with industry actors, data analysis, and questionnaires sent to different interest groups); id. at 5–12 (explaining market dynamics).

\(^{383}\) See id. at 31, 54.
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compliance costs, and direct readers to the paragraphs in the analysis where individual costs are discussed.

V. SUGGESTIONS FOR REFORM

In light of the shortcomings described above, this Article concludes that the SEC should conduct thorough and transparent analyses of the costs and benefits of its rulemakings. This would not only subject it to the same regulatory discipline as other government agencies, but likely improve the quality of its rulemakings and the agency’s ability to justify them to skeptical members of the public and political officials. This Section explores several different ways in which SEC rulemaking could become subject to cost-benefit analysis.

A. Promulgate Formal SEC Guidelines for Cost-Benefit Analysis

The most obvious way by which SEC rulemakings could become subject to cost-benefit analysis is if the agency itself were to adopt formal CBA procedures. Given the existence of OMB guidelines on the conduct of CBA and FSA guidelines specific to the cost-benefit analysis of financial regulation, the SEC would not have to re-invent the wheel to accomplish this task. Further, doing so would be in keeping with former Chairman Donaldson’s pledge to make the SEC’s regulatory actions more “cost-effective.”

B. Bring the SEC Under OMB Review

The next most obvious solution would be to bring SEC within the ambit of OMB review. The idea that independent regulatory agencies like the SEC should be subject to the same procedures as executive agencies has been most forcefully argued by Robert W. Hahn and Cass

384 See FSA, LLOYD’S CONSULTATION PAPER, supra note 218, annex 3, at 27.
Sunstein and their co-authors, but they are certainly not the only scholars to believe that “little rationale exists for distinguishing these agencies from their executive counterparts.”

The argument for OMB review of independent agency rulemaking is essentially the same as for executive agencies. However, the case is arguably tougher to make for the independent agencies whose insulation from political pressure is thought to derive from their greater expertise over technical matters. Elena Kagan has criticized this hands-off view, arguing instead that agency officials are, like Congress and the President, political actors:

Bureaucratic expertise, for reasons I have indicated earlier, cannot alone or even predominantly drive administrative decisions. Most important for current purposes, agency experts have neither democratic warrant nor special competence to make the value judgments—the essentially political choices—that underlie most administrative policymaking. The skills and knowledge these officials possess cannot answer this kind of question; and none of their other shared characteristics makes them specially suited to lead in this field of decision.

In Kagan’s view, agency officials are not pure technocrats, but political beings who routinely make decisions based not on their scientific merit but as a result of “congressional pressure, interest group lobbying, bureaucratic (but nonexpertise-based) policy views, or bureaucratic protection of turf or other self-interest.” Those who continue to hold otherwise reflect “an odd romanticism about bureaucracy” that no longer reflects the realities of the modern administrative state.

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389 See supra Section II.C.

390 Kagan, supra note 1, at 2353.

391 Id. at 2354.

392 Id.

393 A three-judge panel of the United States District Court for the District of Columbia chaired by then-Judge Scalia made the same point in a 1986 case:
However, White House review of independent agency rulemakings gives rise to significant—but unanswered—constitutional issues beyond the scope of this Article. As their name suggests, independent regulatory commissions like the SEC have operated independently from executive control. This proposition was elaborated in the case of Humphrey’s Executor v. United States, which held that the President could not remove a member of an independent commission for reasons other than those enumerated by statute. Thus, while the President may remove an executive agency official at will, members of independent commissions may generally only be removed only for good cause shown. The Humphrey Court wrote:

The Federal Trade Commission is an administrative body created by Congress to carry into effect legislative policies… and to perform other specified duties as a legislative or as a judicial aid. Such a body cannot in any proper sense be characterized as an arm or eye of the executive. Its duties are performed without executive leave and, in contemplation of the statute must be free from executive control.

The Court said that unlike executive agencies over which the President has the power of removal, the independent commissions exercise legislative and judicial powers delegated to them by Congress. Thus, the degree of control exercised by the President over an agency should “depend on the character of the office.”

It is not as obvious today as it seemed in the 1930s that there can be such things as genuinely “independent” regulatory agencies, bodies of impartial experts whose independence from the President does not entail correspondingly greater dependence upon the committees of Congress to which they are then immediately accountable; or, indeed, that the decisions of such agencies so clearly involve scientific judgment rather than political choice that it is even theoretically desirable to insulate them from the democratic process.

Synar v. United States, 626 F. Supp. 1374, 1398 (D.D.C.) (per curiam), aff’d sub nom. Bowsher v. Synar, 478 U.S. 714 (1986). The Supreme Court, however, retreated from the district court’s position. See 478 U.S. at 725 n.4 (“Appellants therefore are wide of the mark in arguing that an affirmance in this case requires casting doubt on the status of ‘independent’ agencies because no issues involving such agencies are presented here.”).


396 See Myers v. United States, 272 U.S. 52 (1926).

397 Humphrey’s Executor, 295 U.S. at 628 (emphasis added).

398 Id. at 630.

399 Id. at 631.
It is not a settled question whether the principles that apply to removal of independent agency officials applies to presidential authority over the policies created by those agencies. Over the last twenty-five years, this question has prompted debate in the literature. While this question remains unresolved, at the time President Reagan promulgated Executive Order 12,291, both the Department of Justice and the American Bar Association concluded that extension of OMB review to the independent regulatory agencies would be constitutional.

C. Engage the Resources of Other Financial Regulators

If the SEC did not develop the native capacity to conduct rigorous cost-benefit analyses of its regulations, it could seek to take advantage of external resources. The most well-known of these is the Federal Trade Commission Advocacy Program, coordinated by the FTC’s Office of Policy Planning. The Advocacy Program advises other government agencies—sometimes publicly, sometimes behind the scenes—on the effects of their regulatory actions on consumers and markets. The program has been in existence in some form for about thirty years, during which time it has issued more than 750 reports to state and federal agencies.


401 OLC Memo, supra note 146; AMERICAN BAR ASSOCIATION, COMMISSION ON LAW AND THE ECONOMY, FEDERAL REGULATION: ROADS TO REFORM 84 (1979) (“Many of the independent agencies have been entrusted with primary missions that may conflict with other statutory goals, and they ought to be subjected to the same balancing discipline as other regulatory agencies.”).


404 Majoras, supra note 402, at 2. However, the FTC has issued significantly fewer reports in recent years, dropping from an average of more than sixty a year from 1985 to 1989 to fewer than twenty a year from 1996 to 2003. See Cooper et al., supra note 403, at 11. The decline was a result of a policy decision by then-FTC Chairwoman Janet Steiger to “reduce tension” between the FTC and other regulatory bodies in 1989. Id. at 16.
While the Advocacy Program has not traditionally provided comments on financial regulation, it has done so in several instances. In 2002, the FTC provided comments to the Department of Housing and Urban Development on proposed regulations implementing the Real Estate Settlement Procedures Act; two years later, it published a more thorough economic analysis questioning the wisdom of some of these regulations. The FTC has also given advice to the CFTC and the Federal Reserve Board. FTC comments for non-financial agencies have considered issues, like advertising and required disclosures, on which the SEC issues regulations with respect to the securities industry. While most of these comments do not take the form of rigorous cost-benefit analyses, the FTC has a large staff of trained economists who may be able to assist the SEC in preparing more thorough analyses of its rulemakings.

D. Require Ex Post Analyses of Existing Regulations

One final suggestion for improving the quality of SEC rulemakings through regulatory analysis is to require ex post analysis of existing regulations. While ex ante analysis better helps agencies avoid promulgating rules that will impose net costs on society, ex post analysis allows agencies to determine whether their rulemakings have had the intended effects. Ex post analysis

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also has the advantages of better data, much of which is generated during the process of implementation.\footnote{See Harrington et al., \textit{supra} note 42, at 304–05 (noting problems with ex post analysis but concluding it is generally more accurate than ex ante analysis).} The results of ex post analysis can also inform future ex ante analyses:

> The regulatory analysis office can enhance the accuracy of its predictions if it obtains feedback from the real world through respective analysis of the actual impact of regulations on the regulated industry and the intended beneficiaries. A good faith review of the effectiveness of existing regulations can loosen up the bureaucratic inertia that often plagues regulatory agencies. Over time, retrospective analysis can be useful in evaluating the entire regulatory analysis enterprise.\footnote{\textsc{McGarity}, \textit{supra} note 1, at 137.}

However, agencies have little bureaucratic incentive for doing retrospective analyses. There is little upside for regulators to prove themselves accurate, while there is a significant risk that ex post analysis will show their initial forecasts to have been far off the mark.\footnote{\textit{Id.}; Harrington et al., \textit{supra} note 42, at 298.}

As long as OMB does not review the major rulemakings of independent regulatory agencies, Congress is in the best position to force the SEC to undertake this sort of retrospective analysis. Senator Gregg’s legislative amendment requiring the Commission to undertake a review of its new regulation on investment company governance is one example of how Congress might implement this requirement.\footnote{\textit{See supra} notes 281–283 and accompanying text.} While sound in theory, this exercise of congressional power may be criticized in practice. After all, while Gregg acted at the behest of Fidelity Investments, a wealthy and powerful campaign contributor, mutual fund investors probably lack the clout required to force a review of a regulation they find unfavorable. Nevertheless, Congress—having delegated its legislative power to the SEC—ought to see to it that the agency uses its rulemaking power wisely, and it can do so by requiring rigorous reviews of important regulations whose benefits may not exceed their costs.
VI. CONCLUSION: FINANCIAL REGULATION AND THE LIMITS OF COST-BENEFIT ANALYSIS

While cost-benefit analysis has become firmly entrenched in the modern administrative state over the last twenty-five years, the SEC has not utilized it in pursuit of cost-effective financial regulation. Yet, if utilized in a manner consistent with existing guidelines promulgated by U.S. and U.K. regulators, it holds tremendous promise for improving the quality of financial regulation. By forcing regulators to consider regulatory alternatives early in the policymaking process, it helps ensure that the agency issues the most cost-effective rule and does not waste time by considering those alternatives seriatim. Further, by requiring that agencies quantify the costs and benefits of regulation, when possible it helps guarantee that government regulations promote societal welfare. CBA can also inform Congress and the public about the effects of regulations and frame public debate on matters of wide concern.

Of course, course-benefit analysis is not a panacea for what ails the regulatory process. With financial regulation in particular, key variables may be difficult to quantify, though there is little evidence that regulators have made a good-faith attempt to do so. Further, cost-benefit analysis is not the only means by which a government agency might evaluate different regulatory options. There are those who would prefer the more informal, value-oriented analysis currently conducted by the SEC to more rigorous cost-benefit analysis. Finally, the practice of cost-benefit analysis can be subject to its own cost-benefit analysis, and it may not be worthwhile for all rulemakings. The Reagan and Clinton executive orders, unlike the FSA, require analyses only for “major” rulemakings. In effect, this limits the use of CBA to those cases where the efficiency gains resulting from CBA are likely to exceed the costs of conducting the analysis.

413 Cf. Mark Sagoff, Policy Analysis and Social Values, in DEMOCRACY, SOCIAL VALUES, AND PUBLIC POLICY, supra note 46, at 91, 100-01 (“Policy analysts who work for government agencies may try to present an agency’s preferred option, . . . by showing how they follow or serve larger social goals, values, or commitments, . . . . This is a more interesting and more productive endeavor than the narrower practice of formal cost-benefit analysis.”).
Imposing a CBA requirement on the SEC will impose some very real costs. The agency has only about 24 economists and statisticians in its Office of Economic Analysis, and that office may need increased staffing to achieve an expanded mandate. More generally, the SEC has been strained by its enlarged workload in recent years, prompting concerns about its effectiveness.

Lacking any institutional motivation to emphasize cost-benefit analysis, it is less likely that the SEC will impose a CBA requirement upon itself than it will have such an obligation thrust upon it. One avenue for such regulation is the judicial system. Even a limited reading of the D.C. Circuit’s opinion in the Chamber of Commerce case supports the imposition of additional procedures—estimation of expected costs, full consideration of reasonable regulatory alternatives—regularly ignored by the SEC in the rulemaking process. Given the business lobby’s success in that case, further litigation can be expected if the Commission does not begin to incorporate cost-benefit principles and practices from the outset of the regulatory process.

The political branches may also force the SEC to undertake cost-benefit analysis of its proposed rulemakings. Just as concern with the costs of health and safety regulation in the 1970s led to the regulatory reform movement of the 1980s, industry opposition to the SEC’s current spate of rulemakings could spur legislative measures to rein in the agency. In that sense, should


Although SEC’s workload and staffing imbalances have challenged SEC’s ability to protect investors and maintain the integrity of securities markets, SEC has generally managed the gap between workload and staff by determining what basic, statutorily-mandated duties it could accomplish with existing resource levels. This approach, while practical, has forced SEC’s activities to be largely reactive rather than proactive,... Although SEC has a strategic plan and has periodically adjusted staffing or program priorities to fulfill basic obligations, SEC has not engaged in a much needed, systematic reevaluation of its programs and activities in light of current and emerging challenges.

Id. at 87. See also Ramirez, supra note 79, at 562–63 (describing the consequences of understaffing in the 1980s). Clearly, absent congressional or presidential direction, more rigorous CBA has not been prioritized. The SEC also faces technological limitations in its ability to gather and process large amounts of information, as often required in economic analysis. See Government Accountability Office, Securities and Exchange Commission: Review of Fiscal Year 2003 and 2004 Budget Allocations 17, Doc. No. GAO-04-818 (2004).
opposition grow to the SEC’s regulatory zeal, Senator Gregg’s successful effort to force the Commission to justify its independent-director rule could foretell a broader mandate akin to that contained in Executive Order 12,291 and its progeny. What is regrettable, however, is that any CBA requirement imposed on the SEC would more likely be motivated by a knee-jerk antipathy to government regulation than a genuine concern that such regulations be tailored to create the maximum benefit for the investors whom the SEC exists to protect.