Written Testimony of Jacqueline C. McCabe

Executive Director for Research, Committee on Capital Markets Regulation

Before the

TARP, Financial Services and Bailouts

of Public and Private Programs Subcommittee

of the House Oversight and Government Reform Committee

United States House of Representatives

April 17, 2012

* * *

Thank you, Chairman McHenry, Ranking Member Quigley and members of the Subcommittee for permitting me to testify before you today on cost-benefit analysis conducted by the Securities Exchange Commission (SEC). I am speaking today on behalf of the Committee on Capital Markets Regulation (Committee), of which I am the Executive Director for Research. The Committee has, since its 2006 Interim Report,[1] strongly supported improved cost-benefit analysis by both the SEC and other agencies. Today, the need for improved cost-benefit analysis is particularly evident in the agencies' respective rulemakings under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). We are deeply concerned that the inadequate cost-benefit analysis in the vast majority of rulemakings under Dodd-Frank could expose these rules to judicial challenge, prevent important rules from taking effect, and contribute to uncertainty in our markets over their fate.

[1] COMM. ON CAPITAL MKTS. REG., INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION (Nov. 2006), http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf.

The broad scope of new regulation under Dodd-Frank, issued by agencies including the SEC, Commodity Futures Trading Commission (CFTC) and others, will result in fundamental changes across the financial industry. Sound cost-benefit analysis must be a part of this process, to ensure that in each case, the proposed rule is optimal among all reasonable alternatives. In light of the ruling last July by the U.S. Court of Appeals for the D.C. Circuit in *Business Roundtable v. Securities and Exchange Commission*,[2] and a current lawsuit seeking to strike down the CFTC's recently promulgated position limits rule,[3] we believe many of the rules under Dodd-Frank could be subject to successful challenge in court. It would be an unfortunate outcome if, after the Dodd-Frank rulemaking process has run its course for several years, important rules are invalidated because of inadequate analysis. Even if such rules are not eventually invalidated, prolonged uncertainty around their fate threatens to hamper economic activity.

The Committee on Capital Markets Regulation has undertaken a study of the cost-benefit analysis provisions contained in 192 proposed and final rules, orders and notices issued under Dodd-Frank through November 16, 2011 (Rules), including Rules promulgated by the SEC, CFTC, Federal Reserve, Federal Deposit Insurance Corporation, Financial Stability Oversight Council, Consumer Financial Protection Bureau, Office of Comptroller of the Currency (OCC), Office of Thrift

[2] Bus. Roundtable & Chamber of Com. of the United States. v. Sec. & Exch. Comm'n, 647 F.3d 1144 (D.C. Cir. 2011). In its decision, the Court struck down the SEC's proxy access rule based on its failure to adequately consider its rules' effects upon efficiency, competition and capital formation, as required by law.

[3] *See* Int'l Swaps & Derivatives Ass'n & Sec. Indus. & Fin. Mkts. Ass'n v. U.S. Commodity Futures Trading Comm'n, No. 1:11-cv-02146 (D.D.C. Dec. 2, 2011); Int'l Swaps & Derivatives Ass'n & Sec. Indus. & Fin. Mkts. Ass'n v. U.S. Commodity Futures Trading Comm'n, No. 11-1469 (D.C. Cir. Dec. 2, 2011). Issued pursuant to Dodd-Frank, the rule sets position limits on 28 classes of derivatives contracts. *See* Position Limits for Futures and Swaps, 76 Fed. Reg. 71,626 (proposed Nov. 18, 2011).

Supervision, Department of Housing and Urban Development, Department of Treasury, Department of Energy, Department of Labor, National Credit Union Administration, Federal Trade Commission and Farm Credit Administration.[4] Our analysis found the following regarding these 192 Rules:

- 57 of the Rules contain no cost-benefit analysis. Certain of these Rules either referenced review that was conducted by the Office of Management and Budget (OMB), with no further detail provided, or they suggested that no cost-benefit analysis is required, including in certain cases because regulators found that the Rules were not discretionary and costs were imposed entirely by Dodd-Frank.
- 85 of the Rules contain entirely non-quantitative cost-benefit analysis. These include numerous Rules where regulators stated they expect costs to be insignificant or minimal, without justification or discussion.
- 50 of the Rules contain quantitative cost-benefit analysis. The vast majority of this analysis is limited to the costs of paperwork, legal and compliance review, technology enhancements and the like and do not contain discussion of the expected broader economic impact of the Rule.

[4] Letter from the Comm. on Capital Mkts. Reg. to Timothy Johnson, Chairman, and Richard Shelby, Ranking Member, S. Comm. on Banking, Hous. & Urban Affairs, and Spencer Bachus, Chairman, and Barney Frank, Ranking Member, H. Comm. on Fin. Servs. (Mar. 7, 2012), http://capmktsreg.org/2012/03/lack-of-cost-benefit-analysis-in-dodd-frank-rulemaking/.

Of the Rules we reviewed, 54 were issued by the SEC alone. This number does not include joint rulemakings by the SEC with other agencies, where it was difficult to determine which agency conducted the cost-benefit analysis, if any, presented in the Rule. Of the SEC's 54 Rules, 4 contained no cost-benefit analysis, 26 contained entirely non-quantitative cost-benefit analysis, and 24 contained quantitative cost-benefit analysis (although of the Rules with quantitative analysis, approximately half included only an analysis of paperwork burdens, labor, compliance costs and the like).

We found that, relative to other agencies including the CFTC, the SEC's analysis was generally more thorough and included more quantitative analysis. Furthermore, in its more recent rulemakings, we have found the SEC has enhanced its cost-benefit analysis. Notwithstanding these facts, we believe that there remains room for improvement. Rules that contain limited cost-benefit analysis are clear candidates for improvement; however, even with respect to Rules that do have broader analysis of a Rule's economic impact, there remains a risk that courts could find the analysis inadequate.

We understand that the SEC's Division of Risk, Strategy and Financial Innovation (RSFI) and Office of the General Counsel (OGC) have recently issued guidance to SEC staff that outlines best practices for conducting economic analysis in rulemaking. We applaud the SEC for taking this step, which we see as an extremely constructive development in ensuring better cost-benefit analysis in its regulation. The SEC has noted that analyses of costs cannot be limited to compliance costs or hourly wage rates. What it does not directly discuss is that broader analysis

into a rule's economic consequences will usually require additional data collection. This data collection, as well as detailed development and analysis of the information, may necessitate that the SEC hire additional economists. We fully support the necessary funding for the SEC to obtain these resources.

We also are pleased that the SEC has recognized the need to consider the overall economic impact of its rules, including both SEC rulemaking pursuant to Congressional mandates, as well as entirely discretionary SEC rulemaking. Even where Congress mandates a rule, it is important to assess the costs and benefits of both the rule and alternative approaches. The SEC acknowledges that this approach will provide the most complete evaluation of a rule's economic effect, particularly because in many cases it is difficult to distinguish between mandatory and discretionary aspects of a rule.

The SEC's approach to this issue of discretion stands in contrast to that taken by the CFTC. In staff guidance issued by the CFTC General Counsel and Chief Economist last May, the CFTC advised its staff that if rulemaking provisions under Dodd-Frank "merely replicate the statutory provisions the Commission is required to promulgate without the exercise of discretion, then cost-benefit considerations may not be a factor in the promulgation of the rule."[5]

According to a November 2010 Congressional Research Service Report more than 55% of Dodd-Frank's rulemaking provisions are discretionary, including over

[5] Letter from Dan M. Berkovitz & Andrei Kirilenko to CFTC Rulemaking Teams 5 (May 13, 2011) [hereinafter CFTC May Memo], *reprinted in* U.S. COMMODITY FUTURES TRADING COMMISSION, OFFICE OF THE INSPECTOR GENERAL, A REVIEW OF COST-BENEFIT ANALYSES PERFORMED BY THE COMMODITY FUTURES TRADING COMMISSION IN CONNECTION WITH RULEMAKINGS UNDERTAKEN PURSUANT TO THE DODD-FRANK ACT 38 (June 13, 2011) [hereinafter CFTC OIG Report], http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/oig_investigation_061311.pdf .

50% of the SEC rulemaking provisions and nearly 60% of the CFTC provisions.[6] Thus, we strongly encourage the CFTC to re-think its approach to this issue, and follow the lead of the SEC. We encourage all agencies tasked with Dodd-Frank-related rulemaking to conduct a comprehensive cost-benefit analysis.

I would now like to discuss some of the challenges faced by agencies when conducting cost-benefit analyses. The SEC has stated that in measuring the benefit of a regulation it will look to the benefit of improving matters from the prior state of affairs, what it calls the pre-regulation baseline. For example, if it estimated that prior practices of some kind had cost the financial system and economy $100 million, it would take $100 million as the benefit of its new rule. But the agency cannot merely assume that a new regulation will necessarily avoid the past loss, as it could have been due, in whole or in part, to matters not affected by or improved by the rule.

In its final rule on Derivatives Clearing Organization General Provisions and Core Principles, the CFTC in its cost-benefit analysis cited a comment letter from Better Markets: "Better Markets believes that the benefits must include the avoided risk of a new financial crisis and the best measure of this benefit is the cost of the 2008 crisis, which is still accumulating. It cited … [an estimate] that the worldwide cost of the crisis in terms of lost output was between $60 trillion and $200 trillion, depending on the long term persistence of the effects."[7] This figure, in addition to a

[6] CURTIS W. COPELAND, CONG. RES. SERV., RULEMAKING REQUIREMENTS AND AUTHORITIES IN THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT 7 (Nov. 3, 2010). These totals do not include rulemakings issued jointly by multiple agencies.

[7] Derivatives Clearing Organization General Provisions and Core Principles, 76 Fed. Reg. 69,334 (Nov. 8, 2011).

Paperwork Reduction Act estimate, estimates for implementing and complying with reporting requirements, and annual wage estimates, were the only quantitative data presented in the CFTC's cost-benefit analysis. Better Markets' argument, as reflected in the CFTC Rule, assumes that the CFTC's proposal would have averted the entire crisis, an absurd contention.

We commend the SEC on its focus in assessing the trade-offs among reasonable alternatives to its proposed rules. Whatever the benefit of a proposed regulation, it is best to achieve this benefit at the least cost and this can be determined by comparing alternatives. Agencies should include these reasonable alternatives in an advanced notice for proposed rulemaking, as the CFTC did in December 2010 with its Advanced Notice of Proposed Rulemaking on Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies.[8] Advanced notices provide interested parties the opportunity to comment on a rule before it has been formally proposed. Once an Agency issues a proposed rule, it should clearly explain why the proposed rule was selected over other reasonable alternatives. It is clear that including reasonable alternatives in the rulemaking requires judgment on the part of an agency as to the extent of their authority to adopt alternatives. The Committee recommends that the rulemaking agency not dismiss reasonable alternatives without specifying why the agency lacks the authority to implement them.

[8] Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies, 75 Fed. Reg. 75,162 (proposed Dec. 2, 2010).

The CFTC has acknowledged that final rules should include a "clear explanation of why the Final Rulemaking is being adopted over the alternatives"[9] although clearly, presentation and consideration of these alternatives must also be a part of any proposed rules. The rulemaking notice and comment process must be respected. An agency must provide for notice of, and an opportunity to comment on, any additional information that is more than just supplemental to the initial analysis presented in the proposed rulemaking. Particularly if the proposed rulemaking addresses costs only in general terms like "significant," "insignificant," "minimal," or "incremental," the additional information is likely to require additional notice and comment.[10]

We would also like to comment on some other agency practices. First, we have observed that regulators, including the SEC, have requested input on cost-benefit analysis from industry in many of the Rules. This is a worthwhile approach and can provide useful input for cost-benefit analysis. Oftentimes, industry participants who are more intimate with the details of their firms' operations and the markets are better positioned to judge the potential impact of proposed rules than the regulators. We caution however that when a regulator does not receive information it has requested, this does not relieve it of its duties to conduct cost-benefit analysis.

There are numerous other avenues that regulators can pursue to collect the necessary information. The U.S. Court of Appeals for the D.C. Circuit, in *Chamber of*

[9] CFTC May Memo, *supra* note 5, at 5.
[10] *See* CFTC May Memo, *supra* note 5, at 6 (citing Idaho Farm Bureau Fed'n v. Bruce Babbitt, Sec'y of Interior, 58 F.3d 1392 (9th Circ. 1995)).

Commerce of the United States v. Securities and Exchange Commission, found that when an "agency concludes no … data … has been produced during the comment period, the agency may develop data along the lines it has proposed to fulfill its statutory obligations."[11] Estimates and data based on assumptions may serve this purpose, and can prove helpful in analysis so long as the nature of what has been estimated or assumed is made clear in the analysis.

If the regulator is unable to develop data internally, it must obtain the information from third parties. Specifically, regulators can request information from other agencies and self-regulatory organizations, trade organizations, or industry participants. If the regulator is still unable to obtain the required information, it can request the data directly from firms that will be impacted by the proposed regulation. Requesting data directly from impacted firms may be burdensome on these firms, and may raise confidentiality issues in some cases. We suggest this final option with the caveat that any potential data requests should be made thoughtfully, with an eye to minimizing the imposition on and disruption to market participants.

Finally, in a number of the Rules the Committee analyzed, rulemakers have suggested that cost-benefit analysis is not necessary because the Rules' impact is expected to be minimal or insignificant. In such cases, rulemakers should explain how these conclusions were reached. It is not enough to provide a conclusory statement that cost-benefit analysis is not necessary; rather, the explanation behind this determination must be made clear.

[11] Chamber of Com. of the United States. v. Sec. & Exch. Comm'n, 443 F.3d 890, 904 (D.C. Cir. 2006).

I would now like to make some observations focused on CFTC rulemaking. The CFTC has on several occasions issued guidance to its staff, including a September 2010 memo from the CFTC General Counsel and Chief Economist regarding analysis to be included in proposed rules,[12] as well as the May 2011 memo referenced above which focuses on final rulemakings.[13] In addition, in response to a Senate request for review of four proposed rules under Dodd-Frank, the CFTC Office of the Inspector General (OIG) in June of 2011 issued an analysis of these specific rules.[14] An initial concern is that the more detailed, substantive guidance provided by the CFTC pertains only to final rulemakings. The September 2010 memo, which addresses proposed rules, provides only very high-level guidance and a suggested "template" for use in proposed rulemakings. Not surprisingly, our study found that the vast majority of the Rules issued by the CFTC in 2010 and early 2011 include only a restatement of the template and a conclusion that the benefits of the Rule outweigh its costs. It is critical that the CFTC take a more thoughtful, detailed approach to its proposed rulemakings. It is the cost-benefit analysis in proposed rules which commenters use to guide their analysis, shape their opinions, and in many cases, to develop suggested alternatives. Requiring detailed analysis only in final rulemakings undercuts the value of cost-benefit analysis.

In addition, as discussed above, a key difference between the SEC and CFTC guidance is in their differing treatments of "mandatory" aspects of their

[12] Letter from Dan M. Berkovitz & Jim Moser to CFTC Rulemaking Teams (Sept. 29, 2010), *reprinted in* CFTC OIG Report, *supra* note 5, at 30.
[13] CFTC May Memo, *supra* note 5.
[14] CFTC OIG Report, *supra* note 5.

rulemakings, which the CFTC believes it does not have to address. We strongly encourage the CFTC to reconsider its position and to adopt the SEC's approach here.

We also note that the CFTC believes additional analysis may not be required "[w]hen the Commission has received no comments either on the cost-benefit section of a Proposed Rulemaking or the costs or benefits of the Proposed Rulemaking in general…"[15] In our review of CFTC Rules under Dodd-Frank, we found the vast majority contained only non-quantitative cost-benefit analysis. In numerous cases where the CFTC finds it lacks sufficient data to conduct a quantitative analysis, it has asked commenters to supply this data. We do not agree with the CFTC's assertion that if it receives no comments, it may not be required to perform further analysis. Cost-benefit analysis is an obligation of the rulemaker, not of the commenters. Where the CFTC finds it has inadequate data to conduct an analysis, it must produce this data or obtain it from third parties.

We are further concerned that the CFTC's rule-writing teams have failed to consistently implement the practices recommended by their internal guidance. For example, the CFTC's Proposed Rule on Clearing Member Risk Management from August 2011 failed to include any consideration of reasonable alternatives or reference to a baseline.[16] The cost-benefit analysis amounted to less than 400 words of non-boilerplate language. We believe both the CFTC and the SEC should institute internal processes to ensure that their respective rule-writing teams adhere to their proposed guidance.

[15] CFTC May Memo, *supra* note 5, at 5.
[16] Clearing Member Risk Management, 76 Fed. Reg. 45,724 (proposed Aug. 1, 2011).

I would now like to discuss a very clear example of inadequate cost-benefit analysis, that contained in the Proposed Rule, "Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds" which was jointly proposed by the FDIC, Federal Reserve, SEC and OCC[17] (Volcker Rule) and later by the CFTC.[18] The Volcker Rule has been at the forefront of much recent debate, including with respect to its lack of cost-benefit analysis. The Committee noted in its comments in response to the Volcker Rule that although five agencies each have their own standards and internal practices for economic analysis, the Volcker Rule contains virtually no quantitative analysis other than estimated paperwork burdens. There are no estimates of broader economic impact, no comparisons of the costs of the Volcker Rule against baselines, and no analyses of the economic consequences of the Volcker Rule versus other regulatory alternatives. Clearly the Volcker Rule fails to comply with the new SEC guidance, and we would strongly encourage not only the SEC but also the other proposing regulators to address this issue urgently.

We acknowledge that the Volcker Rule does include requests for comments on potential costs and benefits, including through general questions like: "Question 358: What are the expected costs and benefits of complying with the requirements of the proposed rule?",[19] as well as more pointed questions regarding the expected impact of particular provisions in the Volcker Rule. However, as noted above, mere

---

[17] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68,846 (proposed Nov. 7, 2011) [hereinafter Volcker Rule].
[18] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Covered Funds, 77 Fed. Reg. 8,332 (proposed Feb. 14, 2012).
[19] Volcker Rule, *supra* note 17, at 68,934.

requests for comments are not an adequate substitute for these agencies' cost-benefit analysis obligations.

Furthermore, the OCC, in compliance with the Unfunded Mandates Reform Act of 1995 (UMRA), conducted an impact analysis and found that the Volcker Rule is not economically significant because "this proposed rule will not result in expenditures by state, local and tribal governments, or by the private sector, of $100 million or more in any one year."[20] This conclusion is, to say the least, puzzling and unfortunate. We would strongly encourage the OCC to explain how this conclusion was reached. If the Volcker Rule would in fact exceed the $100 million threshold, the OCC would be required to identify and consider a reasonable number of regulatory alternatives and from those to select the least costly, most cost-effective, or least burdensome alternative that achieves the objectives of the rule (or explain why that alternative was not selected). Such an analysis would greatly benefit the Volcker Rule, which will undoubtedly have far-reaching effects. If the Volcker Rule is to withstand judicial scrutiny, a robust analysis of the costs and benefits of the rule is critical.

In closing, we recommend that with respect to any outstanding proposed rules that have been presented for comment but not yet finalized, the SEC apply its new guidance to analyzing these proposed rules—the SEC has indicated it will do so. But the SEC must also review all of its final rules to ensure that they can withstand legal challenge. We note that approximately half of the SEC Rules we reviewed were in final form, including rules with non-quantitative cost-benefit analysis.

[20] Volcker Rule, *supra* note 17, at 68,939.

Further, I would like to emphasize that in calling for better cost-benefit analysis as part of the rulemaking process, we are not suggesting that the Dodd-Frank rulemaking process should be sidetracked or delayed. Many provisions of Dodd-Frank are crucial to ensuring the safety and soundness of our financial markets, and thus should be made effective as soon as possible. For example, the Committee has publicly voiced its support of central clearing and reporting of derivative transactions with an aim to reduce risk and increase transparency. Rules needed to protect the financial system can be put in jeopardy by the failure to conduct a cost-benefit analysis that can withstand judicial scrutiny. We commend the new direction the SEC has taken on this issue and would hope other agencies would follow suit.

Jacqueline McCabe Executive Director for Research, Committee on Capital Markets Regulation

Ms. McCabe joined the Committee as Executive Director for Research in August of 2011. She has had 15 years of experience in law and regulation. Prior to joining the Committee, Ms. McCabe was a Vice President and Associate General Counsel at Goldman Sachs & Co., where she worked for seven years in the Investment Management Division (GSAM). Ms. McCabe served as counsel to the firm's hedge funds, including Goldman Sachs Investment Partners (a $7 billion fund and largest to launch at Goldman Sachs). Ms. McCabe also oversaw relationships with GSAM's large institutional clients including pension plans, sovereign wealth funds and state governments. While at Goldman, Ms. McCabe had extensive interaction with the firm's regulators, including the SEC, CFTC and Federal Reserve. Prior to Goldman Sachs, Mrs. McCabe was an associate at Skadden, Arps, Slate, Meagher & Flom LLP in the investment management group.

Mrs. McCabe graduated from Princeton University where she earned an A.B. in History. She also earned a J.D. from Harvard Law School. Mrs. McCabe is admitted to the bar in New York and New Jersey.

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

Name: Jacqueline C. McCabe

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.

Committee on Capital Markets Regulation: I am the Executive Director for Research of the Committee.

3. Please list any federal grants or contracts (including subgrants or subcontracts) received since October 1, 2009, 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: /s/ Jacqueline C. McCabe Date: April 16, 2012