

THE SEC'S AVERSION TO COST-BENEFIT ANALYSIS

HEARING

BEFORE THE

SUBCOMMITTEE ON TARP, FINANCIAL SERVICES
AND BAILOUTS OF PUBLIC AND PRIVATE PROGRAMS

OF THE

COMMITTEE ON OVERSIGHT
AND GOVERNMENT REFORM
HOUSE OF REPRESENTATIVES

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THE SEC'S AVERSION TO COST-BENEFIT ANALYSIS

TUESDAY, APRIL 17, 2012,

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON TARP, FINANCIAL SERVICES, AND
BAILOUTS OF PUBLIC AND PRIVATE PROGRAMS,
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM,
Washington, D.C.

The subcommittee met, pursuant to call, at 10:03 a.m., in Room 2154, Rayburn House Office Building, Hon. Patrick T. McHenry [chairman of the subcommittee] presiding.

Present: Representatives McHenry, Walsh, Gowdy, Guinta, Maloney, and Quigley.

Staff Present: Katelyn E. Christ, Majority Research Analyst; Peter Haller, Majority Senior Counsel; Ryan M. Hambleton, Majority Professional Staff Member; Christopher Hixon, Majority Deputy Chief Counsel, Oversight; Justin LoFranco, Majority Deputy Director of Digital Strategy; Rebecca Watkins, Majority Deputy Press Secretary; Jaron Bourke, Minority Director of Administration; Jennifer Hoffman, Minority Press Secretary; Adam Koshkin, Minority Staff Assistant; Jason Powell, Minority Senior Counsel; and Brian Quinn, Minority Counsel; Molly Boyd, Parliamentarian; David Brewer, Counsel; Gwen D'Luzansky, Assistant Clerk.

Mr. MCHENRY. The Committee will come to order, the Subcommittee on TARP, Financial Services, and Bailouts of Public and Private Programs. Our hearing today is entitled The SEC's Aversion to Cost-Benefit Analysis, and on our first panel we have Chairman Schapiro from the Commission.

We will begin as is traditional for this Subcommittee and for this Committee, which is to begin the Oversight and Government Reform Committee's mission statement. The Oversight Committee exists to secure two fundamental principles: first, Americans have a right to know that the money Washington takes from them is well spent and, second, Americans deserve an efficient, effective government that works for them.

Our duty on the Oversight and Government Reform Committee is to protect these rights. Our solemn responsibility is to hold government accountable to taxpayers, because taxpayers have a right to know what they get from their government. We will work tirelessly in partnership with citizen watchdogs to deliver the facts to the American people and bring genuine reform to the Federal bureaucracy. This is the mission of the Oversight and Government Reform Committee.

I will now recognize myself for five minutes for the purposes of an opening statement.

For nearly all Americans, the practice of cost-benefit analysis is a part of everyday life. Decisions about the method of transportation we take, to the type of television, make and model that we buy, right down to the food we cook for dinner are all based on a form of cost-benefit analysis.

In the world of government regulators, specifically the Securities and Exchange Commission, the stakes are obviously much higher, influencing the behavior of millions of investors, allocation of trillions of dollars, and the competitiveness of our job and economic markets. The consequences of careless and unwarranted Federal regulations serve as a de facto tax on employers and consumers to the tune of over \$1 trillion each year. Needless regulations lead to higher costs, reduced wages, and diminished hiring that harm our economy more than they benefit it.

With those thoughts in mind, the SEC's record on cost-benefit analysis is deeply troubling. The evidence of unjustifiable SEC regulations was so alarming that it spurred the bipartisan JOBS Act, which was signed into law this month by President Obama; passed by a Democrat controlled Senate and a Republican controlled House, and signed by a Democrat president, a rare moment of bipartisanship in Washington.

Simply put, the SEC's complacency emboldened Congress and the White House to make simple, yet meaningful, improvements to the securities laws to address the competitiveness of our capital markets and opportunities for U.S. startups and small businesses that had long been ignored by the Commission.

Nonetheless, it is widely recognized that the SEC continues to fail at delivering adequate cost-benefit analysis of its rules and regulations. In January of this year, outgoing SEC Inspector General David Kotz issued a report identifying failures in the cost-benefit analysis procedures of the Commission. The report concludes that "The SEC may not be fulfilling the essential purposes of such analyses, providing a full picture of whether the benefits of a regulatory action are likely to justify its costs and discovering which regulatory alternatives would be most cost-effective."

Mr. Kotz is not alone in taking issue with the SEC's decision on cost-benefit analysis. In July of last year, the United States Court of Appeals for the District of Columbia issued an opinion vacating the SEC's proxy access rule, holding that the SEC acted arbitrarily and capriciously for having failed to adequately assess the economic effects of the rule.

In particular, the court stated that "The Commission consistently and opportunistically framed the costs and benefits of the rule, failed adequately to quantify certain costs or to explain why those costs could not be quantified, and failed to respond to substantial problems raised by commentators." In further explaining its objection, the court characterized the Commission's reasoning as "unutterably mindless." This is particularly harsh language from any court, but even more harsh considering this is a Federal bureaucracy that they were talking about, and an important one at that.

This was at least the third time in the last two years that an SEC rule has been struck down by the court for inadequate cost-benefit analysis.

Even the Obama Administration has recognized the need for more effective analysis. In a report to Congress, the Administration argued, "We emphasize that for the purposes of informing the public and obtaining a full accounting, it would be highly desirable to obtain better information on the benefits and costs of the rules issued by the independent regulatory agencies. The absence of such information is a continued obstacle to transparency and it might also have adverse effects on public policy."

In light of the SEC's track record, Chairman Issa and I wrote a letter to Chairman Schapiro regarding the SEC's decision not to perform cost-benefit analysis where Congress has mandated regulation. I am happy to learn that Chairman Schapiro, in response to that and other concerns, obviously, seems to have revised her earlier position on these issues. The Commission recently distributed a guidance memo to its staff that incorporates many of the policy suggestions we offered.

While many questions remain about the implementation of these policies at an agency that has resisted this approach for many years, I am hopeful that the personal attention of Chairman Schapiro to the guidance's implementation will lead to an improved decision-making process at the agency, and I appreciate her thoughtful attention to the concerns that we have raised.

Make no mistake, however, this Subcommittee intends to vigorously monitor the implementation of this document at the Commission and we will hold Chairman Schapiro accountable for the commitments that she has made. And we certainly appreciate your service to our Government, Chairman Schapiro. You have a long and distinguished service, and we know that with some oversight from Congress, you know that we will have a fruitful discussion today, as we always do.

The mission of the U.S. Securities and Exchange Commission is to protect investors, maintain fair, orderly, and efficient markets, and to facilitate capital formation. It is clear that performing rigorous cost-benefit analysis is necessary to help the Commission successfully live up to these goals.

Thank you again, Chairman Schapiro, for being here, and for our other witnesses that will be on the second panel here this morning.

With that, I recognize the distinguished Ranking Member of the Subcommittee, Mr. Quigley of Illinois, for five minutes.

Mr. QUIGLEY. Thank you, Mr. Chairman, and thank you, Mr. Chairman, for holding today's hearing on SEC's rulemaking and cost-benefit analysis.

Chairman Schapiro, thanks for being here. I understand this is your fourth appearance in the 112th Congress before this Committee. There is no truth to the rumor that with six appearances you get a set of steak knives, but we do appreciate your efforts.

Mr. MCHENRY. We will be willing to test that later this year, if the Chairman is willing.

[Laughter.]

Mr. QUIGLEY. I would like to acknowledge the SEC's responsiveness to the inquiries and oversight of this Committee, and I want

to commend you for your willingness to be so responsive to the Committee's numerous and varied inquiries.

Obviously, the SEC has been heavily scrutinized since it assumed numerous regulatory mandates under Dodd-Frank. Regulations are vital to protecting Americans, but we must ensure that they are carefully considered.

After recent investigations by the SEC Inspector General and the U.S. Court of Appeals for D.C., the SEC created new staff guidance for cost-benefit analysis. I look forward to Chairman Schapiro's testimony regarding this new guidance.

As we examine this important issue, we have to remember that this is about good government pure and simple. As Chairman Schapiro previously noted in a January 26th letter to Chairman Issa, "The primary purpose for performing cost-benefit analysis should be assisting the Commission in making sound regulatory choices about the difficult discretionary decisions with which it is faced."

Since Dodd-Frank was signed into law, the SEC's cost-benefit analysis procedures have been heavily criticized. According to a March 6, 2012 Bloomberg article, the SEC's Dodd-Frank related rulemaking has slowed in the face of these criticisms.

While we have to hold the SEC to the highest standards, the regulations that have been delayed are critical to addressing the causes of the 2008 financial crisis. There can be no amnesia about the fact that financial markets were not working for Americans before the financial crisis. A hands-off approach by Federal regulators contributed to the fraud that destroyed the retirement income of thousands of Americans. "If our economic system is going to work," says Nobel laureate Joseph Stiglitz, "we have to make sure that what people gain when they cheat is offset by a system of penalties."

The financial regulatory form law passed last year was a step in the right direction, but it alone is insufficient. Trust in our financial system is at its lowest ebb, which means that laws have to be enforced and the SEC needs to be a strong enforcer.

Unfortunately, the FY 2012 budget only appropriated \$1.3 billion to fund the SEC. For comparison sake, Citibank spent \$1.6 billion on marketing alone in 2010. How is the SEC expected to police Wall Street when its entire budget is less than the marketing budget of one bank?

I strongly support cost-benefit analysis for SEC rulemaking, but challenges to the SEC's cost-benefit analysis process should not be used by those opposed to financial reform to delay or derail the Commission's implementation of Dodd-Frank. Our Country will be safer from another financial crisis if the SEC implements Dodd-Frank in accordance with the law in a timely fashion.

I look forward to the testimony of all of our witnesses and, without objection, respectfully, Mr. Chairman, I ask that a letter addressed to the Chairman, yourself, and myself from former Chairman Harvey Pitt be included in the record.

Mr. MCHENRY. Without objection.

Mr. MCHENRY. With that, we will ask our witness to stand and be sworn in, as is the practice of this Committee.

Raise your right hand. Do you solemnly swear or affirm that the testimony you are about to give will be the truth, the whole truth, and nothing but the truth?

[Witness responds in the affirmative.]

Mr. MCHENRY. You may be seated.

Let the record reflect that the witness answered in the affirmative.

Chairman Schapiro, I know you have testified a time or two before Congress, so we don't have to explain the lighting system, but for those watching we have a very simple thing everybody knows from their stop lights: green means go, red means stop, yellow means hurry up.

So, with that, you can summarize your statement and please feel free to take as much time as you need to fully summarize that. With that, you are recognized.

**STATEMENT OF THE HONORABLE MARY SCHAPIRO,
CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION**

Ms. SCHAPIRO. Thank you, Mr. Chairman. I would note that I think this is my forty-second testimony since I became Chairman of the Securities and Exchange Commission.

Chairman McHenry, Ranking Member Quigley, members of the Subcommittee, I do appreciate the opportunity today to address the apparent confusion regarding whether there is an aversion to providing economic analysis in Commission rulemakings.

The SEC has for years considered economic analysis to be a critical element of its rule writing process. Indeed, I believe the SEC's substantive rule releases include more extensive economic analysis than those of any other financial regulator.

Economic analysis is a challenging task. Predicting how people and entities will respond to regulatory changes involves extremely difficult judgments. While supporting rulemaking with economic analysis is difficult under the best of circumstances, the unprecedented numbers, scope, significance, and complexity of rulemakings required by the Dodd-Frank Act have stretched the analytic and resource capabilities of the agency.

With passage of the Dodd-Frank Act, the SEC, which might normally write, on average, about 20 rules in a given year, received a mandate from Congress to promulgate almost 100 under impossibly short time frames. As always, our goal in addressing these statutory rulemakings has been to get them right, but also to get them done as quickly as possible to provide certainty to our markets and to our regulated entities.

Our rulemaking process has been open and transparent, seeking detailed input from interested parties through meetings and comments, in many cases even before proposing rules, and our formal rule proposals include economic analysis and seek comment and data from the public and industry to inform our thinking about the potential economic impacts of the proposal as the rulemaking progresses. Finally, when rules are adopted, after careful consideration of the comments and any additional data provided by commentators, we again include an economic analysis. The economic analyses we have done have informed and improved our rulemaking.

The Commission and its staff, including our economists, have spent considerable time grappling with difficult judgment calls in the scores of rules that the Act requires the Commission to issue. As you know, the SEC's cost-benefit analysis in rulemaking has been subject to reviews by the GAO and the SEC's Inspector General. While these reviews found that the Commission engages in a systematic approach to cost-benefit analysis in rulemaking, it also provided useful direction for improvement in our processes.

A recent court decision and communications from members of Congress also have raised issues about certain aspects of the Commission's economic analysis in rulemaking. We have learned valuable lessons from our experiences in implementing the Act to date. As a result, our rulemaking processes have continued to improve and evolve.

As part of this continuing effort, I directed the Division of Risk, Strategy, and Financial Innovation, and the Office of the General Counsel to develop specific guidance for staff engaged in rule writing to further improve the economic analysis the SEC employs. Recently, they provided the SEC's divisions and offices with detailed guidance on conducting economic analysis in rulemaking. The newly operative guidance also has been provided to my fellow commissioners to solicit their views and to incorporate their suggestions for any additional process improvements.

Among the specific steps that we have been taking and that are included in the current staff guidance are: involving our economists in the rulemaking process before preferred approaches are decided; assuring that rule releases clearly identify the justification for the proposed rule, such as a market failure or statutory mandate; where a statute directs rulemaking, considering the overall economic impacts of the rule, including those attributable to congressional mandates and those resulting from the Commission's exercise of discretion; quantifying the costs and benefits where feasible and, where not feasible, transparently explaining why not; more fully integrating analysis of economic issues in the Commission's rule releases; explicitly encouraging commentors to provide quantitative, verifiable estimates of costs and benefits; and adding greater discussion of reasonable alternatives not chosen.

In conclusion, economic analysis is a critical element of SEC rulemaking. As we have worked through the unprecedented workload required by the Dodd-Frank Act, we have learned a great deal and our rulemaking processes have continued to evolve and improve. Our new guidance reflects many of the current best practices in economic analysis which the agency will continue to refine in the future as necessary, and I am, of course, happy to answer any questions.

[Prepared statement of Chairman Schapiro follows:]

**Testimony concerning Economic Analysis in SEC Rulemaking
before the
Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs
Oversight and Government Reform Committee
U.S. House of Representatives**

**by
Mary L. Schapiro
Chairman
U.S. Securities and Exchange Commission
April 17, 2012**

Chairman McHenry, Ranking Member Quigley, and Members of the Subcommittee:

Thank you for the opportunity to testify today about economic analysis in Commission rulemakings.¹ High-quality economic analysis is an essential part of SEC rulemaking, as it helps ensure that decisions to propose and adopt rules are informed by the best available information about a rule's likely economic consequences. I welcome this opportunity to discuss the steps the SEC has taken and is taking to strengthen our economic analyses.

The SEC has for years considered economic analysis to be a critical element of its rulewriting process. Indeed, I believe the SEC's substantive rule releases include more extensive economic analysis than those of any other federal financial regulator. In recent years, even in the face of an unprecedented rulemaking burden generated by the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act" or "the Act"), the agency has continually enhanced its economic analysis efforts by, among other things, hiring additional Ph.D. economists and involving our economists earlier and more comprehensively in the

¹ The views expressed in this testimony are those of the Chairman of the Securities and Exchange Commission and do not necessarily represent the views of the Commission.

rulemaking process. At my direction, our staff also has recently received new guidance to inform their rulemaking work, which we will refine in the future as necessary.

Introduction

The Commission's mission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. When the Commission engages in rulemaking, it strives to adopt rules that further that mission without imposing unjustified costs. Understanding the potential economic consequences of rules the Commission is considering is an integral component of that process. Economic analysis is a challenging task. Predicting how people and entities will respond to regulatory changes involves difficult judgments. While supporting rulemaking with economic analysis is difficult under the best of circumstances, the unprecedented number, scope, significance, and complexity of rulemakings required by the Dodd-Frank Act have stretched the analytic and resource capabilities of the agency.

The SEC's cost-benefit analysis in rulemaking, particularly for rulemaking required by the Dodd-Frank Act, recently has been reviewed by the Government Accountability Office ("GAO")² and the SEC's Office of Inspector General ("OIG").³ While these reviews found that the Commission engages in a systematic approach to cost-benefit analysis in rulemaking,⁴ they also provided useful direction for improvement in our processes. Recent court decisions and

² GAO Report to Congressional Addressees, "DODD-FRANK ACT REGULATIONS Implementation Could Benefit from Additional Analyses and Coordination" (Nov. 2011) ("GAO Report No. 12-151").

³ SEC Office of Inspector General, *Follow-Up Review of Cost-Benefit Analyses in Selected SEC Dodd-Frank Act Rulemakings*, Report No. 499 (Jan. 27, 2012) ("OIG Report No. 499"). http://www.sec.gov/Reports/AuditsInspections/2012/Rpt%20499_FollowUpReviewofD-F_CostBenefitAnalyses_508.pdf.

⁴ See OIG Report No. 499 at 15; GAO Report No. 12-151 at 14.

communications from Members of Congress also have raised issues about certain aspects of the Commission's economic analysis in rulemaking.

Enhancing the Commission's economic analysis capabilities was a primary goal in the Commission's September 2009 creation of the Division of Risk, Strategy, and Financial Innovation ("RSFI"). Among the economists within RSFI that provide analysis in support of the Commission's mission, twenty-four economists assist in the provision of economic analysis for SEC rules, eighteen of whom are Ph.D. economists.⁵ The creation of RSFI as a Division has helped to provide more focus on the economic effects of our rules and to increase the involvement of economists in the rulewriting process. Since its inception, RSFI staff has been engaging with the Commission's relevant rulewriting divisions in, among other things, conducting meaningful economic analyses to inform rulemaking, formulating viable alternatives to a given regulatory approach, and determining when it might make economic sense to apply one regulatory approach versus another.

More recently, I specifically directed RSFI and the Office of the General Counsel ("OGC") to develop specific guidance for staff engaged in rulewriting to further improve the economic analysis the SEC employs in rulemaking. As described in more detail below, RSFI and OGC provided the other Divisions and Offices detailed guidance on economic analysis in rulemaking. The newly operative guidance also has been provided to Commissioners to solicit their views and to incorporate their suggestions for any additional process improvements.

⁵ Beyond the economists assisting in the provision of economic analysis for SEC rules, there are additional economists within RSFI focused on other aspects of economic analysis in areas such as litigation support, quantitative modeling, and risk analysis.

I continue to be committed to ensuring that the Commission engages in sound, robust economic analysis in its rulemaking, in furtherance of the Commission's statutory mission, and will continue to work to enhance both the process and substance of that analysis.

The Commission's Rulemaking Process Generally

The Commission's rulemaking process is governed by a number of legal requirements, including those under the federal securities laws, the Administrative Procedure Act ("APA"),⁶ the Paperwork Reduction Act of 1980 ("PRA"),⁷ the Small Business Regulatory Enforcement Fairness Act of 1996,⁸ and the Regulatory Flexibility Act.⁹ The securities laws require the Commission, when it engages in rulemaking and is required to consider or determine whether the rulemaking is in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.¹⁰ In addition, Section 23(a) of the Exchange Act requires the Commission, in making rules and regulations pursuant to the Exchange Act, to consider, among other matters, the impact any such rule or regulation would have on competition. The agency may not adopt a rule under the Exchange Act that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Act. No statute expressly requires the Commission to conduct a formal cost-benefit analysis as part of its rulemaking activities, but – since at least the early 1980s – the

⁶ 5 U.S.C. § 551 et. seq.

⁷ 44 U.S.C. §§3501-3520.

⁸ Pub. L. No. 104-121, Title II, 110 Stat. 847, 857 (1996).

⁹ 5 U.S.C. §§ 601-612.

¹⁰ See Securities Act § 2(b); Exchange Act § 3(f); Investment Company Act § 2(c); and Advisers Act § 202(c).

Commission has considered potential costs and benefits in its rulemaking as a matter of good regulatory practice.

Although as an independent regulatory agency the SEC is not included under the guidelines for regulatory economic analysis by executive agencies set out in Executive Orders 12866 and 13563¹¹ and Office of Management and Budget (“OMB”) guidance,¹² Executive Order 13579 indicates that, to the extent permitted by law, independent regulatory agencies should follow EO 13563’s “general requirements directed to executive agencies concerning public participation, integration and innovation, flexible approaches, and science.”¹³ In practice, we strive to accomplish what the recent GAO Report identifies as the basic elements of a good regulatory analysis under OMB Circular A-4: explaining the need for the proposed action, carefully examining alternative approaches, and evaluating the costs and benefits of the proposed action and alternatives. Additionally, in response to recommendations by the GAO and OIG, our staff’s guidance draws upon principles set forth in OMB Circular A-4 and Executive Orders 12866 and 13563.

In general, when the Commission engages in rulemaking, it seeks comments from the public in advance of adopting substantive regulations or amendments to existing regulations.¹⁴

¹¹ See Executive Order 12866 (“Regulatory Planning and Review”) (“EO 12866”), 58 FR 51735 (Oct. 4, 1993); Executive Order 13563 (“Improving Regulation and Regulatory Review”) (“EO 13563”), 76 FR 3821 (Jan. 21, 2011).

¹² OMB Circular A-4 (2003) provides guidance for implementing Executive Order 12866.

¹³ See Executive Order 13579 (“Regulation and Independent Regulatory Agencies”) (“EO 13579”), 76 FR 41587 (Jul. 14, 2011). EO 13579 also indicates that independent regulatory agencies should develop a plan for retrospective reviews of their existing regulations.

¹⁴ The Commission typically engages in “informal” rulemaking, which is distinct from “formal” rulemakings. Sections 556 and 557 of the APA provide procedures that apply to rules known generally as “formal” rulemakings.

The APA requires that agencies provide interested parties with adequate notice of proposed rulemaking and the opportunity to participate in the rulemaking “through submission of written data, views, or arguments.”¹⁵

The Commission’s rulemaking process is open and transparent, seeking input from interested parties, in many cases even before issuing formal rule proposals.¹⁶ In its proposing releases, the Commission includes discussion of and invites public comment on the potential economic effects of the proposed rules, including their costs and benefits, routinely requesting that commenters provide empirical data and economic analyses relating to our rulemakings. In making a recommendation to the Commission, the staff carefully considers the comments provided in determining whether to adopt the rule as proposed, modify the rule to respond to issues raised in the comments, or substantially reconsider or revise the approach contained in the proposed rule. If the Commission determines to proceed with an approach that departs significantly from the proposing release, it may need to re-propose the rules in order to give the public adequate notice and the opportunity to comment on the new approach. Occasionally, the Commission may extend or re-open the comment period to provide additional time for the public to respond or to seek public input on specific studies or data. In adopting releases, the

or those that “are required by statute to be made on the record after opportunity for an agency hearing.” 5 U.S.C. § 553. These rulemakings require oral evidentiary hearings that employ special procedures analogous to those used in judicial trials. *See* 5 U.S.C. §§ 556, 557.

¹⁵ 5 U.S.C. § 553(c). An agency may adopt substantive rules without prior notice and comment in limited circumstances. *See* 5 U.S.C. § 553(b). The Commission does not frequently use this procedure.

¹⁶ For example, to facilitate public input on rulemaking required by the Dodd-Frank Act, the Commission provided a series of e-mail links, organized by topic, on its website at <http://www.sec.gov/spotlight/regreformcomments.shtml>. Comments received on particular topics were then considered as part of the rulemakings to implement the various provisions of the Dodd-Frank Act, in addition to the comments received on specific proposing releases. The Commission has taken a similar approach with the recently passed Jumpstart Our Business Startups Act, <http://sec.gov/spotlight/jobsmactcomments.shtml>. Additionally, the Commission occasionally publishes “concept” releases to solicit the public’s views on securities issues so that we can better evaluate the need for future rulemaking.

Commission responds to the information and comments provided and revises its analysis as appropriate.

Economic Analysis Generally

The Commission performs economic analysis as a regular part of its rulemaking process. Our economic analysis considers the direct and indirect costs and benefits of a proposed regulation – including expected investor protections and the likely effects on competition, efficiency and capital formation – as compared with alternative approaches for meeting the need the proposed rule seeks to address. RSFI is directly involved in the rulemaking process by helping to develop the conceptual framing for, and assisting in the subsequent writing of, the economic analysis contained in the Commission’s rulemaking releases.

Analyzing the predicted economic effects of proposed rules, while critical to the rulemaking process, can be challenging. As the GAO noted in its recent review of Dodd-Frank cost-benefit analyses, “the difficulty of reliably estimating the costs of regulations to the financial services industry and the nation has long been recognized, and the benefits of regulation generally are regarded as even more difficult to measure.”¹⁷

Certain potential economic effects may be difficult to quantify or value with precision, particularly benefits that are indirect or intangible and benefits that reflect adverse outcomes avoided. In the words of GAO: “[m]easuring regulatory benefits remains [a] challenge largely because of the difficulty in quantifying benefits such as improved consumer protection or

¹⁷ GAO Report No. 12-151 at 19 (citing GAO Report No. 08-32). *See also* OIG Report No. 499 at 14 n. 37 (same).

financial stability” in the context of financial services regulation; “[w]hile regulation provides a broad assurance of the strength of financial markets, it is difficult to measure those benefits, in part because regulations seeking to ensure financial stability aim to prevent low-probability, high-cost events.”¹⁸ These analytical challenges often can be traced to the absence of suitable data. This situation is most common in Commission rulemakings designed to respond to perceived problems by modifying the behavior of market participants. When there are no direct precedents that can be used as a basis for analysis, it may not be possible to predict with a high degree of confidence how market participants will respond to a proposed regulation.

In addition, relevant data often may be available only from certain market participants.¹⁹ Our rule proposals frequently ask commenters to quantify the estimated costs and benefits, especially when the dollar costs of proposed rulemaking are known only to or best determined by market participants. Although this can be an effective method for obtaining data, data developed in this manner is often highly specific to the firm or individual providing it, and accordingly may make broad generalizations difficult. Often commenters report aggregated estimates without providing either supporting analyses or the underlying data necessary for Commission staff to have a basis for replicating their results. Moreover, since firms and individuals providing comments must bear the cost and effort of developing or obtaining such data, it may be difficult to obtain a representative sample. Such data also may be biased in favor of the commenter’s preferred outcome. The Commission’s ability to gather data for use in its economic analysis also

¹⁸ See GAO Report to Congressional Committees: “FINANCIAL REGULATION Industry Trends Continue to Challenge the Federal Regulatory Structure” (Oct. 2007) (“GAO Report No. 08-32”), at 3, 13.

¹⁹ See GAO Report No. 12-151 at 20.

is constrained in some respects by administrative laws, such as the PRA, although the Dodd-Frank Act provides some relief from PRA data-gathering constraints in the rulemaking context.²⁰

In addition to the difficulties of quantification and measurement, assessing the impact of qualitative costs or benefits can be quite complex. Persons may legitimately disagree as to the proper weight or value to attach to a particular benefit or cost, not infrequently disagreeing as to whether the alleged benefit or cost at issue is even appropriate for consideration.

It is important that our rules clearly explain the analysis that we are conducting, the reasoning that we use, and the basis for our conclusions. We seek and welcome public input on our analysis and conclusions at the proposing stage so that we can make better-informed choices at the adopting stage. Considering public comments is not simply a legal requirement – it is an essential part of understanding the reasonable alternatives available before determining which of the alternatives best achieve the Commission’s objectives.

Defining a Baseline

One important component of a good regulatory economic analysis is to define a baseline against which to measure the likely economic consequences of the proposed regulation. The baseline is the best assessment of how the world would look in the absence of the proposed

²⁰ Securities Act Section 19(e), as added by Section 912 of the Dodd-Frank Act, provides that, for the purpose of evaluating any rule or program of the Commission issued or carried out under any provision of the securities laws and the purposes of considering, proposing, adopting, or engaging in any such rule or program or developing new rules or programs, the Commission may: (1) gather information from and communicate with investors or other members of the public; (2) engage in such temporary investor testing programs as the Commission determines are in the public interest or would protect investors; and (3) consult with academics and consultants. Securities Act Section 19(f) provides that any action taken under Section 19(e) will not be construed to be a collection of information for purposes of the Paperwork Reduction Act.

action and serves as a primary point of comparison for an analysis of the proposed regulation.²¹ An economic analysis of a proposed regulatory action compares the current state of the world, including the problem that the rule is designed to address, to the expected state of the world with the proposed regulation (or regulatory alternatives) in effect.²² Economic impacts of proposed regulations are measured as the differences between these two scenarios. The baseline includes both the economic attributes of the relevant market and the existing regulatory structure.

In its economic analyses for discretionary rulemaking, the Commission's general practice has been to follow this approach and to consider fully the effects of its proposed rules against a baseline of the regulatory status quo, taking into account all the costs and benefits of the proposed rule. In the Dodd-Frank Act, however, the Commission was faced with many new statutory provisions that required Commission rulemaking, and some of these new requirements presented challenges in determining the appropriate baseline to use in the economic analysis.

The recent OIG Report raised an issue concerning the Commission's choice of baseline for cost-benefit analyses in Dodd-Frank rulemakings. Focusing on a memorandum prepared by the Commission's then-General Counsel in September 2010, the OIG Report appeared to conclude that the Commission had adopted a bright-line policy not to consider the economic effects of statutorily-mandated portions of Dodd-Frank rules. The OIG Report recommended that the staff consider using, whenever possible, a pre-statute baseline – that is, to consider as

²¹ See Circular A-4 at 15.

²² See Circular A-4 at 2 (“To evaluate properly the benefits and costs of regulations . . . you will need to . . . [i]dentify a baseline. Benefits and costs are defined in comparison with a clearly stated alternative. This normally will be a ‘no-action’ baseline: what the world will be like if the proposed rule is not adopted.”).

part of the cost-benefit analysis the costs and benefits of the statute itself, not just those portions of the rule over which the Commission exercised discretion.

Although I understand that the principles underlying the memorandum were considered by the staff as they began the process of drafting rules required by the Dodd-Frank Act, the Commission and staff developed an economic analysis for each rule that was considered most appropriate in each case, taking into account the different type of rulemaking mandate specified by Congress, and making clear in its public releases the approach that it was following.

For example, in many Dodd-Frank Act provisions, Congress provided open-ended directives for rulemaking, leaving the Commission with at least some discretion – and in some cases, broad discretion – for possible action. In cases where it exercised discretion, the Commission sought to explain the approach it applied in its analysis. Where the Commission's analysis focused on its discretionary choices, the public release included language clearly stating the bases of the analysis.²³ In instances where such a separation between discretionary and mandatory elements was not possible, the staff was aware that it needed to understand and acknowledge the potential economic impacts of the mandatory components of rules to provide

²³ See, e.g., Release No. 34-65148, *Suspension of the Duty to File Reports for Classes of Asset-Backed Securities Under Section 15(d) of the Securities Exchange Act of 1934* (August 17, 2011). In this release adopting rules to provide thresholds for the suspension of the reporting obligations of asset-backed securities issuers, the Commission stated:

The discussion below focuses on the benefits and costs of the decisions made by the Commission in the exercise of its new exemptive authority provided by the Act, rather than the costs and benefits of the Act itself.

The cost-benefit analysis proceeded to discuss the effects of the statutory provision and to analyze the range of discretion given to the Commission. The Commission explained that it "sought to balance the value of the information to investors and the market with the burden on the issuers of preparing the reports," and the analysis demonstrated that the final rule was based on an assessment of the circumstances in which the benefits of disclosure required by the statute justified the costs of preparing the reports.

the proper context for the areas in which the Commission was exercising discretion. Here, the Commission was again clear in stating the bases for its analysis and invited public comment on the potential economic consequences of both the underlying statute and the Commission's discretionary choices.²⁴ By contrast, in the situation where the statute was quite specific and prescriptive in directing what rule changes to make and gave the Commission no discretion in writing implementing rules, the Commission took a different approach and explained it as well.²⁵

The Commission's overall approach in these Dodd-Frank rulemakings has therefore been transparent, and – as the OIG Report recognized – followed a systematic process and was consistent with applicable legal requirements.²⁶

Nonetheless, I understand the policy views articulated in OIG Report No. 499 and by other commenters in support of the recommendation to consider or use a pre-statute baseline in the economic analysis of mandated rulemaking. Accordingly, as part of the response to the report, I directed RSFI and OGC to consider in particular the use of appropriate baselines as it

²⁴ See Release No. 34-63346, *Regulation SBSR – Reporting and Dissemination of Security-Based Swap Information* (Nov. 19, 2010). In proposed Regulation SBSR, the Commission tailored its cost-benefit assessment to reflect the new regulatory regime that the Dodd-Frank legislation created, considering the baseline to be the absence of any SBS reporting, *i.e.*, the regulatory status quo directly before the adoption of Dodd-Frank. In so doing, the Commission discussed the full range of costs and benefits associated with the proposed rules without seeking to exclude costs and benefits resulting from the statutory mandate.

²⁵ See Section 939B of the Dodd-Frank Act, which directed that, within 90 days of the date of enactment, the Commission “shall revise Regulation FD to remove from such regulation the exemption for entities whose primary business is the issuance of credit ratings.” The Commission followed Congress's explicit direction by issuing a very short and simple final rule barely two months after enactment. The Commission did not provide public notice or an opportunity for the public to comment on the rule, stating that good cause existed to dispense with those APA requirements “[b]ecause this revision is required by Congress, [and] it does not involve the exercise of Commission discretion or policy judgments.” Similarly, the Commission did not include a cost-benefit analysis of this rule, explaining that “any costs and benefits to the economy resulting from the amendments are mandated by the Act.” See Release No. 33-9146, *Removal from Regulation FD of the Exemption for Credit Rating Agencies* (Sept. 29, 2010).

²⁶ See *supra* note 4 and the accompanying text.

developed the updated guidance on economic analysis in rulemaking. The new guidance to the staff of the SEC's rulewriting divisions and offices states that as a policy matter, where a statute directs rulemaking, rulewriting staff should consider the overall economic impacts, including *both* those attributable to Congressional mandates *and* those that result from an exercise of the Commission's discretion.²⁷ This approach should allow for a more comprehensive evaluation of alternative means of meeting a statutory mandate and give the most complete picture of a rule's economic effects, particularly in those situations in which it is difficult to distinguish between the mandatory and discretionary components of a rule.

Improvements to Commission Economic Analysis

The Dodd-Frank Act required an unprecedented number of statutorily mandated rules for implementation by the SEC. The Commission and its staff – including our RSFI economists – have spent considerable time grappling with difficult judgment calls in the scores of rules the Act requires the Commission to promulgate. Moreover, we have learned valuable lessons from our experiences in implementing the Act to date. As a result, our rulemaking processes have continued to improve and evolve, including the analyses we conduct both to meet our legal requirements and to inform our policy judgments.

As noted above, the SEC's Chief Economist and General Counsel have jointly developed new guidance for conducting economic analysis, taking into account the recommendations made in the reports from the GAO and OIG as well as comments from others, including Members of Congress and the courts. RSFI and OGC have distributed the new guidance both to the other

²⁷ Cf. Circular A-4 at 15-16 ("In some cases, substantial portions of a rule may simply restate statutory requirements that would be self-implementing, even in the absence of the regulatory action. In these cases, you should use a pre-statute baseline. If you are able to separate out those areas where the agency has discretion, you may *also* use a post-statute baseline to evaluate the discretionary elements of the action.") (emphasis supplied).

Divisions and Offices and to the Commissioners, and are seeking any additional input from the Commissioners to incorporate suggestions for improvements.

Among the specific steps that we have been taking, and that are included in the current staff guidance, are:

- earlier and more comprehensive involvement of RSFI staff in the rulemaking process, so that RSFI economists can provide economic analysis of different policy options before a proposed course is chosen and throughout the course of the development of the rule;
- assuring that rule releases clearly identify the justification for the proposed rule, such as a market failure or a statutory mandate;
- where a statute directs rulemaking, staff should consider the overall economic impacts of the rule, including those attributable to Congressional mandates and those resulting from the Commission's exercise of discretion;
- where feasible, quantifying the costs and benefits and, where not reasonable to do so, transparently explaining why not, and then qualitatively explaining the remaining costs and benefits;
- more integrated analysis of economic issues (including efficiency, competition, and capital formation) in the Commission's rule releases;
- more explicit encouragement to commenters to provide quantitative, verifiable estimates of costs and benefits, and fuller analysis and discussion in Commission rule releases of the cost-benefit information received from commenters; and
- greater discussion of reasonable alternatives not chosen.

A fundamental improvement we have made that will enable us to implement more effectively the new guidance is the strengthened role of economists in rulemakings. Economists must play a central role in rulemaking – whether in identifying concerns or issues that may justify regulatory action or analyzing the likely economic consequences of competing approaches – and the staff's current guidance emphasizes that significant role. The guidance notes that to make the best use of RSFI's expertise, RSFI economists should be involved at the

earliest stages of the rulemaking process (*e.g.*, before the specific preferred regulatory course is determined) and throughout the course of writing proposed and final rules. Close collaboration with RSFI will help to integrate economic analysis as key policy choices are being made, thereby:

- assisting in the evaluation of different or competing policy options by identifying the major economic effects of those options;
- influencing the choice, design, and development of policy options;
- assisting in the evaluation of whether and to what extent any proposed policy would promote efficiency, competition, and capital formation;
- improving the quality of regulation;
- better supporting policy choices made by the Commission; and
- increasing confidence in the regulatory process.

Additionally, we are engaged in an ongoing effort to provide additional resources to RSFI. For example, we expect to have at least 20 additional economists join the Division over the coming months, and we will continue to pursue additional hiring opportunities, including requesting additional funding from Congress for 20 additional economists in fiscal year 2013.

The new guidance also provides more specific ways to strengthen what we recognize as the essential components of sound regulatory economic analysis: clearly identifying the justification for the proposed rule; defining the baseline against which to measure the proposed rule's economic impact; identifying and discussing reasonable alternatives to the proposed rule; and analyzing the economic consequences of the proposed rule and the principal regulatory alternatives.

In discussing best practices for analyzing the economic consequences of a rule and alternative regulatory approaches, the guidance emphasizes the importance of developing an integrated analysis that focuses on all the costs and benefits of the rule, to the extent feasible quantifies the expected costs and benefits, and identifies and discusses uncertainties underlying the estimates of benefits and costs. It notes that court decisions addressing the economic analysis in Commission rules have stressed the need to attempt to quantify anticipated costs and benefits, even where the available data is imperfect and where doing so may require using estimates (including ranges of potential impact) and extrapolating from analogous situations. To the extent that costs and benefits cannot reasonably be quantified, the guidance indicates that the release should:

- include an explanation of the reason(s) why quantification is not practicable;
- include a qualitative analysis of the likely economic consequences of the proposed rule and reasonable regulatory alternatives; and
- discuss the strengths and limitations of the information supporting the qualitative cost-benefit analysis.

The guidance indicates that rulewriters should work with RSFI economists to clearly identify important uncertainties underlying the analysis and explain the implications of these uncertainties for the analysis. The guidance also states that rule releases should support predictive judgments and clearly address contrary data or predictions, and frame the costs and benefits neutrally and consistently.

As recommended in the OIG Report, we have begun to phase in through some of our recent releases the use of an integrated economic analysis of the rule rather than including separate sections captioned “Cost Benefit Analysis” and “Efficiency, Competition, and Capital

Formation.” The approach being phased out sometimes results in redundancy and unnecessary parsing of economic effects. The newer integrated approach allows for a more comprehensive economic analysis of the rule as a whole while still fulfilling our specific statutory obligations.

Overall, the guidance should result in the public, Commission, and staff being better informed about rules’ likely economic consequences and in more clear and comprehensive economic analyses. With the review and input of my colleagues, we will continue to make further improvements to the guidance in the weeks and months ahead.

Conclusion

In conclusion, economic analysis is a critical element of the SEC’s rulemaking obligation. Although the SEC has incorporated economic analysis into its rulemaking processes for many years, the unprecedented rulemaking burden generated by passage of the Dodd-Frank Act has tested the resources and analytical capabilities of the agency. As we have worked through these responsibilities, we have learned a great deal and our rulemaking processes have continued to evolve. Our new guidance reflects many of the current best practices, which the agency will refine in the future as necessary to ensure high quality economic analysis in its rulemaking.

Thank you for the opportunity to be here today. I am happy to answer any questions.

Mr. MCHENRY. Thank you, Chairman Schapiro, and thank you for your service to our Government. You have a long and distinguished career in government service and broadly in the financial marketplace, and I want to start, before anything we say today, and thank you for your service.

We also know it is difficult to testify before Congress, but you have been willing to submit yourself to this process. We certainly appreciate it. And as I said in my opening, as well as with the mission statement of the Subcommittee and this Committee, it is important that the American people know what is happening in their government so they have some confidence in it.

So, with that, I recognize myself for five minutes for purposes of questions.

I want to begin by the culture within the SEC. Now, the SEC has a very fine staff. You have over 3,000 staffers, but Meredith Cross, who is the Director of Corporate Finance, she has testified before this Subcommittee and before Congress, she is a very fine individual, but culturally the SEC, if we look at an email from September 13, 2010, from Meredith Cross, the Director of Corporate Finance, to the Director of Risk Fin, which is this process where you are going to have economic analysis attached to it, cost-benefit analysis, "I think there will be some rulemaking that it doesn't bother anyone to say the rule benefits are along the lines of what Congress was trying to achieve, but there will be some where we really can't go there and maintain any level of internal harmony."

Next quote: "My main request is that Risk Fin not add qualitative cost-benefit discussions that could be controversial without having senior discussions."

Seems to me that there is a deeply held cultural problem with cost-benefit analysis if you have to have senior level discussions before an economist attaches any real costs that could raise problems. So the reason why we have a Commission is not to put power in one person, but to hash out those controversies and try to get better rulemaking more agreeable to everyone.

I want to go on to something else. In your prepared testimony today you said, "No statute explicitly requires the Commission to conduct a formal cost-benefit analysis as part of its rulemaking activities."

Well, let's go back to the House Commerce Committee report that accompanied H.R. 3005, the National Securities Market Improvements Act. "In considering efficiency, competition, and capital formation, the Commission shall analyze the potential costs and benefits of any rulemaking initiative. The Committee expects that the Commission will engage in rigorous analysis pursuant to this section. Such analysis will be necessary to the Congress in connection with Congress's view of major rules."

So what is important about this, and this is back from 1996, when that became the law of the land, and there is a speech that we can go on to about Chairman Bliley when this passed. The point is, and my question is, is cost-benefit analysis the rule of the land, the law of the land for the Securities and Exchange Commission?

Ms. SCHAPIRO. Mr. Chairman, it obviously is and has been for many years. While the testimony says there is no specific statutory requirement to conduct cost-benefit analysis, there is, and we cer-

tainly acknowledge in our testimony and in our actions, that there are requirements for the Commission to conduct a Regulatory Flexibility Act analysis, a Paperwork Reduction Act analysis, and whenever we are engaged in rulemaking, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation; and when we are doing rulemaking under the 34 Act, to consider burdens on competition that our rules might impose.

So we do broadly economic impact analysis, which often includes a cost-benefit analysis, and, of course, under the new guidance it is quite explicit the extent to which the staff needs to try to quantify costs and benefits and, where they can't, explain why.

But if I could just add one other thing. I think Meredith Cross is one of the finest public servants I have ever worked with. She has only been at the SEC a couple of years and came from the private sector. She believes deeply in cost-benefit analysis, economic analysis, and our engaging in rulemaking in a way that is fully transparent and responsive to congressional mandates.

Mr. MCHENRY. Well, I think it is important to understand the cultural problem here that I see with the communications within your staff and the discussions going forward.

So the question is about this guidance that you are working through that mandates cost-benefit analysis, and the question I have is does it mandate that before these rules can go forward there has to be basic clearance through the economists on the costs and benefits of rulemaking?

Ms. SCHAPIRO. Yes. The new guidance does require that even before there is a preferred approach from the rule-writing divisions about what a regulatory response might be, that the economists need to be involved. They are to be integrated into the process as key policy choices are made through the pre-proposal stage, the proposing stage, the comment period, and the adopting stage; and they are as integral a part of the rulemaking team as anybody else.

Mr. MCHENRY. But is there a veto power?

Ms. SCHAPIRO. I believe there is sign-off—I have to pull the guidance out to look at it specifically—by the economists on the economic analysis.

Mr. MCHENRY. Please, go ahead, because I would like to know. I think it is important for folks to understand. Is it required as a precondition?

Ms. SCHAPIRO. Concurrence is required by the economists, yes.

Mr. MCHENRY. Concurrence is required.

Ms. SCHAPIRO. Yes. And, Mr. Chairman—

Mr. MCHENRY. So that can act as a veto power.

Ms. SCHAPIRO. It certainly would be something that would be brought to the attention of the commissioners if there was no concurrence. And it is important to note that the commissioners are deeply involved in any rule proposal and any rule adoption, including analyzing whether the staff's cost-benefit analysis is up to the task, meets the requirements that they think are important, whether we have explored the appropriate issues.

Mr. MCHENRY. So roughly how many economists do you have at the Securities and Exchange Commission?

Ms. SCHAPIRO. Working on rulemaking, we have 24 economists in Risk Fin. We have a number of additional economists who are doing risk analytics, modeling—

Mr. MCHENRY. And what is a comparable number of attorneys you have?

Ms. SCHAPIRO. We have obviously many more attorneys. I would be happy to get you the exact number, but—

Mr. MCHENRY. Is it hundreds?

Ms. SCHAPIRO. Oh, yes, it is—

Mr. MCHENRY. Hundreds of attorneys. Okay.

Ms. SCHAPIRO.—hundreds of attorneys. We also are in the process of hiring 20 additional economists this year and we have asked, in the FY 2013 budget, for 20 more economists. So it is—

Mr. MCHENRY. And is that part of Risk Fin?

Ms. SCHAPIRO. Those are all part of Risk Fin. There actually are economists in other parts of the agency, but in terms of those who support from an independent perch the rulemaking process, those are in Risk Fin.

Mr. MCHENRY. Thank you.

With that, I recognize the Ranking Member for his five minutes, but I ask unanimous consent he have two additional as well. Without objection.

Mr. QUIGLEY. Thank you, Mr. Chairman.

Madam Chairman, my harshness isn't directed towards you, but when we start thinking about benefits, you have to think about what the costs are of the risk. So in a broad picture, those were some pretty big oops since the 2000s. We missed Enron, we missed Worldcom, Madoff's Ponzi scheme. Extraordinary cost and risk. So how do you determine, when you try to do this cost-benefit analysis, how can you possibly take into consideration the thousands of lives that were ruined and the millions of dollars that were lost with the lack of accurate and adequate regulation?

Ms. SCHAPIRO. Congressman, even the GAO has recognized that the task of quantifying cost is difficult, but the task of quantifying benefits is very much more difficult because they are often very, very hard to put a dollar number on, to monetize. So our challenge is to do the best that we can; where we can't actually quantify the benefits with hard numbers, to explain what we believe the benefits are from a qualitative perspective and lay that out for commentators and the public to react to.

Mr. QUIGLEY. But what do you use now to try to ascertain that the potential risk involved—they have to be included in your analysis, correct?

Ms. SCHAPIRO. Right. And we do talk about, depending upon the rulemaking, what, for example, with respect to over-the-counter derivatives that were largely unregulated or wholly unregulated during the financial crisis and leading up to that time period, we talk about the impact of the financial crisis on the economy and on citizens, and talk about the benefits that we think creating a regulatory regime around derivatives will be. But, again, they are very, very hard to quantify.

Mr. QUIGLEY. Let's just elaborate to an extent. Just dealing with cost, do you talk with industry experts about what their best guess on what costs would be when they talk about regulating a product?

Ms. SCHAPIRO. We do. We talk to them about direct costs that they might incur as a result of a new rule. Do they have to put in a new compliance system as their new recordkeeping obligations?

Mr. QUIGLEY. Staff?

Ms. SCHAPIRO. Staffing. We talk about competitive effects on them and might they withdraw from a business and what would be the impact not just on them, but on the economy or their customers more broadly. So we talk extensively with them.

We also, after we have made an estimate of what we think the costs are and detailed what types of costs we believe there to be, we affirmatively ask for data that can help support the cost-benefit analysis that we have done or that tells us we got it completely wrong and we need to go back to the drawing board. So we affirmatively seek that data from commentors.

Oftentimes only industry has access to the data that might be useful for us to understand what the true costs are of a regulatory action.

Mr. QUIGLEY. Costs and benefits, I guess you have come to the conclusion you are not going to be able to capture it all, correct?

Ms. SCHAPIRO. It is very difficult. If I could give you another example. When we do a disclosure rule there are lots of benefits to that, including that investors will have better information upon which to make their capital allocation decisions, maybe that will lower risk premiums, it will lead to lower prices and better competition. Those are all things that we try to measure as benefits. Might it lead to some fewer number of securities class actions with multi hundreds of millions of dollars of awards. Those kinds of things are benefits that we try to measure, for example, when we do a disclosure rule. The costs are going to be the cost of providing that information to investors, the costs of assembling disclosure documents for the intermediaries that are required to provide them.

Mr. QUIGLEY. And on the benefits side you talked about getting industry help on the cost side. Besides the things you just mentioned, who, if anyone, helps detail what the risks are in helping you ascertain how risky a product might be and what the benefits of reducing that risk are?

Ms. SCHAPIRO. Well, in that regard the staff of the SEC has a lot of the expertise to understand the risk profile, for example, of a product, or to study it and learn it. Industry is much better situated to provide data and to influence the rulemaking process in a very specific and operational kind of way. We do have investor groups that often comment very constructively and helpfully, and we rely on their input and data as well. They are sometimes in a position even to commission studies and analysis better than provide it to us in part of the comment file.

Mr. QUIGLEY. And if you have answered this, I apologize, but, in short, do you always use cost-benefit analysis as you are developing new rules for consideration?

Ms. SCHAPIRO. We always do regulatory flexibility analysis, Paperwork Reduction Act analysis, and analysis of the impact of our rules on competition, capital formation, and efficiency. We don't al-

ways find ourselves in a position to be able to monetize those costs and benefits, but we always have at least a qualitative discussion.

Mr. QUIGLEY. I began the conversation talking about the disparity in budgets. Do you feel like you have a sufficient budget to police Wall Street?

Ms. SCHAPIRO. I have become fond of saying we are about the size of the District of Columbia Police Department, yet our responsibility is to police the entire U.S. capital markets, mutual funds, public company disclosure, brokerage firms and investment advisors, and now hedge funds and over-the-counter derivatives, as well as our many stock markets and trading venues. So while Congress has given the SEC some budget increases in the last two years, for which we are very grateful, my view is that the agency is still under-resourced to the task that we face.

Mr. QUIGLEY. Thank you. I yield back.

Mr. MCHENRY. But hopefully you have fewer cars stolen than in the District of Columbia.

With that, I recognize the Vice Chairman, Mr. Guinta, for five minutes.

Mr. GUINTA. Thank you, Mr. Chairman.

Thank you very much for appearing this morning. Can you just briefly talk about—I listened to your opening statement. I just briefly read through it again. It seems like, and I don't want to put words in your mouth, but the Dodd-Frank Act has dramatically expanded the SEC role and the requirements placed on the SEC. Is that a fair statement?

Ms. SCHAPIRO. In the rule writing context, yes.

Mr. GUINTA. And I think you referred to some of those requirements in Dodd-Frank as either overburdensome, challenging.

Ms. SCHAPIRO. I don't believe I said overburdensome. I think some of them are challenging, some are very, very different rulemakings for the Securities and Exchange Commission, for example, the requirement to have disclosure rules around the use of conflict minerals mined in the Democratic Republic of the Congo. Those are very different kinds of rules that we have been called upon to do. The over-the-counter derivatives market, wholly unregulated market until Dodd-Frank, we have developed a lot of expertise. We continue to develop it, but, again, challenging because of both its breadth and its complexity and its novelty from our perspective.

Mr. GUINTA. So is Dodd-Frank putting—I guess I will ask it. Is it putting an undue burden on the SEC?

Ms. SCHAPIRO. I am enormously proud of the work the SEC staff has done to date. We have about 100 rulemakings to do and 20 studies. I believe 13 or 14 of the studies are completed. Seventy-five percent of the rulemakings have been either proposed or adopted. But this is with staff pretty much working around the clock for the last year and a half. But we continue to work. It is, as I said to the Chairman earlier in a private conversation, this is the law of the land and we will implement it to the best of our ability, and the staff continues to work towards doing that.

Mr. GUINTA. Well, how would you feel if we repealed it.

Ms. SCHAPIRO. I think my personal view is it would be a mistake to repeal Dodd-Frank. I think we are working through, in the rule-

making process, those areas where the legislation has created challenges to implementation, but I think there are significantly important portions of the law that deal with systemic risk and regulation of entirely unregulated areas that are important. We think that, to the extent there are imperfections, that we can deal with them largely through the rulemaking process.

Mr. GUINTA. And going back to the rulemaking process, is 20 additional economists enough, in your opinion, to implement?

Ms. SCHAPIRO. First of all, I should say that we are getting people of enormous quality and depth of expertise, and even the Inspector General's report and the GAO report, but particularly the Inspector General report, acknowledged deep knowledge and expertise on the part of our SEC economists, and our chief economist is here with me today. We can certainly use more economists, but I think this is a very, very rapid expansion of our economics group over just a very short period of time.

Mr. GUINTA. But I'm not sure. In your opinion, though, would the 20 additional be sufficient? You said it is a rapid expansion, but it is 20, correct?

Ms. SCHAPIRO. It is 20. We have 24 currently working just on rulemaking. We have other economists doing other kinds of work like litigation support and risk and analysis and quantitative modeling. Twenty we expect to hire this year, of which 17 are PhDs, and as soon as the academic year is over they will be joining us. And then we have asked for 20 additional in our fiscal year 2013 budget.

I think it is our view that that will help us significantly. But I would also add that, as a result of Dodd-Frank, extraordinary amounts of new data will be coming into the agency about hedge funds and their investing, over-the-counter derivatives, and in a number of other areas, so we will need economists who have analytic capabilities to help us understand what that data is telling us and also to do our 10 year review of the Sarbanes-Oxley rules that is required under the Regulatory Flexibility Act, which we will begin in 2013. We will need economists to do those reviews.

Mr. GUINTA. Well, if the assumption is that we need additional economists and you have an increase in your budget request, to help you with that, would you consider freezing certain hiring areas, particularly attorneys, in order to fulfill the need on the economic side?

Ms. SCHAPIRO. Congressman, I don't think is as simple as saying freezing attorneys and hiring economists. We have very broad responsibilities and we are also a law enforcement agency, and we cannot bring our cases and do our investigations without our investigative staff and our attorneys. We rely heavily on accountants as well at the SEC because of our responsibility for oversight of financial accounting standards.

So I think we have shifted resources around the agency, as appropriate, to support those divisions that are struggling in particular with the Dodd-Frank rulemaking, and I think the Risk Fin division where the economists are housed has particularly been a beneficiary of that flexible approach to staffing.

Mr. GUINTA. Okay, thank you.

I yield back.

Mr. MCHENRY. I recognize the gentlelady from New York, Mrs. Maloney, for five minutes, co-author of our crowd funding legislation that was included in the JOBS Act.

Mrs. MALONEY. Thank you, Mr. Chairman, and thank you for mentioning that. I enjoyed working with you.

Welcome, Chairwoman Schapiro. I believe this is the fourth time that you have testified before the Oversight Committee or one of its subcommittee, but in your opening statement I believe you said you have testified 34 times before Congress, is that correct?

Ms. SCHAPIRO. Forty-two.

Mrs. MALONEY. Forty-two times before Congress. How in the world do you have time to do your rulemaking when you are before Congress so many times?

Ms. SCHAPIRO. Well, I view this as a very important part of my job and clearly a very important part of Congress's job to oversee the agency and our activities, so—

Mrs. MALONEY. But 42 times. That has to be a record.

Ms. SCHAPIRO. I work on the weekends.

Mrs. MALONEY. The SEC's mission is to protect investors and to maintain orderly markets and facilitate capital formation. And while some concerns have been raised in the past about the SEC's economic analysis, this hearing's title suggests that the SEC has systematically avoided cost-benefit analysis whenever it is possible, so I would just like to ask you, Chairwoman, under your leadership, how many SEC regulations have been overturned due to the quality of the economic analysis?

Ms. SCHAPIRO. In my little over three years at the SEC, we have done 51 final substantive rules and one has been challenged and overturned.

Mrs. MALONEY. Well, I think that that is a pretty good record, and despite the Majority's title for this hearing, I do not see any evidence of any erosion to cost-benefit analysis or engaging in analysis to understand the impact of the SEC's rulemaking. And you have to realize that the SEC's rulemaking is being put in place to protect this Country and our citizens from the \$18 trillion economic loss caused by the financial crisis. Economists, government leaders have all said this was the first recession that was caused by the financial mismanagement of markets.

Now, I would like unanimous consent to put in the record an article dated March 6, 2012, from Bloomberg, and that article—is that all right to put in the record?

Mr. MCHENRY. Can you give us further reference what that is?

Mrs. MALONEY. I will give you a copy of it. I will put it in your hands. If you don't want to put it in the record, you can turn it down. Anyway, I think—

Mr. MCHENRY. What is the title of it?

Mrs. MALONEY. The title was an article about the ruling in the Business Roundtable and the SEC, and it talked about—

Mr. MCHENRY. If it pertains to today's hearing, without objection, we will allow it to be part—

Mrs. MALONEY. Fine. Whatever. Whatever. It is an interesting article.

Mrs. MALONEY. Anyway, the article says that it has slowed the Dodd-Frank rulemaking process, which I think is really important.

If it slowed the Dodd-Frank rulemaking process, that means you are slowing the protection of the American economy and our citizens from another financial crisis. Now, this article says—and it talks about the delayed regulations and he says that these regulations are designed to curb the kind of risky practices that fueled the 2008 financial crisis. Some of the SEC's delayed rules strike at the very roots of the causes of the 2008 crisis. One example is a rule that would ban firms from designing asset-backed security deals that put their interests in conflict with investors. Other rules are being drafted and revised in coordination with other regulators, complicating the process. These include the Volker rule to ban proprietary trading at banks; the risk retention rule forcing lenders to keep a stake in loans they bundle; and several rules defining new swap market oversight.

Now, the risk retention rule, many believe that that would have prevented the subprime crisis. So I am concerned that these rules are not in place. Chairwoman Schapiro, is this a good summation of some of the rules you are working on, rules designed to prevent a repeat of the practices that led to the financial crisis?

Ms. SCHAPIRO. I think so.

Mrs. MALONEY. How are these rules—you should prioritize your rules. You should prioritize that you are taking care of the rules that caused the crisis first. You have a lot of responsibility. We know your budget has been cut. But the rules that I just mentioned, when are you going to get them completed?

Ms. SCHAPIRO. We have tried to prioritize the rules. The ones that we have done first were those that had the shortest statutory deadlines, although admittedly we have missed a number of statutory deadlines. And we are proceeding to work as quickly and as deliberately as we can. As I said at the outset, our goal has always been to get the rules right, to do adequate analysis of the economic impact, and also the usefulness and workability of the rules.

Mrs. MALONEY. Do you think you will complete these? When do you think? Do you think you will complete them this year?

Ms. SCHAPIRO. I think we will complete the bulk of the rules this year, particularly in Title VII, which covers over-the-counter derivatives. And, of course, we have finished a number of rules. The whistleblower rules were done; the registration of private funds are done.

Mrs. MALONEY. But the ones that I mentioned that Bloomberg News pointed out were the crux of what caused the financial crisis. Those, I would venture to say, are the most important.

Ms. SCHAPIRO. I don't disagree with you.

Mrs. MALONEY. I request an additional minute, if I could, from the Chairman.

Mr. MCHENRY. In addition to the minute you have just taken or—

Mrs. MALONEY. Yes.

Mr. MCHENRY. One additional minute?

Mrs. MALONEY. Yes.

Mr. MCHENRY. Without objection, the gentlelady will have one additional minute.

Mrs. MALONEY. I just want to go back to the hearings that we had back in 2008, when President Bush asked for an astonishing

\$700 billion to prevent a contagion spreading through the financial markets, and this Congress approved it. And it saved our financial markets. And on that day members of this Committee had a very important hearing with the former chairman of the Federal Reserve, and it was a shocking hearing. I will never forget what he said. He said, "I made a mistake in presenting that the self-interest of organizations, specifically banks and others, was such that they were best capable of protecting their own shareholders." This was the strongest statement I have ever heard from the former chairman of Federal Reserve that we need to have strong regulations to prevent it. After the Great Depression we put some rules in shape. We had 60 years of economic prosperity.

Mr. MCHENRY. The gentlelady's time has expired.

Mrs. MALONEY. Please complete your rulemaking. Congratulations on your hard work.

Mr. MCHENRY. The gentleman from South Carolina is recognized for five minutes.

Mr. GOWDY. Thank you, Mr. Chairman. I was going to use my time to ask about the holding in Business Roundtable versus SEC because the holding, Mr. Chairman, is very provocative.

I do want to commend Chairwoman Schapiro for not criticizing an unelected group for passing judgment on that law, as has been done recently.

But what I am going to do instead, Mr. Chairman, because you inspired me with your line of questioning, is I am going to give you my time and perhaps I can ask another panel to work our way through the holding in Business Roundtable.

Mr. MCHENRY. Thank you. I certainly appreciate the gentleman yielding.

To my colleague's question earlier about the prioritization of Dodd-Frank rulemaking, just for the record, the SEC is attempting to have rulemaking on conflict minerals in the Congo, so in terms of prioritization, I think it would be best for the SEC to attempt to do that.

The question about the cost-benefit analysis, now, understanding obviously two sides of the aisle. One says that there are costs and wants to focus on the cost of government regulations; the other wants to talk about the benefits of government regulation. Perhaps we should have some harmony and agree that there are both costs and benefits to regulations.

Now, I am not going to ask the question; it is an economic reality and an economic fact that regulation, no matter how beneficial, no matter how benevolent, has costs associated with it. Also some regulations have benefits that outweigh those costs. And we all have that debate in society on where that line is and there is reams of economic analysis about how to balance those cases. The question before us is about the guidance memo with the SEC. And I am very grateful, Chairman Schapiro, for your leadership on this. The question is is this guidance memo on cost-benefit analysis now binding?

Ms. SCHAPIRO. Yes, Mr. Chairman, it is. Although I will say that I have asked my colleagues on the Commission for their comments and input, so it is possible that the memo and the guidance will evolve with their comments. But, yes, it is binding.

Mr. MCHENRY. Will that process be public once this memo is fully decided with all input from commissioners?

Ms. SCHAPIRO. I am sure that there will be opportunities for us to make it public, yes.

Mr. MCHENRY. Okay. And have you directed all offices and divisions within the SEC to adhere to this guidance?

Ms. SCHAPIRO. I haven't sent out a specific directive, but everybody understands that this—and it has been distributed to the rule writing divisions; they all understand that this is how rule writing, economic impact analyses will be conducted, yes.

Mr. MCHENRY. Okay. Has it been done in writing?

Ms. SCHAPIRO. Well, it was directed to each of the divisions.

Mr. MCHENRY. Okay. So there is no doubt from all the staff that is working on it that it is binding?

Ms. SCHAPIRO. I have no doubt at all. And, of course, the Commission is the ultimate arbiter of all of our rule proposals, so I would expect that if an analysis did not live up to the expectations of the guidance, the Commission would make that clear to the staff.

Mr. MCHENRY. Okay. Now, would you agree—and this is just a basic question—that economists should be doing the economic analysis?

Ms. SCHAPIRO. I think the economists should be deeply involved in the economic analysis. I think it should—

Mr. MCHENRY. Who should be doing economic analysis if not economists?

Ms. SCHAPIRO. They should be doing the analysis, but I think they can't do it in a vacuum, without consultation and coordination with the rule writing teams as well, with analysts and others who have expertise, perhaps, in the particular areas, the particular product.

Mr. MCHENRY. So there are exceptions to economists doing the economic analysis?

Ms. SCHAPIRO. No.

Mr. MCHENRY. Okay, okay. I just want to make sure. These are very basic questions.

Now, I understand that the SEC currently has 28 Dodd-Frank rules that have been proposed but are not yet final. Will this guidance apply retroactively to those rules that have been proposed but are not yet final?

Ms. SCHAPIRO. You are correct there are 28 rules that have been proposed that have not been adopted finally. The staff is analyzing all of those cost-benefit analyses for each of those rules because, as you know, many of them actually followed much of this guidance, because we had adopted in practice Circular A-4 provisions, executive order provisions and so forth. So many of them will not have issues, but the staff is going back through each of them to determine whether we need to do any more analysis in light of the new guidance.

I will say, with a rule proposal that we expect to adopt tomorrow, we did just that and we reopened the comment period, put new data and the economic analysis in the public comment file as a way to inform our ultimate final rule adoption.

Mr. MCHENRY. So this guidance will be binding on those 28 Dodd-Frank—

Ms. SCHAPIRO. Yes, going forward, yes.

Mr. MCHENRY. Okay. And is there any process or thought of looking back at regulations that are on the books and making sure this guidance is used?

Ms. SCHAPIRO. No, I don't think so. I mean, the rules are final. Industry has started to develop its systems operations compliance around rules that are already on the books. And, as I said, because I think it is so important to understand, we have been doing economic analysis in all of our rules. We haven't, for example, always chosen, as the new guidance requires, a pre-statutory baseline, which has been an important point, but we have always done economic impact analysis. And, indeed, the report that one of the witnesses on the next panel will speak to showed that for 54 rules that were done by the SEC coming out of Dodd-Frank, we had done 347 pages worth of cost-benefit analysis. Compare that to the Federal Reserve, which did 24 rules and 12 pages of cost-benefit analysis, or the FDIC with 6 rules and 6 pages of cost-benefit analysis.

So I would not want it to be lost that this agency has been engaged in significant economic analysis. This guidance gives us clarity and some more specificity particularly around the selection of a baseline and the preference or the requirement to use a pre-statutory baseline.

Mr. MCHENRY. Okay. Now, we have testimony in the second panel that says that four of those rules included no cost-benefit analysis.

Ms. SCHAPIRO. Yes, but we should be clear what those were. One was a delegation of authority to the chief accountant, one was a delegation of authority to enforcement, one was a temporary exemption related to security based swaps, and one was the Reg. FD amendment, where Congress said remove from Reg. FD the exemption that exists for credit rating agencies, so we did that quickly. We didn't see what a cost-benefit analysis would yield there, since we had no discretion whatsoever in enactment of that rule.

Mr. MCHENRY. So going back to the Becker Amendment—well, actually, why don't we wrap up this round and we will go to a second round, because the time has expired. With that, we will open a second round of questioning and I recognize myself for five minutes.

So with the Becker memo outlining cost-benefit analysis and the idea that if Congress mandates a rulemaking to the SEC, that the SEC does not have to do cost-benefit analysis. It sounds like that still is in your thinking based on the four that you outlined, two of which were mandated by Congress.

Ms. SCHAPIRO. No, Congressman, not at all. Of course, those were done before the new guidance, so they operated under the preexisting guidance. What I will say is that the Becker memo was advice from a general counsel to an agency that was facing really a daunting number of congressionally mandated rules to write, and it set forth an initial framework to analyze what needed to be done when the Commission exercised discretion. And there was concern, frankly, about not second-guessing the judgments that had been

made by the Congress in the passage of the Dodd-Frank Act about what needed to be done.

That said, going forward, we have clearly said in this guidance that we will evaluate the economic impact of the pre-statutory condition, as well as those areas where we are actually exercising discretion. Those four that you mentioned predate this guidance.

Mr. MCHENRY. Okay, so, to be clear, the new guidance, in effect, repudiates the Becker memo that was operational before the guidance.

Ms. SCHAPIRO. I think there are some things in the Becker memo that are actually captured in the new guidance. For example, to the extent we are exercising discretion, we should describe that, and we should be honest and clear with the Congress and the American people that we are doing so because we think it is the right thing to do, not because Congress directed us to do it. It calls on us to identify the choices that are being made when we have alternate ways to achieve the regulatory purpose and to quantify, wherever possible. That is incorporated in the new guidance.

That said, there is much more required in the new guidance than was required in the very brief Becker memo, and, of course, one of the most important changes is the requirement that we use a baseline that includes the existing state of the world, including the state of efficiency, competition, and capital formation; and it is against that baseline that we will use consistently through that rulemaking that we measure the impact of our rules and the impact of potential reasonable alternatives.

Mr. MCHENRY. Okay. Now, the JOBS Act was enacted last week, signed into law. It has a number of provisions, but one of the provisions that I, along with my colleague, Mrs. Maloney, were highly involved in is the so-called crowd funding portion of this, which originated out of the House and called the Entrepreneur Access to Capital Act. It received over 400 votes in the United States House of Representatives, meaning it was a very overwhelming bipartisan vote, received a bipartisan vote through both subcommittee and full Committee markup; was included as a provision in the JOBS Act. It also is commented upon from your March 13th letter to Chairman Johnson in the Senate and Ranking Member Shelby. You outlined your objections, and I assume it is just your objections, to this and a number of other provisions. So I am very concerned about implementation.

Now, I am not going to ask you broadly because I have a very specific interest on the portion that I authored on crowd funding. You have 270 days to write and promulgate rules for crowd funding. Very interested in the process you are taking now, the number and type of staff you will have working on this issue, and we would like to give you an opportunity to address those things.

Ms. SCHAPIRO. I am happy to, Mr. Chairman. As you know, as we have discussed, the JOBS Act is the law of the land and the SEC will implement it and as faithfully to congressional intent as we possibly can. A number of the provisions, as you know, are immediately effective: the IPO on-ramp provisions. Those don't require SEC rulemaking. They have required that we provide some mechanisms for filing with the SEC and some clarifications around how Reg. A exemption will work—I am sorry, around how some of

the provisions will work, and we have done that. Within a week of the bill being signed, we sent out both a system for processing confidential filings and issued two sets of frequently asked questions on the process.

With respect to crowd funding, there is a 270 day deadline. That is very tight, as we know from Dodd-Frank. Congo had a 270 day deadline for rulemaking. We know how difficult that is. I would have to get back to you on specifically how many people are working on each provision, but I can tell you that because we had significant work underway already at the SEC to work on issues related to small business capital formation and general solicitation, the shareholder triggers, and crowd funding, that work is no longer necessary and those people can be shifted to the rule writing provisions.

Mr. MCHENRY. Okay. And I understand from your letter your aversion to this crowd funding piece, and I want to ensure that the SEC follows the intent of Congress.

Ms. SCHAPIRO. I can just assure you again that the law of the land is the law of the land and we will do what Congress has asked us to do, as we have always tried to do. Whether we agree at the end of the day or not, we will do our best to fulfill what you have intended for us to do.

Mr. MCHENRY. Thank you.

With that, Mr. Quigley is recognized for five minutes.

Mr. QUIGLEY. Thank you, Mr. Chairman. I have no questions of Ms. Schapiro at this time.

Mr. MCHENRY. I recognize the Vice Chairman, Mr. Guinta, for five minutes.

Mr. GUINTA. Thank you, Mr. Chairman.

I want to follow up on something we were talking about before. You mentioned the rulemaking relative to minerals, conflict minerals in the Congo. If we can pull up slide 5 for a moment.

[Slide.]

Mr. GUINTA. I want to read to you Section 1502 of Dodd-Frank. This is the conflict minerals rule. It says the rule's stated objective to reduce murder and other forms of criminal violence in the Congo. When I look at this slide—and I don't know if you have it in front of you, but this is the guidance of cost-benefit analysis—can you tell me where in that guidance there is any kind of specificity that we could apply to the conflict minerals rule?

Ms. SCHAPIRO. I can't read the whole thing. Let me say that the conflict minerals rule, as I said earlier, are very different rules for the Securities and Exchange Commission. We generally write rules that deal with financial transactions and disclosure requirements. This is, in essence, a disclosure rule, but it is really quite a different one, and—

Mr. GUINTA. What kind of a social objective?

Ms. SCHAPIRO. But Congress—so what we have quoted here, I believe—and, again, I would have to go back and look at the full page—we have restated Congress's objective for us, not an objective we believe that can be achieved by the conflict minerals rule. We have tried to be very faithful, because this is outside of our wheelhouse, to what Congress has said the purpose of this provision of the law is, to deal with massive human rights abuses in the Congo.

That is what we have been given and that is what we are trying to work with.

Mr. GUINTA. Well, I appreciate that and I agree with you. I don't think that your guidance, which is cost-benefit analysis, reducing incentives of misalignment, dealing with monitoring costs, lowering the cost of capital, I don't think that has anything to do with the social objective that was included in Dodd-Frank. My earlier conversation is the expansiveness of Dodd-Frank and the burden it places on the SEC. I think there are many that would like you to focus on a certain scope of issues in a reasonable way, and I think that you want to try to meet that same objective. This clearly, well, at least in my view, takes your limited focus of economics and apply it to something that is social in nature.

So I heard what you said about you will do whatever Congress essentially says, but I guess let me ask it this way. Would you prefer that Congress not make these types of decisions and ask the SEC to then promulgate rules or address them through a cost-benefit analysis process?

Ms. SCHAPIRO. I think that is a very hard question and it really is a question for Congress.

Mr. GUINTA. I thought it was an easy question.

Ms. SCHAPIRO. No. There are no easy questions anymore. I think it is really a decision for Congress whether the Federal securities laws are an appropriate vehicle for disclosure of this type, and there are several. I will say the vast majority of Dodd-Frank rules relate to specific financial matters that go to systemic risk, that go to investor protection, and we have a high level of comfort with our ability to master, do full analysis, and understand the comments that we receive before we adopt our final rules. This one is harder, there is no question about it. It is one reason we have missed the deadline and we have taken so much time. We have had so many meetings; we have had roundtables; we have engaged very broadly with the corporate community, as well as with the NGOs, the Jesuit Conference, and a number of others to try to understand the implications of these rules and to do the best job that we can.

Mr. GUINTA. Well, how about this. Is it fair to say that the conflict minerals rule is more about social justice than financial analysis?

Ms. SCHAPIRO. I think Congress clearly says that in the language that accompanies the debate around the rule, that it is about trying to make better a horrific situation in the Democratic Republic of the Congo.

Mr. GUINTA. But that is not the jurisdiction of the SEC.

Ms. SCHAPIRO. No, but the disclosure documents filed by public companies is the hook here for furthering this goal.

Mr. GUINTA. Are there other ways in which we could meet that objective, outside of the SEC?

Ms. SCHAPIRO. I assume that there are. I am not an expert on those, but I assume so.

Mr. GUINTA. Okay. Thank you very much.

I yield back.

Mr. MCHENRY. With that, Mr. Gowdy from South Carolina.

Mr. GOWDY. As before, I would give the Chairman my time for him to use in such fashion as he sees fit.

Mr. MCHENRY. All right, thank you. I certainly appreciate that. Just to finish out my question on crowd funding, not to belabor the point, but I will belabor the point. You know, there is obviously a comment period and things of that in the normal process of rule-making, but I want to make sure that market participants and members of Congress that crafted the JOBS bill have adequate opportunity to comment throughout this process to make sure that what the SEC enacts is actually Congress's intent, and, obviously, the oversight hearings are an important part of that. So, Chairman Schapiro, you have always been willing to give us feedback and be very forthright with that, and I thank you for that. I would ask and encourage you to continue that process throughout the remainder of this year as these rules are enacted.

Ms. SCHAPIRO. Of course. We would be happy to talk with you at any time that you want. Our rules will be published for comment; there will be an economic analysis associated with them; we will seek data to support the choices that we make and the alternatives that we offer up. This will be a fully transparent rule writing process, as we always engage in.

Mr. MCHENRY. Okay. Thank you. You know, with the crowd funding piece, there are extraneous provisions put into that section that the Senate added and some of these experts have commented on. They have concerns with the amendment that the Senate added with crowd funding, with their liability provisions are extremely confusing and riddled with hypothetical questions that raise some liability concerns. Some have called it liability trap. So with that concern, do you see it that way?

Ms. SCHAPIRO. I am not sure I know enough of the detail to answer that. It is something we will be sensitive to. We have also, I should say, opened up email boxes to ask for comment, even before we propose any rules, on some of the issues that people feel we need to address most quickly, and we have gotten, actually, some significant interest from people calling to find out about how they can engage and begin to engage in crowd funding. So I think whatever the hurdles that were placed into the bill in the Senate and the ultimately adopted version, I think there is real interest in people using this provision, and we will try to provide the best guidance that we can through the rules.

Mr. MCHENRY. Thank you. How will the SEC ensure that crowd funding serves startups and small businesses that are currently underserved, that sort of \$50,000 to \$500,000 equity raising section of the marketplace?

Ms. SCHAPIRO. I don't know the specific answer to that, but I can tell you that if you look back over a number of rules we have done at my time at the SEC, we have made use of scaled requirements so that smaller companies have a delayed compliance date in some areas, they have lesser filing requirements in other areas, and we will continue to look at, as the executive order suggests we do, scaled requirements for the smallest companies.

Mr. MCHENRY. Is that really the example to the world? As you talk to your peers in other countries around the world, that scaled regulations are really the next generation of securities regulations?

Ms. SCHAPIRO. That is a very good question. I don't really know the extent to which other countries utilize that, but we have been

doing it with respect to compensation disclosure. If you look at the new rules requiring private funds reporting under Form PF, systemic risk reporting, you can see that we exempted funds with assets under management of \$150 million or less completely, and those up to \$1 billion that are hedge funds only report annually, instead of quarterly, and much less information. So we are aggressively trying to utilize that kind of a mechanism.

Mr. MCHENRY. Okay. Now, I am sure you have heard of this, but this morning the Investment Company Institute and the U.S. Chamber filed suit against the CFTC with their Rule 4.5, and, as I understand it, the mutual fund industry claims that the CFTC has imposed an additional unnecessary layer of regulations on hundreds of mutual funds that are currently under your purview at the SEC, broadly speaking, and the lawsuit says the CFTC made little attempt to establish there is any regulatory gap to be filled here and that the CFTC failed to conduct an adequate cost-benefit analysis before adopting the amendments. I am not sure if they timed this in conjunction with the hearing today, but the cost-benefit analysis is interesting.

But to many market participants it seems that the CFTC's amendments could have an adverse effect on an industry that is currently regulated by the Securities and Exchange Commission. Was the SEC aware of the CFTC's actions?

Ms. SCHAPIRO. I believe we were aware. They are an independent agency and, except where we have been directed to write joint rules, we aren't in a position to tell them whether or not to go forward with something, although we do try to consult and coordinate, to the extent we possibly can, where our rules may affect the same entities. But I just don't know the details on this. I would be happy to try to provide those to you.

Mr. MCHENRY. Okay. Obviously, with mutual funds, even with money market funds, they weren't the cause of the financial crisis and weren't really the intention of Congress to subject them to additional regulations. But, in closing—I don't know if my Ranking Member has any additional questions.

Chairman Schapiro, you have been wonderful to submit yourself to congressional oversight. I know you spent some time on Capitol Hill, but I would say to my colleagues on both sides of the aisle that it is important for us to have oversight, to make sure the public knows that Congress, that their servants in Washington, their elected officials in Washington are having proper oversight of the bureaucracy.

Now, this has been a problem in all administrations. If you have Republicans in Congress, they say Democrats are subjecting that Republican President to too much oversight, and vice versa.

But, with that, with the regulations, with the JOBS Act, the regs that SEC has to promulgate, will you be willing to come back before the end of the summer, before this Subcommittee and give us an update on those implementations?

Ms. SCHAPIRO. Of course.

Mr. MCHENRY. Thank you. I certainly appreciate that. And if we could have a regular update from your staff and from you, that would be very helpful as well.

So I certainly appreciate your testimony.

With that, the Committee stands in recess until we put in place the second panel.

[Recess.]

Mr. MCHENRY. The Committee will come back to order and have witnesses take their seats. Is Mr. Yerret present today?

All right, the Chair will now recognize the second panel of witnesses and I will begin by recognizing Dr. Henry Manne as the Dean Emeritus of George Mason University School of Law; Ms. Jacqueline McCabe is the Executive Director for Research of the Committee on Capital Markets Regulation; Mr. Mercer Bullard is an Associate Professor of Law at the University of Mississippi School of Law; Mr. J.W. Verret is an Assistant Professor of Law at George Mason University School of Law; Mr. H. David Kotz is the former Inspector General of the Securities and Exchange Commission, and current Managing Director of Gryphon Strategies.

With that, it is the policy of this Committee that witnesses will be sworn in before they testify. If you will please rise and raise your right hands.

Do you solemnly swear or affirm that the testimony you are about to give will be the truth, the whole truth, and nothing but the truth?

[Witnesses respond in the affirmative.]

Mr. MCHENRY. You may be seated.

Let the record reflect that the witnesses answered in the affirmative.

Members will have five legislative days to submit written opening statements, and in order to allow time for discussion, I ask the panel to limit their testimony or to summarize their testimony, and if you can keep that to five minutes. The lights are there for your instruction, and if you could please adhere to that, we will get time for an exchange of ideas and a discussion afterwards.

After that, we will first recognize Dr. Manne.

STATEMENT OF HENRY MANNE, PH.D.

Mr. MANNE. Thank you, Mr. Chairman.

Mr. MCHENRY. If you will pull the microphone close to your mouth. They are very directionally oriented.

Mr. MANNE. I presume first recognition of me is in recognition of age, but I almost believed that I would never live long enough to see the day of March 16th, when the SEC put down this new memorandum. I have spent my entire career, over 50 years in law teaching, pressing the idea of the need for economic analysis in legal policy-making. We have had some enormous successes. I don't think there is any law school in the Country today that doesn't have substantial work in law in economics, and, indeed, I think the rising popularity of this interdisciplinary field in part accounts for what has happened in the SEC now.

Nonetheless, most of my career was not happy in this regard. In 1966, I wrote the first book that was fundamentally critical of the SEC from the point of view of not using economics. It was a detailed economic analysis of what came to be called insider trading. It was studiously ignored by the SEC. In fact, I am told that by decision in a staff meeting no one would be allowed to review it and, furthermore, that I had the happy position for many years

that no staff member at the SEC was even allowed to cite any work that I had written.

The following year I edited a conference that I ran that was the first comprehensive treatment by economists of securities regulation. There had been one or two spotty articles up to that point, but that was the first one. Again, it met with, I would say, resounding hostility from the SEC, as most everything that I did in those days was.

So you can see that having come a long way. I don't suggest that I think that cost-benefit analysis is the be all and end all of correction of problems with securities regulation, but it is very definitely a step in the right direction.

Having said that, I want to say some general things about cost-benefit analysis and this in particular. First of all, this cost-benefit analysis is merely one part of economic analysis. There are occasions, as was pointed out in that memorandum, when cost-benefit analysis is not the most appropriate thing to use. Economic analysis of a non-empirical sort can be used, and each has its appropriate role.

There are several aspects about overlapping on those, because I see I have run out of time much faster than I ever expected to, that I raised by way of warning to the agency. I take them in perfect good faith that they really mean what they said, but I am not sure they know fully what the implications are of what they said.

First of all, data of the kind they use in many cost-benefit analysis is about as malleable as clay. There is an old saying, if you squeeze the data hard enough, you can make it say anything you want. Well, what that does is puts a degree of responsibility for objectivity on an agency using cost-benefit analysis that maybe they are not even aware of. One of you Congressmen mentioned earlier the whole culture of the Securities and Exchange Commission has not been the culture of a highly intellectualized economics department in a university; it has been heavily politicized and, indeed, hostile to economic analysis because that is a kind of often serves to restrict what would be preferred political things to do.

This came out, I saw, mainly in the memorandum in two places, both footnote 16 and footnote 19, which were the principle places in which the memorandum actually mentions some of the substantive techniques and problems of cost-benefit analysis. I would like really just I will mention one of them as an example that this entire list is big enough to run a truck through, doing away with sufficient appropriate analysis.

One is the notion of asymmetric information. This is defined in that memo as a market failure. Well, if asymmetric information is a market failure, then everything in the world is a market failure. Asymmetric information merely means that the two people negotiating don't have exactly the same information, the same education, the same attitudes, the same risk aversion; many differences. And to talk about it as a market failure is to, in effect, beg the question entirely, even before you get started.

There are several other places in that memo that, if you want to talk about later, we can, which I haven't gone into.

If I may take just a minute, I have a list of—

Mr. MCHENRY. If you are able to summarize. We have a large panel. If you are able to summarize in another 30 seconds, that would be very helpful.

Mr. MANNE. I would just mention and list some practical consequences that I think should grow out of this. One, I think the SEC is totally fooling itself when it talks about 17 or 20 new economists. For the job that they really presented themselves, to do well and to do adequately, I think is a minimum of 150 economists. I don't think small numbers even begin to grab at it. And you should pursue the number of laws they have because it has long been a lawyers agency with no input from the economists, and that ought to change. The culture and the internal dynamics of that agency should be changed because it is an economic regulatory agency.

And it is not true, as I am afraid Mrs. Maloney said, that the important thing is to get those regulations out. No. The important thing is to get regulations right. Better to get two correct, really effective regulations under Dodd-Frank than to get 150 out that are random, that you don't know what the impact is or what the cost-benefit is, or anything else.

[Prepared statement of Mr. Manne follows:]

Mr. Chairman and Members of the Subcommittee, thank you for the opportunity to testify before you today on an issue that has occupied me professionally and intellectually for well over 50 years, the use of economic analysis in the development of legal policies, especially those relating to corporate and financial laws. As an undergraduate at Vanderbilt University, I majored in Economics and went to the University of Chicago Law School (in 1949) because I was told that there were economists on the law faculty there¹. My SJD thesis at the Yale Law School was on the economics of insider trading laws. I subsequently founded the first of the now numerous academic centers for Law and Economics, and later, as Dean of the George Mason University School of Law, I developed a strongly economics-oriented law school curriculum. In retirement I have continued to teach a course in Law and Economics at the Ave Maria Law School.

For better or worse, I was perhaps the first legal academic to introduce modern forms of economic analysis into the corporate area of legal scholarship. The “better” part of that happenstance is that I largely succeeded in the task, though it took several decades for the type of analysis that I introduced to become academically mainstream, as it is today. The “worse” part of introducing a new intellectual paradigm is that the introducer suffers the disdain and calumny of the established scholars, which is only fun for masochists, which I am not. But oddly enough, that academic battle, about which I have written,² bears considerable similarity to the issue which we are discussing here today, the role of economics in various aspects of law making.

As with all good issues, there is some relevant history which it would do well to note. The modern history of this issue can probably be dated to the New Deal, when there was a ferocious fight in the legal community about the establishment of what we have come to call the “administrative state,” but which is more clearly seen as a form of central planning. This was not central planning or resource allocation on the scale usually associated with the Soviet Union and advocated by a variety of 20th Century socialist economists. Rather this was - and remains - planning or resource allocation on a very detailed, micro scale, but it is central economic planning and resource allocation nonetheless. The regulatory agencies, the alphabet soup, were each given enormous authority to make rules for the regulation of various private endeavors. The main fight, however, was not about the economic value or correctness of the ensuing decisions. Rather it was about Congress’ constitutional power to delegate this much rule-making authority to non-elected agencies.

Eventually that issue was put to rest with the arguments (largely pursuant to the “necessary-and-proper” clause of the Constitution) that society had become so complex that Congress had to rely on experts to do the detailed work of regulating which Congress, by virtue of its expertise limitations, could not do; that the delegation had to have some semblance of reasonableness; and that due process, usually in the form of a right to appeal to the courts, be available. Note that none of these justifications was premised on economic concerns. This issue was thought to be exclusively the province of lawyers and political theorists, not economists, though who was to convey expertise was never made clear.

¹ Notably the legendary Aaron Director, indisputedly the first person ever to do Law and Economics.

² Manne, “How Law and Economics Was Marketed in a Hostile World: A Very Personal History” in Parisi and Rowley, *The Origins of Law and Economics - Essays by the Founding Fathers* (Elgar, 2005)

The next phase in the debate³ about administrative powers came from an unexpected source, the new (1962) field of Public Choice theory⁴, or, as it is sometimes described, the analytical techniques of economics applied to political phenomenon. There are two main thrusts to the Public Choice criticism of regulatory agencies. The first is that the behavior of bureaucrats is more accurately seen as self-serving rather than motivated by the public interest. This would frequently manifest itself, not simply in the older idea that bureaucrats were slothful, but in agencies' push for an ever greater budget to fund expanded powers.⁵

The second criticism, in two parts, was that agencies could and very often were co-opted by the very interests they were supposed to regulate, and, second, that these combined interests would be used for so-called "rent-seeking" purposes. Each of these criticisms of regulatory agencies has become standard fare in political theory, and to a large extent these ideas have permeated all levels of serious discussion about the administrative state. But "permeating the discussion" is a long way from having a real political influence, and, on that score, the main thing that seems to have changed is intellectual or academic understanding about regulation.⁶ There has been no serious check on the possibility of regulatory abuse since 1946. But perhaps, often with considerable lag, academic discussion is the source of all good government reform. It should be noted again that, regardless of Public Choice's origins in economic theory, this kind of criticism is not, in its essence, a complaint about regulation based on economic concepts.

But economic criticism of central planning does have a long history, and a more nuanced pedigree. A now classic debate about free markets versus central economic planning raged in the late 1920s and the 1930s. This was generally in reference to ideas of "scientific socialism" being advanced by apologists for the Soviet Union's extreme form of socialist planning. The principal criticism of this kind of planning probably originates with Ludwig von Mises⁷, a founder of the Austrian School of Economics. Mises declared that central planning and non-market allocation of resources could not work, since the only logical basis for making efficient decisions was the existence of a market price. But a market price would not be available in a socialist system, since price evolved out of the voluntary interactions of individual buyers and sellers in the marketplace. This style of criticism was developed further and elaborated by Mises' student, Friedrich Hayek, notably in one of the most famous and influential articles in all of economic history, "The Uses of Knowledge in Society".⁸

Hayek's basic thesis in that article and much of his later writings was that the knowledge necessary to make "correct" centralized economic decisions could never be mastered by one person or agency, since the information required to make such decisions was so enormous and so

³ That is, apart from whatever influenced the Administrative Procedure Act of 1946, probably a carry-over from the earlier debate.

⁴ Buchanan and Tullock, *The Calculus of Consent* (1962)

⁵ Niskanen, *Bureaucracy and Representative Government* (1971)

⁶ We should perhaps make an addendum to the Public Choice criticism of administrative regulation for a related criticism growing out of more recent work in Behavioral Economics, suggesting that various biases and unnoticed psychological distortions severely impact regulators' efforts to engage in rational planning. For a very relevant use of Behaviorist ideas in connection with the SEC, see Pritchard and Choi, *Behavioral Economics and the SEC*, 56 *Stanf. L. Rev.* 56 (2003). That work can be seen as complimentary to the better known economic work, to be discussed in the text, relating to the impossibility of efficient central planning.

⁷ See his *Socialism* (1922) for a lucid exposition of his arguments.

⁸ Hayek, *The Uses of Knowledge in Society*, 35 *Amer. Econ. Rev.* 519 (1945)

totally diffused throughout society in the minds of countless individuals; furthermore the necessary knowledge changed from moment to moment as circumstances changed. Thus reliable information could never be imparted in timely fashion to central planners.

This presented a practical argument against centralized planning that is today almost undisputed. And with the collapse of the Soviet economy in the late 1980s Hayek's explanation became a sort of gospel for anyone trying to understand the fatal weakness of such a system. But what many observers failed to notice was that the same arguments applied with small modification to the kind of administrative regulation endemic today in the United States. We rarely call it "central planning," but the types of decisions and the knowledge required for correct industry or sector-planning decisions, as for instance with the SEC or the NLRB or the EPA, are the same in a regulatory regime as in a centrally planned economy. True, the SEC does not make decisions as to which industries should receive new capital, but even mundane decisions affecting the cost of different forms of financing can indeed have allocational consequences. Indeed it is difficult to think of any significant substantive regulation that does not have some allocational consequences. The mere fact that these consequences are ignored does not mean that they are not present.

In a nutshell Hayek's argument is that the technical expertise necessary to make efficient allocational decisions is, *of necessity*, simply unavailable, whether that decision is to be made by a Soviet-style central planner or an SEC rulemaking procedure. Furthermore, there is no evidence to make us believe that a series of uninformed decisions will on balance do more good than harm. By happenstance some rules will work and a great many will be almost insignificant economically, but even this cannot be known for sure in advance. No sort of Darwinian survival process operates almost automatically, as it does in the private sector, to weed out bad decisions and allow good ones to survive. The bad survive along with the good, and we do not even have an apparatus in place to test which is which. Apart from a totally unjustified blind faith in the skills and good faith of our regulators, there is no real way of justifying much of their work.

But, alas, we are not yet at one of those defining moments in our history when we can make a choice between continuance of our present regulatory-state model and a freer, more growth-oriented and less intrusive free-market model. But the last time we did face such a defining moment, during the New Deal, we certainly did not have the intellectual support of free-market ideas that is flourishing again today, nor did we have a great many of the newer tools of economic analysis that we now enjoy. Inertia and the complexities of politics undoubtedly explain a great deal of this unwillingness to introduce new thinking into our regulatory system, though Political Scientists would more usually point to the fact that interests become vested in any prevailing regulatory system and that the force required to divest them is far greater than that required to introduce them in the first place. This is, of course, consistent with the view that regulatory agencies are regularly captured by the very interests they are supposed to regulate.

But I think that there is also an even more fundamental factor at work. While the intellectual culture of the United States at one time condoned *laissez faire* capitalism, it no longer does. And, although the intellectual lessons of Hayek, Mises and Milton Friedman, are perhaps more robust than they ever were, this thinking has not permeated the attitudes of enough people to

make a big difference. Moreover career or strongly politically-minded bureaucrats (and even some elected officials) have every reason to ridicule and disparage this kind of economic thinking, since it is decidedly not in their political or financial interests. And let's face it, it is a difficult psychological adjustment to give up a paradigm that one has lived successfully with for a long time, no matter how logically or empirically unjustifiable that older paradigm may be. So I do not think that it is out of consciously selfish motives that no high-level regulator is ever found to be an advocate of deregulation, nor that voters do not push for it in large numbers. I think they simply do not appreciate the analytical and explanatory power of modern economics and the tremendous advantages of free and unregulated markets. And while this may at root be a symptom of problems with our educational system, the fact remains that *laissez faire* and far-reaching deregulation is not part of the 2012 American *zeitgeist*.

But that is a long way from saying that there is nothing we can do to make the system of administrative regulation work more effectively in the public interest. While a rigorous cost-benefit approach to regulation may to some degree be at odds with Hayek's notions about "expertise" and Mises' doubts about the practical validity of empirical evidence, we may have to live in a second-best world. That is, even if our present regulatory apparatus is doing more harm than good, it cannot in the foreseeable future be thoroughly dismantled. So we might at least try to minimize the losses that it causes. I take it that this is the goal of these hearings.

The techniques and power of so-called cost-benefit analysis have improved remarkably in the past fifty years. This reflects in part the huge advancement in the field of econometrics, of which cost-benefit analysis can be said to be a sub-field. The quality of the data available for calculations is also much improved, largely as a result of the accessibility computers have given to new data bases and the increased reliability computerization has added to the collection of data. There has also been a vast improvement in the economic models we can use to test the efficacy of proposed regulations. A clear example of this is provided by the development of a field called "transactions cost economics," for the introduction and elaboration of which Ronald Coase and later Oliver Williamson received Nobel prizes in economics. The influence of this concept can clearly be seen in Judge Ginsburg's opinion in *Business Roundtable v. SEC*⁹, where he lays out a veritable catalog of components of an acceptable cost-benefit analysis. But while the advent of these newer techniques and ideas has greatly strengthened the ability of willing administrators to make sensible empirical judgments, it has by no means vitiated the fundamental objections of Austrian School economists, or even many Chicagoans, to this kind of regulation.

Still second best is better than no "best" at all, and the latter is exactly what the SEC and many other agencies have been offering us for a long time by their failure to offer up any form of economic justification for their rules and decisions. This has always seemed to be particularly ironic in light of the justification legally and popularly made in the 1930s for administrative regulatory agencies. That was, of course, that these "experts" would have the technical skills required to do "scientific" economic planning or rulemaking. It is a little weird then to find the very officials, to whom was delegated this power of exercising their expertise, ridiculing its application. I don't think that it was with reference to Hayek or Mises that a former commissioner of the SEC criticized economists who "attempt to compress the complexity of our

⁹ 905 F2d 406 (DCCA 2011)

security markets into horribly complicated formulae.”¹⁰ Apparently he preferred to have complex questions addressed without reference to rigorous analytical models, but more likely he, like the entire securities bar at the time, was simply unaware that such useful models even existed.

In 1974 I was invited to give the annual Charles C. Moscovitz memorial lecture at New York University's College of Business and Public Administration. This lecture, “Economic Aspects of Required Disclosure under Federal Securities Laws” was subsequently published as part of a book¹¹ that received little known attention by the SEC, though it dealt with a topic that had not previously been widely addressed. The lecture was - and was intended to be - a rather damning criticism of the very centerpiece of the New Deal's revolution in government controls of business, the SEC. Like the king who had on no clothes, this economic regulatory agency had no economics, though the investing public had been told repeatedly that these “experts” in matters related to securities markets would make rules that would save them from the depredations of ruthless and manipulative bankers, corporations and brokers and would make securities markets work effectively in the investors' interest. The gravamen of my complaint in 1974 was that the SEC had never once sought to justify its vast and complex web of “disclosure” regulations with anything like rigorous economic analysis.¹² It will be interesting to see how the agency responds to Dodd-Frank's requirement that they justify old rules as well as new ones.¹³ When the world notes how gargantuan this task is, it may for the first time become aware of how poorly the SEC has managed its main responsibility over the years

While much of my criticism in the aforementioned lecture dealt with disclosure provisions under the 1933 Securities Act, there is one dramatic episode discussed that I should like to raise again to show how shameful this history really is. In 1934 the SEC adopted Rule 10b-5, a kind of catch-all anti-manipulation provision using substantially the words of Section 10 of the 1934 Act. This was done in order to establish the agency's jurisdiction over a kind of transaction (definitely not insider trading) not explicitly mentioned in the Act. The *total* record of the hearings leading to the adoption of this provision show one commissioner's remarking “Well, we are against fraud, aren't we?”

¹⁰ This quote is from a speech given by Commissioner A. Sommer, Jr. in the late 1960s cited in H. Manne (ed.) *Economic Policy and the Regulation of Corporate Securities* (Washington, D.C. 1969). This book presented the contents of a conference on this subject held 33 years after the founding of the SEC. It was the very first attempt ever to develop a comprehensive economic analysis of securities regulation and was soundly ignored by the SEC. Comparable, and even less flattering, remarks are legion among old members of the securities regulation establishment, most of whom seemed to be infected with the self-serving notion that only lawyers could provide good answers to matters of economics. There is less of that legal hubris around today, perhaps because of the advent and influence of Law and Economics in American law schools. But the evidence for a blossoming of economic sophistication among the regulators, or even a serious effort to discover what parts of economics might inform Commission decision making, is still lacking.

¹¹ Manne and Solomon, *Wall Street in Transition* (NYU Press 1974)

¹² Note that this was before there was much interest or talk about cost-benefit analysis. I was suggesting a more analytical and not necessarily empirical style of economic justification, a style that perhaps most lawyers could understand but which would still offer a semblance of economic justification for their work product.

¹³ In this connection it is perhaps pertinent to note a recent failure in the SEC to appreciate what economic analysis can offer. This evidence is found in the memorandum from the SEC's former General Counsel, David Becker, to agency staff regarding cost-benefit analysis. Mr. Becker argued that this requirement did not apply in any case where Congress had mandated a rule but only in those where the Commission had “discretion.” Perhaps this was just lawyers' blather, but the truth is that the agency still has enormous discretion in drafting a rule required by Congress, and this argument is just a new version of the SEC's hostility to anything but superficially analyzed rule making.

Rule 10b-5 remained substantially dormant for another 27 years until one day in 1961, in an extremely suspect use of administrative process,¹⁴ the SEC declared, *in an administrative adjudication* allegedly interpreting Rule 10b-5, the famous case of *SEC v. Cady Roberts and Co.*, the most significant change in substantive corporation law and market trading regulation in over a hundred years, what is today called “the rule against insider trading.” Note that this is popularly called a “rule” and by any stretch of the imagination, this “interpretation” has had all the effects, significance and appearances of a real rule. But it was not promulgated as a rule, no hearings as required by the Administrative Procedure Act for rulemaking were held, and, Lord knows, no economic analysis of the new rule was conducted.¹⁵ It is hard to imagine that perhaps the most famous bit of rulemaking in the history of the SEC was done without one iota of an attempt to measure the impact of this ruling on stock market pricing, on the behavior and motivation of corporate insiders, or even to discover who might be injured by the outlawed practice. That is the level of intellectual and economic rigor that has long characterized SEC rulemaking, and it is certainly time for that kind of irresponsibility to stop. But give credit where it is due, even though the SEC has not been very adept at economic analysis, they have proved to be masters of the art of creating near mass hysteria about the “immorality” of insider trading. But they were not created to be our moral guardians; they were created to be our expert securities regulators.

In the years since *Cady Roberts* the world has been inundated with economic analyses of rules against insider trading. Every conceivable aspect of that seemingly endlessly fascinating topic has been explored. Literally hundreds and hundreds of articles, books, columns, conference volumes, blogs and treatises have been written on the subject all over the world. Numerous aspects of the insider trading debate remain highly controversial, though some important economic aspects seem reasonably well settled.¹⁶ But the SEC has never entered this highly charged economic debate,¹⁷ has never moved to do a study of some of the more controversial aspects of the insider trading, and has never attempted to do any sort of cost-benefit analysis of this rule. And while the comment requirement for administrative rule making does allow outsiders to offer economic pros and cons of proposed new rules, there is no evidence that the Commission or the relevant rule drafting staff is ever significantly influenced by such comments.¹⁸

¹⁴ See Manne, *Insider Trading and the Administrative Process*, 35 *Geo. Wash. L. Rev.* 473 (1967). It may, however, be that this way of dealing with the issue was used because no one at the Commission even understood the enormous economic complexity of the insider trading issue. The fact that the decision in this case was not really treated - or enforced - as a “rule” by the SEC until many years after that reinforces the view that the SEC thought that *Cady Roberts* was really a one-off situation. Such are the costs of economic illiteracy.

¹⁵ Query whether *Cady Roberts* as an administrative adjudication would even have to be re-examined under the Dodd-Frank requirement? But if the original Rule 10b-5 is re-examined, that could implicate an investigation of the economic merits of the insider trading rule, which the Commission solemnly avers in *Cady Roberts* was dictated by the existence of Rule 10b-5. Oh, the delicious irony of it all.

¹⁶ Two issues that seem to be settled today in the literature are (a) the person whose shares are bought or sold on an anonymous exchange cannot be injured by the fact that the counter party has inside information and (b) any trade by someone with undisclosed information has a tendency to or will actually move the price in the correct direction, thus in many cases generating a more efficient market. By not understanding the first point here and explaining it to Congress, the SEC allowed Congress to embarrass itself by giving the right of a civil action for damages to anyone who traded near the time the insider was in the market, when in fact that person suffered no damage.

¹⁷ Unless one counts as economic analysis the endlessly repeated refrain that the rule against insider trading is necessary to maintain investor confidence in the market. But this claim too has been studied to a fair thee well, and there is not one bit of evidence to support it. Nada. There ought to be some way to stop a regulatory agency from continually repeating a lie.

¹⁸ See, for instance, Judge Ginsburg’s comments regarding the use of academic studies in the *Business Roundtable* case.

This is shameful behavior on the part of a powerful economic regulatory agency, and this “lawyerization” of fundamentally economic questions should be stopped before it does more harm than it already has.¹⁹ Thus the idea sometimes mooted to give the SEC’s Office of Economic Analysis some sort of veto over any proposed rule with economic effect (which might be a justiciable issue) makes a lot of sense. Undoubtedly such a rule would create enormous internal and bureaucratic upheaval, but that is exactly what is wanted. This should be an agency staffed overwhelmingly in its regulatory role by economists, securities-industry specialists and statisticians, not lawyers.²⁰ There is nothing inherent in the training or practice of lawyers that gives them any capability or expertise in the matters the SEC confronts regularly.²¹ And, if the agency were not so lawyer-oriented, there would be much less chance for agency “capture” by the industry most dependent on its work, namely the securities bar, or for accusations about the Washington Merry-Go-Round of employment after an “apprenticeship at an agency. Such an approach might even curtail some of the needless and damaging litigation so common in this area.

But the SEC’s problems with economics don’t end with their failure to do the basic kind of analysis one would expect of an economic regulatory agency. They don’t even do the kind of analysis that Congress has explicitly required them to do. In his now famous decision in *Business Roundtable v. SEC*²² Judge Douglas Ginsburg excoriated the SEC for its failure adequately to address, in connection with the recent proxy solicitation rule regarding nominations of directors, the Congressional requirement that rules take into account the effects on “efficiency, competition and capital formation”.²³ Such failure made the SEC’s rule “arbitrary and capricious” within the meaning of the Administrative Procedure Act of 1946, and it was sent back to the Commission for further consideration. In effect Judge Ginsburg’s opinion is a catalog of requirements for what we normally term a “cost-benefit study.” The case seems to stand for the proposition that many agency rules (including well-established ones, under Dodd-Frank’s requirement for a cost-benefit study of old rules) will now have to stand the test of a rigorous cost-benefit analysis before they can receive the sanction of legality.

This requirement, which could be strengthened and made escape-proof by confirming Congressional action, will undoubtedly have a number of salutary effects, in spite of the difficulty of getting reliable data on some of the issues that the Commission regularly faces. First, this requirement will provide a analytical template for the consideration of any new rule. That is, it will force the agency to give adequate consideration to a variety of significant economic questions which it now regularly sluffs off or simply assumes the answer to. Next it will force the agency to make real-world quantitative comparisons instead of simply assuming answers or even finessing hard questions altogether. It will offer some assurance (not perfect by any means) that the agency will not adopt rules that are economically harmful. And finally it will make the discussion of new regulations more open to truly informed community comment as opposed to special interest pleading, since third-parties will know that their comments will be examined by

¹⁹ Vide the Bernie Madoff example of bad stewardship or, more academically, see Manne, *op.cit.* note 11.

²⁰ The Federal Trade Commission seems to have learned this lesson, much to the benefit of consumers. See

²¹ That is, other than the make-work regulations created by and for the lawyers involved in the process. Corporate costs be damned if a rule can, with even the slightest justification, become meat for the trial lawyers’ grinder.

²³ As required by the amended Securities and Exchange Act of 1934

sensible and knowledgeable experts and not bureaucrats interested mainly in the political implications of a new proposal. An incidental advantage of such an approach is that courts will now give a proper amount of deference where it makes sense to do so, on rules vetted by true experts in the field and not by regulatory poseurs. In time we should develop something like a common law of good practices in cost-benefit analyses and incidentally improve the quality of economic regulation.

ADDENDUM

After the text above was written, I read an SEC MEMORANDUM, dated March 16, 2012, from RFSI and the Office of the General Counsel of the SEC, addressed to all staff members involved in rule making. It is a highly sophisticated, comprehensive plan for cost-benefit analysis of SEC rules, both future and existing. This represents an almost revolutionary turnaround from the past practices and culture of that agency, and, though it comes 80 years after this sort of thing should have been done on a regular basis, it is better late than never. And the requirement of the Dodd-Frank legislation that significant older rules be subjected to such analysis makes it even more revolutionary than might first appear. I do not want to appear ungrateful for this obviously thorough and informed document, though I do have a few, I hope, constructive questions and comments about some of the substantive details and the operation and enforcement of this new requirement.

Footnote 16 of the Memorandum contains the most significant substantive aspects of the economic approach the staff will be expected to observe. It correctly states that regulation should follow upon some recognized failure of the free market, and it lists as such examples “[negative] externality, market power, and inadequate or asymmetric information”, with generalized examples of each of these and a couple more claimed market failures. The problem here is that each of these alleged types of market failure needs to be addressed with considerable circumspection. The negative externality argument, exemplified by “spill-over financial risks” is of a sort very uncommon, though theoretically correct, in financial markets. Further, the root causes of such are often well beyond the SEC’s powers to deal with, such as certain aspects of the 2008 crash that could be blamed on Federal housing policies largely untouched by the SEC. Turning then to the benefits of “positive externality”, the example listed is certainly a bit too self-serving, since it begs an economic question: do and to what extent do “positive externalities” flow from a “disclosure” regime?. One cannot simply assume the benefits of this fundamental regulatory tool when trying to measure the costs and benefits of new regulation. Of course, if there were overwhelming evidence that the disclosure regime we have had in place for nearly 80 years has benefited society more than it has cost, perhaps that exercise would not be necessary for each new disclosure type rule. But I know of no such evidence. There are studies, however, indicating the contrary.

Comment is also indicated for the inclusion of “market power” as a kind of market failure that justifies regulation. The SEC has not very often in its entire history encountered a true and significant cartel or monopoly that was not either generated or protected by government regulation of one kind or another (including SEC). The now-defunct regime of a fixed

commission rate structure on the New York Stock Exchange would be a good example of market power that was protected by SEC policy. It is hard to imagine another problem of market power that is not of this variety that the Memorandum writer had reference to. Again, perhaps theoretically appropriate but practically, a near-dead letter.

Next listed is “principal-agent problems” arising in the form of “moral hazard or in situations involving potential conflicts of interest.” Here, even at a theoretical level, the economics of the Memorandum is wanting. Principal-agent problems and moral hazard are not indications of market failure. They simply represent market costs, and though sometimes “transactions costs” of this sort are thought of as changing the fundamentals of market economics, we now know that this is not so. Such costs may be high, but that does not in and of itself make them into market failures.²⁴ Since much of the edifice of modern corporate governance literature is built on the Berle and Means fallacy²⁵ of the principal-agent problem as a market failure, this example in the Memorandum might represent a shortcoming of the underlying economics.

But then comes the most revealing and misleading statement about market failure in the entire document: “There is asymmetric information, for example, when investors seeking to trade securities are not fully informed of all material information that could affect their investment decisions.” Investors are never “fully informed,” for, if they were, there would be no risk in investment. This is the shibboleth (obviously merely the converse of “full disclosure”) under which the entire “disclosure” philosophy of the SEC has been maintained during the long years of excluding economics from Commission consideration. To consider less than full information to be a market failure is to misunderstand the basic idea of scarcity as part of the human condition. Information is an economic good that follows all the fundamental rules of economics, and while it does have some unique characteristics that give rise to special consideration, a simple lack of full information is not one of them. This statement is a big enough hole in the otherwise highly appropriate document to make the entire thing an exercise in futility. A sound cost-benefit analysis of any aspect of “disclosure” regulation must not start with the question-begging assertion that asymmetric information represents a market failure.

Some observations about the most celebrated work on asymmetric information, that of George Akerlof on a “lemons” market in used cars, is very revealing. Akerlof showed how theoretically a lack of information by consumers could theoretically eventuate in the collapse of an entire market for a good product. This would indeed represent a market failure *par excellence*. Unfortunately this theoretical demonstration (which has yet to be certified as ever existing in the real world) captured the imagination of a lot of economists searching arduously for any new market failure they could lay hands on. What most references to the Akerlof theory have failed to note is that the used car market did not disappear and that the private market had already provided all manner of solutions to the problem that Akerlof identified. And so it is with other areas of asymmetric information, including securities markets. There is no proof of the theory, and consequently the theory itself may be lacking. This is not to suggest that some investors may not be benefited by mandated disclosures, or even that on balance this form of regulation is never beneficial. It is to say, however, that the asymmetric information form of

²⁴ See Demsetz, The Problem of Social Cost: What Problem? A Critique of the Reasoning of A.C. Pigou and R. H. Coase, *Review of Law and Economics*, Vol. 7 (2011), Issue 1.

²⁵ See Manne, Mergers and the Market for Corporate Control, *Jnl. of Pol. Econ.*, vol 73, p.110 (1965).

market failure is a weak reed on which logically to base much regulation, but it provides a big opening for rationalizing poor regulation as having been done on the basis of a cost-benefit analysis.

Footnote 19 the Memorandum addresses the contentious issue of whether the Commission is required to offer a cost-benefit analysis when Congress has mandated a rule. The Commission has stuck to its seemingly untenable position that it should not do such an analysis when Congress has mandated a rule, thus allegedly leaving the agency with no discretion (and no need for an economic analysis) in the matter. Presumably the basis for this argument is that the analysis might contradict a stated or implicit Congressional finding of a market failure. But no one is arguing that the SEC can overrule an Act of Congress. Even considering the extreme case of such a contradiction, such a finding would seem to be of the essence of regulatory responsibility. After all these agencies were created and tolerated because it was generally understood that Congress did not have the expertise to do this kind of detailed regulation. If Congress has made a mistake in the eyes of SEC analysts, they should say so and not hide from their responsibility from fear of some kind of retribution. Furthermore, there are few if any cases of Congress mandating a rule on which the agency in question does not still have enormous discretion about what the final product will look like. When Congress mandates that an agency adopt a rule, Congress is not writing the rule (or there would be no need to require the agency to write a rule), and the approach clearly implies that Congress believes there are many different ways the rule can be detailed. The Devil, after all, is in the details, and it is precisely those details which need to be justified on a cost-benefit basis.

I should now like to turn to some practical aspects of the March 16 Memorandum. While I applaud the Commission's adoption of a more sophisticated economic approach to rule making than they have heretofore exhibited, there are certainly significant practical problems with the implementation of this bold plan. There are presently 16 economists among the over-3000 employees of the SEC, and I believe that this is an all-time high number. Given the tasks of generating new rules under the Dodd-Frank law and that Act's additional requirement for cost-benefit studies of existing rules, the number of highly trained and competent economists necessary to complete this job in several years is more likely to be on the order of 100 to 150 if not more. The foundational task of assembling the required data bases for this work will in itself engage a huge number of experts for a long period of time, and each of the new staff members will have to be brought up to speed on the institutional aspects of securities regulation before they can begin this work. Where are the resources for this gargantuan task? I suggest that they already exist at the SEC in the persons of what will soon be redundant lawyers and policy experts presently working on rule making in the "old style." In other words there will simply have to be a shift in the Commission's orientation from law to economics, and personnel policies should reflect this new reality. This job should be able to be accomplished with no additional funding.

The next practical question is how to make this new policy become and remain a reality. In other words how is this new approach to be enforced and monitored? This is especially relevant as there will undoubtedly be agnostics in and out of the Commission who will fight relentlessly to guard their existing intellectual and bureaucratic capital. To this end the appropriate committee of Congress should mandate something along the line of the SFRJ and OGC's

Memorandum of March 16 and then require regular and detailed progress reports from the SEC. These reports should also be available for public comment. For example, this Sub-Committee might require such a report from the Commission three months from now, then in six months, in one year and thereafter once every two years. This report should make it evident whether the Commission is actually using sophisticated and objective cost-benefit techniques in their rule-making work, and it should discuss any respectable criticisms made of the Commission's work in this regard. As an additional safeguard judicial review of the substance of the economic analysis should also be guaranteed and not allowed to disappear under the rubric of "agency deference." I have no doubt that the D.C. Court of Appeals decision in *Business Roundtable v. SEC*, along with the announcement of these hearings, had some effect on the SEC's turnaround on the question of economic analysis, and I think that the right of judicial review to oversee possibly faulty analysis or other forms of mistake can have an enormously salutary effect on making these new requirements really meaningful.

This will not overcome the inhibiting effects of 80 years of a different intellectual culture at the SEC, but it will be a start. But with Congressional oversight, judicial review and the good faith sympathetic administration of these new rules by the SEC, a far more effective regulatory system may come about than we have had and one with some real intellectual credibility. In time the everyone involved with the SEC may come to understand what an economic regulatory agency is really all about.

Mr. MCHENRY. Dr. Manne, we will have to leave it there. I could listen to you all day; you are speaking my language. Or, I am trying to understand the depth of your language I think is probably a better way to say it.

With that, we will have to recognize Ms. McCabe for the purposes of her opening statement.

STATEMENT OF JACQUELINE MCCABE

Ms. MCCABE. 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 SEC. I am speaking today on behalf of the Committee on Capital Markets Regulation, of which I am the Executive Director for Research.

The Committee has, since 2006, 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 agency's respective rulemaking under Dodd-Frank. We are deeply concerned that the inadequate cost-benefit analysis could expose these rules to judicial challenge, particularly in light of the Business Roundtable decision and a current lawsuit seeking to strike down the CFTC's recently promulgated position limits rule.

The Committee studied cost-benefit analysis provisions in 192 proposed and final rules issued by 15 regulators under Dodd-Frank. Here are the numbers. Our analysis found that of these 192 rules, the vast majority do not discuss the expected broader economic impact of the rule; 57 of the rules contain no cost-benefit analysis; 85 of the rules contain entirely non-quantitative cost-benefit analysis; 50 of the rules contain quantitative cost-benefit analysis; however, most of this analysis is limited to the costs of paperwork, legal and compliance review, technology enhancements, 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; however, there is still significant room for improvement. Of the 54 SEC rules we reviewed, 4 contained no cost-benefit analysis, 26 contained non-quantitative cost-benefit analysis, and 24 contained quantitative cost-benefit analysis, although of these 24 rules only about half discussed any economic impact broader than paperwork, labor, compliance costs, and the like.

The SEC has recently issued guidance to its staff that outlines best practices for economic analysis in rulemaking. We applaud the SEC for taking this step. The SEC has noted that analyses of costs cannot be limited to compliance costs or hourly wage rates. Broader analysis will usually require additional data collection and may necessitate that the SEC hire additional economists. We fully support the necessary funding for the SEC to obtain these resources.

We are also pleased that the SEC has recognized the need to consider overall economic impact of its rules, including its rulemaking pursuant to congressional mandates, as well as entirely discretionary rulemaking. Even where Congress mandates a rule, it is important to assess the costs and benefits of both the rule and alternative approaches. We note the SEC's approach here stands in

contrast to that approach taken by the CFTC, and we strongly encourage the CFTC to rethink its position.

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. We would caution that 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.

We commend the SEC on its focus in assessing the tradeoffs 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.

We have observed that regulators, including the SEC, have requested input on cost-benefit analysis from industry in many of the rules. We caution, however, that when a regulator does not receive the information it has requested, this does not relieve it of its duties to conduct cost-benefit analysis. Rather, there are numerous other avenues regulators can pursue. First, they may develop data, estimates and data based on assumptions may serve this purpose. If the regulator is unable to develop data internally, it must obtain the information from third parties, for example, other agencies, self-regulatory organizations, trade organizations, or industry participants. Finally, regulators can request the data directly from firms that will be impacted by such proposed regulation. Any such data request should be made with an eye to minimizing the imposition on market participants.

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 these proposed rules, and 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.

In closing, again, we commend the new direction the SEC has taken on this issue and we hope that other agencies would follow suit. Thank you.

[Prepared statement of Ms. McCabe follows:]

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.capmksreg.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://capmksreg.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 Cir. 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 OCC¹⁷ (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.

Mr. MCHENRY. Thank you, Ms. McCabe.
Mr. Bullard.

STATEMENT OF MERCER E. BULLARD

Mr. BULLARD. Chairman McHenry, Ranking Member Quigley, members of the Subcommittee, thank you for the opportunity to appear before you today to discuss cost-benefit analysis in SEC rulemakings.

There is general agreement that in the past the SEC has afforded the economic costs and benefits of its regulations too little consideration. However, it has made significant improvements in this area and it plans to make additional improvements in the future. In my view, the SEC is well on its way to establishing the kind of deeply embedded institutional processes that will ensure that economic analysis plays a central role in the agency's rulemaking.

The Commission has hired a strong contingent of economists and plans to hire many more. Its Division of Risk Strategy and Financial Innovation now plays a key role in all rulemaking. Reports recently issued by the SEC's Inspector General paint a generally positive picture of the SEC's cost-benefit analysis in action. Nonetheless, I would like to address four concerns regarding the SEC's cost-benefit analysis going forward.

First, I am concerned the SEC's cost-benefit analysis may become too focused on economic factors. Cost-benefit standards are naturally inclined to favor analysis that produces quantifiable, reducible results. Costs and benefits that can be monetized will generally be favored over those that cannot because monetized factors can be more easily compared; they use a common unit of measure. For example, monetized estimates of compliance costs are consistently afforded disproportionate weight not because they are more important, but because they are precise and reducible. As discussed in the OIG's report, Professor Kyle observed instances of this bias at work where micro considerations were afforded greater weight and some macro costs were ignored or under-emphasized.

Second, the ultimate solution must lie with the SEC's lawyers. The lawyers exercise ultimate staff authority in the rulemaking process and it is, therefore, lawyers who will decide the extent to which economic analysis is reflected in a rulemaking. Lawyers tend to imply an overly legalistic analysis to what are ultimately non-legal issues. This problem can be mitigated somewhat by hiring lawyers with industry experience and expertise in business, accounting, and finance. The SEC should, and I believe already may, incorporate these criteria into its hiring practices. It should consider encouraging junior and senior staff to leave the SEC to obtain industry experience, while seeking out lateral hires from industry to replace them.

Third, the Commission should attend to the risk of administrative paralysis. The rulemaking process, like any forward looking process, is inherently uncertain; it is necessarily based on incomplete information; and cost-benefit analysis is ultimately inherently subjective. Many criticisms of the SEC's cost-benefit analysis simply reflect unreasonable expectations. The Commission must en-

sure that it does not avoid rulemaking altogether out of fear that its rules will be attacked and even vacated by courts.

And, finally, the Commission should consider reforming the rule-making process to be more like the creative, somewhat risk-taking process that it is. In my view, any cost-benefit aversion the SEC may have may be more a reflection of a 20th century workplace culture in charge of regulating a 21st century industry. Although some rulemaking initiatives are preceded by a concept release, most begin with a commitment of a team to the goal of producing a proposal. It is not really a proposal, at least not in the sense of a business would develop internal proposals for a new business initiative, it is a full-blown rule based on extensive analysis and a set of assumptions. It reflects the incorporation of different viewpoints, but not in the sense of competing viewpoints. It is subject to change, but it still reflects, to some degree, the vested interest of its creators, including cost-benefit analysis done by economists.

The Commission should consider workplace processes that will produce more robust collaborative analysis. For example, it could issue initial precis, a short umbrella proposal that outlines the problem, lists potential solutions, and makes a first cut at the types of costs and benefits that it expects the proposal to implicate, before deeper analysis has been conducted, substantial resources have been committed, and vested interests have begun to set. It could issue multiple proposals so that, as with movies, with multiple outcomes, there is a genuine doubt as to how it would end.

Proposals are often viewed as positions from which the Commission must be moved, as if anchored to vested staff interests. Multiple proposals could be issued by competing teams within the SEC, created through a competitive process. Rulemaking staff could submit their own proposals that, if approved for further develop, could entitle them to devote a certain number of workdays to take it to the next level. The staff could appoint red and blue teams whose job it would be to tear apart proposals in mock cost-benefit challenges. For example, the staff has 270 days to adopt rules for crowd funding that it address 15 or 20 or so requirements. Why not start by assembling the entire rulemaking staff in trading and markets and give each one two hours to sketch out the essential elements of the rules and then to present their ideas to a group for a no holds barred brainstorming session? A series of face-offs could winnow down the pile with winners allowed to cannibalize elements from their defeated opponents' proposal, or maybe put them all on a remote island where one is voted off every day.

When I see pictures of successful startups' offices engaged purely in the business of creating intellectual property, they are not working in separate offices or even separate cubicles, but lined up in a row, at a long table, elbow to elbow, much like, and not coincidentally, the trading desk of large broker dealers.

The SEC is also engaged in a kind of collaborative, complex intellectual property creation, as am I as a law professor, and as are members of Congress as lawmakers. What should our collaborative, complex intellectual property places look like? Probably not the way they look today.

In conclusion, rulemaking is, no matter how thoroughly analyzed by economists, a venture into the unknown. It is a creative process

in which one must assume, indeed, embrace, the risk of getting it wrong if change can ever happen. Let's ensure that all reasonable costs and benefits are considered before acting, but let's not impose so many burdens that action becomes impossible.

Thank you again for inviting me to testify, and I would be happy, of course, to try to answer any questions you might have.

[Prepared statement of Mr. Bullard follows:]

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

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%20DE1%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.

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 or 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

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

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.

<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 than 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,

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."

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 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.

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

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 it must enact.") (testimony of former SEC Chairman Harvey Pitt) available at <http://financialservices.house.gov/UploadedFiles/091511pitt.pdf>.

Mr. MCHENRY. Thank you, Mr. Bullard.
Mr. Verret.

STATEMENT OF J.W. VERRET

Mr. VERRET. Chairman McHenry, Ranking Member Quigley, and members of the Committee, I really appreciate the opportunity to join you today. As mentioned, I teach corporate and securities law at George Mason Law School and am a senior scholar with the Mercatus Center.

In September 2011, I had the opportunity to testify before the House Committee on Financial Services on this issue. SEC staff and Chairman Schapiro were present, and it was argued there that economic analysis is not always required when rules are mandated under legislation. In any event, measuring the impact of new rules can be prohibitively difficult.

I am aware that staff have prepared a memo that represents an about-face in terms of this thinking. I want to congratulate the Commission and the staff and Chairman Schapiro and this Committee and the various oversight committees of Congress and, frankly, the judiciary for their oversight on that issue.

It remains to be seen whether this memo is just a memo or it will be put into place in future rulemaking.

After careful review of the legislative requirements that the SEC consider investor protection, efficiency, competition, and capital formation in adopting new rules, I would like to offer a list of eight items that I think would demonstrate a sincere commitment by the SEC to fulfill its statutory mission in this regard. The first five, in fact, are mandated by law, if one carefully reads the judicial interpretations in the legislative history of this issue.

I offer this list as a test of their resolve, the SEC's resolve to make economic analysis a sincere constraint on SEC rulemaking and a limit on any political pressures it might face to politicize its activities in a way that might undermine investor protection.

First, rules must have sunsets and look-back requirements. When the agency represents in a rulemaking that costs and benefits are difficult to estimate, as it represented in rulemaking pursuant to Section 404(b) of Sarbanes-Oxley. At times, data relevant to rules, costs and benefits might not be available until years after implementation. When this is true, as it was under Sarbanes-Oxley 404(b), where the SEC initially estimated implementation costs of \$90,000 per company, later estimated at \$1.8 million per company, sunsets and look-back requirements that automatically stop the rule and urge a reconsideration and re-adoption of the rule are necessary.

Number two, the SEC has to consider the costs of a new rule against any alternatives advanced by dissenting commissioners. This is required under various interpretations from the D.C. Circuit.

Number three, mandatory disclosure rules must be subject to the same materiality standard as private plaintiffs in 10b-5 cases. A disclosure not material to investors cannot be legitimately said to further the goals of investor protection.

Four, the agency must, in order to meet its requirement to consider the impact of a rule on competition, capital formation, and ef-

iciency, estimate the impact of a rule on the competitiveness of U.S. exchanges against foreign exchanges for new listings, the competitiveness of U.S. issuers, the risk that proprietary information might be revealed, and the impact of a rule on the stock prices of affective companies. The agency must also estimate the impact of a rule on items like job creation and GDP, economic factors, in sum.

Five, the agency must retract and re-propose rules advanced pursuant to the Dodd-Frank Act to reflect the agency's new policy on cost-benefit analysis and its about-face shift on this issue. The SEC's rule proposal under Section 1504 of Dodd-Frank is a case in point, where it fails to consider the impact of disclosures on the risk that it will reveal proprietary exploration plans of U.S. energy companies.

Six, the agency has to freeze attorney hiring until it hires at least 200 more economists. And I know that sounds like a lot but, in fact, it is not when you compare the SEC against its sister agencies. The FTC staff, very similar market-based mission. In fact, the securities laws were originally placed in the jurisdiction of the FTC in 1933, until the SEC was created in 1934. The FTC has about 10 percent PhD economists. At the CFTC it is less than 5 percent, and at the SEC that number is less than 1 percent. Ten percent at the FTC; less than 1 percent at the SEC. In order to be on par with sister agencies like the FTC, the SEC has to hire at least 400 new economists. I think 200 would be a modest commitment in this regard. The fact that it has misallocated resources in the past should not justify added appropriations but, instead, suggests a need for reallocation of present resources.

Seven, the Division of Risk Fin should get authority in rule-making. And I know the Chairman has indicated in testimony today and in the memo they have indicated that this is the case, but until I see a changed SEC internal official operating procedures, I question that observation, the continuance of that observation.

Number eight, the Risk Fin must be given a role in rating the impact of cases brought by enforcement lawyers in their personnel reviews. The agency's existing metric, which focuses on size of recovery and number of cases resolved, can distort incentives and lead to missed opportunities to stop ongoing fraud like that seen in the Madoff case. If we had economists measuring the rate of fraud, one example, the rate of fraud prior to a case being brought, we can estimate the rate at which it grows and estimate the amount saved to investors. And I think though the internal enforcement staff will be resistant to this, it could be very beneficial.

So I thank you for the opportunity to testify and I really look forward to answering your questions today.

[Prepared statement of Mr. Verret follows:]

Chairman McHenry, Ranking Member Quigley, and members of the Committee, I want to thank you for the opportunity to testify today. My name is J.W. Verret. I am an Assistant Professor of Law at George Mason Law School, where I teach corporate and securities regulation, and a senior scholar with the Mercatus Center at George Mason University.

In September of 2011, I had the opportunity to testify before House Committee on Financial Services on this topic. SEC staff were also present, where it was argued that economic analysis is not always required when rules are mandated under legislation and in any event measuring the impact of new rules can be prohibitively difficult.

I am aware that the SEC staff have prepared a memo on cost-benefit analysis in the past few weeks that represents a profound shift in the SEC's thinking. I want to congratulate the Commission and the Staff for their willingness to reconsider that position in this new memo. It remains to be seen whether that memo is just a memo, or will be put into practice in future rulemaking.

After a careful review of the legislative requirements that the SEC consider investor protection, efficiency, competition and capital formation in adopting new rules, I would like to simply offer a list of eight items that would demonstrate a sincere commitment by the SEC to fulfill its statutory mission. The first five I will list are in fact required by law if one carefully reads the legislative and judicial history of the SEC's mandate to consider the economic impact of new rules.

I offer this list as a test of the SEC's resolve to make economic analysis a real constraint on SEC rulemaking and a limit on the pressures it may face to politicize its activities and undermine its investor protection mission.

- 1) Rules must have sunsets and look back requirements when the agency represents that costs and benefits are difficult to estimate, as it represented in rulemaking pursuant to Section 404(b) of Sarbanes Oxley. At times much of the data relevant to a rule's costs and benefits will not be available until years after its implementation. This is demonstrated by the SEC's rulemaking under Sarbanes Oxley 404(b), where the SEC initially estimated compliance costs of \$90,000, despite their later revealed to be nearly \$1.8 million per company.
- 2) The SEC is required to compare the costs of a new rule against any alternatives advanced by a dissenting Commissioner. This was part of the reason SEC rules were overturned in two prior challenges before the DC Circuit.
- 3) Mandatory disclosure rules must be subject to the same materiality standard as private plaintiffs in 10b5 fraud cases. A disclosure that is not material to investors cannot be legitimately said to further "investor protection."
- 4) The agency must, in order to meet its requirement to consider the impact of a rule on capital formation and efficiency, estimate the impact of a rule on the competitiveness of U.S. exchanges against foreign exchanges for new listings, the competitiveness of U.S. issuers, the risk of proprietary information being revealed in mandatory disclosures, and the impact of a rule on stock prices of affected companies. The agency must also estimate the impact of a new rule on job creation and GDP.
- 5) The agency must retract and re-propose rules advanced pursuant to the Dodd-Frank Act to reflect the agency's new policy on cost-benefit analysis, as it has not met this new guidance in design of existing pending rules. The SEC's rule proposal under Section 1504 of Dodd-Frank is a case in point, where the agency fails to consider the impact of disclosures on the proprietary exploration plans of US energy companies.
- 6) The agency should freeze attorney hiring until it hires at least 200 more economists. In achieving its market oversight mission, the FTC staff have about 10% phd economists. At the CFTC, it is less than 5%. At the SEC, that number is still less than 1%. In order to be on par with its sister agencies like the FTC, the SEC needs to hire at least 400 new economists, but even 200 more would be a serious start. The fact that it

has misallocated resources in the past should not justify added appropriations, but instead suggests a need for reallocation of present resources.

7) The Division of Risk, Strategy and Financial Innovation should get authority in rule making. Economic analysis has historically been a mere afterthought for the agency, used to justify rules after the fact rather than to help in their design. The recent SEC memo notwithstanding, that practice is likely to continue unless the Division is given formal authority by way of changes to SEC internal operating procedures.

8) The Division of Risk, Strategy and Financial Innovation must be given a role in rating the impact of cases brought by enforcement lawyers for purposes of their personnel reviews. The agencies existing metric, which focuses on size of recovery and number of cases resolved, can distort incentives and lead to missed opportunities to stop ongoing fraud like that seen in the Madoff case.

I thank you for the opportunity to testify and I look forward to answering your questions.

Mr. MCHENRY. Mr. Kotz.

STATEMENT OF H. DAVID KOTZ

Mr. KOTZ. Thank you for the opportunity to testify before this Subcommittee. I served as the Inspector General for the SEC from December 2007 through January 2012. I am currently the managing director of a private investigations firm called Gryphon Strategies.

Prior to my leaving the SEC on January 27th, 2012, my former office issued a report entitled Followup Review of Cost Benefit Analyses in Selected Dodd-Frank Act Rulemakings. In connection with this report, we retained an expert, Dr. Albert S. Kyle, to assist with our review. In this review, our objectives were to assess whether the SEC was performing cost-benefit analyses for Dodd-Frank rulemaking initiatives in a consistent manner and determine whether problematic areas existed and where improvements were needed to enhance the overall methodology used to perform cost-benefit analyses.

In the course of the review, we learned that when questions arose in 2010 about the extent to which cost-benefit analyses should be conducted for Dodd-Frank Act rulemakings, rulemaking teams and the Division of Risk Fin consulted with the then SEC general counsel. On September 27, 2010, following these consultations, the former general counsel, in a memorandum to rulemaking teams and Risk Fin, advised that where the Commission has a degree of discretion, the release should discuss an attempt to quantify the costs and benefits of the choices. However, where the Commission has no discretion, the memorandum advised that the release should say so and that, because the Commission is making no policy choices, there would be no choices to analyze or explain.

We found that the approach articulated by the former general counsel dovetailed with the approach utilized by the SEC rulemaking teams in the cost-benefit analyses we reviewed. For example, the introduction to the cost-benefit analysis section of the adopting release for the shareholder approval of executive compensation in Golden Parachute Compensation Rule stated the following: The discussion below focuses on the costs and benefits of the amendments made by the Commission to implement the Act within its permitted discretion, rather than the costs and benefits of the Act itself.

The January 27th, 2012, report describes how, pursuant to OMB guidance, a cost-benefit analysis is intended to inform the public and other parts of the government, including Congress and the regulating entity itself, of the effects of alternative regulatory actions. This OMB guidance also specifies that agencies should establish a baseline for use in defining the costs and benefits of alternative regulatory actions and the baseline will be a no action or pre-statute baseline.

We found that to the extent that the SEC performed cost-benefit analyses only for discretionary rulemaking activities without a pre-statute baseline, the SEC may not be providing a full picture of whether the benefits of a regulatory action are likely to justify its costs and which regulatory alternatives would be the most cost-effective.

In addition, based on an examination of several Dodd-Frank Act rulemakings, the review found that the SEC sometimes used multiple baselines in its cost-benefit analyses that were ambiguous or internally inconsistent. The review also found that there was often considerable overlap between the cost-benefit analyses and efficiency, competition, and capital formation sections of the releases for Dodd-Frank Act regulations and that such redundancy could be reduced by combining these two sections. Further, we found that some Dodd-Frank Act rulemakings lacked clear, explicit explanations of the justification for regulatory action. The report found that a more focused discussion of market failure in cost-benefit analyses would lay out the rationale for regulation more clearly to Congress, the general public, and the SEC itself. Finally, the review found that although some of the SEC's Dodd-Frank Act rulemakings may result in significant costs or benefits to the Commission itself, internal costs and benefits were rarely addressed in the cost-benefit analyses.

Based on the results of our review, the report made several recommendations for improvements to the SEC's practices. These recommendations included, one, considering ways for economists to provide additional input into cost-benefit analyses; two, reconsidering the approach that the SEC only perform cost-benefit analyses for rulemaking activities to the extent that the SEC exercises discretion; three, using a single consistent baseline in the cost-benefit analyses; four, discontinuing the practice of drafting separate cost-benefit analysis and efficiency, competition, and capital formation sections; five, directing rulemaking teams to explicitly discuss market failure as a justification for regulatory action in the cost-benefit analysis of each rule as appropriate; and, six, including internal costs and benefits in the cost-benefit analyses of rulemakings.

While I left the Commission shortly after the report was issued, I understand that the SEC has now taken significant steps to implement the report's recommendations.

Thank you again for the opportunity to testify, and I would be happy to answer any questions.

[Prepared statement of Mr. Kotz follows:]

Introduction

Thank you for the opportunity to testify before this Subcommittee on the subject of “The SEC’s Aversion to Cost-Benefit Analysis.” I served as the Inspector General for the Securities and Exchange Commission (SEC) from December 2007 through January 2012. I am currently the Managing Director of a private investigations firm called Gryphon Strategies. In my testimony, the views that I express are not necessarily reflective of the views of the Commission or any Commissioners.

Office of Inspector General Reports on Cost-Benefit Analyses

Prior to my leaving the SEC, on January 27, 2012, my former office issued a report entitled, “Follow-up Review of Cost-Benefit Analyses in Selected Dodd-Frank Act Rulemakings.” This report was the second report my former office issued relating to cost-benefit analyses conducted by the SEC for Dodd-Frank rulemakings. On June 13, 2011, my former office released a report in response to a May 4, 2011 letter from several members of the U.S. Senate Committee on Banking, Housing, and Urban Affairs requesting a review of the cost-benefit analyses performed by the SEC in connection with six specific rulemaking initiatives pursuant to the Dodd-Frank Act.

In the June 13, 2011 report, we concluded that the SEC had conducted a systematic cost-benefit analysis for each of the six rules, but found that the level of involvement of the Division of Risk, Strategy and Financial Innovation (RiskFin) varied considerably from rulemaking to rulemaking. We decided to issue a follow-up report in which we could examine in greater detail the cost-benefit analyses the SEC performed and retained an expert, Dr. Albert S. Kyle to assist with our review.

In the follow-up review, our objectives were to assess whether the SEC was

performing cost-benefit analyses for rulemaking initiatives that were statutorily required under the Dodd-Frank Act in a consistent manner and determine whether problematic areas existed where rigorous cost-benefit analyses were not performed and where improvements were needed and best practices could be identified to enhance the overall methodology used to perform cost-benefit analyses.

In the follow-up review which culminated in the January 27, 2012 report, we found that although the SEC is not subject to an express statutory requirement to conduct cost-benefit analyses for its rulemakings, it is subject to statutory requirements to consider factors such as the effects on competition and the needs of small entities. We further found that the SEC must generally also provide the public with notice of and opportunity to comment on its rulemakings. Moreover, SEC Chairmen previously committed to Congress that the SEC would conduct cost-benefit analyses in connection with its rulemaking activities, and it has consistently performed such analyses in its rulemakings. According to senior SEC management, the SEC shares the goals of and adheres to many of the requirements of executive orders that call for executive agencies to perform cost benefit analyses for rulemakings, and SEC staff use internal compliance guidance that provides a detailed overview and an extensive list of best practices for use by SEC rulemaking divisions and offices in preparing cost-benefit analyses.

In the course of the review, we learned that when questions arose in 2010 about the extent to which cost-benefit analyses should be conducted for Dodd-Frank Act rulemakings, rulemaking teams and RiskFin consulted with the then-SEC General Counsel. On September 27, 2010, following these consultations, the former General Counsel, in a memorandum to rulemaking teams and RiskFin, advised the following

approach with respect to which rulemakings or portions of rulemakings should discuss and quantify costs and benefits:

Where the Commission has a degree of discretion, the release should identify the discretion the Commission is exercising, the choices being made, and the rationale for those choices. To the extent that the Commission is exercising discretion, the release should discuss the costs and benefits of the choices proposed or adopted, including where possible, a quantification of the costs and benefits. With respect to those choices made by Congress, the release generally should cite to the legislative record to support and explain the benefits Congress intended by enacting the provision, but only as a matter of citation and not as a matter of assertion by the Commission.

Where the Commission has no discretion, the release should say so. Because the Commission is making no policy choices, there are no choices to analyze or explain.

We found that the approach articulated by the former General Counsel dovetailed with the approach utilized by the SEC rulemaking teams in the cost-benefit analyses we reviewed. For example, the introduction to the cost-benefit analysis section of the adopting release for the Shareholder Approval of Executive Compensation and Golden Parachute Compensation Rule stated the following: “The discussion below focuses on the costs and benefits of the amendments made by the Commission to implement the Act within its permitted discretion, rather than the costs and benefits of the Act itself.”

The January 27, 2012 report describes how pursuant to Office of Management and Budget (OMB) guidance, a cost-benefit analysis is intended to inform the public and other parts of the government, including Congress and the regulating entity itself, of the effects of alternative regulatory actions. This OMB guidance also specifies that agencies should establish a baseline for use in defining the costs and benefits of alternative regulatory actions and the baseline will be a no-action or pre-statute baseline.

We found that to the extent that the SEC performs cost-benefit analyses only for discretionary rulemaking activities without a pre-statute baseline, the SEC may not be providing a full picture of whether the benefits of a regulatory action are likely to justify its costs and which regulatory alternatives would be the most cost-effective.

The report examined two Dodd-Frank Act rulemakings that considered only the costs and benefits of discretionary components and did not establish a pre-statute baseline. In the first example, the Shareholder Approval of Executive Compensation and Golden Parachute Compensation rulemaking, we found that the SEC's cost-benefit analysis was confined to the costs and benefits of the provisions that went beyond the requirements of the Act. The SEC's cost-benefit analysis did not discuss the costs and benefits of "say-on-pay" votes, frequency votes or disclosures and votes on golden parachute compensation that are mandated by the Dodd-Frank Act. Similarly, in the rulemaking related to Issuer Review of Assets in Offerings of Asset-Backed Securities, we found that the SEC cost-benefit analysis did not discuss the costs and benefits of the requirement for issuers to perform a review of the underlying assets and disclose the nature of the review. The report explained that had the SEC analysis included a calculation of the costs of the mandatory provisions of the rulemaking, both Congress and the public might use this information to consider whether to seek to repeal or weaken the mandatory provisions.

In addition, based on an examination of several Dodd-Frank Act rulemakings, the review found that the SEC sometimes used multiple baselines in its cost-benefit analyses that were ambiguous or internally inconsistent. For example, in the SEC's interim final temporary rule for registration of municipal advisors, portions of the cost-benefit analysis

assumed as a baseline a minimal registration process that would allow municipal advisors to continue their usual activities with limited disruption. However, other parts of the cost-benefit analysis assumed that municipal advisors would be required to cease their advisory activities in the absence of a registration process, resulting in a shutdown of the municipal advisory market. The review also found that there was often considerable overlap between the cost-benefit analyses and efficiency, competition, and capital formation sections of the releases for Dodd-Frank Act regulations, and that redundancy could be reduced by combining these two sections. Further, we found that some SEC Dodd-Frank Act rulemakings lacked clear, explicit explanations of the justification for regulatory action. The report found that a more focused discussion of market failure in cost benefit analyses would lay out the rationale for regulation more clearly to Congress, the general public, and the SEC itself. Finally, the review found that although some of the SEC's Dodd-Frank Act rulemakings may result in significant costs or benefits to the Commission itself, internal costs and benefits were rarely addressed in the cost-benefit analyses.

Based on the results of our review, the report made several recommendations for improvements to the SEC's practices. These recommendations included: (1) considering ways for economists to provide additional input into cost-benefit analyses of SEC rulemakings to assist in including both quantitative and qualitative information; (2) reconsidering the approach that the SEC only perform cost-benefit analyses for rulemaking activities to the extent that the SEC exercises discretion and considering whether a pre-statute baseline should be used whenever possible; (3) using a single, consistent baseline in the cost-benefit analyses with such baseline being specified at the

beginning of the cost-benefit analysis section; (4) discontinuing the practice of drafting separate cost-benefit analysis and efficiency, competition, and capital formation sections and instead provide a more integrated discussion of these issues in rule releases; (5) directing rulemaking teams to explicitly discuss market failure as a justification for regulatory action in the cost-benefit analysis of each rule; and (6) including internal costs and benefits in the cost-benefit analyses of rulemakings.

SEC management concurred with all but one of the report's recommendations and indicated that they welcomed the constructive recommendations for improvements to SEC practices contained in the January 27, 2012 report. While I left the Commission shortly after the report was issued, I understand that the SEC has taken steps to implement the report's recommendations.

Conclusion

In conclusion, I appreciate the interest of the Chairman, the Ranking Member, and the Subcommittee in my former Office's report and in the cost-benefit analyses conducted by the SEC. I believe that the Subcommittee's and Congress's continued involvement with the SEC is helpful to strengthen the accountability and effectiveness of the Commission. Thank you.

Mr. MCHENRY. I thank the panel and, with that, I would like to yield to my colleague, the Ranking Member, to ask questions first. Mr. Quigley.

Mr. QUIGLEY. Thank you, Mr. Chairman.

Lady and gentlemen, as I listen to your testimony, I am struck by the questions I asked the Chairman, and that is this is important and very dry, mind you, but you get stuck with the emotional aspects and the real world pain caused by what happens when we don't capture this Worldcom, Enron, Madoff, and the 2008 crisis.

Dr. Manne, is it your assumption or your belief that those are happenings that regulation couldn't have caught, that a good regulation or good practice wouldn't have caught? Could an economist catch that or where did we miss that? And isn't that our main concern when we determine what the benefit is in a cost-benefit analysis? Doctor, how do you measure the thousands of people who were pained and the millions of dollars that were lost when you do, in your minds, a good cost-benefit analysis?

Mr. MANNE. Well, I think there certainly may be aberrations all over the place. Some of the episodes you mention can partially be put at the foot of the SEC, some of it elsewhere. Some of it is omission. Certainly in the case of Madoff that seems to be clear. Others of it may strangely be results, unforeseeable results of actually regulations in effect. There is a very strong view, for instance, that if insiders in a corporation were allowed to engage in insider trading, instead of doing whistleblowing, the Enron thing wouldn't have shown up, because very early on people would have made a lot of money by, in effect, letting that information out into the market by selling shares.

So there are a variety of different ways, and that brings me to the point of this discussion, that there are many different forms of economics. You made the point about cost-benefit analysis being merely one form of analysis. There are economists and then there are economists. The SEC could hire 200 economists whom I would not think qualified, really, to do the job I want them to do. A lot of it, I think the heavy work still remains not in the cost-benefit and empirical data business, but, rather, in terms of getting the analytical model straight. I don't think that anyone has ever devoted themselves to that kind of problem in connection with this regulation.

Mr. QUIGLEY. Doctor, let me move on because I have somewhat limited time.

Mr. Verret, could you comment? I understand your answer and what you talked about in your five minutes, but how do you measure what the benefit is if the risk could potentially be so great?

Mr. VERRET. I think you have to do the best job you can to measure the costs and benefits, and that may be a dry phrase. I think you can rephrase it accurately to be the regulatory taxes that get passed through to American consumers, American investors. And one way that we have estimated this is with respect to the first rulemaking the SEC did pursuant to Dodd-Frank, the rulemaking that was struck down in the D.C. Circuit case, the Business Roundtable case.

My coauthor, Professor Stratman and I, are publishing a peer review article in the Stanford Law Review that estimates just a small

subset of the firms that were affected by that rule. So, in fact, the proxy access amendment to Dodd-Frank requires the SEC to consider the impact on small firms and consider an exemption for small firms, and the SEC, despite the will of Congress, the SEC did not provide an exemption for small firms. We measure what impact did that have on small firms, or was it just delayed for them a couple of years, rather than a full exemption. We find it caused almost half a billion dollars in shareholder losses just for that small group. You extrapolate that out to all the companies affected by that proxy access rule that was struck down by the D.C. Circuit, we are talking about billions of dollars in regulatory taxes.

So I think it is important to estimate that and to include it at the benefits of preventing long-tail risk. But I wouldn't always assume that regulations are going to prevent it. Sarbanes-Oxley certainly didn't prevent the financial crisis of 2008.

Mr. QUIGLEY. Sure.

Mr. Kotz, let me throw in this quote from Chairman Greenspan's testimony before the full Committee. He said it was a mistake to presume "that the self-interest of organizations, specifically banks and others, was such that they were best capable of protecting their own shareholders."

Getting to the points I raised before, how do you strike this balance? I understand, as you suggest, that we want to avoid ambiguity, overlap, and redundancy, and we need to do this as best as we possibly can. How much faith do you have in the market policing itself that we don't need to be very strong, the SEC doesn't need to be very strong with its regulatory measures to protect the public?

Mr. KOTZ. Absolutely I think that the SEC needs to be strong, and that is the reason why it is so important to do a thorough cost-benefit analysis; to look not only at the costs, but also the benefits. There are situations where there is market failure, and one of the points that we made in the report was the SEC should point that out and explain that. So our focus in the Office of Inspector General report was to ensure that they do the best job possible to look at the benefits that you articulated, as well as the costs.

Mr. QUIGLEY. Mr. Bullard?

Mr. BULLARD. I thought the question was about fraud, and I was looking forward to Professor Verret explaining his rate of fraud analysis. I would be interested how one could quantify the costs of the rate of fraud. It is an extremely difficult problem, I found, and one is exactly the kind of benefit of regulation that is hard to put your finger on, and that economic analysis invariably downplays.

I also can't help but respond to Dr. Manne's analysis. His insider trading analysis I found to be brilliant, but the fact is Enron executives were selling and they weren't telling anyone, and one of them stood in front of a roomful of employees and told them that they should buy more shares as the company was sinking, and those people testified before committees of Congress about how their entire retirement had been destroyed. And, in fact, fortunately, this Country has never adopted the idea that insider trading should be a permissible course of action. So I think it is a classic example of where economics takes you if you don't also consider the social construct within which law is made.

The problem from an investor advocate point of view, Ranking Member Quigley has put his finger right on the point, which is it is extremely difficult to quantify what the cost is when an 85-year-old man suffering from dementia is sold a valuable annuity, or when somebody who has a \$20,000 income is defrauded in a \$2,000 offering over the Internet. That is tough to measure. If someone has a quantification analysis they can provide that will allow the SEC to do that, then I would like to know about it. But the SEC has to be allowed to make those calls. That is its job; it is the job Congress gave it to do. And at some point the cost-benefit analysis requiring quantification of every piece of analysis makes that virtually impossible to do.

Mr. QUIGLEY. Ms. McCabe, I don't want to be rude. I had limited time, but, please, if you would give us your thoughts.

Ms. MCCABE. Sure. Yes, just very briefly. I acknowledge that the benefits of different rules will be certainly difficult to measure, but as I mentioned earlier, I think it is important that the analysis not be conclusory and we don't assume that a regulation will have a benefit equivalent to the value of the crisis that had occurred prior to the regulation.

Secondly, and I discuss this more extensively in my written testimony, but there are rules like the Volker Rule, for instance, proposed by five different agencies with five different sets of cost-benefit analysis requirements with zero cost-benefit analysis. So, again, we would just encourage that there needs to be thoughtful cost-benefit analysis.

Mr. QUIGLEY. Thank you. And I appreciate your efforts and the Chairman for letting me speak. I need to get to the floor. Thank you.

Mr. MCHENRY. I certainly thank my colleague for his questions. This is a fascinating subject matter and certainly appreciate the answers and the testimony this panel has given.

Mr. Kotz, I want to begin with you. Now, you are the former Inspector General for the Securities and Exchange Commission and certainly appreciate your service in government, especially the final report before you went to the private sector. In your final report you call into question the cost-benefit analysis and the use of it with the Securities and Exchange Commission.

Out of that report Chairman Issa and I wrote a letter to the Securities and Exchange Commission, and they have acted relatively quickly, in the world of the Securities and Exchange Commission, with new guidance incorporating many of the provisions that you called into question, the solutions to those issues you called into question, and answering a number of the concerns that Chairman Issa and I have about the importance of cost-benefit analysis to all rules that go through the whole process.

So I want to thank you for that. You have done a good service for your government to draw this report to people's attention and actually getting it changed based upon a good work.

Mr. KOTZ. Thank you.

Mr. MCHENRY. So in discussion with that, you reviewed the Securities and Exchange cost-benefit analysis and the cost associated with their failure to follow the letter of the law and the direction of Congress, and the regulatory costs and the staff time. Can you

discuss that cost of their failure to use cost-benefit analysis, the cost to the taxpayer and to market participants?

Mr. KOTZ. Yes. We didn't quantify it specifically, but clearly if you have a regulation and you just assume, without doing a cost-benefit analysis, that the benefits outweigh the costs, and you don't provide that information to Congress, to the public, then you set up a situation where the information isn't out there about whether this regulation is useful or not, and that is something that is a concern.

In my time as Inspector General of the SEC there have been occasions where we found that there were certain rules put into place and the rules required certain disclosures, certain filings, and yet the documents that were filed were not really used by the SEC, they were put in a drawer. So you have certainly a cost that is associated with it on the part of a company, for example, in having to do this filing, but then you don't really have any use of it by the SEC.

So notwithstanding the fact that it was mandatory or whether the SEC had any discretion or not, it is very important for the SEC to assess that. And if they don't assess that, then Congress doesn't have the information to know whether this rule that was put in place is actually working and is actually cost-beneficial.

Mr. MCHENRY. Is there a need for a wholesale cultural change in order to incorporate this, the cost-benefit analysis at the SEC?

Mr. KOTZ. I think that this March 16, 2012 memo is a very good start. As you said, it really changes the way things are done completely. The differences between the Becker memo that you discussed before that I mentioned in my testimony and this one are very great. So I think the proof will be in the new rules. Clearly, I am not the Inspector General anymore, but, if I were, I would certainly look at the new rules to make sure that it is not just guidance that is put forward, but that there is actual application of that guidance in the new rules.

I do think that if the SEC, when they issue the new rules, follow the latest guidance, as opposed to the Becker memo, I think you will see a significant difference in how they do their cost-benefit analysis.

Mr. MCHENRY. So, Mr. Bullard, is that an essential ingredient to rulemaking, a cost-benefit analysis?

Mr. BULLARD. Yes, absolutely. And I think that one thing we can probably all agree on is that by the end of the year we will probably be able to say that Chairman Schapiro has done more to improve cost-benefit analysis in SEC rulemaking than every SEC chairman in history combined, and I think those are critical steps.

Mr. MCHENRY. I would like that to be the case. I would like that to be the case.

Mr. BULLARD. I think you might even be able to say that today. I agree with my other panelists that, historically, this has been a major inadequacy, and Dr. Manne is one of those leaders in moving the SEC toward much more economic analysis.

But I would like to just warn my colleagues. Speaking from having been inside the SEC, hiring more economists is not going to fix the problem any more than hiring more workers would change the architecture of the pyramid. You have to get the lawyers on board.

As I noted in my written statement, part of the problem is our American legal education, is that lawyers do not have the competence in business, finance, accounting, and industry in order to do the job. And I think the SEC is already, based on my anecdotal experience, doing something, hiring people with more of that kind of experience. It has to be the lawyers; the economists won't do it.

Mr. MCHENRY. With all due respect, is this really a moment to insert a lawyer joke?

Mr. BULLARD. Please. Feel free.

Mr. MCHENRY. Because I think it might be, as a non-lawyer.

Mr. VERRER. I would take this opportunity to emphasize that at George Mason Law School, founded by Dean Manne, we have, as part of the first year curriculum, an economic analysis course for law students, and we do have law students interested in working at the Securities and Exchange Commission.

Mr. MCHENRY. I knew that pitch was coming. I just knew.

[Laughter.]

Mr. BULLARD. But for half the price you can go to Ole Miss and get a law degree as well.

Mr. MCHENRY. Mr. Bullard, are you trying to change the culture of Ole Miss so that your lawyers come out?

Mr. BULLARD. I am not trying to highlight Ole Miss, and I am not suggesting that there isn't more that I could do personally, and I always strive to do more personally in order to integrate these issues into the curriculum, but there is a major systemic problem in American law schools.

Mr. MCHENRY. But it is also a cultural problem.

Mr. BULLARD. It is a cultural problem. It is an aversion to—

Mr. MCHENRY. So this process, and I asked Chairman Schapiro about this, I said, in essence, does the economic analysis, the cost-benefit analysis, can that be a veto.

Mr. BULLARD. And I was interested by your question because it depends what veto means. I think the Chairman was fair in trying to get at that.

Mr. MCHENRY. She was saying that it has to be signed off by Risk Fin, so you are going to have to have the economists sign off on rules, which I think is structurally a very different concept than what we have seen, as you said, with SEC over the last, let's just say, 50 years. We could say 80.

Dr. Manne, in terms of this discussion, you have followed this extensively, obviously, but when we have this discussion about a market failure, this has been used. You mentioned this in your testimony; it has been mentioned a couple times on this panel. How common is a market failure, just to understand this discussion?

Mr. MANNE. Well, as I said, there are economists and economists. My own sense about it is that true market failures are extremely rare, and particularly among some of the kind that are listed in the March 16th memo. For instance, they talk about market power. I presume they mean monopolistic organization of the market.

Well, that is a very unusual kind of market failure for the SEC to confront. Historically, they supported the most famous market failure of all, and that was the fixed commission rate structure in the New York Stock Exchange for many, many, many years. I

couldn't really think, even, of what they had in mind in that connection.

Then they talked about a negative and positive externalities. Now, that is sort of a cop-out because it was in the context of explaining when it would be difficult to get good quantifiable data on these externalities. And that is why I say that that kind of thing, if you assume that a negative externality is a market failure and you start regulating to prevent the externality, you can make a big mistake because the market almost always finds a solution to these negative externalities, just as it does to the problems we talked about, I mentioned before of asymmetric information.

The most famous work on that subject is by a man who got a Nobel Laureate in economics, David Akerlof, who talked about the market failure in the market for used cars, and he theoretically showed that if systematically people don't have good information, that the entire market could collapse for what is obviously an economically good product, but people wouldn't have the information and, therefore, the market would collapse.

The odd thing about it is that when that lemons problem is mentioned over and over and over and over again in economics, very few writers even notice the market had already provided a solution to that problem before Akerlof even identified it. There was no failure in the market of used cars.

That is the same thing here if they talk about asymmetric information. The market deals with those issues maybe in ways that we can't even project at this point. But that is the virtue of a free market, that new innovations will constantly come up. And if there are real costs, the market will always provide a good solution.

Mr. MCHENRY. So to that question, and this is a discussion, Mr. Bullard asked you this when we had our crowd funding hearing, with securities regulation, no matter how perfect the rulemaking of any regulatory body, there will be fraud in the marketplace. Does the whole panel agree? Actually, should I say do you disagree?

So with this, all rules, all securities regulations bear a cost, do they not? Okay. So everyone agrees.

Okay. I don't know if it is all, but with some there are benefits that outweigh those costs, right? Okay.

So I just want to make sure that we are all in agreement. There is no sort of disagreement with those basic notions of this when we have this discussion.

Mr. Verret, you mentioned, you ticked through a number of interesting pieces with your testimony and you talk about a few recommendations, and you note that the first five of these recommendations are already existing law that the Securities and Exchange Commission is required to abide by, right?

Mr. VERRET. Particularly in the fifth one, where I mentioned re-proposal. Maybe not necessarily every single rule, but any rule that doesn't abide by the operating guidance and the about-shift in the agency's position I think has to be re-proposed, absolutely. It runs a very high risk of being overturned in the D.C. Circuit.

Mr. MCHENRY. Okay. So what is the time frame that they should undertake in order to do that?

Mr. VERRET. I think that they should address these issues in the memo right away, would be my suggestion.

Mr. MCHENRY. Okay.

Mr. VERRET. And also, in addition, change SEC operating procedures to delegate authority to Risk Fin. The agency frequently delegates authority within its operating procedures to the various divisions, and I would suggest keeping an eye on whether the SEC does any actual amendment to its internal operating procedures with respect to Risk Fin's authority.

Mr. MCHENRY. Interesting. So what you are suggesting is that the SEC needs to go back through their existing regs.

Mr. VERRET. And delegations of authority in the operating procedures, yes, internal operating procedures of the Commission.

Mr. MCHENRY. Mr. Kotz, in your experience with the SEC, that seems very far-reaching, what Mr. Verret just suggested.

Mr. KOTZ. I don't know that the SEC plans to go back and look at the regulations that they already did; I think the Chairman seemed to indicate that they would not. So I am not saying anything about the idea, but I don't know that that is actually going to happen.

Mr. VERRET. I was referring to the operating procedures of the SEC.

Mr. MCHENRY. The operating procedures.

Mr. VERRET. Asserting certain authorities delegated to Division of Corporate Finance or IM, or something of that nature.

Mr. MCHENRY. Okay. So not full-scale, all the regs that on the books.

Mr. VERRET. Although I won't say that there aren't regs on the books that are subject to significant challenge, just as Business Roundtable was. Frankly, I would question the SEC's taking credit for regs that aren't challenged, because not everyone has the funding to challenge the regs. It is very expensive to challenge a regulation in the D.C. Circuit. I am sure that was very expensive, and average investors don't have the funding to go all the way through a D.C. Circuit challenge, necessarily.

Mr. MCHENRY. Ms. McCabe, in your testimony you outline that 192, if I find my notes correctly, 192 proposed rules across the government are required by Dodd-Frank, and it appears that a great majority of these rules either had no or deficient cost-benefit analysis performed on them, according to your testimony, according to the work that you have done. Could you go into some detail about the problems that you found in the study you performed?

Ms. MCCABE. Sure. And just to clarify, it was 192 of the proposed and final through last November that we looked at, so obviously there will be more eventually.

And we didn't attempt in any individual case to really weigh in on whether we thought the cost-benefit analysis was adequate or inadequate, we tried to keep it very objective; and obviously in some cases where there is no cost-benefit, for instance, clearly would be inadequate.

In the rules with no cost-benefit analysis, a number of rules reference that OMB had provided analysis, but the rules themselves contain no detail, which again I think doesn't absolve the issuing regulator of their responsibility. Other rules we found suggested that cost-benefit analysis was not required because the rules were

not discretionary; and we have seen the SEC reverse course on that issue at this point.

Regarding the rules that have non-quantitative cost-benefit analysis, we saw a number of rules where regulators simply stated they expect costs to be insignificant or minimal, and just said that in a conclusory way, with no further explanation. And then of the rules with quantitative cost-benefit analysis, again, we didn't look specifically at whether the quantitative cost-benefit analysis was adequate, but the vast majority contained just compliance, labor, technology costs, and that sort of thing.

And where there is quantified cost-benefit analysis, you know, it in many cases would relate only to one aspect of the rule or to one specific question in the rule, and it wouldn't be an overall view of the economic impact of the rule, which is clearly what the cost-benefit analysis is aimed to get at.

Mr. MCHENRY. So to this point, in essence, the practice we see from regulators is to only do basic fixed costs that are the easiest to analyze, paperwork functions and—

Ms. MCCABE. In the vast majority of cases, yes, that is what we found.

Mr. MCHENRY. Right. So they wouldn't analyze, for instance, impact of a company to go public. That would not be something that—

Ms. MCCABE. No.

Mr. MCHENRY.—in most of these?

Ms. MCCABE. That is correct. And I am speaking in generalities again, but, yes. There were a few instances where there were attempts to look at broader economic impact of a proposed rule, but it tended to be focused on a single aspect of the rule, not sort of looking across the board at impact.

Mr. MCHENRY. Right. So with the JOBS Act, which is the largest rewrite of securities laws since the 1970s, by any fair view, with the JOBS Act, which is in essence so much about securities regulations, essential parts of this bill are securities regulations, the impact on the ability of a small company to go public—and this is not just Sarbanes-Oxley, it is a whole litany of the regulatory processes—that in essence we price out the ability for small companies to go public.

Ms. MCCABE. Sure. That would be one piece.

Mr. MCHENRY. So there is no real duty for a regulator to even be concerned, with the SEC to even be concerned about the impact they have. So we have fewer IPOs than we did a generation ago; we have fewer public companies than we had a generation ago; and in essence we have the Securities and Exchange Commission say that is of no cost. Is that basically the practice we are seeing, Mr. Verret?

Mr. VERRET. I think it is a fair representation of the practice, and I think it violates the SEC's obligations under the 1996 amendments to NSMIA, the National Security Markets Improvement Act, the required consideration of efficiency and capital formation in particular.

Mr. MCHENRY. So how do we fix this? Beyond cost-benefit analysis, obviously. This is certainly an ingredient, don't you think? But what else?

Mr. VERRET. Well, I would continue to urge the eight suggestions that I have given for consideration. I would urge a more expansive view of economic analysis, along the lines of what Dean Manne suggested, that you look at empirical observations when they are available, when they are useful; you look at non-empirical, but still economic concepts when they are useful; the ability of parties to transact around things. But you are not permitted to look at non-economic variables.

So despite Professor Mercer has argued in favor of that, but the 1996 NSMIA amendments not only just on their face, but in their legislative history make clear that isn't at all what was intended. So if you want to talk about a new statute, maybe that might be an interesting debate we could have, but under the present rules it is not permitted.

But to do the best job you can, I would try to urge continued investment in the economic analysis function at the SEC, giving more authority and transferring resources from other places to there.

Mr. MCHENRY. Okay. So we have a number of questions, but one final question from me, then I have a broad request for the whole panel.

If the SEC fails to require both PCAOB and FINRA to adhere to these updated guidelines for incorporating cost-benefit analysis, do you think that is regulatory failure? We can begin with Mr. Kotz and go across the panel.

Mr. KOTZ. That wasn't a specific area that I looked at, but it would seem as though that would be a significant problem, certainly.

Mr. MCHENRY. To not include FINRA and—

Mr. KOTZ. Right.

Mr. VERRET. I would classify that as a regulatory failure. And I am aware that this item is, I believe, included in the SEC Regulatory Accountability Act, which I think goes a long way toward getting at this issue. I would also urge consideration of the impact of not only on SROs, but the impact of preemption on a State law-based incorporation system in the competition, and the innovations around market failure that take place at the State level that the SEC can at time impede by preemption.

Mr. MCHENRY. Mr. Bullard?

Mr. BULLARD. I would like to look back at the actual SEC authority to oversee FINRA in that way before answering that question. It is not immediately clear to me that they can delve into rule-making in that way. As a matter of policy, I think they should attempt to impose those standards, but I can't say, offhand, whether legally they have the authority to do so.

I also want to note the Chamber of Commerce has directly commented on the issue of FINRA's cost-benefit analysis and was very critical of it; yet, the House Financial Services Committee, probably either this week or next, will be dropping a bill that will create an entire new SRO that will not be subject to these cost-benefit analyses, and it will raise exactly the issue that you are raising here today.

Mr. MCHENRY. That bill, by the way, has not gone through the markup process, so you will hear otherwise.

Ms. MCCABE. I would comment that the Committee, in its comment letter on the PCAOB's proposed rules on audit firm rotation, discussed this issue specifically and said that the SEC having oversight over the PCAOB should encourage more thoughtful cost-benefit analysis. In that rule, again, there was very minimal analysis.

Mr. MCHENRY. Thank you.

Mr. MANNE. I would like to address a tangential aspect of that, and that is that anything the SEC does under present jurisprudence given down by the Supreme Court in the Chevron case, the courts often simply dodge, really, overseeing this task in the sense of giving deference to the agency's discretion. This is particularly true if the agency shows up with a highly complex mathematical cost-benefit econometric study.

I think that congressional legislation beefing up the standard the courts ought to use in reviewing these agency rulings would be very much in place. I think an increase in civil actions, complaining about errors and mistakes made in various cost-benefit analysis or other economic analysis would certainly be true. I would have a review of not merely the coming rules that are on the Floor now; I would have them go back over many years and do a different kind of analysis that they did. There is very, very little academic work over many years empirically justifying the vast bulk of rules that the SEC has promulgated. Maybe they ought to be looked at; maybe the findings would be of a different sort.

Finally, I would suggest, and this is the hardest one of all, that the agencies, in explaining the economic rationalization of whether it is cost-benefit analysis, an econometric analysis, or whatever, they be required to do it in plain English. I don't think there is any good economics that cannot be understood in English. But I think that lawyers and judges, for some good reasons, some bad reasons, simply can't handle the level of sophistication and mathematics and complex economics that economists engage in among themselves, and it would be tragic if that was used as a coverup for what was going on here.

Mr. MCHENRY. Fascinating. Well, it is an interesting perspective that you share here today.

I typically like to end a hearing, when we have a moment, to ask a broad question of what we can do to fix the state of the economy today. Now, we are talking in light of securities regulations. If there is one thing that we can do, that you would recommend. And if you don't want to engage in it, that is fine, you can pass, but this is the one opportunity to say here is one interesting thing we can do to update securities laws that would have a beneficial impact on the economy.

So we will start with Mr. Kotz. If you want to pass, I certainly understand; I know you have moved to the private sector.

Mr. KOTZ. I would just say that I think the issue we are talking about today is important. Clearly, when you have a problem, a financial crisis, there is an interest in deciding to put forth regulations to try to fix that. But I think we need to figure out whether these make sense, whether they are actually beneficial, and I think that would help benefit the overall economy and things as we go forward.

Mr. MCHENRY. Mr. Verret?

Mr. VERRET. I would suggest that I think one of the fundamental ironies of securities regulations since its inception in the 1930s has been that security regulation is designed around the idea, and the SEC has always assumed, that investors are intelligent and sophisticated enough to be able to process the mandatory disclosures that they get, but they are not intelligent and sophisticated enough to exercise choice in opting out of those disclosures, or any other rules for that matter.

Specifically I would consider the issues of permissive securities arbitration in charters of companies going public. The Carlyle Group tried to insert one and was very quickly beaten down by institutional investor groups and by the SEC to allow shareholders the choice of opting for securities arbitration rather than securities litigation, and the SEC would have none of it.

I think it is something worth considering. I think there is something to the securities litigation system, of course, and to tinkering with it and reforming it, but I think there is also no reason not to give investors the choice to opt out of it altogether.

Mr. MCHENRY. Well, in essence, the market, not to interrupt, but the market has already spoken. If you look at Facebook, those folks that had the opportunity to invest, they are actually foreign investors, that invested through Goldman's conduit to invest in a privately held company, that means they didn't get all the mandated disclosures that a public company would have to give, and yet they were able to raise billions of dollars worth of capital for a privately held company outside of those mandatory public disclosures.

So your point is very fascinating because it seems as though the market has looked for a way to opt out in certain circumstances.

Mr. Bullard.

Mr. BULLARD. I also have a somewhat related comment to the sophistication issue. There has been a longstanding problem with the disclosure regime, and that what triggers being a public company is essentially sales to unsophisticated investors. And the way the structure of the law responds to that is to give them company-specific information that not allowing them to buy in private offerings assume they can't handle and make decisions on the basis of anyway.

So there is a deep sort of contradiction in the whole structure where one should really think that if those investors are allowed to invest at some point, it should be diversification and sort of basic ideas of what nature of risk you are taking on when you are investing in this company, not company-specific information that the regulatory structure assumes that they are least capable of doing, and that by engaging in that market they are most likely to lose their shirts.

So my approach to that would be more try to move away from disclosure regimes, increase private markets, and at the same time shift, to the extent you are going to have regulations protecting investors, to the intermediary stage. It is much more efficient to do that and we had that discussion in connection with crowd funding, the idea of the fixed costs and standardization happening at one place, rather than lots of different issuers. Saves everybody a lot of money and I think it is much more consistent with the idea of protecting the people that you want to protect.

Mr. MCHENRY. Thank you.

Ms. McCabe? And I am not sure if in your position you want to advocate anything beyond that, but you are more than welcome to.

Ms. MCCABE. Thank you, that is exactly what I was going to say, is I am speaking today on behalf of the Committee, I can't really speak to a single issue that would be most important to everyone on the Committee. But I would like to echo former Inspector General Kotz's comments that we have long believed that thoughtful cost-benefit analysis would really benefit and improve the competitiveness of the U.S. capital markets, which is obviously the long-time cause of the Committee. Thank you.

Mr. MCHENRY. Thank you.

Dr. Manne?

Mr. MANNE. I would like to see some real beefing up of judicial review of regulatory actions. Whether that would take the form of overturning the Supreme Court's case in the Chevron case or simply affirmatively mandating that the courts do review these things, in time I think we can solve a lot of the technical problems of cost-benefit analysis by building up the kind of common law of what is good analysis and what is bad analysis. I don't see any agency other than the courts that could do that.

Now, courts tend to fight off these highly technical cases, but we have schools for judges. We can help them in many ways. As far as I can see, that is the last possible monitor to really ratchet in this thing and guaranty that it builds in the right direction.

Mr. MCHENRY. Mr. Verret wants a mulligan here.

Mr. VERRET. I just want to add one more second observation, if I can pick two things for Christmas, rather than just one. Reconsideration of not even the Dodd-Frank Act, that I think actually points out an inconsistency, a very strong inconsistency in the Obama Administration's rhetoric on a number of items recently. The Obama Administration has emphasized, for example, the Buffet Rule, an increase in taxation on individuals making more than, millionaires, essentially.

Well, a little-known provision of the Dodd-Frank Act signed by President Obama actually secures and maintains special investment opportunities in private equity funds and hedge funds and other vehicles, only provided that those investors are worth \$1 million. This is an exemption that pre-existed Dodd-Frank, but was made even more difficult, and it preserves investments for people only in the top essentially one percent, as estimated by the SEC.

I would reexamine that. I would reexamine the idea generally of using wealth as a proxy for sophistication. I think that we could all name a movie star that may be wealthy, but might not necessarily be a sophisticated financial investor. I would consider also maybe a financial literacy test to let investors access these opportunities, but I would certainly point out that severe inconsistency in the Obama Administration's rhetoric on this issue.

Mr. MCHENRY. Now we are opening up a whole new ball of wax, but, Mr. Bullard.

Mr. BULLARD. I will only respond very briefly to recommend to Professor Verret a close reading of the Crowd Funding Act. It allows access to precisely those low income investors. I think it has a lot of good aspects to it and I would be interested to know what

he thinks about that as at least the beginning of trying to break down that barrier.

Mr. VERRET. Well, the Crowd Funding Act, as useful as it is, doesn't deal with this issue of investments. Crowd funding is not permitted for hedge funds and private equity funds; this is a different animal altogether.

Mr. MCHENRY. But hopefully what this will exhibit with the crowd funding legislation we are able to get passed, even with the flawed portions that the Senate added to the legislation that we wrote here in the House, and I will repeat that again, the flawed elements the Senate added as the Senate is apt to do, I think this will be a useful market to see if you have average everyday investors are able to function in a free marketplace of exchange and buy equity and be a part of the equity side of businesses in a larger mass sort of way, with a light touch level of regulation. I think this could show the Securities and Exchange Commission how many of their existing preconceived notions about investors are simply wrong.

So we have a couple generations of securities law in this Country that assume, based on wealth, that you are sophisticated, which is absolutely absurd, absolutely absurd, especially in the Internet age, especially in the internet age, when information is more diffuse, more variable for individuals than in the history of mankind. Truly in the history of mankind.

So, with that, I certainly appreciate your testimony. I appreciate the panel's willingness to engage in these idea.

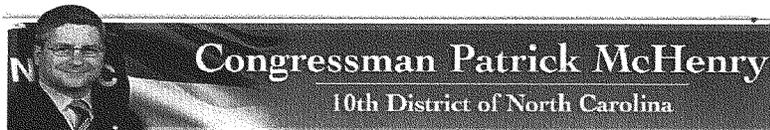
Mr. Kotz, I certainly appreciate your service in government, and thank you so much for the hard work you put in, especially with this final report that has culminated in this hearing today. Thank you.

And thank you to the rest of the panel. Very interesting ideas and very serious thought you have given to your testimony and the words you have offered today.

Today was really about the cost-benefit analysis of the SEC and the larger ramifications it has on the marketplace, and the importance of a cost-benefit analysis when you are in the rulemaking process. Whether it is mandated by Congress in law that a regulator write rules or the regulator takes it upon itself to write new rules, a cost-benefit analysis has to be an essential ingredient before a rule is put into place. Even the best of rules do have a cost and a benefit that need to be analyzed and weighed. So thank you for being here today and thank you for your testimony.

This hearing is now adjourned.

[Whereupon, at 12:35 p.m., the subcommittee was adjourned.]



Rep. Patrick McHenry, Chairman
Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs

Opening Statement
“The SEC’s Aversion to Cost-Benefit Analysis.”
April 17th, 2012

For nearly all American families, the practice of a cost-benefit analysis is part of everyday life.

Decisions about the method of transportation we take to work, to the type of television we buy, right down to the food we cook for dinner are all based on a form of cost-benefit analysis.

In the world of government regulators – specifically the SEC – the stakes are much higher, influencing the behavior of millions of investors, allocation of trillions of dollars, and the competitiveness of our job and economic markets.

The consequences of careless and unwarranted federal regulations serve as a de facto tax on employers and consumers to the tune of over 1 trillion dollars each year.

These needless regulations lead to higher costs, reduced wages, and diminished hiring that harm our economy more than it benefit it. With those thoughts in mind, the SEC’s record on cost-benefit analysis is deeply troubling.

The evidence of unjustifiable SEC regulations was so alarming that it spurred the bipartisan JOBS Act, which was signed into law this month by President Obama.

Simply put, the SEC’s complacency emboldened Congress and the White House to make simple and meaningful improvements to securities laws to address the competitiveness of our capital markets and opportunities for U.S. startups and small businesses that had long been ignored by the Commission.

Nonetheless, it is widely recognized that the SEC continues to fail at delivering adequate cost-benefit analysis on its rules and regulations.

In January of this year, outgoing SEC Inspector General David Kotz issued a report indentifying failures in the cost-benefit analysis procedures of the Commission.

The report concludes that the “SEC may not be fulfilling the essential purposes of such analyses – providing a full picture of whether the benefits of a regulatory action are likely to justify its costs and discovering which regulatory alternatives would be the most cost-effective.”

Mr. Kotz is not alone in taking issue with the SEC’s decision on cost-benefit analysis.



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Chief Executive Officer

Tuesday, April 17, 2012

Honorable Patrick T. McHenry Honorable Mike Quigley
Chairman *Ranking Member*
Subcommittee on TARP, Financial Services and
Bailouts of Public and Private Programs
House Oversight and Governmental Reform Committee
2157 Rayburn House Office Building
Washington, DC 20515

Re: "The SEC's Aversion to Cost-Benefit Analysis"

Dear Chairman McHenry and Ranking Member Quigley:

I write on the eve of your Subcommittee's hearing, scheduled for tomorrow morning, April 17th, with the unfortunate title of "The SEC's Aversion to Cost-Benefit Analysis." I apologize if this unsolicited letter adds to the Subcommittee's burdens. But, I have spent my entire professional life dealing with the issues with which you are appropriately interested, both from a variety of private sector experiences as well as two separate public service tours of duty with the Securities and Exchange Commission (the "Commission" or the "SEC")—the first culminating with three years of service as SEC General Counsel (1975-78), and the second, as the 26th Chairman of the SEC (2001-2003).¹

Issues regarding SEC cost-benefit analyses are critically important, and can benefit from the Subcommittee's oversight. I am a strong proponent of requiring effective cost-benefit analyses to accompany proposed regulatory action, and endorse the Subcommittee's desire to ensure that those regulatory agencies subject to its jurisdiction follow appropriate steps in performing meaningful cost-benefit analyses before adopting new rules. My reason for writing, however, is that the title of your hearing creates what I believe is an inaccurate picture of the SEC's

¹ In between my two tours of duty with the SEC, I spent nearly a quarter century as a senior partner at an international law firm, leading the firm's securities and corporate practices, as well as co-chairing the law firm itself. Since leaving the Commission in 2003, I founded, and I am the CEO of, the global business consulting firm, Kalorama Partners, LLC, as well as its law firm affiliate, Kalorama Legal Services, PLLC.



current efforts to ensure that it appropriately and accurately considers the potential costs and benefits of any rules it might adopt. While the SEC has encountered some criticism in performing cost-benefit analyses since 2004, of which this Subcommittee is surely aware, the current Commission has shown a serious desire to respond to those who have questioned cost-benefit analyses in the past. The Commission, I believe, understands its responsibilities and is doing a very credible job of trying to satisfy those obligations.

The efforts of the Commission should be considered in the context of its substantial rulemaking obligations. Starting at the beginning of this decade, Congress passed two major pieces of legislation (and a number of significant smaller legislative efforts), imposing considerable burdens on the SEC that have not been confronted by other financial services regulators. I refer principally to the Sarbanes-Oxley Act² and the Dodd-Frank Wall Street Reform and Consumer Protection Act.³ In the aggregate, the Commission has been given extensive new responsibilities, and has been mandated to adopt over a hundred rules, usually under extremely tight and infelicitous time deadlines. In some instances, Congress has not given the SEC any discretion to eschew the adoption of certain rules—the Commission is legally directed to do so.

This is not to say that the SEC should be excused from meeting the same burdens every other federal financial services regulator must meet in adopting new rules. The SEC has not sought such an exemption, and it would be unwise for Congress to grant one. But, the oversight role that Congress plays will be all the more effective if the Subcommittee gives appropriate credit to the Commission, under Chairman Schapiro's leadership, for revamping the way the Agency now approaches cost-benefit analyses. There is no reason to believe that the SEC has any aversion whatsoever to performing cost-benefit analyses. Rather, this Subcommittee should acknowledge the steps that have been, and are being, taken, and evince its support for those efforts. If the Subcommittee believes the SEC should do more, rather than castigating the Agency the Subcommittee should constructively identify areas where it believes additional tools and other approaches should be brought to bear.

² Pub. Law 107-204, 116 Stat. 745 (July 29, 2002).

³ Pub. Law 111-203, 124 Stat. 1376 (July 21, 2010).

Chairman McHenry and Ranking Member Quigly
 Subcommittee on TARP, Financial Services and Bailouts of Public and
 Private Programs
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Among other things, the Commission's General Counsel and Chief Economist have developed new guidelines for the performance of cost-benefit analyses, taking into account recent judicial decisions, and a recent GAO review of SEC rulemaking.⁴ In addition, the Commission's new Division of Risk, Strategy, and Financial Innovation has been involved at the incipient stages of most critical rulemaking efforts, ensuring that true economic considerations are given primacy in connection with the performance of Agency rulemaking activities. Above all else, the Commission has taken appropriate steps to ensure that rulemaking exercises reflect the overarching economic issues raised, a step I had proposed in a Wall Street Journal Op-Ed article.⁵

In sum, there is no basis to assume that the current SEC has an "aversion" to performing appropriate cost-benefit analyses. Indeed, the evidence is to the contrary. This Subcommittee should recognize the efforts that have been undertaken, and given the Agency credit for its willingness to listen to constructive criticism and improve the way it handles the adoption of a multiplicity of mandated new rules.

I request that the Subcommittee make these views a part of its hearing record, and thank the Subcommittee in advance for affording me that opportunity.

Sincerely,

Harvey L. Pitt

Cc: Subcommittee Members

⁴ See, e.g., *Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir, 2011). See also General Accountability Office, "Report No. 12-151: Dodd-Frank Act Regulations Implementation Could Benefit from Additional Analyses and Coordination" (Nov. 2011). The Agency's former IG, who apparently will be testifying at tomorrow's hearing about his Office's Report also produced a report, based substantially upon work performed by an economic consultant. SEC Office of Inspector General, Report No. 499: "Follow-Up Review of Cost-Benefit Analyses in Selected SEC Dodd-Frank Act Rulemakings (Jan. 27, 2012).

⁵ Harvey L. Pitt, "Overlawyered at the SEC," WALL ST. J.L. (July 26, 2006).



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Prior to becoming the SEC's Chairman, Mr. Pitt was a senior corporate partner at the international law firm of Fried, Frank, Harris, Shriver & Jacobson. Former Chairman Pitt also served previously with the SEC, from 1968 until 1978, including three years as General Counsel (1975-78). Former Chairman Pitt received a J.D. degree from St. John's University School of Law (1968), and his B.A. from the City University of New York (Brooklyn College) (1965). He was awarded an honorary LL.D. by St. John's University (2002), and was given the Brooklyn College President's Medal of Distinction (2003).

Mr. Pitt is currently a Director and Audit Committee member of GWU Medical Faculty Associates, Inc., a §501(c)(3) corporation. He is a member of the Global Advisory Forum of the CQS Hedge Fund, and a member of the Regulatory and Compliance Advisory Council of Millennium Management LLC. He also serves on the Board of Directors to the offshore funds of Paulson & Co. and its affiliates.

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Opening Statement

Rep. Mike Quigley, Ranking Member

Subcommittee on TARP, Financial Services, and Bailouts of Public and Private Programs

“The SEC’s Aversion to Cost-Benefit Analysis”

April 17, 2012

Thank you, Mr. Chairman, for holding today’s hearing on SEC rulemaking and cost/benefit analysis. At the outset, I’d like to acknowledge the SEC’s incredible responsiveness to the inquiries and oversight of this Committee.

Today’s hearing will mark SEC Chairman Mary Schapiro’s fourth appearance before the Oversight and Government Reform Committee during the 112th Congress. I commend her for her willingness to be so responsive to the Committee’s numerous and varied inquiries.

The SEC has been heavily scrutinized as it has assumed numerous regulatory mandates under *Dodd-Frank*. Regulations are vital to protecting Americans, but we must ensure that they are carefully considered. After recent investigations by the SEC Inspector General and the U.S. Court of Appeals for DC, the SEC created new staff guidance for cost/benefit analysis. I look forward to Chairman Schapiro’s testimony regarding this new guidance.

As we examine this important issue, we have to remember that this about good government, pure and simple. As Chairman Schapiro previously noted in a January 26th letter to Chairman Issa:

[T]he primary purpose for performing cost-benefit analyses should be assisting the Commission in making sound regulatory choices about the difficult discretionary decisions with which it is faced.

Since *Dodd-Frank* was signed into law, the SEC’s cost/benefit analysis procedures have come to be heavily criticized. According to a March 6, 2012 *Bloomberg* article, the SEC’s *Dodd-Frank*-related rulemaking has slowed in the face of these criticisms.

While we have to hold the SEC to the highest standards, the regulations that have been delayed are critical to addressing the causes of the 2008 financial crisis. There can be no amnesia about the fact that financial markets were not working for Americans before the financial crisis. A “hands-off” approach by federal regulators contributed to the fraud that destroyed the retirement income of thousands of Americans.

"If our economic system is going to work", says Nobel laureate Joseph Stiglitz, "then we have to make sure that what [people] gain when they cheat is offset by a system of penalties."

The financial regulatory reform law passed last year was a step in the right direction, but it alone it is insufficient. Trust in our financial system is at its lowest ebb, which means that laws have to be enforced, and the SEC needs to be a strong enforcer.

Unfortunately, the FY 2012 budget only appropriated \$1.3 billion dollars to fund the SEC. For comparison's sake, Citibank spent \$1.6 billion dollars on marketing alone in 2010. How is the SEC expected to police Wall Street when its *entire budget* is less than the *marketing* budget of one bank?

I strongly support cost/benefit analysis for SEC rulemaking. But challenges to the SEC's cost/benefit analysis process should not be used by those opposed to financial reform to delay or derail the Commission's implementation of *Dodd-Frank*.

Our country will be safer from another financial crisis if the SEC implements *Dodd-Frank* in accordance with the law and in a timely fashion. I look forward to the testimony of all of our witnesses.

Thank you and I yield back.

Contact: Ashley Etienne, Communications Director, (202) 226-5181.

