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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 Vandferbilt 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 there[1]. 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

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

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 in Naples. Florida.

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

[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)

allocation on a very detailed, micro scale, but it is central economic planning and resouce 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 "neccessary-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 .

The next phase in the debate[3] about administrative powers came from an unexpected source, the new (1962) field of Public Choice theory[4], 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 bureacrats is more accurately seen as self-serving rather than motivated by the public

[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)

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

[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 psycholgical 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.

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 Mises[7], 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, Frederich 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 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

[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)

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 observors 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 thast 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 neccesity, 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 inroduce 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 was 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 accessability 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 of Mises that a former commissioner of the SEC criticized economists who "attempt to compress

[9] 905 F2d 406 (DCCA 2011)

the complexity of our 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. Moscowitz 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 book[11] 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

[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)

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 jusify old rules as well as new ones.[13] When the world notes how gargantuan this task its, it may for the first time become aware of how poorly the SEC has managed its main reponsibility over the years

While much of my criticism in the aforementioned lecture dealt with disclusre 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 jursdiction over a kind of transaction (definitely not insider trading) not explictly 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?"

[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

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[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.

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]

[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. Undoutedly such a rule would create enormous internal and bureacratic 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 statiticans, 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

[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.

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 wsas 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 requirment 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 undoutedly 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

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

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 sensible and knowledgable 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 disclsure 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 fallacy[25] of the principal-agent problem as a market failure, this example in the Memorandum might represent a shortcoming of the underlying economics.

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[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).

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 Ackerlof on a “lemons” market in used cars, is very revealing. Ackerlof 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 Ackerlof thory 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 Ackerlof 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 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' 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 commmittee of Congress should mandate something along the line of the SFRI 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 ever 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 analyusis or other forms of mistake can have an enormously salutoary 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 Congresional 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.

Biography of Henry G. Manne

Henry G. Manne received a B.A., cum laude, in Economics in 1950 at Vanderbilt University, his J.D. at the University of Chicago Law School in 1952, and his S.J.D. at Yale Law School in 1966. He holds honorary doctorates in law from Seattle University, Universidad Francisco Maraquin (Guatemala), and George Mason University. He is Dean Emeritus and University Professor Emeritus at the George Mason University School of Law, where he was Dean from 1986-1996 and University Professor from 1986 to 1999. He has also taught at St. Louis University, the University of Wisconsin, George Washington University, the University of Rochester, University of Miami, and Emory University. He is presently Distinguished Visiting Professor at Ave Maria Law School.

He is a member of numerous professional organizations and boards, and an Honorary Life Member of the American Law and Economics Association, which honored him as one of the four founders of the field of Law and Economics. Professor Manne has published many books and articles, with emphasis on law and economics, the free market, and securities regulation. His development of the theory of a "market for corporate control" is credited with opening the entire field of corporate law to economic analysis, and his 1966 book, "Insider Trading and the Stock Market," began, and still heavily influences, the vast literature on that subject. He is a frequent contributor to the Wall Street Journal. The Liberty Fund, of Indianapolis, IN, recently published “The Collected Works of Henry G. Manne” in three volumes.

Among his notable educational innovations were the Law and Economics Center (LEC), the first academic center devoted to the development of the field of Law and Economics (presently part of the George Mason University School of Law); the Economics Institutes for Law Professors; the Law Institutes for Economists; the Economics Institutes for Federal Judges; the first specialized law degree program for Ph.D.'s in economics; and the first law school (George Mason) whose curriculum was built around the use of economics in law.

Professor Manne now resides with his wife, Bobbie, in Naples, Florida.

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

Name:

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

None

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

None

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

None

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

Date: 4/13/2012

Henry G. Manne