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on

The SEC's Aversion to Cost-Benefit Analysis

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Chairman McHenry, Ranking Member Quigley, members of the Subcommittee, thank you for the opportunity to appear before you today to discuss the cost-benefit analyses in the context of SEC rulemaking. It is an honor and a privilege to appear before the Subcommittee today.

I am the Founder and President of Fund Democracy, a nonprofit investor advocacy group, and a Jessie D. Puckett, Jr., Lecturer and Associate Professor of Law at the University of Mississippi School of Law. I am also a Vice President of the financial planning firm, Plancorp LLC; a member of the CFP Board's Public Policy Council; and an Accredited Investment Fiduciary. I was formerly a member of the SEC's Investor Advisory Committee and chaired its Investor as Purchaser Subcommittee; an Assistant Chief Counsel in the SEC's Division of Investment Management; and an attorney in the securities practice of Wilmer, Cutler & Pickering (now WilmerHale).

This testimony is based on my general experience over a number of years as an investor advocate, journalist, academic, regulator, financial planner, private practitioner and expert witness and consultant. I have been engaged in securities regulation issues from a variety of perspectives and attempt to provide testimony that reflects the interests of investors, diverse views of various constituents, and the practical exigencies of real-world legal practice and compliance.

I. INTRODUCTION

Like rulemaking by other agencies, rulemaking by the Securities and Exchange Commission ("Commission" or "SEC") is subject to the "arbitrary and capricious standard" of review under Section 706 of the Administrative Procedures Act, which provides that a court shall vacate rules that it finds, among other grounds, to be "arbitrary, capricious, [or] an abuse of discretion." Various provisions of the federal securities laws impose heightened cost-benefit standards on SEC

rulemaking. For example, Section 2(b) of the Securities Act requires that the Commission "consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."[1] Section 23(a)(2) of the Exchange Act requires that the Commission "consider . . . the impact . . . on competition" and prohibits the adopting of any rule that "would impose a burden on competition not necessary or appropriate in the furtherance of the purposes of [the Exchange Act]." That provision also requires a written statement of the "reasons" for a determination that any [such] burden on competition" is necessary and appropriate in the furtherance of the purposes of [the Exchange Act]."

The Commission has been criticized for failing to conduct adequate cost-benefit analyses in connection with its rulemaking. Financial services firms and businesses, either directly or through their proxies, have successfully challenged SEC rulemaking for failing to satisfy cost-benefit analysis requirements.[2] Members of Congress have questioned the qualifications and credibility of the SEC staff responsible for economic aspects of its cost-benefit analysis.[3] The House Financial Services Committee has reported a bill that would heighten cost-benefit standards that apply to SEC rulemaking, as discussed further in Part III of this testimony. This

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[1] The full text of Section 2(b) is as follows:

> Whenever pursuant to this title the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

[2] *See*, *e.g.*, *Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011) (vacating proxy access rule on arbitrary and capricious grounds and because of failure to conduct adequate cost-benefit analysis); *American Equity Inv. Life Ins. Co. v. SEC*, 613 F.3d 166 (D.C. Cir. 2010) (vacating equity-indexed annuities rule on arbitrary and capricious grounds); *Chamber of Commerce v. SEC*, 412 F.3d 133 (D.C. Cir. 2005) (vacating mutual fund rule because of failure to consider costs and alternatives).

[3] *See*, *e.g.*, Letter from Darrell Issa, Chairman, House Committee on Oversight and Government Reform, to Mary Schapiro, Chairman, Securities and Exchange Commission, at 11 (Mar. 22, 2011) *available at* http://democrats.oversight.house.gov/images/stories/FULLCOM/510%20future%20of%20cap%20form/2011-03-22%20DEI%20to%20Schapiro-SEC%20-%20capital%20formation%20due%204-5.pdf.

hearing is premised on the view that the Commission has an "aversion" to cost-benefit analysis.

There is substantial support for the view that the SEC's cost-benefit analysis could be improved, just as there is substantial support for the view that the Commission has already made significant improvements. Recent analysis by one of the SEC's most vehement critics found that its rulemaking under the Dodd-Frank Act of 2010 has effectively, if imperfectly, incorporated significant cost-benefit analysis.[4] A follow-on report found that:

> SEC rulemaking teams consistently adhere to internal policies for preparing cost-benefit analyses. As a result, the cost-benefit analyses follow a systematic process from inception to completion.[5]

These reports, unlike virtually all other commentary on the SEC's cost-benefit process, actually analyzed the inner workings of specific rulemakings. In contrast, many other commentaries reflect broad misperceptions regarding rulemaking cost-benefit analyses in general and the SEC's analyses in particular. For example, charges that the Commission has an aversion to cost-benefit analysis are, in some cases, nothing more than an observation that agency rulemaking is necessarily premised on incomplete information, or an expression of bias in favor of economic factors over non-economic ones, or a complaint about problems that are outside of the SEC's control. It is important to separate such perceived inadequacies in cost-benefit analyses from inadequacies that have a genuine empirical basis.

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[4] *See Report of Review of Economic Analyses Performed by the Securities and Exchange Commission in Connection with Dodd-Frank Act Rulemakings*, Office of Inspector General, Securities and Exchange Commission (June 13, 2011) *available at* http://www.sec-oig.gov/Reports/AuditsInspections/2011/Report_6_13_11.pdf.

[5] *Follow-Up Review of Cost-Benefit Analyses in Selected SEC Dodd-Frank Act Rulemakings*, Office of Inspector General, Securities and Exchange Commission at 12 (Jan. 27, 2012) *available at* http://www.sec-oig.gov/Reports/AuditsInspections/2012/Rpt%20499_FollowUpReviewofD-F_CostBenefitAnalyses_508.pdf.

II. DISCUSSION

One difficulty in evaluating the claim that the Commission has an aversion to cost-benefit analysis is that the term "cost-benefit" is often used to refer exclusively to economic factors or factors that are easily quantified. The academic literature on regulatory cost-benefit analysis frequently acknowledges as cost-benefit factors only those that are susceptible to economic of other quantitative analysis, such as the investment performance of mutual funds, while excluding factors that are not, such as the likelihood that a chairman of a mutual fund who was not affiliated with the fund's investment adviser would take steps to prevent fraudulent market timing by investment adviser personnel.[6] Under this approach, some would argue that the Commission demonstrates an "aversion" to cost-benefit analysis when, for example, it adopts investor protection rules based on a reasonable belief that the unquantifiable benefits of preventing and deterring fraud and misleading sales practices exceed the often quantifiable costs of compliance with the rules.

In my view, this argument is not based on a disagreement with cost-benefit analysis as much as a disagreement with the relevance of cost-benefit factors that are not economic or easily quantified. In this sense, the SEC's aversion to cost-benefit analysis is nothing more than a refusal to surrender to facile analysis and simplistic econometric models. It is not an aversion at all, but a willingness to accept the challenge of the very real complexity of financial regulation and to consider all appropriate cost benefit factors.

Another difficulty with the "aversion" claim is that, to some extent, the SEC's "aversion" simply reflects the fact that it lacks the resources to conduct an extensive cost-benefit analysis. Thus, it is an "aversion" only in the sense of the Commission not doing what it does not have the resources to do. Congress should provide the

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[6] *See In the Matter of Strong Capital Management, Richard S. Strong, et al*, Admin. Proceeding 3-11498 (May 20, 2004) (sanctioning mutual fund chairman, who also served as CEO of the fund's investment adviser, for defrauding the fund) *available at* http://www.sec.gov/litigation/admin/34-49741.htm.

Commission with the resources that it needs to consider the full range of factors on which efficient, effective rulemaking must be based.

Alternatively, the "aversion" claim is, in some cases, merely a complaint about the reality that no rulemaking can exhaust every avenue of inquiry that might reasonably lead to a better understanding of a rule's costs and benefits. Some claims that the SEC is averse to cost-benefit analysis reflect a failure to understand that regulatory action is invariably based on imperfect information, just as regulation invariably requires the exercise of reasoned judgment in the known absence of information that concededly could improve the regulatory decisionmaking process.[7] It is not an aversion to cost-benefit analysis to accept the reality that decisive action is not possible if perfect information is a necessary predicate. The potential aversion about which Americans should be most concerned is the potential for the Commission to be averse to taking needed regulatory action out of fear that its rules will be vacated for having left some cost-benefit stone unturned.[8]

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[7] Former SEC Secretary Jack Katz discussed this misperception in testimony on H.R. 2308 last fall:

> While I have long supported the use of cost benefit analysis as one component of the rulemaking process, I have also believed that the process has limitations that are often overlooked. Cost-benefit analyses are and will always be fundamentally limited. They require estimates of the impact of events that have not yet happened. Simply put, it is difficult if not impossible for any regulator to know what will happen when a regulation is adopted. Capital markets are the reflection of large numbers of individuals making individual decisions. A regulator rarely has the capacity to predict with certainty how individuals or firms will respond to a new rule. If a regulator can't predict the response, it is difficult to accurately quantify the cost of compliance or quantify the value of benefits before one knows how the industry will achieve compliance. The current means of developing cost benefit analysis may be manipulated or fail to take into account facts that may not be readily apparent yet important to the ultimate purpose of a proposed rule.

Hearing before the Committee on Financial Services, House of Representatives at 14 (Sep. 15, 2011) (testimony of U.S. Chamber of Commerce) ("*H.R. 2308 Hearing*") *available at* http://financialservices.house.gov/UploadedFiles/091511katz.pdf

[8] *See id.* at 15 (testimony of Mary Schapiro, Chairman, Securities and Exchange Commission) (H.R. 2308 "would create a new potential challenge to future rules") *available at* *http://financialservices.house.gov/UploadedFiles/091511schapiro.pdf*. *See also* Jesse Hamilton, *Dodd-Frank Rules Slow at SEC after Cost Challenge*, Bloomberg (Mar. 5, 2012) *available at* http://www.bloomberg.com/news/2012-03-06/dodd-frank-rules-slow-at-sec-after-court-cost-benefit-challenge.html; Phil Mattingly & Jesse Hamilton, *Broker Fiduciary Rule Delayed by Cost-Benefit Analysis, SEC Says*, Bloomberg BusinessWeek (Jan. 20, 2012) *available at*

Such regulatory paralysis imposes substantial net costs on financial services providers and investors alike. The SEC's inaction, for example, in the face of problems arising during the last decade from analysts' conflicts of interest, mutual funds' use of stale prices and inadequate disclosure of revenue sharing effectively ceded these areas to state attorneys general and enforcement officials. The failure to conduct rulemaking resulted in Balkanized, *ad hoc* lawmaking that left all interested parties (other than litigators) worse off. When critics complain that the SEC rulemaking relies on inadequate cost-benefit analysis, they are often choosing, in effect, that law be made through less efficient, less effective means.

If "cost–benefit" analysis means the reasonable consideration of the full panoply of social costs and benefits of regulation, then the charge that the Commission has some aversion to cost-benefit analysis is a fair one. Its historical aversion to economic analysis, for example, is widely recognized and has been undeniably harmful to the credibility and quality of its rulemaking. The Commission has also been handicapped by a tendency to adopt an overly legalistic approach to non-legal issues and a reluctance to recognize the inherently policy-based nature of the rulemaking process.

In my experience, too many senior SEC lawyers view their roles only through a narrow prism of hyper-legal analysis that inhibits their ability to confront the true nature of the practical problems that they are tasked with solving. They often treat the law as an end rather than a means, as if the primary purpose of federal securities regulation were to pay homage to the formal observance of technical legal analysis, rather than to promote investor protection and efficient markets.

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http://www.businessweek.com/news/2012-01-20/broker-fiduciary-rule-delayed-by-cost-benefit-analysis-sec-says.html; Peter Madigan, *CFTC and SEC Facing Legal Anxiety Over Cost-Benefit Analyses*, Risk Magazine (Oct. 3, 2011) (published under the original headline: *Cost-Benefit Paralysis*) *available at* http://www.risk.net/risk-magazine/feature/2111501/cftc-sec-facing-legal-anxiety-cost-benefit-analyses*.*

The SEC's proxy access rulemaking illustrated this problem. In the rulemaking, the Commission made the kind of argument that only a lawyer could appreciate: that the costs that corporations would incur in campaigning for management nominees against shareholder nominees were not attributable to the proxy access that the rule itself would grant to such shareholder nominees, but rather to state laws that authorize such expenditures. Based partly on this position, a federal appellate court vacated the rule on cost-benefit grounds.

Nonetheless, the Commission has taken significant steps to address its weakness in economic analysis, both in reforms to its rulemaking processes and in increased hiring of economists. For example, its Division of Risk, Strategy, and Financial Innovation now plays a key role in virtually all rulemaking initiatives. There is still significant room for improvement, and such improvement would undoubtedly be facilitated by Congress's ensuring that the Commission has the resources that it needs to hire and retain qualified staff. Even greater improvement is necessary in the integration of cost-benefit analysis into the SEC's rulemaking process and in giving greater attention to non-economic areas of cost-benefit analysis.

It is the SEC's aversion to non-economic aspects of cost-benefit analysis that should be of greatest concern to Congress. The significant attention that has been focused on the inadequacies of the SEC's economic analysis has created a risk that emphasizing economic factors will weaken the SEC's overall cost-benefit analysis rather than strengthen it. A genuine cost-benefit analysis considers a variety of factors, many of which are not economic and not easily quantified. Nonetheless, popular critiques of SEC rulemaking have focused almost entirely on economic factors to the exclusion of other important considerations. For example, H.R. 2308's requirement that the SEC's Office of Chief Economist "assess the costs and benefits" of rulemaking, without similarly referencing any non-economic cost-benefit factors, implies that economic factors should receive greater attention to the detriment of noneconomic factors.

This provision of H.R. 2308 may reflect a misperception regarding the dynamics of SEC rulemaking. Decisionmaking authority at the staff level does -- and should -- rest primarily with legal experts, not with economists. A model in which economic analysis is handled separately by economists who ultimately report to lawyers structurally relegates economic cost-benefit analysis to second-tier status. This approach may reinforce the artificial compartmentalization of cost-benefit analyses that can impede the genuine integration of economics and other non-legal factors into the SEC's rulemaking process. It is not economists who need to be integrated into the SEC's cost-benefit analysis so much as cost-benefit analysis needs to be integrated into the rulemaking process.

The Commission appears to have embraced the approach to cost-benefit analysis suggested by H.R. 2308. The SEC's creation of the Division of Risk, Strategy, and Financial Innovation, along with the SEC's emphasis of hiring more economists, properly reflects the importance of thinking outside of the artificial box of legalistic analysis. However, as the use of the term "divisions" itself reflects, creating isolated pockets of expertise risks perpetuating the *dis*-integrated analysis that frequently characterizes SEC rulemaking. Simply throwing economists at a problem whose ultimate source lies in the intransigence of overly legalistic staff who directly oversee the rulemaking process may erect artificial bureaucratic lines where such lines need to be erased. Treating cost-benefit analysis as a separate function may actually prevent cost-benefit analysis from being truly integrated into the overall rulemaking process. In my view, the SEC's aversion to cost-benefit analysis is more a reflection of weak legal analysis than weak economic analysis. The Commission should consider focusing less on hiring more non-lawyer economists, and more on hiring fewer non-economist lawyers.

Additionally, the Commission should broaden its cost-benefit perspective to strengthen its competence in non-economic fields that can be critical to the evaluation of the full costs and benefits of regulation. For example, the regulation of

target-date funds depends critically on investor expectations that are created by fund names that include a specific target retirement date. On April 3, the Commission released a study that documents how investor expectations are inconsistent with the practices of many target-date funds. The study shows that investors routinely underestimate target-date funds' exposure to equities as of the indicated retirement date. This means that any investors in funds with heavy equity weightings will experience greater losses in market downturns that they expected. Research shows that investors often respond to large losses in equities by selling their investments, thereby missing out on subsequent gains as investment returns revert to their long-term mean. Thus, investors in target-date funds with relatively heavy equity weightings are likely to have assumed equity risk that they did not intend to assume and, when their fund balances decline precipitously, to exacerbate their situation by reducing their equity exposure prior to a rebound in stock prices. Investors in target-date 529 plans with heavy equity weightings do not even have the opportunity to recover their losses.

These cost-benefit factors are not based on conventional economic data. Nor are they susceptible to precise quantification or legalistic analysis. Yet they represent essential elements of any cost-benefit analysis of target-date fund regulations. Unfortunately, this is the kind of analysis that typically receives inadequate credit with SEC staff lawyers in the SEC's cost-benefit analysis. It is yet to be seen whether the target-date study will be given the weight it is due.

The Commission should be more proactive in its own efforts to piece together relevant economic and non-economic analysis and to assert its proper role as the independent arbiter of conflicting data. For example, the Commission has shied from embracing the intuitive and empirically well-grounded view that enhanced price discovery strengthens competition. Its treatment of this issue in the context of mutual fund fee disclosure is decidedly tepid in comparison with the Department of Labor's robust recognition of the financial benefits that explicit fee disclosure can achieve. The Commission should take into account the fact that

investor advocates cannot compete with the resources that representatives of the financial industry can devote to their own, often specious cost-benefit analysis.[9] It should be more willing to locate and generate original cost-benefit data on its own initiative.

Finally, it should be noted that to say that the Commission is guilty of having an "aversion" to cost-benefit analysis is simply to say that the Commission reflects the values of American society. There is broad agreement that Americans undervalue the kind of technical training that has become decisive in determining which societies are the greatest creators of wealth. Although blame for this problem is often placed on our educational institutions, these institutions are also simply a reflection of a broad cultural bias against technical proficiency and scientific analysis.

This testimony is not the place for a discussion of such broad cultural biases against the sciences, but it is appropriate to consider how this problem plays out in the context of how we train lawyers. As noted above, it is the lawyers, not the economists (or experts in other disciplines), who inevitably will occupy the key leadership roles in SEC rulemaking. The process of making law that works, especially in technical, complex areas, is best managed by those who have special expertise in how law works. American legal education places inadequate emphasis on practical lawyering skills and principles of business, accounting and finance that are necessary for lawyers to provide competent oversight of comprehensive cost-benefit analysis of regulatory initiatives.

Therefore, an important question to be asked of the Commission is not whether it is hiring more non-lawyer economists and affording them a greater role

[9] *See, e.g.*, *Standard of Care Harmonization: Impact Assessment for the SEC*, Oliver Wyman & SIFMA (Oct. 2010) *available at* http://www.sifma.org/issues/item.aspx?id=21999. *See also* Letter from Barbara Roper, Director of Investor Protection, Consumer Federation of America, to Elizabeth Murphy, Secretary, Securities and Exchange Commission (Nov. 2, 2011) (discussing Wyman study) *available at* http://www.sec.gov/comments/4-606/4606-2831.pdf.

in the rulemaking process, but whether it is taking steps to ensure that its non-economist lawyers – the primary decisionmakers on the SEC's staff – have or are developing the expertise to oversee cost-benefit analyses. What emphasis is the Commission placing on the business background of new hires? Are SEC lawyers required to enroll in continuing education programs in business, finance and accounting? Are they developing expertise regarding ways that investors process information and make decisions? Based on anecdotal experience with students applying for jobs with the Commission, it appears that the Commission is taking steps to ensure that its legal staff has the breadth of skills that is necessary to navigate the broad array of considerations on which efficient, effective rulemaking is based. However, there is also evidence that the SEC's career legal staff continues to be dominated by overly legalistic thinking that impedes the SEC's ability to evaluate regulatory issues in their full social and economic context.

III. SEC Regulatory Accountability Act

The remainder of this testimony discusses the SEC Regulatory Accountability Act ("H.R. 2308" or the "Act"), which was recently reported by the House Financial Services Committee and provides a useful vehicle for discussion of the nature of rulemaking cost-benefit analyses. The Act is generally an appropriate aspirational statement of best rulemaking principles and practices. It captures many of the essential elements of any successful SEC rulemaking. In my opinion, however, H.R. 2308 would detrimentally affect the SEC's ability to engage in rulemaking consistent with its statutory mandate. As a set of legal standards, the Act would favor certain cost-benefit factors to the detriment of fair consideration of others; replace agency discretion with judicial rulemaking; create legal uncertainty; chill necessary rulemaking; generate unnecessary and unproductive litigation; increase the SEC's

operating expense without any countervailing benefit; and promote the development of non-uniform, enforcement-based law.[10]

As an initial matter, it is unclear what problem H.R. 2308 is intended to solve. Critics claim that the problem is that SEC rulemaking has not reflected adequate cost-benefit analysis, and there is support for this critique. But this is different from arguing that *existing* cost-benefit analysis standards are inadequate. A complaint that the Commission is not complying with current standards would logically support legislation designed to bring about such compliance, not to make compliance more difficult. It does not appear that legal mechanisms for enforcing appropriate cost-benefit analysis have failed. Where industry participants believe that the SEC's cost-benefit analysis is inadequate, they have been successful in obtaining judicial relief.[11] Increasing the complexity and burdens of cost-benefit requirements, rather than addressing a perceived failure to comply with existing requirements, is much likelier to degrade the SEC's capacity to make efficient,

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[10] Stephen Crimmins aptly characterized the likely effect of H.R. 2308 in testimony last fall:

> But we can forget about such rulemaking to streamline capital formation or anything else if we keep handing opponents of all political and ideological persuasions more and more tools to block anything the SEC tries to do. This will inevitably be the unintended consequence of the proposed SEC Regulatory Accountability Act. While well meaning, the Act would have the effect of letting any SEC rule opponent litigate in federal court over whether the SEC had appropriately assessed a laundry list of amorphous factors in any SEC rulemaking. Indeed, the Act is drafted so broadly that it could be applied even to the SEC's enforcement "orders," and not just to rulemakings. And beyond this, the Act would consume vast amounts of SEC staff time with periodic reviews of the existing substantial body of federal securities regulations to find anything deemed "outmoded, ineffective, insufficient or excessively burdensome."
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> Just as America's businesses need new SEC rules to streamline capital formation and traders need new SEC rules to streamline markets, so also we must give the SEC itself a streamlined process for issuing those rules. The SEC already has to include dozens of pages of detailed cost-benefit and other e economic analysis every time it writes a rule, and we don't need to pile on more requirements.

H.R. 2308 Hearing, *supra* note 7 at 4 (testimony of Stephen J. Crimmins) *available at* http://financialservices.house.gov/UploadedFiles/091511crimmins.pdf.

[11] *See supra* note 2.

effective rules than to improve it. The heightened standards of H.R. 2308 are likely to make it even more difficult for the Commission to conduct rulemaking, including, for example, rules promulgated under the private offering and crowdfunding provisions of the recently enacted JOBS Act.

The Act's cost-benefit standards create an analytical structure that undervalues or excludes important costs and benefits simply because they are not susceptible to quantitative analysis. The Act creates a strong presumption, if not an outright requirement, that the Commission may adopt rules only if it can set forth a matrix of "available regulatory alternatives" in which every alternative is assigned a precise value on a reducible scale in which the adopted rule has achieved the highest score. The use of terms such as "evaluate" and "determine," in contrast with "consider" and "take into consideration," suggest not only a process of considering every reasonable alternative course of action, but also a definitive scoring – that arguably only a quantitative assessment could satisfy – as to each factor. Similarly, the use of superlatives such as "best ways," "least burden," and "maximize" imply a precise comparative measuring (the term "measure" is also used) of different regulatory alternatives, notwithstanding that such precision can rarely, if ever, be achieved.

The terms of H.R. 2308 will further devalue the kinds of costs and benefits because they are not amenable to econometrics and difficult to quantify. The text of H.R. 2308 is dominated by market-based factors while mentioning soft benefits only to remind the Commission of the high analytical standard it is expected to meet. Where H.R. 2308 refers to "protecting market participants and the public," it seems to do so only to impress upon the Commission that it is expected to choose the "best ways" of doing so. And in "choosing among alternative regulatory approaches," H.R. 2308 expects that the Commission choose the approaches that "maximize net benefits." Econometric analysis is an important part of the rulemaking process, but no econometric model has ever captured the cost, for example, to senior Americans

suffering from cognitive impairment when they are cheated of their life savings by unscrupulous broker-dealers selling unsuitable insurance products.

The cost-benefit standards in H.R. 2308 stack the deck against soft costs and benefits that are difficult to quantify, such as those that assume that investors' decisions do not necessarily reflect their best interest.[12] The forms of cognitive impairment that are common among retail investors have been well-documented in the behavioral finance literature, but the precision of monetary estimates of the cost of poor decisionmaking -- if monetary estimates are even possible -- cannot compete, for example, with the precision of estimates of the costs of updating software systems, and printing and delivering documents that a new disclosure requirement often entails. The benefits of mutual funds' having an independent chairman, or subjecting broker-dealers who provide personalized investment advice to a fiduciary duty, or requiring broker-dealers who receive far more compensation for selling one product than another to disclose their conflict of interest, or requiring that public companies include minority shareholders' board nominees in their proxy solicitations, are only some of the kinds of benefits that are already discounted in cost-benefit analyses.

The standards set forth in H.R. 2308 will ensure that some rules that would create net benefits will not be adopted and that many of the potential benefits of rulemaking will be undervalued. When rulemaking review standards demand a high level of quantitative evaluation, rulemaking analysis will inevitably suppress the measurement of "soft" factors that are less susceptible to quantification.

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[12] As Chairman Schapiro recently stated, "reliably estimating the costs of regulations to the financial services industry and the nation is extremely difficult, and the benefits of regulation are generally regarded as even more difficult to measure." *Dodd-Frank Act Regulations: Implementation Could Benefit from Additional Analyses and Coordination*, GAO-12-151 at 109 – 110 (Nov. 2011) (Letter to A. Nicole Flowers, Director, Financial Markets and Community Investment, Government Accountability Office (Oct. 24, 2011)) *available at* http://www.gao.gov/new.items/d12151.pdf.

For example, the JOBS Act mandates that the Commission adopt rules requiring that issuers in private offerings involving general solicitations "take reasonable steps to verify that purchasers of the securities are accredited investors." The benefits of verifying investor qualifications will be difficult to quantify, whereas industry participants will provide specific estimates of the costs of complying with verification procedures. The standards set forth in H.R. 2308 would increase the likelihood that the benefits of adequate verification procedures will be undervalued because they will seem less weighty than the solid dollar-cost estimates of compliance. In this way, the standards' comparative measuring approach favors overweighting factors that are more easily quantified and underweighting factors that are less easily quantified.

The kind of cost-benefit analysis embodied by H.R. 2308 would eviscerate the SEC's rulemaking function by eliminating any meaningful deference to its exercise of authority as expressly delegated by Congress. The Commission exists, in part, to provide the kind of specialized expertise that is necessary for the efficient, effective implementation of regulation in a highly technical field. This specialized expertise is precisely the expertise that courts lack, but H.R. 2308 does not require that courts afford any meaningful deference to the SEC's reasonable judgments. Rather, it authorizes a virtual *de novo* review of all SEC rulemaking. There is no SEC rule that, under the H.R. 2308 standard, could not be fairly vacated based solely on the particular whims, political views or *de novo* cost-benefit analysis of a federal court. The Act effectively authorizes the federal courts to substitute their opinions regarding the efficacy of an SEC rule whenever a disgruntled special interest group has the motivation and money to challenge it.

Moreover, the Commission faces no litigation risk if it adopts rules that are inadequate to achieve Congress's investor protection purpose. It is highly unlikely that an investor or advocacy group will have the deep pockets or financial incentive to challenge the SEC's cost-benefit analysis. The Commission therefore has an

institutional incentive to make close calls in favor of industry interests in order to minimize the risk of litigation.

The standards contained in H.R. 2308 will chill SEC rulemaking and generate wasteful litigation. Under H.R. 2308, no rulemaking, however thorough its cost-benefit analysis, could ever be viewed as reasonably safe from a successful challenge by whatever special interest can afford to litigate it. Accordingly, the Commission will be reluctant to deal with problems through rulemaking when the benefits of a regulatory solution are significantly less susceptible to quantitative analysis than the costs, as illustrated by its complete withdrawal from any proxy rulemaking under the authority expressly granted by Section 971 of the Dodd-Frank Act of 2010.

The chilling effect of the increased litigation risk will be aggravated by the legal uncertainty that the Act creates. This uncertainty is partly created by the multiplicity of standards for different factors ("consider," "evaluate," "assess," "measure," "determine," "review"), its applying factors that range from the exceedingly broad ("efficiency") to the inappropriately narrow ("price discovery") to the overly vague ("sound risk management practices"), and its lack of clarity on what "orders" the Act is intended to cover.[13] These standards and factors will eviscerate the SEC's discretionary authority and, under appellate review, effectively substitute the judgment of the reviewer for that of the rulemaker. Parts of H.R. 2308 are mandatory ("the Commission shall"), whereas others are permissive ("the Commission may also take the following actions"), yet the permitted actions are, alternately, subsets of the mandatory actions, or the mandatory aspects are subsets of the permitted actions. How is a court to rule if the Commission "shall assess the costs and benefits of available regulatory alternatives," but "may . . . determine

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[13] *See H.R. 2308 Hearing*, *supra* note 7 at 15 – 16 ("Requiring cost-benefit analyses for orders could undermine our ability to issue enforcement orders against wrongdoers, delay exemptive orders needed to facilitate the introduction of new investment products to the market, and impede the capital formation process by delaying orders to registrants that accelerate the registration of their securities.") (testimony of SEC Chairman Mary Schapiro).

whether . . . alternative regulatory approaches . . . maximize net benefits?" As to a number of H.R. 2308's provisions, the same cost-benefit analysis standard is both expressly mandated and expressly discretionary, thereby setting out a feast for those who make their living by attacking the visible hand of government wherever it appears. The uncertainty created by H.R. 2308 will provide full employment for securities industry lawyers who may seek only to delay the implementation of rules or extort special concessions for their clients.[14]

Finally, the burdens of compliance with H.R. 2308 will cause the Commission to make more law through enforcement actions, no-action letters or rulemaking by self-regulatory organizations, which are not subject to cost-benefit requirements. These *de facto* SEC-rulemaking mechanisms often impose greater costs and afford less transparent review and comment by affected parties. The spillover effect of the chilling of SEC rulemaking will also be reflected in state enforcement actions, and private securities litigation in public courts or unreported arbitration decisions. Rulemaking provides clear guidelines that benefit firms that subscribe to a culture of legal compliance. The absence of rulemaking where such guidance is needed simply leads to abusive practices being regulated under non-uniform, non-transparent, *ad hoc* decisionmaking. None of these *de facto* rulemaking mechanisms will be subject to existing cost-benefit constraints on SEC rulemaking, much less the strictures of H.R. 2308. Thus, one effect of the Act will be to further promote less democratic, less transparent, and less uniform means of making securities law.

[14] *See H.R. 2308 Hearing*, *supra* note 7 at 15 ("Since the Agency will continue adopting rules, whether or not the Accountability Act is enacted into law, it begs the question of why Congress would want to drain the Agency's meager resources even further by requiring it to litigate every single challenge to the DFA rules is must enact.") (testimony of former SEC Chairman Harvey Pitt) *available at* http://financialservices.house.gov/UploadedFiles/091511pitt.pdf.

Mercer E. Bullard

Positions

Jessie D. Puckett, Jr., Lecturer and Associate Professor of Law — 8/02 to Present
University of Mississippi School of Law — Oxford, Mississippi
(Assistant Professor: 8/02 – 7/08)

Courses taught: Banking Regulation, Business Law Practicum, Comparative Corporate Law, Contracts, Corporate Finance, Corporations, Law & Economics, Securities Regulation, Raising Capital

Committees: Rankings Working Group (Chair, 3/12 to present), Admissions & Scholarships (8/11 to present), Budget Advisory (8/10 to present), University Research Board (8/09 to present), Facilities (8/10 to 8/11), Faculty Recruitment (8/08 to 8/10), Library and Technology (8/02 to 8/11); Chair 8/10 to 8/11), Speakers (8/02 to 5/08; Chair, 12/07 to 5/08), Ranking (9/07 to 5/08, 8/09 – 8/10)

Founder and President — 1/00 to Present
Fund Democracy, Inc. — Oxford, Mississippi

Vice President — 1/09 to Present
Plancorp LLC — Oxford, Mississippi

Member, Public Policy Council — 9/08 to Present
Certified Financial Planner Board of Standards, Inc. — Washington, DC

Vice Chair, Securities Law Committee — 5/08 to 5/09
Office of the Mississippi Secretary of State — Jackson, Mississippi

Consumer Advisor, Government Relations Committee — 1/02 to 9/08
Financial Planning Association — Denver, Colorado

Visiting Assistant Professor of Law — 8/05 to 12/05
Washington University in St. Louis — St. Louis, Missouri

Columnist — 11/00 to 6/01
TheStreet.com — New York, New York

Vice President and Treasurer — 1/02 to 6/02
Chestnut Lodge Incorporated — Chevy Chase, Maryland

Assistant Chief Counsel, Division of Investment Management — 1996 to 2000
Securities and Exchange Commission — Washington, D.C.
Other Positions: Special Counsel, Branch Chief, Staff Attorney

Director — 1994 to 1995
Fall Line Company — Rockville, Maryland

Associate, Securities Group — Summer 1989; 1991 to 1996
Wilmer, Cutler & Pickering — Washington, D.C.

Law Clerk, Chambers of Judge Will Garwood — 1990 to 1991
U.S. Court of Appeals, Fifth Circuit — Austin, Texas

Education

University of Virginia School of Law — Charlottesville, Virginia
J.D., May 1990
Articles Editor, Virginia Law Review
Order of the Coif
Robert E. Goldsten Award for Distinction in the Classroom

Georgetown University — Washington, D.C.
M.A., National Security Studies, May 1987

Yale College — New Haven, Connecticut
B.A., English and American Studies, *cum laude*, May 1983

Congressional Testimony

Testimony on crowdfunding regulation before the Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs, Committee on Oversight and Government Reform, U.S. House of Representatives (Sep. 15, 2011)

Testimony on money market fund regulation before the Subcommittee on Capital Markets and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives (June 24, 2011)

Testimony on competition and consolidation in financial markets before the Subcommittee on Intellectual Property, Competition and the Internet, Committee on the Judiciary, U.S. House of Representatives (Apr. 1, 2011)

Testimony on investor protection before the Committee on Financial Services, U.S. House of Representatives (Oct. 6, 2009)

Testimony on strengthening SEC's enforcement responsibilities before the Subcommittee on Securities, Insurance, and Investment, Committee on Banking, Housing and Urban Affairs, U.S. Senate (May 7, 2009)

Testimony on the 401(k) Fair Disclosure for Retirement Security Act of 2009, before the before the Subcommittee on Health, Employment, Labor, and Pensions, Committee on Labor and Education, U.S. House of Representatives (Apr. 22, 2009)

Testimony on the regulation of investment advisory services provided to defined contribution plan participants before the Subcommittee on Health, Employment, Labor, and Pensions, Committee on Labor ad Education, U.S. House of Representatives (Mar. 24, 2009)

Testimony on enhancing investor protection and the regulation of the securities markets before the Committee on Banking, Housing and Urban Affairs, U.S. Senate (Mar. 10, 2009)

Testimony on 401(k) fee disclosure before the Special Committee on Aging, U.S. Senate (Oct. 24, 2007)

Testimony on hedge fund regulation, before the Subcommittee on Domestic Policy, Committee on Oversight and Government Reform, U.S. House of Representatives (July 11, 2007)

Testimony on 529 plan regulation, before the Subcommittee on Financial Management, the Budget and International Security, Committee on Governmental Affairs, U.S. Senate (Sep. 30, 2004)

Testimony on financial products sold to military personnel, before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives (Sep. 9, 2004)

Testimony on 529 plan regulation, before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives (June 2, 2004)

Testimony on the need for mutual fund legislation, before the Committee on Banking, Housing and Urban Affairs, U.S. Senate (Mar. 23, 2004)

Testimony on the mutual fund scandal, before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives (Nov. 4, 2003)

Testimony on the mutual fund scandal, before the Subcommittee on Financial Management, the Budget and International Security, Committee on Governmental Affairs, U.S. Senate (Nov. 3, 2003)

Testimony on The Mutual Funds Integrity and Fee Transparency Act of 2003, before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives (June 18, 2003)

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Other Publications

Crooks Lick Their Chops Over 'Crowdfunding' Bill, Morningstar.com (Nov. 22, 2011); Shareholders Locked Out of the Boardroom, Morningstar.com (Oct. 26, 2011); Financial Planners Can Do Better than FINRA-FP, Morningstar.com (Sep. 13, 2011); Does Automatic 401(k) Enrollment Suppress Savings? Morningstar.com (Sep. 6, 2011); The Future of Financial Planning Regulation, Morningstar.com (July 7, 2011); DOL's Fiduciary Proposal Misses the Mark, Morningstar.com (June 14, 2011); The Decline of the Fiduciary Brand? Morningstar.com (Mar. 9, 2011); Facebook Fiasco Reveals Flaws in Private Offerings, Morningstar.com (Feb. 10, 2011); Investor Alert: Impoverished Madoff Victims Actually Made Whole, Morningstar.com (Apr. 20, 2010); Annuities in

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Committee on Oversight and Government Reform
Witness Disclosure Requirement – "Truth in Testimony"
Required by House Rule XI, Clause 2(g)(5)

Name:

1. Please list any federal grants or contracts (including subgrants or subcontracts) you have received since October 1, 2009. Include the source and amount of each grant or contract.

None

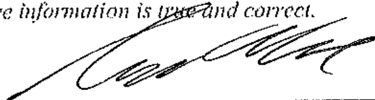
2. Please list any entity you are testifying on behalf of and briefly describe your relationship with these entities.

Fund Democracy, President, Director and Founder – a nonprofit investor advocacy organization

3. Please list any federal grants or contracts (including subgrants or subcontracts) received since October 1, 2008, by the entity(ies) you listed above. Include the source and amount of each grant or contract.

None

I certify that the above information is true and correct.
Signature:



Date: 4-16-12