UNITED STATES SECURITIES AND EXCHANGE COMMISSION
OFFICE OF INSPECTOR GENERAL

REPORT OF REVIEW OF ECONOMIC ANALYSES PERFORMED BY THE SECURITIES AND EXCHANGE COMMISSON IN CONNECTION WITH DODD-FRANK ACT RULEMAKINGS

June 13, 2011

BACKGROUND

a. Congressional Request

On May 4, 2011, the Securities and Exchange Commission (SEC or Commission) Office of Inspector General (OIG) received a letter from several members of the U.S. Senate Committee on Banking, Housing, and Urban Affairs (Senate Banking Committee) requesting that the Inspector General review the economic analyses performed by the SEC in connection with rulemaking initiatives undertaken pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).[1] The letter stated that on February 15, 2011, the same Senate Banking Committee members had sent a letter to the SEC, Commodity Futures Trading Commission (CFTC), Board of Governors of the Federal Reserve System (Federal Reserve), Federal Deposit Insurance Corporation (FDIC), and Office of the Comptroller of the Currency (OCC) in response to concerns raised by Commissioners at both the CFTC and SEC about economic analyses at their agencies.

The May 4, 2011, letter further stated that a CFTC OIG report released on April 15, 2011, raised issues that confirmed the concerns regarding the CFTC rulemaking expressed in the committee's February 15, 2011 letter. As a result, the May 4, 2011, letter requested that the SEC OIG, along with the CFTC, FDIC, Federal Reserve, and Department of the Treasury OIGs, conduct reviews of the economic analyses being performed for rulemakings required under the Dodd-Frank Act. The letter asked that the SEC OIG's review focus specifically on the cost-benefit analyses prepared by the SEC for the following Dodd-Frank Act regulatory initiatives:

- Credit Risk Retention, 76 Fed. Reg. 24090 (April 29, 2011)
- Clearing Agency Standards for Operation and Governance, 76 Fed. Reg. 14472 (March 16, 2011)
- Registration and Regulation of Security-Based Swap Execution Facilities, 76 Fed. Reg. 10948 (February 28, 2011)
- Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, 76 Fed. Reg. 8068 (February 11, 2011)
- Registration of Municipal Advisors, 76 Fed. Reg. 824 (January 6, 2011)
- Conflict Minerals, 75 Fed. Reg. 80948 (December 23, 2010)

The report we are providing today contains our initial assessment of the economic analyses that we were asked to review as they relate to these six specific rulemakings. With the assistance of an expert we have retained, Albert S. (Pete) Kyle, we will be conducting a more in-depth review of specific cost-benefit analyses performed by the agency and will issue a subsequent report on the results of our further review.

[1] Pub. L. No. 111-203 (July 21, 2010).

b. Dodd-Frank Act

The Dodd-Frank Act was signed into law on July 21, 2010. The law reformed the financial regulatory system, including how financial regulatory agencies such as the SEC operate. Among other things, the Dodd-Frank Act

- gave the SEC regulatory authority over advisers to hedge funds;
- authorized the SEC, together with CFTC, to regulate over-the-counter derivatives;
- provided the SEC with additional authority and responsibilities for oversight of credit rating agencies;
- imposed greater disclosure and risk retention requirements with respect to the issuance of asset-backed securities;
- strengthened the SEC's authority with respect to corporate governance; and
- required the SEC to study and adopt a uniform fiduciary duty for investment advisers and broker-dealers.

The Dodd-Frank Act required the SEC to undertake a significant number of studies and rulemakings, including regulatory initiatives addressing derivatives; asset securitization; credit rating agencies; hedge funds, private equity funds, and venture capital funds; municipal securities; clearing agencies; and corporate governance and executive compensation. Although the Dodd-Frank Act mandated specific rulemakings, the SEC may have discretion to determine the content of a particular rule.

c. Statutory and Other Requirements to Perform Cost-Benefit or Economic Analyses

The Paperwork Reduction Act (PRA) and the Regulatory Flexibility Act set forth specific requirements to which agencies must adhere in the rulemaking process. Specifically, the PRA requires agencies to solicit and review public comments on the "collection of information" requirements of proposed rules.[2] The PRA also requires that agencies evaluate the need for the collection of information and provide a "specific, objectively supported estimate of burden."[3] The Regulatory Flexibility Act requires agencies to consider the needs of small entities in evaluating proposed rules or rule changes for all rules that are subject to notice and comment under the Administrative Procedure Act and to describe the impact of proposed rules or rule changes on small entities, unless the agency head "certifies that the rule will not, if promulgated, have a significant economic impact on a substantial number of small entities."[4]

The National Securities Market Improvement Act of 1996 (NSMIA)—which amended the Securities Act of 1933 (Securities Act), Securities Exchange Act of 1934 (Exchange Act), and Investment Advisers Act and the Investment Company Act of 1940 (Advisers Act and Company Act, respectively)—requires the SEC to consider whether an action will promote efficiency, competition, and capital formation whenever it "is engaged in rulemaking and is

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[2] 44 U.S.C. §§ 3506(c)(2)(A) & 3507(a)(1).
[3] 44 U.S.C. § 3506 (c)(1)(A)(iv).
[4] 5 U.S.C. §§ 603(a), 604(a), 605(b) & 609(a).

required to consider or determine whether an action is necessary or appropriate in the public interest."[5] Additionally, Section 23(a)(2) of the Exchange Act requires the Commission to consider the impact that any rule promulgated under the act would have on competition.[6] This provision states that a rule shall not be adopted if it would impose a burden on competition that is not necessary or appropriate in furtherance of the purposes of the act.[7]

In addition, Executive Order 12866, Regulatory Planning and Review (EO 12866),[8] Executive Order 13563, Improving Regulation and Regulatory Review (EO 13563),[9] and Office of Management and Budget (OMB) Circular A-4, Regulatory Analysis (OMB Circular A-4),[10] discuss requirements to conduct cost-benefit analyses of proposed rules and regulations.

EO 12866, which was issued by President Clinton on October 4, 1993, was designed to ensure a regulatory system that, among other things, "improves the performance of the economy without imposing unacceptable or unreasonable costs on society." EO 12866 contains twelve "Principles of Regulation," which call for agencies, to the extent permitted by law and where applicable, to:

- identify the problem to be addressed and assess its significance;
- examine whether existing regulations (or other law) should be modified to achieve the intended goal of regulation more effectively;
- identify and assess available alternatives to direct regulation;
- consider, to the extent reasonable, the degree and nature of risks posed by substances or activities under their jurisdiction;
- design regulations in the most cost-effective manner to achieve the regulatory objective;
- assess both the costs and benefits of the intended regulation, and propose or adopt a regulation only upon a reasoned determination that the benefits justify its costs;
- base decisions on the best reasonably obtainable information;
- identify and assess alternative forms of regulation and, to the extent feasible, specify performance objectives;
- wherever feasible, obtain input from appropriate state, local, and tribal officials;
- avoid inconsistent, incompatible, or duplicative regulations;
- tailor regulations to impose the least burden on society; and
- draft regulations in simple and easy-to-understand language.[11]

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[5] 15 U.S.C. § 77b(b).
[6] 15 U.S.C. § 78w(a)(2).
[7] *Id.*
[8] Exec. Order No. 12866, Regulatory Planning and Review, 58 Fed. Reg. 51735 (Oct. 4, 1993).
[9] Exec. Order No. 13563, Improving Regulation and Regulatory Review, 76 Fed. Reg. 3821 (Jan. 18, 2011).
[10] OMB Circular A-4, Regulatory Analysis (Sept. 17, 2003).
[11] Exec. Order No. 12866 at 51735-36.

EO 12866 also requires that OMB review individual regulations to ensure that these principles are followed and that one agency's decisions do not conflict with the policies or actions of another agency.[12]

OMB Circular A-4 provides guidance to agencies on conducting cost-benefit analyses required by EO 12866 and specifies that agencies should do the following to evaluate properly the benefits and costs of regulations and their alternatives:

- Explain how the actions required by the rule are linked to the expected benefits. For example, indicate how additional safety equipment will reduce safety risks. A similar analysis should be done for each of the alternatives.
- Identify 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. Comparisons to a "next best" alternative are also especially useful.
- Identify the expected undesirable side-effects and ancillary benefits of the proposed regulatory action and the alternatives. These should be added to the direct benefits and costs as appropriate.[13]

EO 13563, which was issued by President Obama on January 18, 2011, supplements and reaffirms the principles and structures of review established in EO 12866.

EO 12866 and EO 13563 apply to agencies as defined in 44 U.S.C. § 3502(1) with the exception of independent regulatory agencies, which are defined in 44 U.S.C. § 3502(5). The SEC is an independent regulatory agency and, as such, is not bound by EO 12866 or EO 13563. Nevertheless, SEC Chairmen have made a commitment to Congress that the SEC will conduct cost-benefit or economic analyses in connection with its rulemaking activities. Specifically, according to Office of General Counsel (OGC) officials, former SEC Chairman Arthur Levitt stated that there was an expectation that the SEC would perform cost-benefit analyses as part of the rulemaking process.[14]

In fact, the Commission's current rulemaking procedures are closely aligned with the requirements of EO 12866, EO 13563, and OMB Circular A-4, as indicated by the following statement on the SEC's website:

> While [EO 13563] does not apply to independent agencies like the Commission, we share its goals, and many of our existing practices are consistent with those described in the Order. For example, we take into

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[12] *Id.* at 51737.
[13] OMB Circular A-4 at 2-3.
[14] Interview with members of the SEC Office of General Counsel on May 17, 2011.

> account benefits and costs in our rulemakings, assess alternative regulatory approaches, afford the public a meaningful opportunity to comment on our proposed regulations through the Internet, and coordinate our rulemakings with other agencies to harmonize regulations.[15]

Further, during a March 15, 2011, hearing before the House Appropriations Committee's Subcommittee on Financial Services and General Government, SEC Chairman Mary Schapiro stated that while EO 13563 does not actually apply to independent agencies, the SEC does much of what it requires, including conducting cost-benefit analyses and trying to make accommodations for smaller businesses.[16] She further stated that the SEC plans to form a small Business Advisory Committee and go back and review rules that have been "on the books" for a long time to determine whether the SEC can provide relief to small businesses.[17]

d. Importance of Economic or Cost-Benefit Analyses

The SEC has begun drafting more than 90 rules required by the Dodd-Frank Act. Recent speeches by Commissioner Troy Paredes have signaled concern that new SEC regulations implemented under the act not excessively constrain the U.S. financial system. In a speech delivered on March 8, 2011 before the National Association for Business Economics, Commissioner Paredes stated the following:

> [T]he Commission must engage in rigorous cost-benefit analysis when fashioning the securities law regime. A demanding cost-benefit analysis that permits us [the SEC] to make informed tradeoffs across a range of potential outcomes is the best way of achieving the common good, of ensuring that the benefits of regulation outweigh the costs. This should include assessing the cumulative impact of the entire package of new regulatory demands to anticipate the overall effect of the regulatory regime when viewed in its entirety.[18]

Further, in a speech at an SEC open meeting regarding proposed rules for Nationally Recognized Statistical Rating Organizations held on May 18, 2011, Commissioner Kathleen Casey stated the following:

> [T]he Commission has not engaged in a cost-benefit analysis of the rulemakings that were essentially dictated by the law. This seems to be a narrow and limiting approach to the requirements and objectives of cost-benefit analysis.

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[15] SEC, Improving Regulations: Reviewing Regulatory Requirements to Ensure They Continue to Promote Economic Growth, Innovation, Competitiveness & Job Creation, http://www.sec.gov/spotlight/regulatoryreviewcomments.shtml.

[16] *Budget Hearing – Securities and Exchange Commission: Hearing Before the Fin. Serv. and Gen. Gov't Subcommittee of the H. Comm. on Appropriations,* 112th Cong. (Mar. 15, 2011)(testimony of SEC Chairman Mary Schapiro), Federal News Service, Inc. transcript at 27.

[17] *Id.*

[18] Troy Paredes, Commissioner, SEC, Remarks Before the 27th Annual NABE Economic Policy Conference (Mar. 8, 2011), at 4 (footnote omitted).

> I believe we are severely limited in our ability to act consistently with congressional interest and intent if we fail to understand the full impact of the new law and the regulations flowing from it. By limiting our cost-benefit analysis to those measures over which the Commission has full discretion, we fail to consider *all* the costs and benefits that will result from a particular regulatory action. . . .
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> Moreover, it will be difficult, if not impossible, to assess effectively the ultimate impact of our rules and their interoperability if we are deliberately ignorant of all the resultant costs and benefits of those rules. . . . [W]ithout thorough and inclusive cost-benefit analyses, we are regulating blind.[19]

SCOPE AND METHODOLOGY OF REVIEW

a. Scope

The subject matter of our review was the SEC's methodology for conducting cost-benefit analyses for the six Dodd-Frank Act rulemaking initiatives identified in the Background section above. Some of these rules are to be issued jointly with other federal financial regulatory agencies (i.e., CFTC, OCC, FDIC, and Federal Reserve). As of the date of this report, none of the six rulemakings, which were initiated from July 2010 through April 2011, had reached the stage of the adopting release. Thus, our review examined the cost-benefit analysis presented in the proposing release of each rule and any comments received from external parties to the proposing release. We also evaluated the pertinent term sheets (i.e., summary documents that provide an overview of the significant matters and/or terms associated with a proposed rule), as well as outlines prepared by the Division of Risk, Strategy, and Financial Innovation (RSFI), as applicable.

In addition, our review included reviewing any statutory requirements for the SEC to perform cost-benefit analyses for rulemakings, as well as a general analysis of the extent to which the SEC's rulemaking procedures meet the intent of EO 12866, EO 13563, and OMB guidance.

b. Methodology

We began our review by gaining an understanding of the federal rulemaking process and the role of cost-benefit analysis in that process. We interviewed staff members of the SEC's primary rulemaking division and offices—Corporation Finance (CF), Trading and Markets (TM), and Investment Management (IM)—and RSFI and OGC to understand each office's or division's role and involvement in the rulemaking process. Additionally, we gathered information concerning internal policies and procedures that govern how each office or division involved with the rulemaking process should perform cost-benefit analyses. We researched

[19] Kathleen Casey, Commissioner, SEC, Speech by SEC Commissioner: Proposed Rules for Nationally Recognized Statistical Rating Organizations, SEC Open Meeting (May 18, 2011), at 2-3 (emphasis in original).

federal guidance pertaining to the SEC that articulated any requirements for the form or substance of a cost-benefit analysis for rulemaking and determined whether the SEC's internal procedures and guidance for each rulemaking office or division met federal standards or other requirements.

We also gained an understanding of the qualifications of the team members involved with the rulemakings and the degree to which external comments are evaluated and incorporated into the cost-benefit analyses. We further obtained an understanding of how quantifiable costs and benefits data is used by the SEC.

c. Retention of an Expert

The OIG has retained an expert, Albert S. (Pete) Kyle, to assist with the OIG's review of the SEC's economic or cost-benefit analyses in connection with Dodd-Frank Act rulemakings. Professor Kyle is uniquely qualified to assist in this review. He joined the University of Maryland faculty as the Charles E. Smith Chair Professor of Finance at the Robert H. Smith School of Business in August 2006. He earned a Bachelor of Science degree in Mathematics from Davidson College in 1974, studied Philosophy and Economics at Oxford University as a Rhodes Scholar, and completed his Ph.D. in Economics at the University of Chicago in 1981.

Professor Kyle was a professor at Princeton University's Woodrow Wilson School from 1981 to 1987, at the University of California's Haas Business School in Berkeley from 1987 to 1992, and at Duke University from 1992 to 2006. Professor Kyle is an expert on many aspects of capital markets, with a particular focus on market microstructure. He has conducted significant research on such topics as informed speculative trading, market manipulation, price volatility, and the information content of market prices, market liquidity, and contagion.

Professor Kyle was elected a Fellow of the Econometric Society in 2002. He was also a board member of the American Finance Association from 2004 to 2006. He served as a staff member of the Presidential Task Force on Market Mechanisms (Brady Commission) after the stock market crash of 1987. He has also worked as a consultant on finance topics for several government agencies in addition to the Commission, including the Department of Justice, the Internal Revenue Service, the Federal Reserve, and the CFTC.

In connection with this report, Professor Kyle analyzed the cost-benefit and economic analyses conducted by the SEC's different rulemaking divisions and specifically reviewed the process and the collaboration between divisions and offices when determining possible costs and benefits of the proposed rules.

SEC INTERNAL POLICIES AND PROCEDURES RELATING TO PERFORMING ECONOMIC OR COST-BENEFIT ANALYSES

The SEC has established staff guidance regarding its rulemaking processes. Section IV of the SEC Compliance Handbook, issued by OGC and last revised on October 1, 1999

(Compliance Handbook) includes the following points in its discussion of the significance and overview of a cost-benefit analysis:[20]

- The cost-benefit analysis in the proposing release should identify possible direct and indirect costs and benefits for members of the industry, relevant market segments (e.g., the over-the-counter market in debt securities), and types of investors and issuers. This analysis should also discuss any available data and solicit comments and additional data.

- The cost-benefit analysis in the adopting release should include a substantive, qualitative discussion of the costs and benefits and the SEC staff's final quantitative analysis of any available data. "A strong cost-benefit section will include both quantitative and qualitative analysis."

- A cost-benefit analysis should address both "micro," or compliance, costs, as well as "macro" costs, such as distributional effects or changes in investment or order flows.

- The former Office of Economic Analysis (currently part of RSFI and referred to hereafter as RSFI) must concur with any numbers used in the cost-benefit analysis, and all numbers should be verified and not be based merely on staff's best estimates.

- The rulemaking divisions or offices "are primarily responsible for generating quantitative and qualitative information that forms the basis of a cost-benefit analysis." If consulted early in the process, RSFI may be able to provide data and analysis.[21]

OGC also listed the following best practices to which rulemaking divisions or offices should adhere when preparing a cost-benefit analysis:

- At the proposing stage, the cost-benefit analysis should be tentative, without reaching any conclusions. As comments are received, the cost-benefit analysis should be refined.

- Rulemaking teams should schedule meetings with OGC and RSFI during the drafting of the proposing release and during the early part of the comment period to establish a work plan for gathering data and finalizing the analysis.

- The proposing release cost-benefit analysis should contain some qualitative analysis, but no conclusions should be reached. It is neither necessary nor appropriate to indicate the Commission's "preliminary beliefs" or "preliminary conclusions."

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[20] Although it contains best practices to follow, the Compliance Handbook states that the SEC has no express standards or guidelines for cost-benefit analyses. Compliance Handbook at 37.
[21] Compliance Handbook at 38-39.

- Staff should only include quantitative data in the proposing release if it has been verified in some way or if the data is derived from an independent source.

- Every proposing release should include a request for comments soliciting data and views on the cost-benefit analysis.

- The proposing release should not present PRA numbers and estimates as Commission estimates unless they have already been verified.

- For the adopting release, the estimated compliance costs must be verified, e.g., by surveying up to nine members of the affected industry segment.

- A complete cost-benefit analysis should consider macro costs, not just micro costs such as paperwork burdens.

- A cost-benefit analysis should consider both direct and indirect costs, as indirect costs may also affect industries not subject to SEC regulation.

- The release for a rule should explain how and why, in particular, the requirements of the rule will result in identified benefits. The benefits of a rule generally will track the purposes of the statutory provision under which the SEC promulgates the rules (e.g., the protection of investors). Benefits may also include promoting competition, efficiency, or capital formation.

- In many cases, it will not be possible to quantify the benefits of a rule. In such cases, a detailed qualitative assessment of the anticipated benefits will be necessary.

- The benefits and costs of a proposed rule should be measured against a baseline—the best assessment of the way the world would look absent the proposed regulation (the "as is" environment).

- It is preferable to monetize costs and benefits when verifiable estimates are available, and effects that cannot be fully monetized or quantified should be described. If a regulation includes a number of distinct provisions, the benefits and costs of the different provisions should be evaluated.

- If a survey is used to gather industry data on compliance costs, OGC and RSFI should be involved in formulating the survey, and both RSFI and the rulemaking division should retain the data retrieved for use in future rulemakings.

- There is no requirement that the SEC weigh the costs against the benefits, or conclude that the benefits outweigh the costs. An adopting release may state that the SEC's view is that the likely benefits justify the costs.

- The adopting release for a rule should include a cost-benefit analysis that goes beyond the cost-benefit analysis in the proposing release and further analyze in some

detail the costs and benefits identified. The adopting release should also summarize and respond to any comments relating to costs or benefits, regardless of whether a comment was expressly directed to the cost-benefit section of the proposing release.

- Backup documentation should be retained to support the SEC's cost-benefit analysis. The documentation may take the form of any data or studies relied upon in the cost-benefit analysis. It may also include internal memos that memorialize conversations with, or information received from, outside persons about anticipated compliance costs or benefits.

- RSFI must concur with the substance of the cost-benefit analysis, as well as any data or numbers included in the final analysis.[22]

SEC DIVISIONS' METHODS FOR CONDUCTING ECONOMIC OR COST-BENEFIT ANALYSES

Introduction

The OIG reviewed the rulemaking process for each of the SEC's rulemaking divisions (CF, IM, and TM). The OIG assessed these processes and generally found that the rulemaking division responsible for the specific rule took the lead but was heavily supported by RSFI and OGC. In addition, we found that input from RSFI is generally obtained when solicited.

Division of Investment Management

The IM rulemaking process is carried out through its three rulemaking offices. These offices are structured according to the various areas regulated by IM: investment company disclosure; other investment company regulation; and investment adviser regulation. IM also has some attorney fellows and senior special counsels who provide specialized expertise for assisting with policy formation for rulemaking initiatives. The rulemaking teams in IM include attorneys who have private sector work experience, such as one attorney who was previously a partner at a law firm and specialized in hedge funds.

IM has a rulemaking manual which staff use as a reference tool during the rulemaking process. In addition, IM has created working groups that include representatives from other SEC divisions and offices to discuss various areas for regulatory policy consideration. For some rulemakings, IM held discussions with stakeholders and received their input prior to presenting a formal proposal to the Commission. Additionally, IM met with industry representatives to obtain their perspectives on various areas of the financial regulatory reform provisions.

In IM, the rulemaking process typically starts with the creation of a term sheet to capture and outline the key aspects of a proposed rule. During the drafting of the proposing release, IM works with RSFI and OGC to consider various legal and economic factors in formulating the regulatory policy, including the costs and benefits of the rulemaking and whether there are ways

[22] Compliance Handbook at 37-47.

to adjust the rulemaking terms to achieve the goals of the rulemaking at a lesser cost to those subject to the rule.

Based on the IM rulemaking manual, the first step in preparing a cost-benefit or economic analysis for a proposing release is to state the problem being addressed and provide background on how the problem arose and the current regulatory approach to the identified issue. An explanation of the objectives of the proposed rule and why the rule is needed is then provided. IM also identifies alternatives to the proposed rule that were considered and any factors that eliminated such alternatives. The cost-benefit or economic analysis also includes an assessment of the impact of the proposed rule on the affected entities, including markets, companies, and individuals, as well as any special effects on small businesses.[23]

In preparing the cost-benefit or economic analysis for a rulemaking initiative, IM works with RSFI to identify data sources for estimating costs. In some scenarios, IM may also obtain data from other financial regulators, industry trade associations, outside data vendors, or industry service providers to assist in formulating its costs estimates. For instance, in the drafting process for various rules, IM used information from the Investment Adviser Registration Depository (IARD) and also obtained information from the Federal Reserve and the United Kingdom's Financial Services Authority (FSA).

Within IM, the estimated costs of a proposed rule are typically presented as average costs, which may vary from the actual costs a particular entity may incur. According to IM, if a wide range of costs is expected because of the diversity of the industry subject to the proposed rule, IM often will break down the cost estimates into subgroups. To the extent possible, IM discloses the source of the data used in calculating cost estimates.

Once a draft of a proposing release has been prepared, IM circulates the draft to other SEC divisions or offices for comment. RSFI and OGC generally provide the most comments on the draft of a proposing release unless it raises issues under the jurisdiction of another operating division. After a proposing release has been approved by the Commission, it is made available for public comment through publication in the Federal Register. The public comment process allows IM to receive input from industry on all aspects of the proposing release, including the cost-benefit analysis. IM reviews every comment received in response to a proposing release and prepares a comment summary document.

During the public comment process, trade or association groups, members of industry, or consumer advocates may also meet with IM staff to share their positions on the proposing release, including their thoughts on the implementation costs that would be incurred by regulated entities. IM is aware, however, that the information from trade or association groups could be biased because of the advocacy role such groups take on behalf of their constituents. IM often contacts commenters to determine the assumptions underlying their cost estimate comments.

[23] IM informed the OIG that the analysis performed may differ for discretionary rulemakings (where the Commission on its own is determining that the rulemaking is necessary) and congressionally mandated rulemakings under the Dodd-Frank Act (where the Commission has discretion regarding the rulemaking only to the extent granted by the statute).

After reviewing the comments received, IM determines whether to make changes that will be incorporated in the adopting release. The adopting release for the rule must provide a response to all significant comments; thus, most comments on the cost-benefit analysis are specifically addressed in the adopting release. The various drafts and revisions are reviewed and edited by senior-level managers in IM, including the Director and Associate Directors. Input from RSFI and OGC is also considered in determining the content of the final version of the release.

Division of Trading and Markets

At the proposing stage, TM considers the possible impacts of its proposed rule. According to TM staff, the nature of each proposed rule is different and might involve, for example, a new reporting requirement, a requirement that regulated entities establish internal policies and procedures, or definition of a market term.

TM considers costs in various categories and benefits, including first- and second-order effects. First-order effect costs include direct costs incurred to comply with additional reporting requirements or additional internal compliance costs. Second-order effect costs are more macro in nature and involve analysis of the effect of a proposed regulation on market participants.

In TM, the cost-benefit analysis is an ongoing process throughout the rulemaking initiative. TM coordinates its cost-benefit analysis with RSFI and OGC. Depending on the subject of the proposed rule, TM may also consult with CF, IM, the Division of Enforcement (Enforcement), or the Office of Compliance Inspections and Examinations (OCIE) to obtain additional information to incorporate into the analysis.

Each TM rule-writing team makes the first effort to draft the cost-benefit analysis; however, there are generally multiple drafts and versions of the proposed cost-benefit analysis that include comments from RSFI. OGC is also extensively involved in the process, focusing on PRA requirements and any issues that may arise in litigation. According to TM, RSFI and OGC are typically involved from the beginning of the rulemaking process.

With many TM rulemaking initiatives, the written cost-benefit analysis does not truly take shape until the nature of the proposal is developed and clarified. During the rulemaking process, to the degree possible and depending on the nature of the proposed rule, TM staff may seek additional information or details on costs from market participants. In certain situations, however, the SEC may be limited in its efforts to make a meaningful request for cost information, especially when the initial proposed release has not yet been made public and details about the proposed rulemaking are still under internal consideration and are nonpublic. Additionally, some regulated entities consider their compliance costs to be nonpublic confidential information that might be disclosed publicly if provided to the SEC.

TM gathers some quantitative information, mostly for PRA purposes, from the Securities Industry and Financial Markets Association (SIFMA) database, which contains information data repositories maintained by RSFI, such as industry salary by position (e.g., salary of the Chief Compliance Officer of a Fortune 500 Company). When formulating policy for a rulemaking

initiative, TM gives some consideration to existing requirements, to the extent applicable, in determining the potential paths for additional regulatory requirements. TM also considers results of OCIE examinations to determine areas where additional oversight may be necessary. For rulemaking initiatives required under Title VII of the Dodd-Frank Act, entitled "Wall Street Transparency and Accountability," SEC cross-divisional teams were created for each of the specific rulemakings.[24]

Further, TM may identify market-related problems through its ongoing supervision of regulated market entities. TM staff members also attend various industry conferences and meet with self-regulatory organizations (SROs) to gather information about market-related issues. The Dodd-Frank Act provided TM with authority over new market areas. TM solicited information from the public on various areas of the Dodd-Frank Act, met with various industry participants, and also held many roundtables (jointly with CFTC staff) to gather information on industry perspectives regarding regulatory provisions. TM also took steps to identify and hire industry experts who could assist with rulemaking initiatives to supplement its current staff.

During its rulemaking process, TM utilizes the expertise of RSFI to gather and analyze additional economic data to assist with the preparation of the cost-benefit analysis. TM is sometimes able to gather data for compliance costs through various industry data repositories such as the SIFMA database. In some instances, in connection with the proposing release, TM has to estimate the compliance costs that may be incurred as a result of a new rule. After a proposing release is distributed for public comment, TM begins to compile a comment summary to assist with the formation of the final analysis for the new rule.

During the period leading up to the adopting release, TM may receive additional comments from RSFI, OGC, or other divisions and offices. A term sheet is also prepared for the adopting release. TM rulemaking teams consist of attorneys, some with private sector work experience, including expertise in derivatives, and some with graduate business degrees as well as law degrees. Each rulemaking team generally has an Assistant Director serving as the team lead. The various rule drafts are reviewed and edited by the Assistant Director, Associate Director, Deputy Director, and Division Director. Additionally, OGC analyzes the adopting release, focusing on whether points raised for comment in the proposing release, as well as the comments received, have been addressed. TM indicated that typically there have been very few comments received on the numerical figures presented in the cost-benefit analysis section of a proposing release.

Division of Corporation Finance

CF does not view the cost-benefit analysis as a segregated process or exercise outside of the overall rulemaking process. Instead, it is viewed as a team approach involving fellow divisions and offices such as RSFI, TM, and IM. As part of the analysis for a proposed rule or regulatory policy initiative, CF sometimes first identifies current issues in disclosures based on the work performed by the disclosure operations offices. On other occasions, CF may identify potential rulemaking projects through rulemaking petitions submitted to the SEC or comments

[24] Title VII of the Dodd-Frank Act addresses the regulation of over-the-counter swaps markets and security-based swap markets.

from stakeholders such as investors or industry. "All hands" meetings with RSFI staff to begin discussions about proposed disclosure rule changes also allow for alternative options and approaches to be voiced and considered. In addition, RSFI sometimes provides CF with written comments suggesting alternative approaches that could be considered. CF also involves OGC early in the rulemaking process.

Once CF has prepared an issues list and preliminary recommendations, RSFI, OGC, and other relevant divisions are asked to provide comments on the preliminary recommendations. CF also typically circulates a term sheet outlining its preliminary recommendations to the Commission.[25] Thereafter, the rulemaking team begins to draft the proposing release.

When conducting the economic analysis for a proposed rule, CF attempts to retrieve as much data as possible through RSFI. RSFI may obtain data from multiple sources (e.g., external trade associations, research studies) and summarize the data in a different format for presentation to CF. Additionally, CF may consult with regulated entities to gather data but typically will not survey more than nine participants because of PRA restrictions.[26] CF also attempts to meet with any external parties who request a face-to-face meeting to discuss a proposed rule or regulation. CF stated that such external parties sometimes claim that the costs of the proposed rule or regulation are significant or more than the SEC estimates, but they rarely provide the SEC with tangible evidence to support such claims. After reviewing all comments and letters received in response to a proposed rulemaking, CF prepares a comment summary that discusses and categorizes the central issues raised during the comment period.

CF's rulemaking office[27] consists of a small number of professionals (fewer than 10), many with previous experience working in the disclosure operations side of CF and, in some instances, with private sector experience as well.[28] When new staff members enter the group, they receive training on various federal regulatory and administrative guidelines that govern the rulemaking process. In addition, CF has an informal checklist to assist rulemaking team members throughout the rulemaking process.

One CF staff member is typically assigned responsibility for drafting the release, with a supervisor also assigned to review the release.[29] In addition, multiple reviews are performed at the Office Chief, Deputy Director, and Director levels for each proposing release. During the review process, OGC may provide comments on a draft of the release asking for additional clarification and the rationale for any changes made to the proposing release or suggested

[25] This process has been slightly altered for some of the Dodd-Frank Act rulemaking initiatives because Congress directed the Commission to adopt rules on specific topics (e.g., specialized corporate disclosures).
[26] If more than nine participants are surveyed, under the PRA, the agency would be required to go through the OMB approval process before conducting the survey.
[27] Other support offices within CF, such as the Offices of International Corporation Finance, Mergers and Acquisitions, and Structured Finance, also undertake rulemaking projects related to their respective specialty areas.
[28] During the first 10 months after the Dodd-Frank Act was enacted, CF's rulemaking office hired four attorneys on a temporary basis from the disclosure operations side of CF to help with Dodd-Frank Act rulemaking projects.
[29] A more seasoned staff attorney was also assigned to each Dodd-Frank Act rulemaking team to help provide guidance for attorneys who were new to rulemaking because they had been temporarily detailed from the disclosure operations side of CF.

changes that were not made. Other divisions and offices are asked to review the release as deemed appropriate.

Division of Risk, Strategy, and Financial Innovation

In September 2009, the SEC created RSFI "to provide sophisticated, interdisciplinary analysis across the entire spectrum of SEC activities, including policymaking, rulemaking, enforcement, and examinations."[30] RSFI's responsibilities include those of the agency's former Office of Economic Analysis, whose staff RSFI assumed, along with those of other Commission offices.

RSFI helps assess the expected economic effects, including potentially unintended consequences, of rules proposed and adopted by the Commission, and of alternatives considered. RSFI helps the Commission identify the benefits and costs of proposed rule changes, including their economic effects. These include effects on competition, efficiency, and capital formation, as well as effects on markets and participants, including investors, issuers and intermediaries, such as broker-dealers, financial advisors and rating agencies.

Where possible, RSFI provides empirical bases for assessing the economic effects of Commission rules. When the Commission lacks the data necessary to assess the economic effects of a rulemaking initiative, RSFI provides a qualitative assessment of the rule's economic effects based on applicable economic theory and relevant evidence. RSFI also helps prepare appropriate questions for inclusion in the proposing release to elicit quantitative data and relevant qualitative information. RSFI works closely with the Commission's rulemaking Divisions and OGC to develop and review the written economic analyses contained in SEC proposing and adopting rule releases, and to maintain and improve the quality and consistency of those analyses.

RSFI's professionals include 35 staff with doctorates in finance, economics and allied quantitative disciplines, 15 MBAs, seven lawyers, four accountants, and one Masters of Financial Engineering. A significant portion of RSFI staff has established records of high quality academic research, while others have substantial Wall Street backgrounds in fields such as computer programming, data collection, directed statistical, quantitative, and qualitative analysis, and transactional experience.

RSFI's role in the drafting process for Dodd-Frank Act rules releases varies from rule to rule, based in part on the character of the rule and the scope of discretion granted to the Commission by Congress, and the sophistication of the economic analysis required. With respect to some rules, the rulemaking division turns the drafting of the cost-benefit or economic analysis over to RSFI, while in other cases RSFI prepares an appropriately detailed outline to ensure the important economic issues are addressed in the release. In still other cases, RSFI reviews and comments on release sections drafted by rulemaking division staff.

[30] SEC website description of Division of Risk, Strategy, and Financial Innovation, http://www.sec.gov/divisions/riskfin.shtml.

RSFI has developed, and continuously updates, internal training materials containing best practices for cost-benefit analyses. According to these materials, and depending on the particular rule in question, an economic analysis should be outlined based on the following broad principles:

- Economic Baseline – "How things are"
- Proposed Rules and Alternatives – "What we propose to do"
- Economic Analysis – "How things will then be"

According to RSFI, this general approach reflects a view that NSMIA's requirements to consider effects on efficiency, competition, and capital formation presuppose a cost-benefit analysis broadly consistent with the Executive Orders in the context of which of these effects will be considered, either as costs or as benefits. RSFI views competition and, generally speaking, efficiency to be attributes of markets, and considers identification of the market or markets that a given rule will effect to be the first step in the economic analysis of a rule. RSFI stressed that particular rules can be very complex and will not always follow a particular template, and that parts of the economic analysis, such as the baseline, can appear in any portion of the rule release.

In preparing for its contributions to the adopting release for a rule, RSFI staff review the summary of public comments prepared by staff of the rulemaking division to identify for fuller study comment letters providing or critiquing economic analysis or data. The rulemaking division staff will sometimes bring to RSFI's attention particular economically-oriented comment letters prior to preparation of the full comment summary.

RSFI noted that its responsibilities include rules proposed by all of the Commission's rulemaking divisions, and that budget and resource constraints necessarily limit the extent of the analysis that can be performed. In addition, in most cases, the PRA prevents the SEC from contacting more than nine respondents with the same question to obtain relevant data without prior permission from OMB, which is usually impractical given the tight deadlines for most rulemaking initiatives. OCIE examination reports and FINRA are additional sources of empirical data to inform rulemaking, but these also may be subject to legal restrictions that RSFI lawyers have been attempting to address.[31]

With the exception of determination required to be made pursuant to the Congressional Review provisions of the Small Business Regulatory Enforcement Act of 1996,[32] RSFI does not

[31] Because SROs are private corporations and do not have subpoena power, their members are required to voluntarily cooperate with investigators and provide testimony and documents. This has given rise to claims that FINRA, when it cooperates with governmental regulators, is acting as a "state actor." *Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office: Hearing Before the H. Committee on Fin. Serv.*, 111th Cong. (Oct. 6, 2009)(statement of Denise Voigt Crawford, Texas Securities Commissioner and President, North American Securities Administrators Association, Inc.) at 2.

[32] The required determination is whether or not the rule will have a "major" (*i.e.* > $100 million) impact on the economy. 5 U.S.C. § 804(2).

have a formal "sign off" on the written economic analysis included in the rule release, or on the final form of the rule itself, although the rulemaking division's action memorandum to the Commission reflects consultation with RSFI. RSFI is also not heavily involved in the calculation of PRA burden estimates, beyond providing access to the SIFMA database of personnel costs and the mechanical conversion of burden hours to dollar costs.

Despite resource constraints, RSFI has on occasion "backtested" SEC rules absent any express statutory or executive mandate to do so. Recent examples of backtesting related to short selling include an analysis of the emergency order requiring a "pre-borrow" on short sales[33] and periodic analyses of fails to deliver.[34] Although backtesting can be beneficial, the SEC does not have sufficient resources to backtest its rules on a regular basis.

Office of General Counsel

OGC generally provides comments on the cost-benefit analyses to the rulemaking division or office as part of OGC's review of the entire rulemaking release. Comments from OGC relate to economic implications as well as legal and policy issues. A number of OGC staff who review cost-benefit analyses have worked at other federal agencies, law firms, and other SEC divisions and offices.

When a new rulemaking initiative begins, the rulemaking division or office evaluates the economic implications of the proposed regulation and assesses the effects of various alternative approaches. In certain areas covered by the Dodd-Frank Act, the SEC has discretion to promulgate new regulatory policy or provide for oversight of entities that were previously not subject to SEC regulation. The OIG found from discussions with OGC that some of the Dodd-Frank Act's directives are not entirely clear or explicit, therefore requiring staff and the Commission to exercise judgment in determining how best to carry out the act's mandates or what degree of discretion the Commission possesses in implementing them. Even in areas in which Congress gives specific direction, the rulemaking division or office still must determine if other areas would be affected by the rule or if additional action is necessary as a result of the new rule or changes. According to OGC, the divisions and offices must consider these possible implications.

Prior to the initial drafting of a proposing release for a rule, OGC typically receives a draft term sheet from the rulemaking division or office that outlines the major aspects of the proposed rule. The term sheet is a two-to-five-page outline that includes information on some of the decisions made when considering the rulemaking. One of the purposes for consulting with OGC at this point is to begin the process of formulating the "back end" of the proposing release, including the costs and possible impact of the proposed rule. In some instances, the rulemaking division or office meets with OGC and RSFI prior to the creation of the term sheet. However,

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[33] Office of Economic Analysis Memorandum, "Analysis of the July Emergency Order Requiring a Pre-Borrow on Short Sales" (Jan. 14, 2009), http://www.sec.gov/spotlight/shortsales/oeamemo011409.pdf

[34] http://www.sec.gov/spotlight/shortsales/shortsales_archive.shtml contains links to seven Office of Economic Analysis Memoranda, dated from Aug. 21, 2006 through Apr. 16, 2009; RSFI Memorandum, "Impact of Recent SHO Rule Changes on Fails to Deliver" (Apr. 25, 2011), http://www.sec.gov/spotlight/shortsales/failsmemo042511.pdf

OGC's involvement typically occurs no later than the point at which the term sheet is developed. OGC may also review the "Reg. text," which is a draft of how the office or division ultimately wants the rule to look.

OGC reviews any discussion of quantifiable data contained in the proposing release, including the cost-benefit analysis and, although there is no formal vetting or recalculation, OGC typically asks questions to assess the source, accuracy, and strength of those numbers. In addition, during the rulemaking process, OGC may review comments received by the SEC on the proposing release, although the rulemaking division is primarily responsible for comment review. OGC also provides comments on the changes made by the rulemaking team to arrive at the adopting release version of the rule.

ANALYSIS OF THE SEC RULEMAKING PROCESS FOR THE SIX PROPOSED RULES IDENTIFIED IN THE CONGRESSIONAL REQUEST

Introduction

The May 4, 2011, letter from the Senate Banking Committee requested information for six specific rulemakings. Each of these rulemakings is discussed below, including background on the proposed rule, the division responsible for the rulemaking, and other offices or divisions consulted in the process. Before any of these rulemakings began, the SEC posted a general request for comment on all Dodd-Frank-related rulemakings on the Commission's public website. Each division, prior to drafting any of these proposed rules, reviewed the comments received and, if applicable, incorporated information from relevant comments.[35]

For each of the six rulemakings, Commission staff conducted an economic or cost-benefit analysis. The OIG assessed these analyses and generally found that the rulemaking division responsible for the specific rule took the lead but was heavily supported by RSFI and OGC. For two rules in particular, pertaining to municipal advisors and credit risk retention, RSFI was integrally involved in the process and assisted in the initial drafting of the economic analysis section of the proposing release. The OIG further assessed that there was less reliance on and collaboration with RSFI with respect to the proposed rule regarding clearing agency standards for operation and governance. Specifically, and as discussed further below, RSFI did not provide input with respect to a certain key area of this proposed rule.

Although the rulemaking divisions are rarely able to quantify the economic impact of a proposed rule, potential costs and benefits were set forth in each of the six proposed rules. Each rule proposal contained an economic analysis section, but RSFI staff also stated that economic analysis is pervasive throughout the entire rulemaking process and that every aspect of the rulemaking takes into account possible economic impact. Further, Commission staff time and costs are not taken into consideration when determining any cost estimates.

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[35] Copies of comments received in response to the Commission's request for comments regarding the various rulemaking initiatives required by the Dodd-Frank Act are available on the SEC's website at http://www.sec.gov/spotlight/regreformcomments.shtml.

Rulemakings Reviewed

a. Credit Risk Retention

i. Description of Rulemaking

Section 941 of the Dodd-Frank Act, entitled, "Regulation of Credit Risk Retention," amended the Exchange Act to add Section 15G, which generally requires the securitizer of asset-backed securities to retain at least 5 percent of the credit risk of the assets collateralizing the asset-backed securities.[36] More specifically, Section 941 required the SEC and the federal banking agencies (i.e., the Federal Reserve, FDIC and OCC), and, in the case of the securitization of any residential mortgage asset, together with the Department of Housing and Urban Development (HUD) and the Federal Housing Finance Agency (FHFA), to jointly prescribe regulations that (1) require a securitizer to retain at least five percent of the credit risk of any asset that the securitizer transfers, sells, or conveys to a third party through the issuance of an asset-backed security, and (2) prohibit a securitizer from directly or indirectly hedging or otherwise transferring credit risk that the securitizer is required to retain under Section 15G and the agencies' implementing rules.[37] Also included in Section 15G are various exemptions, including an exemption for asset-backed securities that are collateralized exclusively by "qualified residential mortgages" as that term is jointly defined by the agencies.[38]

Section 941(c) of the Dodd-Frank Act required the Federal Reserve, in coordination and consultation with the Comptroller of the Currency, the Director of the Office of Thrift Supervision, the Chairperson of the FDIC, and the SEC to conduct a study of the combined impact of each individual class of asset-backed security of the new credit risk retention requirements. This Section also required the Federal Reserve to submit to Congress a report on its study within 90 days after the enactment of the Dodd-Frank Act. In October 2010, the Federal Reserve issued its report to Congress on the potential impact of credit risk retention requirements on securitization markets. The report highlighted the significant differences in market practices and performance across securitizations backed by different types of assets and recommended that the federal banking agencies take these differences into account when developing the rules required by Section 941 of the Dodd-Frank Act.[39]

The SEC, OCC, Federal Reserve, FDIC, FHFA and HUD issued a proposed rule, entitled "Credit Risk Retention, to implement the requirements of Section 15(G) of the Exchange Act, as added by Section 941 of the Dodd-Frank Act.[40] Overall, the proposed rule specified the credit risk retention requirements for securitizers of asset-backed securities pursuant to the statutory requirements, prescribed underwriting criteria for qualified residential mortgages and certain

[36] 15 U.S.C. § 78o-11. An "asset-backed security" is defined in Section 3(a)(77) of the Exchange Act (which was added by Section 941 of the Dodd-Frank Act) as "a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset . . . ." 15 U.S.C. § 78c(a)(77).

[37] 15 U.S.C. § 78o-11(b), (c)(1)(A) and (c)(1)(B)(ii).

[38] 15 U.S.C. § 78o-11(c)(1)(C)(iii), 4(A) and (B).

[39] Board of Governors of the Federal Reserve System, Report to Congress on Risk Retention, at 3 (October 2010).

[40] Credit Risk Retention Proposed Rule, 76 Fed. Reg. 24090 (Apr. 29, 2011).

other asset classes, and provided that sponsors of securitizations of these qualified assets are not required to retain risk under Section 15G.[41]

ii. Economic Analysis

CF led the Credit Risk Retention rulemaking effort on behalf of the SEC. Because this was a joint rulemaking, the process began with coordination with the other agencies involved. Meetings among the agencies began in late September 2010.

Staff from CF, RSFI, and sometimes the Office of Chief Accountant (OCA), participated in approximately three meetings with staff from other agencies (FDIC, Federal Reserve – including the New York Federal Reserve Bank, OCC, FHFA and HUD) to develop the proposed rules. Each of these interagency meetings lasted approximately two to three hours. CF and RSFI worked together to develop a proposed rule, but OGC was also consulted often during the process in order to interpret the statute and rule objectives. In addition, OCA staff were involved in meetings early in the process. Also consulted, but to a lesser degree, were staff from Enforcement, the Office of International Affairs, IM, and TM.

Two economists from RSFI were assigned to the rulemaking and were heavily involved in the rulemaking process and the corresponding economic analysis. RSFI staff utilized the study conducted by the Federal Reserve on credit risk retention requirements and undertook analyses and assessments of the possible impact of the rule. Based on its early participation in discussions and meetings regarding the rulemaking and its familiarity with academic literature on the topic, RSFI prepared a detailed outline of costs and benefits to be included in the economic analysis section of the proposed rule and prepared the first draft of that section. To prepare its outline, RSFI looked at the congressional mandate to determine the extent of discretion that the SEC and the federal banking agencies had in implementing the rule, reviewed data provided by the Federal Reserve and FHFA, and spoke with economists from the other agencies with responsibility for the rulemaking. Staff from OGC were also involved in this process at early stages of the rulemaking.

Section 15G of the Dodd-Frank Act directed the relevant rulemaking agencies to require a securitizer to retain not less than 5 percent of the risk for any asset. According to the statute, the rules can provide for a less than 5 percent of the credit risk retention requirement for an asset that is not a qualified residential mortgage that is transferred, sold, or conveyed through the issuance of an asset-backed security by the securitizer if the originator meets certain underwriting standards that are established by the federal banking agencies.[42] The agencies responsible for the rulemaking chose to offer a "menu" consisting of several alternative risk retention methods in an effort to "structure the proposed risk retention requirements in a flexible manner that would allow the securitization markets for non-qualified assets to function in a

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[41] Under Section 941 of the Dodd-Frank Act, while the Commission and other agencies jointly define a "qualified residential mortgage," only the federal baking agencies are required and authorized to establish the underwriting standards for asset classes outside of a "qualified residential mortgage." 15 U.S.C. § 78o-11(c)(2)(B).

[42] 15 U.S.C. § 78o-11(c)(1)(B)(i) and (ii).

manner that both facilitates the flow of credit to consumers and businesses on economically viable terms and is consistent with the protection of investors."[43]

The costs and benefits were set out separately for the various menu options. Commission staff stated that although they had extensive knowledge related to credit risk retention and felt very prepared when proposing the rule and performing the related economic analysis, they found it difficult to quantify associated costs and benefits and, as a result, provided primarily qualitative analyses. For this rulemaking, as noted above, RSFI was responsible for drafting the economic analysis section. Although this portion of the proposing release was not officially drafted until after extensive discussions had taken place and the rule began to take shape, the possible costs and benefits associated with the rule were considered throughout the entire process of developing the proposal.

Benefits that were identified as being associated with the proposed rule included the flexibility offered to sponsors of securitization transactions by providing them with several risk retention methods from which to choose.[44] Specifically, the proposing release noted that "allowing sponsors to choose a form of risk retention from a menu of options provides them with the flexibility of choosing the form that best suits their operational and financing preferences."[45] The rulemaking agencies also made an effort to include options that represented current market practices to limit disruption to current securitization practices to the extent possible.[46]

Another benefit specified in the proposing release was that requiring disclosure of retained credit risk would provide investors with relevant information regarding sponsors' retained interest in asset-backed securities transactions, thus allowing investors to make informed investment decisions.[47] Specific benefits associated with the various risk retention methods included alignment of investors' incentives with those of originators and sponsors of asset-backed securities, and the balancing of implementation costs for sponsors.[48]

The proposing release also discussed benefits associated with the proposed definition of "qualified residential mortgages." The rulemaking agencies reviewed data prepared by Lender Processing Services' Applied Analytics Division[49] and data from the triennial Survey of Consumer Finances,[50] and the agencies' analysis of this data supported the proposed definition.[51]

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[43] Credit Risk Retention Proposed Rule, 76 Fed. Reg. 24090, 24096-97 (Apr. 29, 2011).
[44] According to the proposing release, a "sponsor" is essentially a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly to the issuer. *Id.* at 24098.
[45] *Id.* at 24151.
[46] *Id.*
[47] *Id.*
[48] *Id.* at 24151, 24152.
[49] Lending Processing Services provides integrated technology and services to the mortgage and secondary market industries. http://www.imn.org/web/pages/sponsor.cfm?sponsor_id=20413. Its Applied Analytics Division "provides comprehensive data, analytics, valuations, modeling and expertise to help mortgage participants gain efficiencies, mitigate losses and position themselves for future growth and to create portfolio transparency for the origination, servicing and secondary markets." *Id.*
[50] The Survey of Consumer Finances is a study sponsored by the Federal Reserve in cooperation with the Department of the Treasury that "is conducted every three years to provide detailed information on the finances of U.S. families." http://www.federalreserve.gov/pubs/oss/oss2/about.html.
[51] Credit Risk Retention Proposed Rule, 76 Fed. Reg. 24090, 24152 (Apr. 29, 2011).

The Federal Reserve and FHFA provided this information, but it was analyzed by RSFI. A stated benefit of the chosen definition was that it should not be disruptive to existing lending practices.[52]

The proposing release also included a provision requiring that an operating adviser oversee the servicing activities of "B-piece buyers," i.e., third party purchasers who, under common market practice, have retained the first-loss position in commercial mortgage-back transactions, under certain circumstances. The benefit cited for this provision was that it would minimize B-piece buyers' ability to manipulate cash flows through special servicing.[53]

In addition, the proposing agencies believed that imposing risk retention standards on sponsors, rather than on originators, should improve underwriting standards, as sponsors "would have strong incentives to monitor the lending practices of originators and consider these practices when acquiring pool assets."[54]

Among the costs cited in the proposed rule cited were the compliance costs to sponsors to prepare and provide disclosures to investors. Although provision of a menu of risk retention methods was intended to give flexibility to sponsors, it also introduced the possibility that, some sponsors might choose "risk retention methods that do not align fully their incentives with those of investors," or that sponsors might have to incur additional financing costs that would have the effect of impeding capital.[55]

According to the proposing release, the Commission did not expect that loan originators would have to incur significant additional costs to collect information in accordance with the proposed underwriting procedures for qualified residential mortgages, but did state that additional costs might be incurred if loan originators and sponsors have to modify their loan origination systems and processes.[56] The proposing release also stated that compliance costs would increase because of the requirement that an operating adviser oversee B-piece buyer servicing activities.[57]

Although CF and RSFI staff stated that they made their best effort to qualitatively describe the costs and benefits of the proposed rule, neither was able to quantify the costs and benefits. The proposed rule requested comment on the potential impact of the proposal on the U.S. economy, any potential increase in costs or prices for consumers or individual industries, and any potential effect on competition, investment, or innovation.[58]

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[52] *Id.*
[53] *Id.* at 24154. "Special servicing" refers to the practice by which a B-piece buyer designates itself or an affiliated company as the "special servicer" in the transaction, which has the potential to create conflicts of interest. *Id.* at 24109.
[54] *Id.* at 24153.
[55] *Id.* at 24151.
[56] *Id.* at 24152, 24153.
[57] *Id.* at 24154.
[58] *Id.* at 24155.

Also included in the proposing release were cost estimates for the collection of information as required by the PRA. For each of the rulemaking agencies, the proposal contained a specific estimate of the paperwork burden and an explanation of the calculation.[59]

According to CF staff, the significant involvement of RSFI in the development of the economic analysis early and throughout the rulemaking was instrumental to the final work product. When estimating the costs associated with the paperwork burden, CF and RSFI used information regarding the universe of sponsors that would be required to comply with the rule and estimated the burden hours that would be required based on similar disclosure obligations. The proposing release contained detailed information regarding the calculations and the source of the information used to arrive at those calculations. Comments were invited on, among other things, "[t]he accuracy of the estimates of the burden of the information collections, including the validity of the methodology and assumptions used."[60]

iii. Comments Received

The proposing release sought comment on all areas of the proposal, including the proposed costs and benefits. The comment period was originally scheduled to end on June 10, 2011, but on June 6, 2011, it was extended until August 1, 2011. Approximately 25 comments had been received as of June 3, 2011, but CF indicated that the number of comments tends to increase nearer to the closing date.[61] CF has indicated that it will prepare a comment summary after the comment period has closed and submit it to RSFI and OGC for review.

Of the comments received as of June 3, 2011, approximately 25 percent expressed general opposition to the imposition of a 5 percent risk retention requirement. Because the 5 percent risk retention requirement is mandated by the Dodd-Frank Act, however, CF has no discretion to change this aspect of the proposed rule, despite these comments. Other comments stated that the 20 percent down payment required for a residential mortgage to be deemed qualified was too high. The comments received as of June 3, 2011, did not specifically address the economic analysis or PRA analysis. Because comments are still being received and analyzed, it is not yet known what changes might be made to the proposed rule based on comments received.

b. Clearing Agency Standards for Operation and Governance

i. Description of Rulemaking

Section 17A of the Exchange Act authorized the Commission to issue rules governing clearing agencies.[62] Clearing agencies generally act as middlemen to the parties in a securities transaction and "play a critical role in the securities markets by ensuring that transactions settle

[59] *Id.* at 24148-49.
[60] *Id.* at 24146.
[61] Copies of comments received on this proposal are available on the SEC's website at http://www.sec.gov/comments/s7-14-11/s71411.shtml.
[62] 15 U.S.C. § 78q-1.

on time and on the agreed-upon terms."[63] "The Dodd-Frank Act enhanced the Commission's authority to adopt rules addressing risk management standards for clearing agencies that are systemically important."[64] The Dodd-Frank Act also amended the Exchange Act "to grant the Commission authority to write rules governing those who are registered as clearing agencies for security-based swaps."[65]

In accordance with Sections 763 and 805 of the Dodd-Frank Act and Section 17A of the Exchange Act, the SEC proposed rules regarding registration of clearing agencies and standards for their operation and governance.[66] The proposed rules would set standards for the operations and governance of clearing agencies, regulate security-based swaps as specifically authorized by the Dodd-Frank Act, and apply in varying degrees for four different categories of clearing agencies. In proposing the new rules, the Commission stated that it "preliminarily believes that applying certain rules to all clearing agencies would promote financial stability, one of the goals of the Dodd-Frank Act, by facilitating prompt and accurate clearance and settlement of all securities transactions consistent with Section 17A of the Exchange Act while promoting the Dodd-Frank Act's stated aims of accountability and transparency."[67]

ii. Economic Analysis

TM was the SEC division that led the rulemaking on clearing agency standards for operation and governance. As the benchmark for formulating such rules, TM used existing international standards addressing risk management of clearing agencies that were developed by the Technical Committee of the International Organization of Securities Commissions and the Committee on Payment and Settlement Systems of the Bank for International Settlements.[68] Additionally, TM considered Credit Default Swap (CDS) Clearing Exemption Orders in formulating the requirement for clearing agencies that perform central counterparty (CCP) services to disseminate pricing and valuation information for security-based swaps.[69] TM created an interdepartmental group in October 2010 consisting of staff from TM, RSFI, and OGC to participate in developing the proposed rule. TM also met with other federal financial regulators, such as CFTC, during the rulemaking initiative.

During the initial phase of the rulemaking process, participants had discussions to identify the level of discretion that the Commission could exercise in promulgating rules and ensuring that any requirements for clearing agency standards for operation and governance that were mandated by the Dodd-Frank Act were addressed. RSFI and OGC provided comments on the draft of the proposing release.

Throughout the proposing release, TM used a consistent approach in outlining and presenting each operational and governance standard requirement of the rule. In the cost-benefit

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[63] SEC Press Release 2011-58 (Mar. 2, 2011).
[64] *Id.*
[65] *Id.*
[66] Clearing Agency Standards for Operation and Governance; Proposed Rule, 76 Fed. Reg. 14472 (Mar. 16, 2011).
[67] *Id.* at 14474.
[68] *Id.* at 14476.
[69] *Id.* at 14492. The proposing release specifically mentioned and cited the CDS Clearing and Exemption Order relating to ICE Trust, Exchange Act Release No. 63387 (Nov. 29, 2010), 75 Fed. Reg. 75502 (Dec. 3, 2010).

analysis section, TM used a similar approach to identify the estimated benefits and related compliance costs associated with each of the proposed rule's operational and governance standards. The costs and benefits of each component of the proposed rule were stated separately.

Among the benefits of the proposed rule that were cited was "promoting implementation of measures that would enhance the safety and efficiency of clearing agencies and reduce systemic risk."[70] Specifically, the proposed rule would help protect "the assets of investors from claims by creditors of intermediaries and other entities that perform various functions in the operation of the clearing agency."[71] Further, net capital requirements in the proposed rule "would help remove an overly burdensome barrier to clearing agency access for market participants with a net capital level of at least $50 million, and promote greater direct access to clearing agencies."[72]

Also cited as benefits of the proposed rule were certain components of the clearing agency standards that would help "to manage systemic risk as increasing amounts of clearance and settlement activity is centralized within clearing agencies."[73] These components relate to measurement and management of credit exposures, margin requirements, and financial resources.[74]

Additional benefits of the rule referred to in the proposing release included publicly available pricing and valuation information and increased confidence in the safety and reliability of clearing agencies.[75] In addition, the proposing release stated that the requirement for clearing agencies to create written policies and procedures would help clearing agencies evaluate their organization and activities and identify areas that might undermine the clearing agency's core business.[76] Furthermore, "[r]equiring registered clearing agencies to establish standards for their board and board committee members helps to ensure that well-qualified individuals contribute to effective governance of a clearing agency."[77]

Costs associated with the proposed rule include those necessary to adjust systems, to perform ongoing monitoring and enforcement activities relating to the policies and procedures the clearing agencies create in response to the proposed standards, and to update policies and procedures.[78] According to the proposing release, some of the costs will be one-time expenditures, while others will be ongoing.

As required by the PRA, the proposing release also included estimated information regarding collection costs—both the estimated paperwork burden and an explanation of the

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[70] Clearing Agency Standards for Operation and Governance, Proposed Rule, 76 Fed. Reg. 14472, 14528 (Mar. 16, 2011).
[71] *Id.*
[72] *Id.*
[73] *Id.*
[74] *Id.*
[75] *Id.* at 14530, 14531.
[76] *Id.* at 14532.
[77] *Id.*
[78] *Id.* at 14528-14529.

calculation.[79] These estimates were based on conversations with industry representatives and on the implementation costs for Regulation NMS[80] and security-based swap data repositories.[81] One-time costs and ongoing annual costs were detailed, including labor categories (e.g., compliance attorney, risk management specialist) necessary to carry out the new requirements, estimated hourly rates for such positions, and the number of respondent clearing agencies expected to comply with the requirement.

Based on discussions with TM staff involved with this rulemaking, the OIG found that there was limited discussion of the macro-level costs associated with the clearing agency standards included in the cost-benefit analysis because in some cases existing industry practice was believed to have been generally consistent with the proposed requirements or TM considered these costs to be difficult to quantify. TM's failure to more fully address macro-level costs appears to vary from the guidance issued by OGC in the Compliance Handbook, which states that cost-benefit analysis should address both micro, or compliance, costs and macro costs, such as distributional effects or changes in investment or order flows."[82]

Proposed Rule 17Ad-22(d)(3) is an example of an instance in this rulemaking in which macro costs do not appear to have been adequately considered. The proposed rule "would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to hold assets in a manner that minimizes risk of loss or delay in access to them, and to invest assets in instruments with minimal credit, market, and liquidity risks."[83] The OIG found that the cost-benefit analysis for this proposed rule did not include significant discussion of the effects, if any, of proposed Rule 17Ad-22(d)(3) on changes the clearing agencies might have to make to their overall investment policies and strategies. Professor Kyle stressed the importance of attempting to consider the macro, as well as micro costs, of a proposed rule. He explained that micro costs are compliance costs, while macro costs result from changes in behavior apart from compliance costs. According to Professor Kyle, a dollar of macro costs is just as important as a dollar of micro costs. The requirement of proposed Rule 17Ad-22(d)(3) that clearing agencies invest assets in instruments with minimal credit, market, and liquidity risks might result in macro costs and benefits by affecting the way in which participants use the services of the CCP.

Professor Kyle further observed that the low interest rates earned on very safe investments may well be passed along to participants, thus imposing a macro cost and reducing the use of the services of the CCP. However, if a result of the rule is that participants can rely on the CCP to perform well in times of financial distress, the perceived safety of the CCP will create a macro benefit. According to Professor Kyle, these macro costs and benefits are magnified to the extent that implementation of the Dodd-Frank Act pushes more business to use CCPs.

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[79] *Id.* at 14501-14527.

[80] Regulation NMS contained a series of initiatives to modernize and strengthen the national market system (NMS) for equity securities. Final rules and amendment to joint industry plans, Release No. 34-51808 (June 9, 2005).

[81] Clearing Agency Standards for Operation and Governance, Proposed Rule, 76 Fed. Reg. 14472, 14509 (Mar. 16, 2011).

[82] SEC Compliance Handbook at 38.

[83] Clearing Agency Standards for Operation and Governance, Proposed Rule, 76 Fed. Reg. 14472, 14515 (Mar. 16, 2011).

RSFI informed us that although it had the opportunity to provide comments to TM on the proposing release, RSFI did not review all the modified content prior to issuance of the release. For example, RSFI stated to the OIG that the highlighted portion of the following provision in Proposed Rule 17Ad-22(c) regarding access requirements to clearing agencies for persons who are not dealers or security-based swap dealers was initially not included[84] in earlier drafts of the proposing release that had been provided to RSFI for comment:

> The proposed rule would also require membership access to clearing agencies for persons that are not dealers or security-based swap dealers, *prohibit the use of minimum portfolio size and minimum volume transaction thresholds as a condition for membership at a clearing agency, and permit membership access to a clearing agency by persons with net capital equal to or greater than $50 million.*[85]

In the opinion of RSFI, such a change from the earlier drafts (which did not contain the $50 million threshold) merited and would have benefited from RSFI's assessment of the economic impact of this provision.

RSFI also commented to the OIG that while it considers its working relationship with TM to be characterized by open communication and collaboration, the level of communication with and involvement of RSFI varies from rulemaking to rulemaking. RSFI noted that the communication with TM in connection with this rulemaking, specifically with respect to changes to the proposed rule made late in the process, could have been better.

According to Professor Kyle, it is critically important for RSFI to be an integral part of the process for an effective cost-benefit analysis. Performing a cost-benefit analysis is fundamentally an exercise in economics. Professor Kyle noted that the employees in RSFI have broader and deeper expertise in economics than the employees outside of RSFI. Furthermore, economists often have skills in econometrics and familiarity with the economic data that are critical for quantifying costs and benefits. The level of RSFI involvement in the SEC's performance of cost-benefit analyses will be a focus for the OIG as we continue our review in this area with the services of our expert consultant, Professor Kyle.

iii. Comments Received

The proposing release sought comment on all areas of the proposal, including the proposed costs and benefits and any costs that had not been considered, whether better alternatives exist, and whether the estimates contained in the proposing release are accurate. The comment period ended on April 29, 2011, but the OIG found that comments have been received and meetings with industry representatives have occurred after that date.

[84] Although TM indicated that RSFI was eventually presented with drafts that contained this comment, RSFI noted that, even at that later date, this comment was not flagged for RSFI. According to RSFI, because of the press of other business, when significant changes in a key element of a rule are made late in the process, RSFI relies on the rulemaking division to call these changes to the attention of its senior staff, as a matter of best practice. Otherwise, the changes may not receive appropriate scrutiny.

[85] Clearing Agency Standards for Operation and Governance, Proposed Rule, 76 Fed. Reg. 14472, 14477 (Mar. 16, 2011)(emphasis added).

As of June 3, 2011, the SEC had received approximately 20 formal, written comments on this proposing release.[86] A number of these comments were from clearing agencies and industry groups, and the comments expressed a wide range of viewpoints and perspectives.

In particular, one commenter claimed that no cost-benefit analysis had been performed to assess the impact the proposed requirement that clearing agencies serving as central counterparties (i.e., financial institutions that act as intermediaries between security market participants) maintain financial resources to withstand default by the two participant families (rather than one) to which it has the largest exposure in certain extreme market conditions.[87]

Another commenter stated that the "record keeping requirements of the Proposal would prove so burdensome to such providers [of post-trade processing services] that the efficiency and alacrity that they provide to the [credit default swap] industry would be adversely affected."[88] Other commenters raised concerns about the possible costs Proposed Rule 17Aj-1 (pertaining to dissemination of pricing and evaluation information by security-based swap clearing agencies) would impose on market participants,[89] and the proposal's "onerous registration requirements."[90]

c. Registration and Regulation of Security-Based Swap Execution Facilities

i. Description of Rulemaking

The Dodd-Frank Act required the SEC to establish a registration framework for security-based swap execution facilities (SB SEF)[91] and required SB SEFs to comply with 14 core principles. Specifically, the Dodd-Frank Act amended the Exchange Act to require that certain security-based swap transactions be cleared through a clearing agency, executed on an exchange or on a registered SB SEF, and all security-based swaps be reported to a registered security-based swap data repository or the SEC.[92]

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[86] Copies of comments received on this proposal are available on the SEC's website at http://www.sec.gov/comments/s7-08-11/s70811.shtml.

[87] *See* letter to Elizabeth M. Murphy, Secretary, Commission, from Larry E. Thompsen, General Counsel, Depository Trust & Clearing Corporation, April 29, 2011, at 12. According to Mr. Thompsen's comment letter, the term "participant family" should be used to include each participant that controls, is controlled by or is under common control with another participant, with control meaning the disclosed ownership of 50% or more of the voting securities or other interests of a participant. *Id.* at 10.

[88] *See* letter to Elizabeth M. Murphy, Secretary, Commission, from R. Trabue Bland, Intercontinental Exchange, Inc., April 29, 2011, at 2.

[89] *See* letter to Elizabeth M. Murphy, Secretary, Commission, from Joanne Medero, Richard Prager, and Supurna VedBrat, BlackRock, April 29, 2011, at 4.

[90] *See* letter to Elizabeth M. Murphy, Secretary, Commission, from Christoffer Mohammar, General Counsel, TriOptima Group, April 29, 2011, at 12.

[91] The definition of an SB SEF is one topic discussed in the proposing release. A "swap" is a derivate contract that is traded in the over-the-counter market; a "security-based swap," over which the SEC has authority," is broadly defined as a swap based on a single security, a loan, a narrow-based group or index of securities, or events relating to an issuer or issuers of securities in a narrow-based security index. SEC Press Release 2011-35 (Feb. 2, 2011), at 2.

[92] Registration and Regulation of Security-Based Swap Execution Facilities, Proposed Rule, 76 Fed. Reg. 10948, 10948-49 (Feb. 28, 2011).

The Commission, in accordance with Section 763, proposed Regulation SB SEF under the Exchange Act to create a registration framework for SB SEFs, establish rules with respect to the Dodd-Frank Act's requirement that an SF SEF comply with the fourteen enumerated principles and enforce compliance with those principles, and implement a process for an SB SEF to submit to the Commission proposed changes to the SB SEF's rules.[93]

ii. Economic Analysis

TM was the lead division for the rulemaking on registration and regulation of SB SEFs. Given the breadth of this rulemaking, TM assembled a relatively large team to work on this rulemaking (nine staff members). TM staff met with RSFI and OGC early in the rulemaking process. In addition, TM held a roundtable discussion with CFTC staff[94] in September 2010, and conducted additional roundtables to discuss the rule proposal. One or more staff members from RSFI attended each of these roundtable meetings.

Much information regarding this rule proposal was gathered through meetings with prospective SB SEFs. Specifically, the staff solicited comments on possible costs and benefits of registration, as well as transparency and possible market impact implications.

The economic analysis for this rulemaking , including the likely market impact of the rule, was considered from the beginning of the rulemaking process and continued though the drafting of the release. TM prepared much of the initial draft of the economic analysis section of the proposing release, although RSFI and OGC reviewed TM's draft and provided comments. Three economists from RSFI participated in this rulemaking, including discussing the effects of alternative approaches on the market before the drafting of the release began and, along with OGC, continued to be consulted throughout the drafting process.

Benefits associated with the proposed rule included bringing more transparency to and improving oversight of the security-based swap market. Specifically, the proposed rule would require SB SEFs to maintain an audit trail and surveillance systems to monitor trading, which would better enable them to oversee trading and detect and deter fraudulent and manipulative activity.[95]

The proposed rule was expected to increase access to security-based swap trading venues and, as a result, would have the benefit of increasing competition in this market.[96] Another benefit cited in the proposing rule was that the rule should provide sufficient flexibility for market participants to create and operate a variety of SB SEFs.[97] Further, the requirement that SB SEFs submit annual compliance reports and financial reports to the SEC would assist the SEC in monitoring the compliance activities and the financial state of SB SEFs.[98]

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[93] *Id.* at 10948.
[94] Under the Dodd-Frank Act, the CFTC regulates swaps, the SEC regulates security-based swaps, and the CFTC and SEC jointly regulated mixed swaps. *Id.*
[95] *Id.* at 11037.
[96] *Id.* at 11037-38.
[97] *Id.* at 11038.
[98] *Id.* at 11039.

The economic analysis section of the proposed rule contained detailed cost estimates, including the anticipated costs of forming an SB SEF, software and product development costs, compliance costs specifically related to registration, costs to compile and review financial statements, and filings costs. Many of these costs were also discussed in the section of the proposing release that addressed the PRA's requirements.

The proposing release also included discussion of contemplated general economic impact costs, such as the effect of the rule on market participants' incentive to trade, where and how security-based swaps are traded, and the number of entities that actually register as SB SEFs, thereby affecting competition.[99] The proposal also discussed the possibility that if the rules were perceived as too burdensome, some trading might move to foreign markets with less restrictive rules.[100] If, on the other hand, the rules were too lenient, they might have little impact or no impact market structure and surveillance, possibly resulting in the loss of many of the intended benefits of the rulemaking and failure to achieve the Dodd-Frank Act's goal of greater transparency.[101]

The proposing release also stated, "Considering the early stage of regulatory development and the existing structure of the SB swaps market, . . . the Commission is mindful that the proposed rules could have unforeseen consequences, either beneficial or undesirable, with respect to the shape that this market will take."[102]

iii. Comments Received

The SEC invited comments on all aspects of the proposed rule, including, among other things, the costs associated with the proposed rule, specifically, the initial costs of completing the registration form and any ongoing compliance costs. Also requested were comments on any costs and benefits not discussed in the proposal and possible alternatives to the proposal. Additionally, comments were sought on the general impact the proposal would have on the markets for security-based swaps.

The comment period ended on April 4, 2011. Approximately 35 comment letters were received as of June 3, 2011.[103] In addition, TM held more than 15 in-person meetings with potential SB SEFs. TM is in the process of reviewing the comments received and will prepare a comment summary that will be distributed to RSFI and OGC for review and input.

Our review of the comment letters submitted revealed that only one letter commented specifically on the cost estimates provided in the release.[104] One comment letter expressed the belief that the proposed rule would "disrupt markets or adversely affect institutional or corporate

[99] *Id.* at 11040.
[100] *Id.*
[101] *Id.*
[102] *Id.* at 11036.
[103] Copies of comments received on this proposal are available on the SEC's website at http://www.sec.gov/comments/s7-06-11/s70611.shtml.
[104] *See* letter to Elizabeth M. Murphy, Secretary, Commission, from Richard M. McVey, Chairman and Chief Executive Officer, MarketAxess Holdings, Inc., April 4, 2011, at 14-16.

users of swaps,"[105] and another comment letter pointed out the substantial amount of resources that would have to be invested to implement the rule.[106] Although TM indicated that it is too early to determine what changes will be made as a result of the comments received, TM noted that the majority of the comments were in favor of the proposed rule.

d. Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF

i. Description of Rulemaking

The Financial Stability Oversight Council (FSOC) was created by Title I of the Dodd-Frank Act, entitled "Financial Stability." Pursuant to Section 111 of the Dodd-Frank Act, FSOC's voting members include the Secretary of the Treasury (who serves as the FSOC Chairperson), the Chairman of the Federal Reserve, the Comptroller of the Currency, the Chairman of the SEC, the Chairperson of the FDIC, the Chairman of the CFTC, the Director of the FHFA, the Chairman of the National Credit Union Administration, the Director of the newly-created Consumer Financial Protection Bureau, and an independent member appointed by the President. Section 112 of the Dodd-Frank Act directs the FSOC, among other things, to identify and monitor emerging risks to financial stability and recommend standards for nonbank financial companies.

Additionally, the Dodd-Frank Act amended certain statutes, including the Advisers Act, to authorize or direct certain federal agencies to support FSOC. In particular, Section 404 of the Dodd-Frank Act amended Section 204(b) of the Advisers Act to require investment advisers registered with the SEC that advise one or more private funds to maintain records and file reports containing information deemed necessary or appropriate for investor protection and the assessment of systemic risk by FSOC.[107] To fulfill this mandate, the Commission, in a joint rulemaking with CFTC, proposed Rule 204(b)-1, which would require private fund advisers to report information for use by FSOC in monitoring risk to the U.S. financial system on Form PF.[108] Private funds would report on Form PF non-public information about the operations of the funds and their trading strategies.[109] The information required to be collected or maintained under the Dodd-Frank Act includes information about assets under management, use of leverage, counterparty risk exposure, and trading and investment positions.[110] The SEC and CFTC designed Form PF in consultation with FSOC, and the amount of information required to be reported would vary depending on the size of the adviser and the type of fund it advises.[111]

[105] *See* letter to Elizabeth M. Murphy, Secretary, Commission, and David A. Stawick, Secretary, CFTC, from Edward J. Rosen, Cleary Gottlieb Steen & Hamilton LLP, April 5, 2011, at 1-2.
[106] *See* letter to Elizabeth M. Murphy, Secretary, Commission, from Stephen Merkel, Chairman, et al., Wholesale Markets Brokers' Association, April 4, 2011, at 13.
[107] Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF; Proposed Rule, 76 Fed. Reg. 8068, 8069 (Feb. 11, 2011).
[108] *Id.* at 8068.
[109] *Id.* at 8071.
[110] *Id.* at 8069.
[111] *Id.* at 8072.

ii. Economic Analysis

IM led this rulemaking on behalf of the SEC, which, as noted above, was conducted jointly with CFTC. IM stated that this rulemaking was different from others, primarily because it involved drafting a form with the primary purpose of collecting information for another entity. As a result, it was important for IM, when drafting the proposed rule, to justify the basis for collecting information required to be provided under the rule.

In creating Form PF, IM and CFTC considered and incorporated provisions of a hedge fund survey conducted by the United Kingdom's FSA.[112] IM also obtained information from industry participants prior to the issuance of the rule proposal. From the information obtained, IM created a term sheet that it submitted to RSFI and OGC for review. RSFI was especially involved in the drafting process because of the economic nature of the information related to systemic risk proposed to be reported on Form PF. IM also consulted with OCIE, OIA, Enforcement, and TM.

Because the Dodd-Frank Act mandated the reporting of information by private funds, the Commission's cost-benefit analysis focused on the filing of the form as proposed rather than on whether reporting should be required. In drafting the proposal, IM and CFTC together tried to avoid requiring funds to provide information that was not already being calculated or collected in the normal course of business. As a result, the economic analysis section of the proposal focused primarily on the cost of compiling information for the form, as well as the costs of filing the form. Because the rulemaking was conducted jointly with CFTC, the SEC and CFTC included separate economic analysis sections in the proposing release.

Potential benefits cited for the proposed Form PF reporting included that the information to be collected is expected to facilitate FSOC's monitoring of risks hedge funds may pose and may enhance the SEC's ability to evaluate and improve the monitoring of markets for investor protection and market vitality.[113] The proposed Form PF reporting would also benefit investors and market participants by improving the information available to the SEC regarding the private fund industry, provide the SEC with a more complete view of the financial markets in general and the private fund industry in particular, and enhance oversight of the private fund industry and its advisers.[114]

The requirement to file Form PF would impose certain costs on private fund advisers.[115] In an effort to minimize these costs, the proposed rule's reporting requirements vary based on adviser size, fund size, and fund strategy. Accordingly, private funds that manage fewer assets or may otherwise pose less risk are required to report less information and to report less frequently.[116] IM indicated that it never undertakes a rulemaking without considering the potential burden of the rule on industry and, with respect to Form PF, the decision to require

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[112] *Id.* at 8070.
[113] *Id.* at 8088.
[114] *Id.*
[115] *Id.* at 8089.
[116] *Id.*

smaller advisers to provide less information and report less frequently was made for cost-benefit purposes.

The proposal stated that the SEC expected the costs of reporting to be the most significant for the first required report because that report would require more attention from senior personnel as they gain familiarity with the new reporting requirements and build systems to support such reporting.[117] It was expected that the costs would be significantly lower for subsequent reporting periods.[118]

The proposed rule contained detailed estimates of the costs to configure systems and to compile, review, and file Form PF. In conducting its analysis prior to the issuance of the proposing release, IM used information from the FSA hedge fund survey that asked industry participants specific questions to obtain cost information, which assisted in quantifying costs associated with Form PF. Included in the cost detail were estimated burden hours, which were largely based on input from the FSA survey. The wage costs associated with these hours were obtained from SIFMA wage data retrieved by RSFI, and certain industry data was obtained from external data vendors and IARD. According to IM staff, they often do not receive solid figures or backup from industry or other external sources and create estimates based on the available information; however, when data is used from sources such as SIFMA or another regulator's data, the source is disclosed in the proposing release.

iii. Comments Received

The SEC sought comment on all areas of the proposal, including the proposed costs and benefits and any other costs or benefits that might result from the proposal. The comment period ended on April 12, 2011, and as of June 3, 2011, approximately 35 comment letters had been received.[119] IM is in the process of reviewing the comments and preparing a comment summary, which will be distributed to RSFI and OGC for review.

The Commission received comments on the proposal that ranged from generally supportive to generally critical. Some of the comments received focused on concerns related to disclosing nonpublic information, but the majority referred to what they considered to be the onerous nature of the proposal. Specifically, some commenters stated that the proposed reporting periods were "unrealistic, burdensome and onerous,"[120] the reporting would necessitate costly new systems and require a significant amount of customized software,[121] "the estimated time and costs to comply with the Proposed Rule . . . are grossly understated,"[122] and the form will create an undue burden and greatly increase compliance costs "without a sufficiently clear

[117] *Id.*
[118] *Id.*
[119] Copies of comments received on this proposal are available on the SEC's website at http://www.sec.gov/comments/s7-05-11/s70511.shtml.
[120] *See* letter to Elizabeth M. Murphy, Secretary, Commission, from Timothy W. Cameron, Managing Director, SIFMA's Asset Management Group, April 12, 2011, at 11.
[121] *Id.* at 15-16.
[122] *Id.* at 16.

benefit to justify such burdens."[123] Other commenters, however, argued that the reporting requirements should be expanded and favored more frequent reporting.[124] IM staff plans to carefully consider all of these comments when preparing recommendations relating to the adoption of Form PF.

Although it is too early to determine what changes will be made as a result of the comments, IM stated that all comments must be reviewed and seriously considered and that the final release must include the rationale for decisions made, including why changes were not made pursuant to comments received.

e. Registration of Municipal Advisors

i. Description of Rulemaking

Section 975 of Title IX of the Dodd-Frank Act, entitled, "Investor Protections and Improvements to the Regulations of Securities," amended Section 15B of the Exchange Act to require municipal advisors to register with the Commission. Specifically, the revised Section 15B made it unlawful for a municipal advisor to provide advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities, or to undertake a solicitation of a municipal entity or obligated person, unless the municipal advisor is registered with the Commission.[125] To enable municipal advisors to temporarily satisfy this requirement, the Commission had adopted an interim final temporary rule and form that will expire on December 31, 2011. The Commission has proposed new rules and forms under the Exchange Act to give effect to the provisions of Title IX of the Dodd-Frank Act that, among other things, would establish a permanent registration regime for municipal advisors and impose certain record-keeping requirements on them.[126]

ii. Economic Analysis

TM led this rulemaking on registration of municipal advisors, and TM staff met with RSFI and OGC very early in the rulemaking process. Meetings began in late September 2010 and drafting commenced in October 2010. As noted above, an interim final temporary rule regarding the registration of municipal advisors, Temporary Registration of Municipal Advisors, became effective on October 1, 2010, and will expire on December 31, 2011.[127] TM, RSFI, OCIE, and OGC worked together to draft a term sheet for the proposed rule. TM indicated that this rulemaking on municipal advisor registration was different from typical rulemakings in

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[123] *See* letter to Elizabeth M. Murphy, Secretary, Commission, and David. A Stawick, Secretary, CFTC, from Joanne Medero, Managing Director, BlackRock, April 12, 2011, at 2.
[124] *See* letter to Elizabeth M. Murphy, Secretary, Commission, and David. A Stawick, Secretary, CFTC,from Richard L. Trumka, President, American Federation of Labor and Congress of Industrial Organizations, April 12, 2011, at 1; letter to Elizabeth M. Murphy, Secretary, Commission, from Glenn H. Davis, Senior Research Associate, Council of Institutional Investors, April 11, 2011, at 2; and letter to Elizabeth M. Murphy, Secretary, Commission, and David. A Stawick, Secretary, CFTC, from Americans for Financial Reform, April 12, 2011, at 2.
[125] Registration of Municipal Advisors, Proposed Rule, 76 Fed. Reg. 824, 825 (Jan. 6, 2011).
[126] *Id.* at 824.
[127] Temporary Registration of Municipal Advisors, 75 Fed. Reg. 54465 (Sept. 8, 2010).

which TM is involved because a temporary rule had been approved and taken effect, and TM had to move quickly to put a permanent rule in place.

Beginning in September 2010, the SEC held field hearings to examine the municipal securities markets. Topics discussed included disclosure and transparency, credit ratings, and internal controls. RSFI was heavily involved in gathering data for these field hearings. According to both TM and RSFI, the field hearings and the preliminary work involved in preparing for those hearings provided a good starting point to begin drafting the rule. A main focus of the rulemaking was to determine how a municipal advisor would be defined and who would be subject to the rule.

IM, Enforcement, CF, and OCIE were also consulted for this rulemaking, with Enforcement and OCIE having the greater involvement. Enforcement was able to provide input based on experience with the municipal securities market, and OCIE provided input on the necessary forms and how municipal advisors would register and be subject to examination.

Two economists from RSFI were assigned to the rulemaking and, as indicated above, were extensively involved early in the process. RSFI gathered and analyzed data in preparation for the field hearings, and this data was used to determine the possible effects of requiring municipal advisors to register with the Commission, including the benefits and associated costs. Although the staff consulted academic literature, that literature contained little more than anecdotal information.[128] Despite the lack of solid academic evidence, RSFI theorized that requiring municipal advisors to register would discourage bad actors from entering the field and would help ensure competition in the municipal securities market.[129] The economic analysis section of the proposed release was written early in the drafting process based on an outline provided by RSFI and with much input from RSFI.

Potential benefits associated with the proposed rule included increased reliability of information submitted by municipal advisors and the ability of municipal entities to have ready access to information to make fully-informed decisions regarding municipal advisors.[130] Also, because the rule would standardize the information provided, it would lower the costs for municipal entities to gather the pertinent information.[131]

With respect to the requirement that municipal advisors disclose their disciplinary histories, a possible benefit would be deterrence of advisors with disciplinary histories from entering the market.[132] Another benefit of the proposal would be the potential for regulators to facilitate enforcement against municipal advisors by using available information to identify trends and risky firms or persons.[133] Overall, a perceived benefit of the rule is that it will improve the average quality of the municipal advisor selection pool.[134]

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[128] Interview with members of TM, RSFI, and OGC staff on May 27, 2011.
[129] *Id.*
[130] Registration of Municipal Advisors, Proposed Rule, 76 Fed. Reg. 824, 874 (Jan. 6, 2011).
[131] *Id.* at 873.
[132] *Id.* at 874.
[133] *Id.* at 875.
[134] *Id.*

The economic analysis section of the proposing release included cost estimates for the collection of information as required by the PRA. Specifically detailed were one-time costs related to the completion of registration forms and gaining familiarity with the rules. The analysis recognized, however, that many firms had been able to gain some familiarity based on the temporary rule. Also discussed were recurring costs, such as labor, to complete, review, and amend the necessary forms. These calculations included specific hours and calculations with cost estimates taken from the SIFMA database.

In addition to the PRA-required figures, the proposing release also analyzed possible economic costs of the proposed rule, including the possibility that some municipal advisors might leave the business because of concern that the costs associated with registration could have a negative effect on their revenues.[135] The OIG found that the economic analysis section addressing the possible impacts of the rule was primarily qualitative rather than quantitative in nature. RSFI noted that this was the case because of the difficulty of quantifying costs and benefits and the limited academic research available.

According to Professor Kyle, measuring costs and benefits requires both qualitative and quantitative analysis. Even when data is readily available and market behavior can be measured, it is often difficult for a skilled economist to measure the extent to which changes in data result from policy changes or from other factors. Qualitative analysis is important for making predictions about how changes in rules will modify behavior. For example, if a regulation makes financial services more expensive, market participants are likely to cut back on the amount of financial services they choose to buy. Qualitative analysis might predict the change in services demanded based on assumptions about elasticities of demand. Moreover, quantitative analysis might sharpen these predictions based on data measuring the market's response to past changes.

Professor Kyle acknowledged that it may be difficult for economists to quantify the extent to which the rule requiring registration of municipal advisors would induce them to leave the industry. However, according to Professor Kyle, it may nevertheless be possible to measure the size of compliance costs relative to the incomes of advisors and then derive a qualitative prediction about the tendency of such costs to induce exit. Furthermore, if the advisors who exit the industry tend to be less desirable than the ones who stay, the cost-benefit analysis could be further refined with qualitative or quantitative estimates of how many advisors are dishonest how many are honest, and how costly the presence of dishonest ones are to the industry.

Professor Kyle noted that one advantage of quantitative analysis is that it can be used to set benchmarks that can then be used to measure costs and benefits when rules are revisited several years after they were adopted. Since the Dodd-Frank Act requires many rules to be implemented in a short time frame, it is likely that there will be many proposals to change the rules in the future. For example, if a combination of qualitative and quantitative cost-benefit analysis leads to the prediction that the pool of municipal advisors will be more honest in the future due to dishonest advisors being unwilling to register, such a specific prediction could be tested years later by examining whether the number of fraud cases against municipal advisors had dropped. Professor Kyle also noted that it is at least conceptually possible that advisors who

[135] *Id.* at 876.

practice fraud earn such high incomes that they are not deterred from registering by regulatory burdens that drive honest advisors out of the industry.

iii. Comments Received

The SEC sought comment on all areas of the proposal, including estimates of the costs and benefits identified in the economic analysis section of the proposing release and any costs and benefits not discussed in the release. TM relied heavily on RSFI to determine those areas on which comments should be solicited.

The comment period ended on February 22, 2011, and approximately 900 comment letters were received as of June 3, 2011, including several on the economic analysis section.[136] TM is still reviewing and analyzing these comments and is in the process of preparing a comment summary. When the review and analysis is completed, TM will distribute the comment summary to RSFI and OGC (as well as to other offices and Divisions within the Commission) for review.

Most of the comments received on the economic analysis section related to the specific PRA costs associated with the registration requirement. This may have been due to the focus of many of the comments on who would be required to register under the proposed rule. Specifically, many commenters interpreted the release to require all appointed officials of municipal governing bodies to register as municipal advisors, despite the fact that the scope of the proposed regulation was not that broad. TM staff stated that they will recommend clarification of this point in the final adopting release.

Because TM is still reviewing the comments received, it cannot identify what changes may be made as a result of the comments. TM stressed, however, that all comments are reviewed and that even one comment on a particular topic will be considered in determining what changes to recommend to the Commission in the final rule.

f. Conflict Minerals

i. Description of Rulemaking

Section 1502 of the Dodd-Frank Act amended the Exchange Act to add Section 13(p), which required the Commission to promulgate disclosure and reporting regulations regarding the use of conflict minerals from the Democratic Republic of the Congo and adjoining countries (collectively the DRC).[137] In enacting Section 1502, Congress recognized that the exploitation and trade of conflict minerals originating in the DRC is helping to finance conflict characterized by extreme levels of violence in the eastern DRC.[138] Under Section 1502, persons required to

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[136] Copies of comments received on this proposal are available on the SEC's website at http://www.sec.gov/comments/s7-45-10/s74510.shtml.

[137] Conflict Minerals, Proposed Rule, 75 Fed. Reg. 80948, 80948-49 (Dec. 23, 2010). The term "conflict mineral" includes "cassiterite, columbite-tantalite, gold, wolframite, or their derivatives, or any other minerals or their derivatives determined by the Secretary of State to be financing conflict" in the DRC. *Id.* at 80950.

[138] *Id.* at 80949.

file reports under Section 13(p) must disclose annually whether any conflict minerals that are necessary to the functionality or production of a product they manufacture originated in the DRC.[139] If the conflict minerals did originate in the DRC, such persons must provide a report to the Commission that includes a description of the due diligence measures taken to determine the minerals' source and chain of custody.[140] Such due diligence measures are to include an "independent private sector audit" of the report.[141]

ii. Economic Analysis

CF led the conflict minerals rulemaking. According to CF staff, this rule differed from others in that the congressional purpose for this disclosure requirement was to end violence in the DRC rather than to protect investors. CF's first steps were to determine the intent of Section 1502 of the Dodd-Frank Act and assess what discretion the Commission had in drafting the rule. Specifically, CF reviewed the mandate to determine the ultimate objective of the rule, and then decided how best to implement that objective and provide general guidance.

CF created a term sheet outlining its preliminary views on the rule, which it then submitted to OGC and RSFI for input. CF also sought input from Enforcement regarding its experience in dealing with the Foreign Corrupt Practices Act. Additionally, CF consulted the Department of State and the Government Accountability Office (GAO) to coordinate efforts under Section 1502 and to ensure that the SEC's final rule is consistent with the actions to be taken by the Department of State and GAO.[142]

Two economists from RSFI were assigned to this rulemaking. In preparing the cost-benefit analysis, RSFI drafted an outline of costs and benefits to be included in the economic analysis section based on CF's term sheet. To complete this outline, RSFI looked at the congressional mandate to determine the extent of discretion the SEC had in implementing the rule. As it was determined that the Commission had limited discretion with respect to this rule, the outline prepared by RSFI was likewise limited. In addition, the RSFI economists also reviewed the statutory language and pertinent academic literature to determine which firms should be subject to the requirements of the rule. Although RSFI attempted to quantify costs and benefits where possible, it was not able to do so with this rulemaking because no analogous cost or benefit data existed that could be used to estimate the costs and benefits associated with this rule.

Based on the outline provided by RSFI, CF drafted the economic analysis section of the proposing release. RSFI indicated that the economic analysis section initially drafted by CF differed from the outline prepared by RSFI and contained only a portion of their

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[139] *Id.*

[140] *Id.*

[141] *Id.*

[142] Section 1502(c) of the Dodd-Frank Act required the State Department to develop a strategy to address the linkage between human rights abuses, conflict minerals, armed groups, and commercial products, and to produce and make public a map of mineral-rich zones, trade routes and areas under the control of armed groups in the DRC. Section 1502(b) of the Dodd-Frank Act required the GAO to establish auditing standards for the conflict minerals report. *See* 15 U.S.C. § 78m(p)(1)(A)(i).

recommendations.[143] RSFI staff subsequently met with CF to discuss their concerns and found that CF was receptive to making changes to the proposing release, and RSFI's comments were ultimately incorporated into the release.

Because Commission staff had limited experience with the subject matter of this rule, they relied significantly on input from industry participants, including issuers, nongovernmental organizations, manufacturers, and smelters, as well as from nongovernmental organizations. As a result of the Commission staff's limited experience in this area and the inability to quantify costs and benefits, the proposal included a qualitative analysis of potential costs and benefits of the proposed rule.

Benefits associated with the proposed rule included furthering Congress's goal of deterring the financing of armed groups in the DRC through commercial activity in conflict minerals.[144] A primary benefit noted was that "market participants and observers may benefit from the increased disclosure and improved reporting to the extent they find information about conflict mineral use relevant to their decision making."[145]

The proposed rule further stated that by specifying the information that reporting companies with necessary conflict minerals must disclose, the proposed rule "would benefit reporting companies by reducing uncertainty about their compliance with Commission rules."[146] Further, specifying the location of the initial disclosure of conflict minerals' origin and the required report "should make it easier for interested parties to locate this information."[147] Another perceived benefit of the proposed rule is that it provides an alternative to manufacturers by considering conflict minerals obtained from recycled or scrap sources to be DRC conflict free.[148]

Costs associated with the proposed rule included the costs that would be incurred to meet additional disclosure requirements and prepare the exhibit that would be part of the firm's annual report.[149] The proposed rule noted that, due to the Commission's proposed definition of "persons described," a large number of companies would be required to comply with the rule and would therefore incur additional compliance costs.[150] The proposed rule also noted that not requiring auditors to assume expert liability could increase costs to market participants, and that costs associated with obtaining and maintaining records related to inquiries to determine the country of origin of conflict minerals could be incurred.[151]

As noted above, the release did not quantify the potential costs of the proposed rule because the Commission did not have and was not able to obtain reliable or relevant information

[143] CF stated that only one point recommended by RSFI was not included in the draft economic analysis section that was initially prepared by CF.
[144] Conflict Minerals, Proposed Rule, 75 Fed. Reg. 80948, 80968 (Dec. 23, 2010).
[145] *Id.* at 80969.
[146] *Id.*
[147] *Id.*
[148] *Id.*
[149] *Id.*
[150] *Id.*
[151] *Id.*

on which to base a quantitative estimate. The proposing release requested comment on the disclosures and accuracy of the estimates included in the cost-benefit analysis section of the release.[152]

Also included in the proposing release were cost estimates for the collection of information as required by the PRA. The proposing release stated generally that the SEC believed "the burden on issuers to determine the origin of their conflict minerals could be significant."[153] The proposal also contained estimates for the cost of preparing the required reports, including the necessary due diligence and audits.

When estimating the costs to perform due diligence, CF obtained information from industry groups and nongovernmental organizations. CF stated, however, that very few industry participants were able to provide actual numbers. Estimates related to obtaining an audit were primarily obtained through outreach to an industry group. For estimating the hours needed to comply with the disclosure components of the rule, CF used burden estimate information for other required forms deemed to be similar to the conflict minerals reports. For this rulemaking, CF's primary emphasis was estimating the possible costs associated with conducting due diligence and obtaining an audit.

iii. Comments Received

The SEC sought comment on all areas of the proposal, including the proposed costs and benefits. The comment period was originally scheduled to end on January 31, 2011, but, at the request of a wide cross-section of commenters, was extended to March 2, 2011. CF indicated that comments have been provided after this date and will continue to be accepted until the rule is finalized.

More than 200 comments on the proposed rule had been received as of June 3, 2011, and these comments and are still being reviewed.[154] CF is in the process of preparing a comment summary, which will be distributed to RSFI and OGC for review.

Given the subject matter of this rulemaking, a large number of the comments related to human-rights and anti-genocide-related issues and did not comment on the economic analysis of the proposal. Other comments focused primarily on the estimates provided in the PRA section of the proposing release, rather than on the costs and benefits outlined in the economic analysis section. One large manufacturing industry group—the National Association of Manufacturers—commented that costs included in the proposal were seriously underestimated because the SEC did not take all relevant factors into consideration.[155] The association also stated that the burden on smaller companies would be disproportionately high and might even lead to companies going out of business.[156]

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[152] *Id.*
[153] *Id.* at 80965.
[154] Copies of comments received on this proposal are available on the SEC's website at http://www.sec.gov/comments/s7-40-10/s74010.shtml.
[155] *See* letter to The Honorable Mary L. Schapiro, Chairman, Commission, from Stephen Jacobs, Senior Director, National Association of Manufacturers, March 2, 2011, at 23.
[156] *Id.*

Because CF is still receiving and analyzing comments on the proposed rule, it does not know what changes will be made to the rule based on the comments received.

Compliance with Spirit of Executive Orders

As noted above, notwithstanding the fact that Executive Orders EO 12866 and EO 13563 do not specifically apply to the SEC, SEC Chairmen have made a commitment to Congress that the SEC will conduct a cost-benefit or economic analysis as part of its rulemaking activities, and the Commission's current rulemaking procedures are closely aligned with the requirements of the executive orders.

In each of the rulemakings we reviewed, we found that the Principles of Regulation listed in EO 12866 were considered. Specifically, each rule was designed to be cost-effective, with the proposing release for each rule setting forth the anticipated costs and benefits of the rule. Our review found that the rulemaking divisions attempted to obtain all relevant available information to draft the proposed rules and made efforts to ensure that the proposed rules were not duplicative of existing regulations.

EO 12866 further requires agencies to identify and assess alternative forms of regulation. Where permitted by the Dodd-Frank Act, the proposing releases we reviewed identified and requested comment on possible alternatives to the proposed rule. While the costs and benefits of alternatives were not assessed in the proposing releases, the releases did seek comment on the costs and benefits of the alternatives. For example, the SB SEF proposing release noted that the Commission's proposed interpretation of the definition of an SB SEF would require that a request for quote (RFQ) be sent to all participants but would permit the quote requesting participant to query less than all participants.[157] The Commission requested comment on whether there were alternative "interpretations of the statutory definition that would promote price transparency and competition," and provide incentive for market participants to trade on SB SEFs rather than in the over-the-counter market.[158] The proposing release also sought comments on the impact of various approaches (i.e., allowing an RFQ to be sent to one participant or requiring a minimum number greater than one) would have on market participants, as well as the costs and benefits of each approach.[159]

Compliance with OGC Compliance Handbook

The OIG also analyzed whether the SEC's economic analyses in the rulemakings we reviewed complied with the provisions of the SEC Compliance Handbook issued by OGC. We found that, in many aspects, the SEC rulemaking divisions appeared to adhere to the guidance in the handbook. Specifically, each proposing release included a solicitation for comments from the public, including comments on the cost-benefit analysis section of the release. For the proposing releases subject to our review, the OIG found that the cost-benefit analyses were

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[157] Registration and Regulation of Security-Based Swap Execution Facilities, Proposed Rule, 76 Fed. Reg. 10948, 10955 (Feb. 28, 2011).
[158] *Id.*
[159] *Id.*

informational in nature, avoiding the impression that any conclusions had been reached by the Commission.

Further, with respect to the proposing releases we reviewed, we identified instances where the cost-benefit analyses were detailed in identifying micro costs, such as paperwork burdens. However, the OIG found that the rulemaking teams' cost-benefit analyses did not always contain a robust analysis of macro-level costs. As stated in the Compliance Handbook, a complete cost-benefit analysis should consider macro costs, not just micro costs such as paperwork burdens. Professor Kyle particularly noted the lack of macro-level analysis in the proposed release enumerating standards for clearing agency operation and governance. As dicussed above, he explained that micro costs are compliance costs, while macro costs result from changes in behavior apart from compliance costs, and noted that a dollar of macro costs is just as important as a dollar of micro costs. He specifically stressed the importance of performing a robust macro analysis in connection with the clearing agency operation standards, as the requirement of proposed Rule 17Ad-22(d)(3) that clearing agencies invest assets in instruments with minimal credit, market, and liquidity risks may result in significant macro costs and benefits by affecting the way in which participants use the services of the central counterparty. We plan to analyze this issue further in our continued review of the SEC's cost-benefit analyses.

CONCLUSION

The OIG's review concluded that a systematic cost-benefit analysis was conducted for each of the six rules reviewed. Overall, we found that the SEC formed teams with sufficient expertise to conduct a comprehensive and thoughtful review of the economic analysis of the six proposed releases that we scrutinized in our review. In several cases, we found that RSFI staff was involved in the process in the early stages and contributed extensively to the scope and breadth of the cost-benefit analyses. In these instances particularly, we found the analyses to be thorough and to have incorporated all aspects of the principles of the applicable Executive Orders and the SEC's internal compliance handbook.

However, the OIG also found from discussions with RSFI staff that RSFI's level of communication and involvement in rulemaking initiatives varied considerably and that RSFI had a stronger working relationship with some rulemaking teams than with others. As Professor Kyle noted, it is critically important for RSFI to be an integral part of the process for an effective cost-benefit analysis. Performing a cost-benefit analysis is fundamentally an exercise in economics. According to Professor Kyle, the employees in RSFI have broader and deeper expertise in economics than the employees outside of RSFI. Furthermore, economists often have skills in econometrics and familiarity with the economic data that are critical for quantifying costs and benefits.

Moreover, Professor Kyle noted the Dodd-Frank Act requires the adoption of many different required regulations. According to Professor Kyle, individual regulations often create costs and benefits which spill over into other regulations. It is critical, therefore, to have cost-benefits analyses coordinated by one group of economists, who can ensure that the costs and benefits of proposed rules are not ignored or double counted. Furthermore, as one rule proposal

changes, spillovers are created in the costs and benefits of other rules. Dealing with such spillovers requires effective lines of communication among personnel conducting the cost-benefit analyses. Communication works most efficiently when the personnel who need to communicate are in one place, such as RSFI. We plan to conduct further analysis of the level and effect of collaboration and input by RSFI with respect to economic analyses for rulemakings.

In addition, the OIG identified two areas of potential deficiencies in the SEC's cost-benefit analyses for which we intend to conduct further review. First, as discussed above, we particularly noted the lack of macro-level analysis in the proposed release enumerating standards for clearing agency operation and governance. Professor Kyle specifically stressed the importance of a robust macro analysis in connection with the clearing agency operation standards. Second, we noted particularly in connection with the requirement that municipal advisors register with the Commission, the lack of an assessment of the impact of the proposed rule on a quantitative level. As Professor Kyle noted, measuring costs and benefits requires both qualitative and quantitative analysis. Moreover, a specific advantage of quantitative analysis is that it can be used to set benchmarks that can then be used to measure costs and benefits when rules are revisited several years after they were adopted. Because the Dodd-Frank Act requires many rules to be implemented in a short time frame, it is likely that there will be many proposals to change the rules in the future. For example, if a combination of qualitative and quantitative cost-benefit analysis leads to the prediction that the pool of municipal advisors will be more honest in the future due to dishonest advisors being unwilling to register, such a specific prediction could be tested years later by examining whether the number of fraud cases against municipal advisors has dropped. We plan to carefully analyze these areas in our more in-depth review of specific cost-benefit analyses performed by the agency and will issue a subsequent report on the results of our further review.