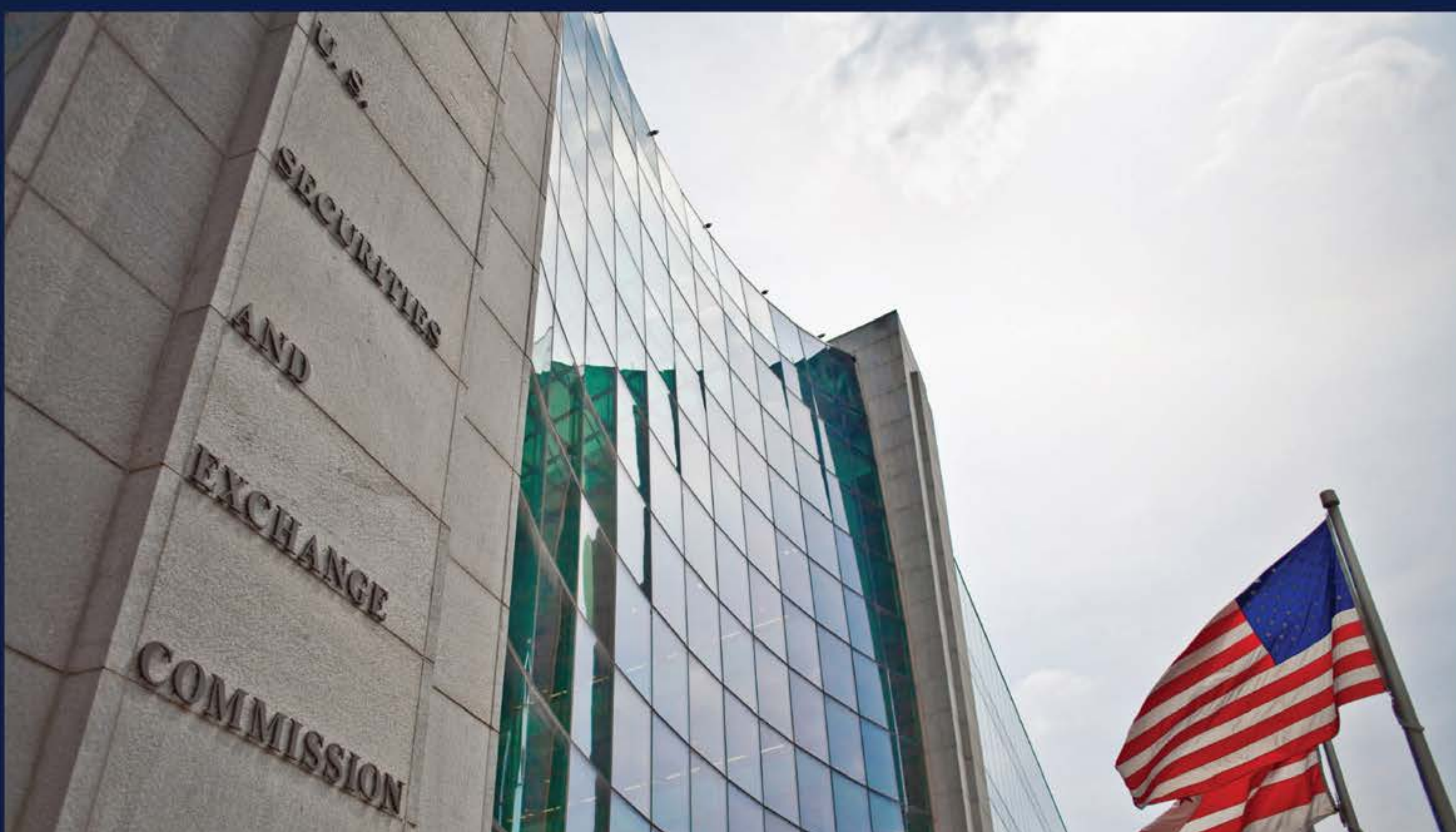
U.S. Securities and Exchange Commission

Office of Inspector General

Office of Audits

Use of the Current Guidance on Economic Analysis in SEC Rulemakings



June 6, 2013
Report No. 518

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
INSPECTOR GENERAL

MEMORANDUM

June 6, 2013

To: Craig M. Lewis, Director and Chief Economist, Division of Risk, Strategy, and Financial Innovation
Anne K. Small, General Counsel, Office of the General Counsel

From: Carl W. Hoecker, Inspector General, Office of Inspector General

Subject: *Use of the Current Guidance on Economic Analysis in SEC Rulemakings,* Report No. 518

This memorandum transmits the U.S. Securities and Exchange Commission (SEC) Office of Inspector General's (OIG) final report detailing the results of our evaluation of the SEC's use of the current guidance on economic analysis in its rulemakings. We conducted this evaluation in response to a Congressional request.

The final report contains six recommendations that, if fully implemented, should strengthen the SEC's economic analysis process. The Division of Risk, Strategy, and Financial Innovation and the Office of the General Counsel concurred with the recommendations addressed to them. Your written response to the draft report is included in Appendix VIII.

Within the next 45 days, please provide the OIG with a written corrective action plan that addresses the recommendations that are addressed to your division or office. The corrective action plan should include information such as the responsible official/point of contact, timeframe for completing required actions, and milestones identifying how your division or office will address the recommendations.

If you have any questions about this report, please do not hesitate to contact me.

We appreciate the courtesy and cooperation that you and your staff extended to our contractors during this evaluation.

Attachment

cc: Erica Y. Williams, Deputy Chief of Staff, Office of the Chair
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Use of the Current Guidance on Economic Analysis in SEC Rulemakings

Executive Summary

Background. On March 16, 2012, the Office of the General Counsel and the Division of Risk, Strategy, and Financial Innovation (RSFI) sent by email, to SEC rulewriting divisions and offices, the Current Guidance on Economic Analysis in SEC Rulemakings (Current Guidance). The Current Guidance states that "[h]igh-quality economic analysis is an essential part of SEC rulemaking." The Current Guidance provides four "[s]ubstantive requirements for economic analysis," as well as "[e]nhanced integration of economic analysis into the rulemaking process and rule releases." The purpose of the Current Guidance is to help rulewriting divisions and offices and RSFI improve and achieve consistency in their economic analyses for rulemakings and better enable the Commission's rules to withstand judicial scrutiny. The Current Guidance states that a high-quality economic analysis "ensures that decisions to propose and adopt rules are informed by the best available information about a rule's likely economic consequences…." The Current Guidance explains that a rule's potential benefits and costs "…should be considered in making a reasoned determination that adopting a rule is in the public interest."

Congressional Request. On July 24, 2012, the U.S. Securities and Exchange Commission's (SEC or Commission) Office of Inspector General (OIG) received a letter from the Chairman of the U.S. House of Representatives Committee on Oversight and Government Reform (House Oversight Committee) and the Chairman of the U.S. House of Representative's Subcommittee on TARP (Troubled Assets Relief Program), Financial Services and Bailouts of Public and Private Programs (Subcommittee on TARP) requesting that the OIG evaluate the SEC's implementation of the Current Guidance. The letter requested that we report on the degree to which the economic analyses supporting proposed and final Commission rules follow the principles and policies of the Current Guidance. The OIG was also asked to assess the degree to which the SEC has ensured that the principles and policies of the Current Guidance are incorporated into the economic analyses of rulemakings of the Financial Industry Regulatory Authority (FINRA), other self-regulatory organizations (SROs) under the Commission's jurisdiction, and the Public Company Accounting Oversight Board (PCAOB).

Objectives. This evaluation determined whether:

- the economic analyses in recent SEC rulemakings complied with the principles and policies of the Current Guidance;

- the SEC ensured that the FINRA, other SROs and the PCAOB followed the Current Guidance;
- the Current Guidance has been effective;
- a consistent methodology for economic analysis is used across rulemaking divisions and offices; and
- further improvements are needed for the SEC's rulemaking processes and procedures.

Results. We found that the SEC rules in our sample followed the spirit and intent of the Current Guidance. All of the rules that we evaluated specified the justification for the rule, considered alternatives, and integrated the economic analysis into the rulemaking process**.** We determined that the SEC's use of the Current Guidance has been effective in incorporating economic analysis into the rulemaking process. Further, we found no notable differences in economic methodologies in support of rulemakings across rulemaking divisions.

However, some rules could have better clarified and specified the baselines in the economic analysis section; the current conditions were often presented separately from the economic analysis in the rule releases. This is a matter of presentation. Also, some descriptions of baseline conditions did not specifically address the state of efficiency, competition, and capital formation (ECCF). In addition, we found that only 1 of the 12 rules in our sample included a quantification of benefits of the regulatory action. Where the rulewriting team determined that the quantification of certain costs or benefits was not practicable, the reasons for that determination were not always fully documented in the release text. We also found that FINRA, other SROs, and PCAOB are not required to follow the SEC's Current Guidance in their rulemakings.

Summary of Recommendations. This report contains six recommendations that we believe if implemented will improve the SEC's application of the requirements in the Current Guidance. For example, we recommend that, in consultation with the rulemaking divisions and offices, RSFI develop a general outline for economic analysis sections in rule releases. We also recommend that RSFI consider whether to create a management control, such as a guide, to achieve greater consistency in presentation of economic analyses.

Management's Response to the Report's Recommendations. The OIG provided RSFI and OGC with the formal draft report on May 24, 2013. RSFI and OGC concurred with the recommendations addressed to them. The OIG considers the report recommendations resolved. However, the recommendations will remain open until documentation showing the recommendations have been fully implemented is provided to the OIG. RSFI and OGC's response to the recommendations and the OIG's analysis of the responses is presented after the recommendations in the body of this report. OIG's response to RSFI and OGC's overall comments to the report is included in Appendix IX.

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Background and Objectives

Background

Congressional Request

On July 24, 2012, the U.S. Securities and Exchange Commission's (SEC or Commission) Office of Inspector General (OIG) received a letter from the Chairman of the U.S. House of Representatives Committee on Oversight and Government Reform (House Oversight Committee) and the Chairman of the U.S. House of Representative's Subcommittee on TARP (Troubled Assets Relief Program), Financial Services and Bailouts of Public and Private Programs (Subcommittee on TARP) requesting that the OIG evaluate the SEC's implementation of the *Current Guidance on Economic Analysis in SEC Rulemakings* (Current Guidance), which was issued on March 16, 2012. The letter requested that we assess and report on the degree to which the SEC has incorporated the principles and policies of the Current Guidance into economic analyses supporting proposed and final Commission rules. The OIG was also asked to assess the degree to which the SEC has ensured that the principles and policies of the Current Guidance are incorporated into the economic analyses of rulemakings of the Financial Industry Regulatory Authority (FINRA), other self-regulatory organizations (SROs) under the Commission's jurisdiction, and the Public Company Accounting Oversight Board (PCAOB).

Interim Inspector General's Response

On December 21, 2012, the Interim Inspector General sent letters to the Chairman of the House Oversight Committee and the Chairman of the Subcommittee on TARP outlining the OIG's approach for responding to their request. The OIG's letters[1] stated that it would:

- conduct an "audit to confirm that procedures have been established and are being used in accordance with the Current Guidance and that the Current Guidance incorporates recommendations offered by others on rulemaking [Phase 1];" and

[1] Jon T. Rymer, Interim SEC Inspector General, letters to Darrell Issa, Chairman, House Committee on Oversight and Government Reform, December 21, 2012, and to Patrick McHenry, Chairman, House Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs, December 21, 2012.

- direct "an experienced contractor with expertise in economic analysis, the securities industry, and SEC operations to perform more extensive rulemaking analyses [Phase 2]."[2]

In response to the Congressional request, the OIG contracted the services of HDR Engineering, Inc. (HDR) to evaluate the effectiveness and use of the Current Guidance in the SEC's rulemaking practices and procedures. This report covers Phase 2 of the OIG's response to the Congressional request.

Former Chairman Mary Schapiro's Testimony on the Current Guidance

On April 17, 2012, and again on June 28, 2012, then SEC Chairman Mary Schapiro testified before the Subcommittee on TARP about economic analysis in SEC rulemakings and the SEC's Current Guidance.[3] In her testimony on April 17, 2012, Chairman Schapiro noted that although the SEC (as an independent regulatory agency) is not subject to the rulemaking[4] requirements of Executive Orders (E.O.) 12866[5] and 13563[6] and Office of Management and Budget (OMB) Circular A-4,[7] the SEC had recently released its Current Guidance that "draws upon principles set forth in OMB Circular A-4 and Executive Orders 12866 and 13563." In her testimony on June 28, 2012, Chairman Schapiro stated that she had "...explicitly directed the rulemaking Divisions and Offices that they are to follow this Guidance"[8] and that the SEC's Chief Economist and the Office of the General Counsel (OGC) had indicated that "...the Guidance is in fact being

[2] See OIG Report No. 516, *Implementation of the Current Guidance on Economic Analysis in SEC Rulemakings*.

[3] Mary L. Schapiro, Chairman, U.S. Securities and Exchange Commission, Statement to the U.S. House of Representatives Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs Oversight and Government Reform Committee, *Economic Analysis in SEC Rulemaking*, Hearing April 17, 2012. Mary L. Schapiro, Chairman, U.S. Securities and Exchange Commission, Statement to the U.S. House of Representatives Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs Oversight and Government Reform Committee*, JOBS Act in Action Part II: Overseeing Effective Implementation of the JOBS Act at the SEC*, Hearing June 28, 2012.

[4] "Rulemaking" is defined in this report as the process for developing rule language. In this report, "release text" refers to the published text implementing the regulatory action.

[5] See E.O. 12866, *Regulatory Planning and Review*, issued September 30, 1993, 58 FR 51735 (Oct. 4, 1993).

[6] See E.O. 13563, *Improving Regulation and Regulatory Review*, issued January 11, 2011, 76 FR 3821 (Jan. 21, 2011).

[7] See OMB Circular A-4, Regulatory Analysis, issued September 17, 2003. Also, Schapiro, Statement to the U.S. House of Representatives Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs Oversight and Government Reform Committee, April 17, 2012.

[8] Rulemaking divisions and offices are all SEC divisions and offices that initiate rulemaking activities. During the evaluation's scope (March 16, 2012, through November 30, 2012), rulemaking divisions that developed recommendations for rules released by the Commission included the Division of Corporation Finance, Division of Trading and Markets, and Division of Investment Management. These divisions were supported by the Division of Risk, Strategy, and Financial Innovation and the Office of the General Counsel.

followed for both the rule recommendations already in process, as well as those at the earliest stages of development."[9]

Overview of the Current Guidance

On March 16, 2012, OGC and the Division of Risk, Strategy, and Financial Innovation (RSFI) sent the Current Guidance by email to the staff of the SEC rulewriting divisions and offices.[10] The Current Guidance provides requirements for producing high-quality economic analysis in SEC rulemakings. It will help rulewriting divisions and offices and RSFI improve and achieve consistency in their economic analyses for rulemakings and help the Commission's rules withstand judicial scrutiny.[11]

Specifically, the Current Guidance states:

> High-quality economic analysis is an essential part of the SEC rulemaking. It ensures that decisions to propose and adopt rules are informed by the best available information about a rule's likely economic consequences, and allows the Commission to meaningfully compare the proposed action with reasonable alternatives, including the alternative of not adopting a rule. The Commission has long recognized that a rule's potential benefits and costs should be considered in making a reasoned determination that adopting a rule is in the public interest.[12]

The Current Guidance has four "[s]ubstantive requirements for economic analysis" as well as "[e]nhanced integration of economic analysis into the rulemaking process and rule releases."[13] The Current Guidance references recent court decisions, reports of the SEC OIG and the U.S. Government Accountability Office (GAO), and Congressional inquiries that have raised questions about or recommended improvements (or both) to various components of the Commission's economic analysis in rulemaking.

The Current Guidance notes that while the SEC is not required to follow Executive Orders 12866 and 13563, and the Office of Management and Budget's Circular A-4, "the following guidance draws on principles set forth in those orders

[9] Schapiro, Statement to the U.S. House of Representatives Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs Oversight and Government Reform Committee, June 28, 2012.

[10] The Current Guidance is available on the SEC's website. See Appendix V for a discussion of the Current Guidance.

[11] Current Guidance, pgs. 1-2.

[12] Id., p. 1.

[13] Id., pgs. 4, 15.

and in the Office of Management and Budget's Circular A-4 (2003), which provides guidance for implementing Executive Order 12866."[14]

The SEC's Chief Economist noted in a speech that the Current Guidance lays out basic elements of a robust economic analysis and that he "believe[s] that the Guidance reflects a common-sense approach to being thoughtful and transparent about economic analysis, including the potential impacts and trade-offs of the regulatory decisions that the Commission is making."[15]

The Current Guidance has substantive requirements in Section A and a process requirement in Section B.

Section A covers four substantive requirements for economic analysis in SEC rulemaking. The requirements are designed to encourage a robust economic analysis. The requirements for preparing an economic analysis are:

1) clearly identify the justification for the proposed rule;

2) define the baseline against which to measure the proposed rule's economic impact;

3) identify and discuss reasonable alternatives to the proposed rule; and

4) analyze the economic consequences of the proposed rule and the principal regulatory alternatives.

Section B covers the process requirement for "enhanced integration of economic analysis into the rulemaking process and rule releases."[16] See Appendix V for an overview of the requirements in the Current Guidance.

Table 1 below summarizes the Current Guidance's substantive requirements and the process requirement.

[14] Id., p. 4.

[15] Craig Lewis, "The Expanded Role of Economists in SEC Rulemaking," remarks made at the Securities Industry and Financial Markets Association Compliance and Legal Society Luncheon, October 16, 2012.

[16] Current Guidance, p. 15.

Table 1: The Current Guidance's Substantive and Process Requirements

Requirement Title and Number	Summary of Required Information
Substantive Requirements (Section A)	
1. There is a "clearly identified justification for the proposed rule." (p. 5)	"Rule releases must include a discussion of the need for regulatory action and how the proposed rule will meet that need. In some circumstances, there will be more than one justification for a particular rulemaking." (p. 5)
2. There is a defined baseline "against which to measure the proposed rule's economic impact." (p. 6)	"The economic consequences of proposed rules (potential costs and benefits including effects on efficiency, competition, and capital formation) should be measured against a baseline, which is the best assessment of how the world would look in the absence of the proposed action . . .[an economic analysis] compares the current state of the world, including the problem that the rule is designed to address, to the expected state of the world with the proposed regulation (or regulatory alternatives) in effect." (p. 6)
3. There are "reasonable alternatives to the proposed rule" which are identified and discussed. (p. 8)	"The release should identify and discuss reasonable potential alternatives to the approach in the proposed rule. Reasonable alternatives include only those that are available to the SEC and not for example, those that the SEC lacks the authority to implement." (p. 8)
4. There is an analysis of the "economic consequences of the proposed rule and the principal regulatory alternatives." (p. 9)	"In analyzing the likely consequences of the proposed rule and alternative regulatory approaches, rulewriting staff should work with the RSFI economists to: (1) identify and describe the most likely economic benefits and costs of the proposed rule and alternatives; (2) quantify those expected benefits and costs to the extent possible; (3) for those elements of benefits and costs that are quantified, identify the source or method of quantification and discuss any uncertainties underlying the estimates; and (4) for those elements that are not quantified, explain why they cannot be quantified." (pgs. 9-10)
Process Requirement (Section B)	
5. Economic Analysis is integrated "into the rulemaking process and the rule releases." (p. 15)	"To make the best use of RSFI's expertise, RSFI economists should be involved at the earliest stages of the rulemaking process (e.g., before the specific preferred regulatory course is determined) and throughout the course of writing proposed and final rules. RSFI economists should be fully integrated members of the rulewriting team and contribute to all elements of the rulewriting process." (p. 15)

Source: HDR Generated from the Current Guidance

As discussed above, the Current Guidance specifies certain requirements for economic analysis in rulemaking, yet it also acknowledges the need for flexibility. Specifically, the Current Guidance states:

> Rulewriting teams should recognize that this guidance is by necessity general in nature. This guidance—while broadly outlining best practices—is intended to allow for flexibility in the context of any particular rulemaking. The rulewriting division or office, RSFI,

> and OGC should work closely to determine the appropriate approach for each rulemaking.[17]

Methodology for Evaluating the Requirements. The Current Guidance specifies five "requirements." Each requirement is expressed as a single sentence. To understand how the Current Guidance defines the meaning of those requirements, we assessed the explanation of each requirement in the Current Guidance. We then divided those explanations into discrete components. A "component" is not a term defined or used in the Current Guidance;[18] we developed the concept of a component solely to facilitate our evaluation.

For example, under requirement 1, "Clearly identify the justification for the proposed rule," the Current Guidance states:

> Rule releases must include a discussion of the need for regulatory action and how the proposed rule will meet that need. In some circumstances, there will be more than one justification for a particular rulemaking. Frequently, the proposed rule will be a response to a market failure that market participants cannot solve because of collective action problems. Traditional market failures include market power, externalities, principal-agent problems (such as economic conflicts of interest), and asymmetric information. Other justifications for rulemaking can include among others, "improving government processes," interpreting provisions in statutes the Commission administers, and providing exemptive relief from statutory prohibitions where the Commission concludes that doing so is in the public interest. Additionally, Circular A-4 recognizes that Congressional direction to adopt a rule is, itself, an independent justification for rulemaking, explaining that "[i]f the regulatory intervention results from a statutory or judicial directive, you should describe the specific authority for your action, the extent of discretion available to you, and the regulatory instruments you might use." [footnotes removed]

We assessed that requirement and defined two components.

- Rule releases must include a discussion of the need for regulatory action and how the proposed rule will meet that need.

[17] Id., p. 2.

[18] The Current Guidance describes each requirement with discussions of methods and procedures. The "components" are drawn from these discussions in the Current Guidance under each requirement.

- Where the justification cited for the rule is a statutory directive, the release text includes a discussion of any justification for regulatory action that is cited by Congress.[19]

We based our definitions of components on whether 1) a discussion point in the Current Guidance constituted an action the SEC could, should, or might take; 2) it was a discrete point distinct from other defined components; and 3) it added clarity to the meaning of the relevant requirement. We drew the components primarily from the text of each requirement section, but in some cases we extracted them from footnote text.

Further, we assessed the rules from our sample, as discussed below, to determine the extent to which they followed the Current Guidance's requirements as defined by the components.

Our evaluation did not seek to assess SEC staff's professional judgment in the rulemakings reviewed in this report. Instead, we based our evaluation on our observations noted during our review, consistent with our methodological approach and the objectives of this report. Specifically, we assessed the presence or lack of, certain required or recommended components in the release texts and, in the case of rules selected for indepth review, supporting documents.

Scope of Substantive Rules. Between March 16, 2012, and November 30, 2012, the Commission proposed or adopted 23 rules. To determine the set of rules to evaluate, we reviewed each rule for purpose and excluded ten rules from our review because they were "interpretative rules, general statements of policy, or rules of agency organization, procedure, or practice,"[20] or included an agency's affirmative finding that "notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest,"[21] and thus are exempt from the rulemaking requirements specified in the Administrative Procedure Act.[22] Those rules reopened comment periods, corrected typographical errors, extended compliance dates, were interim final temporary

[19] We view this component of requirement 1 differently from other components; it does not use words such as "should" or "must," which would indicate a mandatory requirement. Therefore, we view this component as a "recommended" part of requirement 1. Footnote 19 of the Current Guidance notes: "Although we conclude that the Commission is not obligated to identify a justification for rulemaking beyond a Congressional mandate, there may be circumstances in which it could be useful to do so. For example, where Congress has itself stated that the mandate to engage in rulemaking is premised on a market failure or other compelling social need, the rulemaking release may identify that justification (and attribute it to Congress) in its description of the statutory mandate and explain how the rule (including any discretionary choices the Commission is making in the rulemaking) responds to the market failure or other compelling need that Congress identified." Current Guidance at p. 6.

[20] Administrative Procedure Act (5 U.S.C. Subchapter II) § 553(b)(A).

[21] Id., § 553(b)(B).

[22] Id., § 553(b).

rules, or adopted updates to the Electronic Data Gathering, Analysis, and Retrieval (EDGAR) filer manual.

Also, the SEC published, on March 30, 2012, one substantive rule (Release No. 33-9308) that was already before the Commission by the time the Current Guidance was released. That rule is technically within the scope of this evaluation; however, the timing of the release indicates that the staff did not have the benefit of the Current Guidance at the time they prepared the recommendation. Therefore, we have excluded this rule from the scope of our evaluation.

We examined 12 of the 23 rules published during the period of our review.[23] These 12 rules consisted of nine adopting and three proposing releases. See Appendix VI, Table 3, for a complete list of the rules in the sample that we examined. In examining these rules, we applied the Current Guidance's five requirements that are outlined in Appendix V. Further, we assessed the rules against the 20 components that are contained in the discussions of the Current Guidance's five requirements.[24]

Rules Selected for Indepth Review to Evaluate Process Requirements. We developed a sample of 7 of the 12 rules to further evaluate the components of the requirements for RSFI's involvement in the rulemaking process. This required our review of nonpublic documents.[25] Evaluation of these rules included examination of supporting documentation other than the release text, such as term sheets,[26] other memoranda, draft analyses, meeting notes and minutes, and other correspondence. See Table 2 in Appendix II for a list of the rules that we selected for the indepth evaluation.

Objectives

HDR's objectives were to determine whether:

1) Economic analyses in recent proposed and final rulemakings followed the principles and policies identified in the Current Guidance. Specifically, we looked at whether rulemakings published from March 16, 2012, to November 30, 2012:

[23] See Table 3 in Appendix VI for a listing of the 12 rules reviewed.

[24] See Table 4 in Appendix VII for a list of the components, including direct language from the Current Guidance.

[25] Selection was made by judgment, based on the criteria described in Appendix II.

[26] Term sheets are an internal SEC communication mechanism for stating the conceptual terms of the proposed or final rule to rulemaking staff, other SEC staff, and the SEC Commissioners for their review and comment.

- followed the four "[s]ubstantive requirements for economic analysis in SEC rulemaking"[27] per the Current Guidance; and

- followed the process and procedures for "[e]nhanced integration of economic analysis into the rulemaking process and rule releases"[28] in the Current Guidance.

2) The Commission ensured that the Current Guidance was followed by the Public Company Accounting Oversight Board, Financial Industry Regulatory Authority, and other SROs under the Commission's jurisdiction;

3) The Current Guidance has been effective;

4) The SEC rulemaking divisions and offices used a consistent methodology for economic analysis; and

5) Further improvements are needed for the SEC's rulemaking processes and procedures.

[27] Current Guidance, p. 4.

[28] Id., p. 15.

Findings and Recommendations

Finding 1: Overall, the SEC Has Followed the Current Guidance in its Rulemakings, but Could Improve the Application of Some Requirements

> Overall, SEC rulemakings followed the Current Guidance. However, for some rules that we reviewed, the SEC could have better clarified and specified the baselines for analysis in the manner described in the Current Guidance. In addition, not all rules adequately presented a justification for not quantifying certain costs and benefits.

Overview

Our review found that the SEC rules in our sample followed the spirit and intent of the Current Guidance. All the rules fully addressed three of the five requirements–the rules specified the justification for the rule, considered alternatives, and integrated the economic analysis into the rulemaking process. However, some rules did not clearly specify and discuss baselines in the economic analysis section; the current conditions were often presented separately from the economic analysis in the rule releases. This is primarily an issue of presentation. Also, some baselines did not completely address the state of efficiency, competition, and capital formation (ECCF) as it exists in the baseline state. In addition, we noted that only 1 of the 12 rules in our sample included a quantification of benefits.

We assessed the 12 rules in our sample against requirements 1-4. To assess requirement 5, we had to review nonpublic documentation and, therefore, relied on a sub-sample of 7 of the 12 rules to complete a more indepth review to assess that requirement.

Results of Review of Application of the Current Guidance[29]

Requirement 1 - Rule Justification. *All of the rules we examined fully followed this requirement.* We found that the 12 rules in our sample followed the requirement that there be "a clearly identified justification for the proposed rule."[30]

[29] Our determination whether a rule followed the Current Guidance was made based on review of each rule and the requirements and components specified in Appendix VII.

[30] Current Guidance, p. 5.

Specifically, we found each rule provided a clear justification for the proposed rule.

Requirement 2 - Specification of the Baseline. *All of the rules we examined either fully or partially followed this requirement.* Two rules (Release Nos. 34-68071 and IA-3483) had clear, well-defined baselines. These two releases described the economic consequences of the rules against a single baseline that 1) includes any assumptions and underlying uncertainty, 2) describes the state of ECCF in the baseline, and 3) identifies and describes the markets and participants that would be affected by the proposed rule presented at the beginning of the economic discussion. Ten of the 12 rules in our sample discussed the baseline in the release text, but did not include all of the components for specification of the baseline.[31]

To assess whether each of the 12 rules followed Requirement 2, we looked at three components of that requirement that are in the Current Guidance. Those three components are:

> 2.1 "The economic consequences of proposed rules...should be measured against a baseline, which is the best assessment of how the world would look in the absence of the proposed action…including the existing state of efficiency, competition, and capital formation, against which to measure...;"[32]
>
> 2.2 "The baseline being used should be specified either at the beginning of the economic analysis section or as part of a general introduction to the economic issues that will be considered throughout the release and should clearly describe the assumptions that underlie the descriptions of the relevant baseline and detail those aspects of the baseline specification that are uncertain;"[33] and
>
> 2.3 "...Rulewriting staff should work with the RSFI economists to describe the state of the world in the absence of the proposed rule."

We found that 10 rules followed some, but not all, of those three components and so only partially followed all components of the requirement. Specifically, we found that:

- nine of the 12 rules did not include a specific discussion of the existing state of ECCF in the release text. Three of the rules did include a specific discussion of the existing state of ECCF:

[31] See Appendix V and VII for greater detail on the components of Requirement 2.

[32] Current Guidance, pgs. 6-7.

[33] Id., p. 7.

Release Nos. IA-3483, 34-67457 and 34-68071. (This does not refer to whether or not the releases addressed the *impact* of the rules on ECCF.); and

- five of the 12 rules partially followed component 2.2, because the release texts had an implied baseline of the current state of the world. However, these baselines were not presented in a clear and explicit manner.

Overall, most of the rules that we reviewed followed the requirement that the baseline should be described in the release text at the beginning of the economic analysis section, or as part of a general introduction to the economic issues that are considered throughout the release.

The sample of seven rules that we evaluated in greater depth all followed component 2.3. We did not assess the remaining five rules for this component, but we have no reason to believe that they did not follow this component.

The rulewriting teams and economists that we interviewed said they interpreted their presentation of the baseline in the rules as following the Current Guidance's requirements.[34] Many of those we interviewed said that rules that did not follow all components of a requirement should still be considered as having "followed" that requirement because the Current Guidance generally allows for flexibility.[35]

While we acknowledge the inherent flexibility of the Current Guidance, we determined that following the requirement means following all the components of that requirement. We also determined that the Current Guidance's requirements on the presentation of the baseline and incorporation of uncertainty and ECCF are not clear.

Fully specified baselines could help to avoid confusion among the general public or make it easier for interested readers to fully understand the starting point of the economic analyses that the SEC uses in its rulemakings.

Requirement 3 - Consideration of Alternatives. *All rules that we examined fully followed this requirement*. We found that all of the 12 rules in our sample fully followed requirement 3 that "[t]he release should identify and discuss reasonable potential alternatives to the approach in the proposed rule."[36]

[34] For a summary of rules included in the process evaluation, see Appendix II.

[35] On page 2, the Current Guidance states, "Rulewriting teams should recognize that this [G]uidance is by necessity general in nature. This guidance—while broadly outlining best practices—is intended to allow for flexibility in the context of any particular rulemaking. The rulewriting division or office, RSFI, and OGC should work closely to determine the appropriate approach for each rulemaking."

[36] Current Guidance, p. 8. This is the basis of component 3.1.

In addition, the Current Guidance requires that "proposing release[s] should also solicit public comment to help assess and inform the economic analysis of the alternatives."[37] All three of the proposing releases—Release Nos. IA-3483, 33-9354, and 34-68071—followed the requirement.[38] This component of the requirement did not apply to nine of the rules in our sample because they are adopting releases.

Requirement 4 - Analysis of Economic Consequences. *All of the rules that we examined either fully or partially followed the requirement that the economic analysis include "the economic consequences of the proposed rule and the principal regulatory alternatives.*"[39] Five of the 12 rules that we reviewed–Release Nos. 34-68071, 34-68080, 34-67716, 34-67717, and 34-66868–followed all components for requirement 4; and 7 rules followed some of the components of requirement 4.

Requirement 4 consists of the following components:

4.1 "rulewriting staff should work with the RSFI economists"[40] to develop the economic analysis.

The economic analysis should:

4.2 "identify and describe the most likely economic benefits and costs of the proposed rule and alternatives;"[41]

4.3 "quantify those expected benefits and costs to the extent possible;"[42]

4.4 "describe the measurement approach used, include references to statistical and stakeholder data if available, and specify the timeframe analyzed;"[43]

4.5 "identify and discuss uncertainties underlying the estimates of benefits and costs;"[44]

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[37] This is the basis for component 3.2. This component of the Current Guidance applies only to proposing releases.

[38] Current Guidance, p. 9.

[39] Id.

[40] Id.

[41] Id.

[42] Id.

[43] Id., p. 13.

4.6 “include [in the release] an explanation of the reason(s) why quantification is not practicable and include a qualitative analysis of the likely economic consequences...”[45] if RSFI economists and rulewriting staff conclude costs and benefits cannot reasonably be quantified;

4.7 “support predictive judgments and clearly address contrary data or predictions [and];”[46]

4.8 “combine the economic analysis considering costs and benefits with consideration of the effects on efficiency, competition, and capital formation” in the rule release.[47]

The Current Guidance explicitly provides flexibility to the Commission in determining whether a rule’s economic effects can be reasonably quantified. The Current Guidance states:

> To achieve this objective, rulewriting staff should engage with RSFI economists at the earliest stages of rulemaking to determine whether there are areas in which monetization or other quantification can reasonably be undertaken and, if so, whether RSFI has the available resources necessary to develop such data. Before issuing a proposing release, staff should identify any specific data that would be necessary for or that would assist in quantification, and should consider various mechanisms by which to seek such data. The proposing release should also include a request for such data.[48]

Where quantification is not possible, the Current Guidance expresses the following expectation:

> If costs or benefits cannot reasonably be quantified, the release should include an explanation of the reason(s) why quantification is not practicable and include a qualitative analysis of the likely economic consequences of the proposed rule and reasonable regulatory alternatives. The release should discuss the strengths and limitations of the information underlying the qualitative cost-benefit analysis. Rulewriters should work with RSFI economists to

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[44] Id., p. 12.

[45] Id., pgs. 13-14.

[46] Id., p. 14.

[47] Id., p. 14.

[48] Id., p. 12.

> clearly identify important uncertainties underlying the analysis and to explain the implications of these uncertainties for the analysis.[49]

Our review found that qualitative descriptions of costs and benefits were almost always included and often fairly well-developed in the rules, but the quantification of costs beyond Paperwork Reduction Act (PRA) costs was not extensive and the quantification of benefits was presented in only one of the rules. Specifically, 7 of the 12 rules presented quantified costs beyond PRA costs.[50] In this evaluation, we are not stating that these releases should have had quantified benefits and additional quantified costs, but are noting the large number of rules that did not estimate benefits or costs beyond PRA costs. In discussions with rulewriting teams and economists, as well as reviews of supporting documentation for many of these rules, it was clear that effort was made to identify costs and benefits and potential data to use in quantification of those impacts, but not all of that effort was evident in the releases themselves, despite the Current Guidance's specification to include them in the "economic analysis."[51]

Requirement 4, Component 1

Component 1 addresses the collaboration between RSFI economists and the rulewriting teams that should occur in preparing the economic analysis of a rulemaking. Requirement 4 does not require documentation of the collaboration. Thus, we evaluated internal documents to verify that collaboration had occurred.

All seven of the rules included in our indepth examination of nonpublic documents had clear evidence of collaboration between RSFI economists and the rulewriting teams in the analysis of the economic effects of the rule.

In addition, one rule that was not included in the indepth examination, Release No. 34-67286, had information in its rule release that served as evidence that this component had been met. For the remaining four rules that were not selected for indepth investigation, we were unable to assess whether collaboration took place, although we have no reason to believe it did not.

[49] Id., pgs. 13-14.

[50] The following rules presented PRA costs as the only quantified estimates: Release Nos. IA-3483, 33-9338, 34-67901, 34-68080, 33-9330, 33-9308, 34-67457 and 34-67286.

[51] Current Guidance, pgs. 10, 11, 13, 14, and 15. See specifically "Court decisions addressing the economic analysis in Commission rules have likewise stressed the need to attempt to quantify anticipated costs and benefits, . . ." pg. 13.

Requirement 4, Component 2

Component 2 addresses whether a rule "identif[ies] and describe[s] the most likely economic benefits and costs of the proposed rule and alternatives."[52] This component includes addressing compliance costs, direct costs, or indirect costs as well as "significant ancillary economic consequences"[53] of the proposed rule and alternatives. All 12 rule releases that we evaluated had economic analyses that identified and described the most likely economic benefits and costs of the proposed rule and alternatives.

Requirement 4, Component 3

Component 3 specifies providing evidence in the rule that:

1) an attempt to quantify and monetize costs and benefits was undertaken;

2) RSFI identified the resources necessary to develop quantification data;

3) the proposing release requested public comment on necessary data not otherwise available to RSFI; and

4) the economic impacts of both statutory (Congressionally mandated) and discretionary elements of the rule were considered.

The ability to demonstrate that a rule followed those elements of the Current Guidance hinges on whether quantification of expected costs and benefits is presented in the release text. The absence of quantified benefits or costs in the release text does not necessarily indicate that the Current Guidance was not followed. The Current Guidance acknowledges that economic effects cannot always be quantified. The Current Guidance does discuss other steps that the SEC should take when it determines that quantification is not feasible, and we have separately evaluated below whether this requirement was satisfied. (See discussion below on component 4 of requirement 6.)

Of the 12 rules reviewed, 10 of the rules provided evidence in their releases for all of the above-noted elements on quantifying expected benefits and costs.

The other two rules provided evidence that some of the aspects of quantifying expected benefits and costs had been addressed. Specifically:

[52] Id., p. 9.

[53] Id., p. 10.

- Release No. IA-3483, an extension of a temporary rule that was scheduled to "sunset,"[54] did include a qualitative analysis of the proposed extension and had requested comment on all aspects of the economic analysis. The release also referenced the economic analysis of the rule itself, which was included in the original 2007 adopting release text in order to provide context for the discussion of the extension. However, there was no presentation of an attempt to quantify and monetize costs and benefits; rather the rule referenced an analysis prepared in 2007 for the first release of this temporary rule.

- Release No. 34-67457 deferred detailed economic analysis until the SROs submitted a single National Market System (NMS) plan. While the release provided justification for not quantifying costs of the SROs' preparation of the NMS plan, it did not address the potentially significant internal costs and benefits to the SEC as a result of this rulemaking.

Requirement 4, Component 4

Component 4 stipulates that, for those rule releases in which benefits or costs (or both) are quantified, the release text should identify the sources and methods of quantification, specify statistical and stakeholder data used, and specify the timeframe of the analysis.

Of the 12 rules that we reviewed, we found that 11 rules identified the sources and methods of quantification, and one did not. The rule that did not specify its sources and methods was Release No. IA-3483, which is an extension of a temporary rule. The release text referenced an economic analysis in a 2007 release but did not include the sources and methods used. While the rulewriting team and RSFI emphasized that they did not believe costs had materially changed, it was our view that excluding the sources or methods used to make this determination does not follow the spirit of the Current Guidance for this part of requirement 4.

In general, rule releases that specified a timeframe considered one-time or annual costs (or both). They did not include an explicit duration such as 10, 20, or 30 years, as is generally expected in cost-benefit analysis for public policymaking.[55] Moreover, the rule releases in our sample, which calculated

[54] A "sunset" provision is a stipulation that a rule or a component of a rule expires at the end of a fixed period.

[55] The Current Guidance uses the term cost-benefit analysis throughout, but does not specify that the economic analyses performed for SEC rulemakings include several elements that are characteristic of such analyses which use that term, such as a specified timeframe (i.e., number of years with a specific beginning and ending date), discounting of costs and benefits, and a metric of comparison between costs and benefits.

annual costs, assume those costs are constant over time. The Current Guidance does not require inclusion of an explicit period, and RSFI has stated that to the extent it was deemed material to the analysis, staff economists would select an appropriate horizon on the basis of the circumstances underlying the analysis.

Requirement 4, Component 5

Component 5 specifies that the rule should discuss uncertainties underlying estimates of costs and benefits by describing all available quantitative information for non-monetized costs and benefits. Additionally, where monetization or other quantification is possible, the proposing release should include those numbers and solicit comment on them, and the adopting release should address any comments on the numbers. The absence of additional quantified information for non-monetized benefits or costs (or both) in the release text does not necessarily indicate that the Current Guidance was not followed.

Our review found that 9 of the 12 rules in our sample followed this component. The three rules that partially followed the component are described below.

- Release No. 33-9338 included no descriptions of quantitative information beyond PRA-type costs presented. For example, the release text did not have information about the size of the markets to be regulated by this rulemaking.

- Release No. 33-9354 only partially followed the component because there was no discussion of uncertainties underlying the estimates.

- Release No. 33-9330 did not include any quantitative information for non-monetized costs and benefits. The release did address comments received on data used in the proposing release; therefore, it partially followed the component.

While the Current Guidance does not mention discounting of costs and benefits or assessing the two against each other, it does use the term “timeframe,” though not as typically applied in cost-benefit analysis.

Requirement 4, Component 6

As noted above in the discussion of *Component 3*, when RSFI economists and rulewriting staff conclude that economic effects cannot reasonably be quantified, then *Component 6* applies. We evaluated releases for:

1) an explanation of the reason(s) why quantification was not practicable;

2) a qualitative analysis of the likely economic consequences of the proposal and the principal alternatives if complete quantification was not possible; and

3) a description of the strengths and limitations of the information underlying the qualitative cost-benefit analysis.

Of the 12 rules in our sample, we found that 5 rules fully explained the justification for not quantifying costs and benefits. Below we describe seven rules that partially followed this component.

- Release No. 34-67457 partially followed the component because it deferred detailed economic analysis until the SROs had submitted a single NMS plan. Specifically, the evaluation team found that the rulemaking provided adequate justification for not quantifying costs since the SROs would best be able to estimate their own internal costs when submitting the NMS plan. However, there are significant internal costs and benefits to the SEC as a result of the rulemaking. While the Current Guidance notes that the standard procedure of the SEC is to ignore internal costs, we found that there was not adequate justification given for ignoring internal costs and benefits.[56] Therefore, the rulemaking partially followed the component.

- Release No. 33-9330 partially followed the component because while it did not detail the reasons why quantification of costs and benefits was not practical, it did provide a qualitative analysis.

- Release Nos. 33-9354 and 34-67286 partially followed the component because they did include explanations of why quantification is not practicable, but did not explain the strengths and limitations of the information underlying the qualitative

[56] The Current Guidance states, “But in some cases the effect of the rules on internal SEC operations may be significant enough to be considered as a component of the overall costs and benefits. The degree of consideration given to internal costs and benefits will differ depending on their importance in a particular rulemaking.” p. 12.

economic analysis. In the case of Release No. 34-67286, the rulewriting team stated that this was strictly a process rule that prescribed the form and manner in which information is submitted to the SEC. Therefore, they felt that a discussion of the strengths or limitations of the qualitative economic analysis was not applicable to this release.

- Release No. 33-9338 partially followed the component. It stated that "programmatic costs were very difficult to quantify and measure," which the evaluation team found to be a statement rather than "an explanation of the reason(s) why quantification is not practicable."[57] However, the rule did include a substantial qualitative analysis of the proposal.

- Release No. IA-3483 partially followed the component. While interviews with RSFI and the rulewriting team revealed that they could not quantify the costs and benefits of the rule because they did not know the extent to which firms currently rely on the rule, a discussion of this was not in the benefits and costs section of the release. Specifically, the statement, "The extent to which firms currently rely on the rule is unknown," is in the release text, but the text does not suggest that this is why quantification is not possible and so we do not consider this to be "an explanation of the reason(s) why quantification is not practicable."[58]

- Release No. IC-30268 partially followed the component. While the release text documents that the lack of comprehensive data on Business and Industrial Development Companies (BIDCOs) prevents quantification beyond per-firm compliance costs, the release does not provide justification for not quantifying benefits.

We interviewed the rulewriting teams about those seven rules. (See Table 2 in Appendix II) We also interviewed RSFI economists about use of the Current Guidance generally during rulemakings. They told us that the economic analyses could not specify any additional cost estimates or benefits because the SEC did not have access to the detailed and robust data that it needed.

Requirement 4, Component 7

Component 7 includes language on supporting predictive judgments and framing costs and benefits. RSFI economists should:

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[57] The Current Guidance states that "the release should include an explanation of the reason(s) why quantification is not practicable." p. 13.

[58] Id., p. 13.

1) investigate the availability of studies or other empirical evidence that might inform the analysis at the outset of the rulemaking;

2) present in the rule a justification for reliance on certain empirical evidence or studies (or both) over others;

3) include in the rule an explanation of why any available studies or comments were discounted in the analysis for the rule; and

4) discuss in the release the impact of scenarios that might mitigate the costs or enhance the benefits of the rule, if the release discusses those scenarios.

Of the 12 rules in our sample, we found that 6 rules supported predictive judgments and addressed contrary data; 1 rule partially followed this component; and 5 rules were not assessed for this component. For those five rules, the scope of our evaluation did not enable us to assess the component, but we have no basis to believe that they did not comply.[59]

We found that Release No. 33-9338 partially followed the component because it did not cite studies, or explain why studies were discounted. It did, however, cite in the release GAO testimony about mitigating risks and so partially met the component.

Requirement 4, Component 8

Component 8 specifies guidance on combining the economic analysis of costs and benefits with the consideration of the effects on ECCF.[60] Specifically, the Guidance states:

> SEC rulemaking releases have often included separate sections captioned 'Cost-Benefit Analysis' ("CBA") and 'Efficiency, Competition, and Capital Formation' ("ECCF"). We do not believe this is necessary. This approach can result in redundancy and unnecessary parsing of economic effects.[61]

The Current Guidance then recommends potential approaches for integrating the ECCF analysis throughout the release.

Eleven rules discussed their effects on ECCF in the economic analysis and thus fully satisfied this component. One rule, Release No. IC-30268, did not include a

[59] We did not assess this component for these rules, as they were not selected for the indepth evaluation.

[60] Current Guidance, p. 14.

[61] Id.

discussion of ECCF in its economic analysis section. The rulewriting team stated that they understood the Current Guidance required a discussion of the most likely ECCF impacts of the rule, but because they believed that the rule would have no effect on ECCF, they did not include such information in the release. HDR understood the Current Guidance to require integration of consideration of the effects on ECCF into the economic analysis section of the release text. In this case, even though the rulewriting team believed the rule would have no effect on ECCF, we interpreted the Current Guidance to mean that the rulewriting team's determination of "no ECCF effect" should have been included in the release text.

Requirement 5 - Integration of Economic Analysis into the Rulemaking Process. *We found that all seven rules for which this requirement was assessed fully followed requirement 5 that "Economic Analysis [should be] integrated into the rulemaking process and the rule release."*

Our review of requirement 5 included a detailed evaluation of nonpublic documents beyond the rule release for the seven rules that we reviewed in more depth. We met with rulewriting team members for these seven rules.

We did not fully assess the five other rules that were a part of this evaluation for this requirement. We partially assessed these rules against requirement 5 on the basis of evidence that was in the rule release. We were unable to evaluate rules against components 2 and 3 using only publicly available release texts.[62] However, there is no requirement in the Current Guidance for documenting collaboration on the rules in release texts. Therefore, while we were not able to fully assess requirement 5 for these five rules, we did not find any evidence to suggest that requirement 5 was not fully met in any case. Further interviews with rulewriting teams, OGC, and RSFI indicated a broad belief that the implementation of the Current Guidance had resulted in collaboration across all rulemakings.

Conclusion

Our review found that the SEC rules in our sample followed the spirit and intent of the Current Guidance. All rules that we evaluated specified the justification for the rule (requirement 1), considered alternatives (requirement 3), and integrated the economic analysis into the rulemaking process (requirement 5).

All of the rules that we examined either fully (two rules) or partially (ten rules) followed requirement 2 on specification of the baseline. We further found that some rules did not clearly specify and discuss baselines in the economic analysis section; the current conditions were often presented separately from the economic analyses in rule releases. This is primarily an issue of presentation.

[62] See Appendix VII.

Also, some release texts did not completely and explicitly address the existing state of ECCF in the baseline discussion.

All of the rules that we examined either fully (five rules) or partially (seven rules) followed requirement 4 on the analysis of economic consequences. In addition, while all but one rule release discussed benefits qualitatively, only 1 out of 12 included quantification of benefits, which is a notably small portion of the rules that we evaluated. Further, while many rules estimated compliance costs in a manner similar to those presented for PRA submissions, only six attempted to estimate other costs. RSFI staff and the rulewriting teams indicated in interviews that they were hampered by lack of available data that was robust and specific enough to estimate many of the costs and benefits. They also indicated that the Current Guidance does not require that such estimates be made if the staff determines that it is not feasible to estimate those costs or benefits (or both). However, the Current Guidance requires that the release specify reasons why quantification was not feasible. We found that 5 of the 12 rules followed that component.

In addition, we found definitions of baselines for extensions to existing rules uniformly assumed continuation of the expiring regulation. However, the Current Guidance does not specify how the baselines for extensions should be treated. Instead, it requires a baseline that is "the best assessment of how the world would look in the absence of the proposed action." The Current Guidance also notes that "[a]n economic analysis of a proposed regulatory action compares the current state of the world, including the problem that the rule is designed to address, to the expected state of the world with the proposed regulation (or regulatory alternatives) in place."[63] In the case of extensions, the above two quotes from the Current Guidance offer contradictory direction.

Recommendation 1:

In consultation with the rulemaking divisions and offices, the Division of Risk, Strategy, and Financial Innovation (RSFI) should develop a general outline of economic considerations that discusses the substantive requirements for economic analyses in rule releases. Topics covered should include defining a baseline, explaining any quantification in the release, or explaining the reasons why benefits or costs (or both) could not be quantified. RSFI should also create a checklist that rulewriting teams can use when drafting rule releases. The checklist should clearly identify which elements of the *Current Guidance on Economic Analysis in SEC Rulemakings* must be included in public documents and which elements are recommended for inclusion in public documents, but are not required.

[63] Current Guidance, p. 6.

Management Comments. RSFI concurred with this recommendation. See Appendix VIII for management's full comments.

OIG Analysis. We are pleased RSFI concurred with our recommendation. The OIG considers this recommendation resolved. However, this recommendation will remain open until documentation is provided to the OIG that supports it has been fully implemented.

Recommendation 2:

The Division of Risk, Strategy, and Financial Innovation, in consultation with the Office of the General Counsel, should document the policies and procedures on how the *Current Guidance on Economic Analysis in SEC Rulemakings* applies to extensions of existing rules.

Management Comments. RSFI and OGC concurred with this recommendation. See Appendix VIII for management's full comments.

OIG Analysis. We are pleased RSFI and OGC concurred with our recommendation. The OIG considers this recommendation resolved. However, this recommendation will remain open until documentation is provided to the OIG that supports it has been fully implemented.

Finding 2: FINRA, other SROs, and the PCAOB Are Not Required to Follow the SEC's Current Guidance in their Rulemaking Efforts

The Current Guidance does not apply to the Financial Industry Regulatory Authority (FINRA), other self-regulatory organizations (SRO) under the Commission's jurisdiction, or to the Public Company Accounting Oversight Board (PCAOB). SROs are not required to conduct economic analysis under the Exchange Act, but are required to include in their rule filings a discussion of the potential impact of a proposed rule change on competition.

According to SEC staff, the Current Guidance does not apply to self-regulatory organizations, including FINRA, or to the PCAOB.[64] The Commission does not require SROs to follow the Current Guidance when submitting a proposed rule, nor are they required to conduct economic analysis under the Securities

[64] The PCAOB is not a self-regulatory organization; it is an independent, District of Columbia nonprofit organization established by the Sarbanes-Oxley Act. The SEC oversees PCAOB rule filings in a manner similar to SROs.

Exchange Act of 1934 (Exchange Act). The Commission does, however, consider the effects of SRO rule filings on ECCF. The Exchange Act requires SROs to include in their rule filings a discussion of the potential impact the proposed rule could have on competition. The Current Guidance was developed to focus exclusively on the process for SEC rulemakings and does not address Commission reviews of SRO rule filings. SEC staff members believe that the application of any specific requirements for SROs on how they conduct economic analysis in support of SRO rule filings would first require either a separate SEC rulemaking or legislation specifically establishing SEC direction on SRO economic analysis for rulemaking.

SROs under the SEC's Oversight

SROs are industry sector-specific participation organizations that set standards and requirements for their members and their activities in the marketplace. The Exchange Act, which established the SEC, includes standards that are applicable to SROs in connection with their obligation to oversee their members and markets. The SEC has oversight of 34 SROs including:

- seventeen national securities exchanges;
- nine registered clearing agencies;
- five notice-registered future exchanges;
- the Financial Industry Regulatory Authority;
- the Municipal Securities Rulemaking Board; and
- the National Futures Association.

The SEC also exercises oversight responsibility over the PCAOB, which is a nonprofit organization established by the Sarbanes-Oxley Act and not an SRO. However, the PCAOB's authorizing statute subjects its rule filings to a process similar to the process that is applied to SRO rules.

SRO Rulemakings and the Commission

While the Exchange Act does not explicitly require SROs to conduct any specific economic analysis, the notice and comment process under Section 19(b) of the Exchange Act allows for the SEC's consideration of potential impacts of proposed rule changes, including issues on economic analysis. SROs are required by the Exchange Act to include in their rule filings a discussion of the potential impact of the proposed rule change on competition,[65] but there is no existing requirement that the discussion include a broader assessment of economic effects.

The Exchange Act requires SROs to file proposed rules or proposed rule changes with the SEC. It gives the Commission authority to approve the SRO's proposed rule or rule change if it finds that the rule is consistent with the Exchange Act, or to disapprove the SRO's proposed rule or rule change if it does not make such a finding. Section 3(f) of the Exchange Act also requires the Commission, in rulemaking or in the review of a rule of an SRO, to consider or determine whether an action is necessary or appropriate in the public interest. The Commission must also consider, in addition to the protection of investors, whether the SRO rules or rule changes will promote efficiency, competition, and capital formation.[66] The definition of what constitutes an SRO rule or rule change is fairly broad and includes, among other things, changes in standards, fees, business or commercial practices, new products, etc.[67] In fiscal year 2012, the SEC received approximately 1,600 rule filings from SROs.

In some cases SEC economists may provide assistance in assessing SRO rule filings, depending on the nature of the rule filing and the issues that are raised. Currently, the SEC generally reviews SRO rule filings for consistency with the Exchange Act and in consideration of promoting ECCF and investor protection, among other things.

SRO rulemakings can take one of two paths:

> *Path 1*: The SRO rule takes effect automatically when filed with the SEC. These often consist of fee changes, 'non-controversial' rules and other similar actions. The SEC can temporarily suspend the proposed rule change that became effective upon filing if such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Exchange Act.

[65] See Item 4 of the General Instructions for Form 19b-4 (requiring that an SRO include in each rule filing a statement as to "whether the proposed rule change will have an impact on competition" and, if so, to provide certain additional explanation and details about such effects). This requirement is not applicable to the PCAOB, which, as noted above, is not an SRO.

[66] Section 3(f) of the Exchange Act. Section 3(f) does not apply to PCAOB rulemaking because the PCAOB is not an SRO. However, the Jumpstart Our Business Startups Act (JOBS Act) amended the Sarbanes-Oxley Act to provide that rules of the PCAOB adopted after the effective date of the JOBS Act do not apply to an audit of an emerging growth company unless the Commission determines that the rule is necessary or appropriate in the public interest, after considering the protection of investors and whether the rule will promote efficiency, competition, and capital formation. The PCAOB has incorporated ECCF analysis into its rulemaking since the JOBS Act became effective.

[67] See Section 19(b)(3)(A) of the Exchange Act, for example.

> ‘Non-controversial’ rules are effective immediately, but compliance is delayed unless the SEC waives the 30-day operative delay. The majority of SRO rulemakings – approximately 1,200 of the 1,600 in fiscal year 2012 – were “effective on filing.”
>
> *Path 2*: The SEC must make an actual finding to approve or disapprove the SRO rule. Many of these filings can have a business impact on the SRO.

SROs and the Current Guidance. Staff in RSFI, the rulemaking divisions and offices, and OGC informed us that the Current Guidance was developed expressly for SEC rulemakings only and was not intended to apply to SROs or the PCAOB. The SRO rulemaking process differs from the SEC rulemaking process in terms of both procedures and subject matter. Interviews with OGC and RSFI indicated that the Current Guidance was developed to apply to SEC rulemakings and does not address how the SEC reviews SROs’ proposed rules or the process SROs should use to assess impacts on competition arising from their rule proposals.

SEC management further informed us that none of the rules and forms applicable to SRO rule filings currently includes any requirements that direct SROs to conduct their rulemakings in a specific manner. SEC management believes that to establish rules or guidelines for the use of economic analysis in SRO rulemakings, Congress would have to adopt legislation or the Commission would have to undertake a separate rulemaking specifically to prescribe how SROs should conduct economic analysis in support of their rulemakings.

Conclusion

The Current Guidance does not apply to FINRA, other self-regulatory organizations under the Commission’s jurisdiction, or the PCAOB. As a result, the Commission does not require SROs to follow the Current Guidance when submitting a proposed rule. SROs are not required to conduct economic analysis under the Exchange Act, but SROs are required to include, in their rule filings, a discussion of the potential impact the proposed rule could have on competition. Additionally, the Commission considers the effects of SRO rule filings on ECCF when making a finding to approve or disapprove an SRO filing.

We make no recommendation for this finding.

Finding 3: The SEC's Use of the Current Guidance Has Been Effective in Incorporating Economic Analysis in the Rulemaking Process, but Improvements are Needed in Presenting Economic Analysis

> We determined that the SEC's use of the Current Guidance has been effective in incorporating economic analysis into the rulemaking process and in supporting decisionmaking on rule content. However, use of the Current Guidance has not always resulted in consistent presentation of information about the anticipated economic effects of regulatory actions across all rulemakings.

To measure effectiveness, we reviewed all 12 rules in our sample to determine if they included economic analysis in line with the Current Guidance. We also interviewed RSFI and the rulewriting offices about the subset of seven rules that we chose for a more indepth analysis. Specifically, for clarification, we interviewed RSFI and the rulewriting team for each of the seven rules. Further, we reviewed the supporting internal documentation for those seven rules to assess whether the collaboration and process requirement was followed.

While the rulewriting teams have generally followed the Current Guidance, economic analysis is not always consistently presented in the release text in alignment with the requirements of the Current Guidance. RSFI economists were involved in the rulemaking process from the outset of all the SEC rules that we reviewed to determine if they followed requirement 5 of the Current Guidance.[68] RSFI staff informed us that implementation of the Current Guidance has resulted in the rulewriting divisions and offices understanding the economic analysis requirements and that the rulewriting divisions and offices have engaged the support of RSFI at the beginning of the rulemaking process.

The following is a summary of our work outlined in Finding 1 of this report that is relevant to assessing the effectiveness of the Current Guidance.

> Requirement 1: All 12 rules in our sample followed the requirement that releases include a clearly identified justification for the regulatory action being discussed.
>
> Requirement 2: We found that the rulewriting teams did not consistently apply the Current Guidance for all 12 rules. Only 2 of

[68] See Appendix II for a discussion of the procedure we used to select rules for our evaluation of the process requirement in the Current Guidance.

the 12 rules had well-defined baselines fully in line with the requirements of the Current Guidance; the remaining 10 rules only partially followed the requirements. Also, most of the rules we reviewed did not specifically address the existing state of ECCF in the baseline.

Requirement 3: We found that all 12 rules followed the requirement that releases identify alternatives to proposed rules.

Requirement 4: We found that 5 rules fully followed this requirement and 7 partially followed it. While acknowledging that all rules are somewhat unique and rulewriting teams need flexibility in preparing economic analyses, we found that many rule releases did not address all components of this requirement.

- Component 3: Nine of the 12 rules provided evidence in their releases of all four elements for quantifying expected benefits and costs. Three of the rules provided evidence of some, but not all, of the elements.

- Component 6: Five of the 12 rules provided justification in their releases for not fully quantifying costs and benefits. Seven rules provided partial justification.

Requirement 5: We found that all 7 of the rules we assessed for this requirement followed the Current Guidance. For this requirement, we examined nonpublic documents for 7 of the 12 rules (see Appendix II for details) and found evidence that RSFI's economists were involved at or near the outset of the rulemaking process for the rules. For the remaining five rules, we did not assess internal documentation for adherence to this requirement.

Our review of internal documentation such as term sheets and draft proposing and adopting releases indicated that there was collaboration between the OGC, RSFI, and the rulewriting divisions and offices in many aspects of the rulemaking process, as required by the Current Guidance. Also, there was evidence of strong collaboration in drafting the economic analysis sections for the seven rules that we reviewed to determine if they followed the process requirement. Therefore, we determined that the Current Guidance has generally been effective in increasing the use of economic analysis throughout the rulemaking process and in supporting decisionmaking on rule content.

Conclusion

The Current Guidance has been effective in increasing the use of economic analysis through the rulemaking process, ensuring collaboration between RSFI and the rulewriting teams, and supporting decisionmaking on rule content. However, use of the Current Guidance has not always resulted in a clear and consistent presentation of information in the economic analyses. Specifically, the specification of baselines and information on the anticipated economic effects of regulatory actions in economic analyses supporting rulemakings was not always clearly and consistently presented.

We suggest that the SEC implement a management control, such as a guide, to assist economists and rulewriting teams in ensuring that the economic analyses are presented in a more consistent manner within release texts. A guide should include:

1) *Justification for the rulemaking action.*

    - Does the rule release include a discussion of the need for regulatory action and how the proposed rule will meet that need?

    - Where a cited justification for the rule is a statutory directive, does the release include a discussion of any justification cited by Congress for the need for regulatory action?

2) *The assumed baseline*.

    - Are the economic consequences of proposed rules measured against a baseline, which is the best assessment of how the world would look in the absence of the proposed action?

    - Is a "clearly stated" baseline described?

    - Is the baseline specified in the release text at the beginning of the economic analysis section or as part of a general introduction to the economic issues considered through the release?

    - Does the release include a specific discussion of: the existing state of efficiency; the existing state of competition; and the existing state of competition?

3) *Alternatives considered*.

- Does the release identify and discuss reasonable potential alternatives to the approach in the proposed rule?

- Does the proposed rule release solicit public comments on the alternatives and their analysis?

4) *Costs and benefits of the regulatory action and principal alternatives.*

- Does the rulewriting staff work with RSFI economists to develop the economic analysis?

- Does the analysis identify and describe the most likely economic benefits and costs of the proposed rule and alternatives?

- Does the analysis quantify expected benefits and costs to the extent possible?

- Does the analysis identify the source and method of quantification of costs and benefits?

- Does the analysis discuss any uncertainties underlying estimates of costs and benefits?

- Does the analysis explain the justification for not quantifying any unquantified costs and benefits?

- Does the analysis support predictive judgments and clearly address contrary data or predictions?

- Does the economic analysis of costs and benefits also include consideration of the effects on efficiency, competition, and capital formation?

Recommendation 3:

In consultation with the rulemaking divisions and offices, the Division of Risk, Strategy, and Financial Innovation should consider developing a management control, such as a guide, to facilitate greater consistency in presentation of economic analyses in proposing and adopting release texts. If developed, this guide would include sections identified as the four substantive requirements in the *Current Guidance on Economic Analysis in SEC Rulemakings.*

Management Comments. RSFI concurred with this recommendation. See Appendix VIII for management's full comments.

OIG Analysis. We are pleased RSFI concurred with our recommendation. The OIG considers this recommendation resolved. However, this recommendation will remain open until documentation is provided to the OIG that supports it has been fully implemented.

Finding 4: Rulemaking Methodologies Across the SEC Demonstrate Consistency

We found no notable differences in economic methodologies or practices in support of rulemakings across the divisions that developed the rules in our sample.

Of the 12 rules included in our sample, 4 were developed by the Division of Corporation Finance (CF), 6 by the Division of Trading and Markets (TM), and 2 by the Division of Investment Management (IM). All four of the rules that CF developed fully or partially followed the five requirements; all six of the rules that TM developed fully or partially followed the five requirements; and both rules that IM developed fully or partially followed the five requirements.

Of the seven rules that we reviewed in our analysis of process integration, two were published by CF, three by TM, and two by IM. Our interviews with rulewriting teams indicated that the staff worked with economists in RSFI to implement the Current Guidance throughout the rulemaking process.

Each rulewriting team described how they had discussed the baseline for the rule's costs and benefits with RSFI, which provides evidence of following requirement 2, specifically component 3. Each team also said that they sent comment summaries to RSFI during the rulemaking process. At least one rulewriting team stated that the economic costs of the rule helped form the final rule's requirements.

Across all rulewriting divisions and offices, RSFI staff are integrated into the rulemaking process prior to the completion of a draft. On the basis of our interviews and review of internal documentation, we determined that the SEC followed requirement 5 of the Current Guidance consistently across rulewriting divisions and offices. In some cases, RSFI staff drafted sections of the economic analysis and provided them to the rulewriting division. RSFI staff also described their plan to train each rulewriting division this year on implementing the Current Guidance and working with RSFI economists.

Overall, we determined that the rulemaking divisions and offices largely followed the requirements of the Current Guidance. We make no recommendation for this finding.

Finding 5: The SEC Could Benefit From Exploring Alternate Estimation Methodologies and Practices Used by Other Federal Administrative Agencies

> Although the SEC is not subject to Executive Order (E.O.) 12866, certain approaches that other Federal administrative agencies apply to rulemakings might be beneficial to the SEC in its rulemakings.

Although the SEC is not subject to E.O. 12866,[69] it could benefit from using certain approaches that other Federal administrative agencies–that are required to follow E.O. 12866–apply to their rulemakings. Specifically, the SEC should consider:

1) assessing uncertainty in quantified cost-benefit analyses;

2) scaling the level of analyses on the basis of classification of major and minor rules;

3) establishing and applying standards on application of analytical timeframes such that the future effects of proposed and adopted regulations might be included in economic analyses of regulatory effects; and

4) using proprietary or confidential business information to support economic analysis without identifying the source of the data.

[69] See E.O. 12866, *Regulatory Planning and Review*, issued September 30, 1993, 58 FR 51735 (Oct. 4, 1993).

During interviews with staff in RSFI and the division and office rulewriting teams, we discussed the processes, methods, and complexities faced when preparing economic analyses in support of rulemaking. We compared the results of these discussions and our review of the Current Guidance to the processes, methods, and requirements for conducting the "cost-benefit analysis" that is described in OMB Circular A-4, other related OMB documents on rulemaking, and our knowledge of rulemaking approaches at other administrative agencies.

We found that the term "economic analysis" is used throughout the Current Guidance; the term CBA is used a few times. The Current Guidance describes the approach the Commission takes in analyzing the costs and benefits of a rule. However, the Current Guidance does not define CBA or how this term differs from other types of economic analyses that the SEC prepares. Not defining the terms could lead to some SEC personnel using the two terms interchangeably, although they are different.[70] For external parties, the Current Guidance's use of the term CBA may result in expectations that the SEC intends to produce CBA metrics that compare costs and benefits against each other, such as net present value or internal rate of return. After evaluating the Current Guidance, we do not believe that this is the SEC's intention.

Some challenges that the SEC has faced and some issues identified during this evaluation could potentially be addressed by further incorporating specific elements in OMB Circular A-4 or practices that Federal administrative agencies have adopted. For example, many of the economic analyses in the SEC's rules do not incorporate an explicit analytical timeframe because they do not include either: 1) a full lifecycle cost analysis of the rule in their evaluation; 2) changes in costs and benefits over time; 3) dynamic impacts of rule changes; or 4) a discounting of the value of time. Administrative agencies typically estimate costs and benefits over an explicit timeframe, frequently 10, 20, or 30 years into the future, and present those monetized costs and benefits on a discounted basis.[71] The Current Guidance states that when quantifying costs and benefits, the economic analyses should "specify the timeframe analyzed."[72] Our interviews with rulewriting teams and RSFI found that they generally believe that releases should provide an estimate in the first year and a discussion of ongoing costs

[70] We generally observed conflation between the two terms by rulewriting teams. While the two have many similarities, a CBA should result in one or more metrics that are a direct comparison of benefits and costs, and that includes discounting of future benefits and costs such that the comparison is presented on a present value basis. (See OMB Circular A-4: "A distinctive feature of CBA is that both benefits and costs are expressed in monetary units, which allows you to evaluate different regulatory options with a variety of attributes using a common measure." p. 10.) SEC staff explained that economic analysis in support of rulemaking would include any analysis on the possible economic effects of a rulemaking, even where a comparison of costs and benefits, an assessment of discounted future effects, or one or more metrics indicating a level of favorability of an alternative are not presented.

[71] "The time frame for your analysis should cover a period long enough to encompass all the important benefits and costs likely to result from the rule." OMB Circular A-4, p. 15.

[72] Current Guidance, p. 13.

and benefits, if appropriate. They further indicated that they do not believe that there would be value in presenting a discounted present value of future benefits and costs over a longer timeframe.

Most notably, we found the following:

- In several rules that we reviewed, there was no evidence of an attempt to estimate beyond one-time compliance costs, and there was little evidence of assessing the size of affected markets or quantifying benefits.

- The Current Guidance does not address the application of economic analysis to extensions for temporary rules. As a result, the treatment of analyses in releases for extensions to existing temporary rules, even though they were the product of agreement between RSFI and rulemaking staff, contrasted with the requirements of the Current Guidance.[73] For Release No. IA-3483, the analysis in the original temporary rule was referenced, but it was not modified or updated.[74]

- Of the six rules that quantified ongoing costs, all of the rules presented costs as annual or first year and ongoing costs that do not change over time. None of these incorporated long-term potential dynamic impacts for structural changes in the financial markets.

RSFI staff informed us that they are concerned that they do not generally have enough robust data to calculate multi-year estimates of costs and benefits and generate common CBA metrics. Their chief concern was that such efforts could mislead readers who do not understand the strengths and weaknesses of the CBA methodology. While CBA methodology can highlight the overall impact of temporal changes and patterns in costs and benefits, it can also lead to overreliance on only those costs and benefits that are easily quantified and monetized.

We asked RSFI economists and rulewriting teams whether they had considered any of the approaches that other Federal administrative agencies use to facilitate a better understanding of costs and benefits when robust data is unavailable. Those approaches include using:

[73] The Current Guidance states that a baseline “is the best assessment of how the world would look in the absence of the proposed action.” p. 6.

[74] The baseline in this rule is the continuation of a temporary rule that was going to expire unless action was taken.

1) estimation of break-even points when costs are known, but benefits cannot be monetized with confidence;

2) costs per example firm or benefits per average beneficiary (or both) with characteristics defined by the economists preparing the analysis; and

3) benefit transfer methodologies when known benefits of a similar situation are calibrated and use a proxy.

The SEC has explored applying some of these approaches to its economic analyses. RSFI staff expressed some concerns about potential limitations of these approaches. In a 2012 speech, the SEC's Chief Economist discussed using estimation methodologies that draw from other areas: "We should identify and discuss uncertainties about estimates. Perhaps we had to analogize to another regulatory area to develop a quantified estimate."[75]

Many rulemaking staff we interviewed indicated that current SEC policies on the treatment of confidential data hampered their ability to gather and use data that could substantially improve economic analysis. A consensus among the rulewriting teams and RSFI staff is that generally all data used in the analysis should be part of the public record and can be subject to Freedom of Information Act (FOIA) requests. However, we found that other administrative agencies that use confidential data in their Regulatory Impact Analyses do not disclose details that are proprietary or the name of the entity to the public.[76]

Some of the releases we examined discussed the risks of market failure, but did not present an estimate of the likelihood or impact of failure. The SEC should examine and document the advisability of using a formalized risk analysis or sensitivity analysis (or both) as stipulated by OMB Circular A-4 (the former for rules with very large potential impacts and the latter for rules with less significant economic impact). In situations where costs are somewhat robust, but benefits are less tangible, break-even calculations can be used to determine the point at which costs equal benefits.

With the exception of Technical Rules, rulewriting teams must assess the likely economic impacts for each rulemaking. The level of effort required varies by the rule type, level of impact, complexity, and other factors. The SEC should consider revising the Current Guidance to require fewer analytical tasks for rules

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[75] Craig Lewis, "The Expanded Role of Economists in SEC Rulemaking," remarks made at the Securities Industry and Financial Markets Association Compliance and Legal Society Luncheon, October 16, 2012.

[76] For example, see the use of proprietary data via "subject matter expert" in U.S. Department of Transportation's *Final Regulatory Impact Analysis of Rulemaking on Enhanced Airline Passenger Protections,* Docket ID DOT-OST-2007-0022-0265 and its *Enhancing Airline Passenger Protections II – Final Regulatory Analysis,* Docket ID DOT-OST-2010-0140-2046.

that have a small impact and additional analytical requirements for rules that could potentially have a very large impact. This would result in a more formal differentiation of level of effort among rules and would also align with OMB Circular A-4.

Recommendation 4:

The Office of the General Counsel (OGC) should consider options for allowing the Division of Risk, Strategy, and Financial Innovation (RSFI) to include confidential information in the SEC's rules without releasing it to the public. The OGC and RSFI should prepare a memorandum that documents a process that they have vetted, to describe any potential new approaches to handling such information.

Management Comments. OGC and RSFI concurred with this recommendation. See Appendix VIII for management's full comments.

OIG Analysis. We are pleased OGC and RSFI concurred with our recommendation. The OIG considers this recommendation resolved. However, this recommendation will remain open until documentation is provided to the OIG that supports it has been fully implemented.

Recommendation 5:

The Division of Risk, Strategy, and Financial Innovation should examine the feasibility of presenting costs per example firm and benefits per average beneficiary where feasible for rule releases for which overall costs and benefits cannot be estimated. The results of this examination should be factored into the *Current Guidance on Economic Analysis in SEC Rulemakings* or its implementing procedures*.*

Management Comments. RSFI concurred with this recommendation. See Appendix VIII for management's full comments.

OIG Analysis. We are pleased RSFI concurred with our recommendation. The OIG considers this recommendation resolved. However, this recommendation will remain open until documentation is provided to the OIG that supports it has been fully implemented.

Recommendation 6:

The Office of the General Counsel and the Division of Risk, Strategy, and Financial Innovation should consider revising the *Current Guidance on Economic Analysis in SEC Rulemakings* to apply different levels of analysis for rules having different degrees of impact, remove reference to cost-benefit analysis, and specify procedures to be used for extensions of temporary rules.

Management Comments. OGC and RSFI concurred with this recommendation. See Appendix VIII for management's full comments.

OIG Analysis. We are pleased OGC and RSFI concurred with our recommendation. The OIG considers this recommendation resolved. However, this recommendation will remain open until documentation is provided to the OIG that supports it has been fully implemented.

Abbreviations

BIDCO	Business and Industrial Development Company
CBA	Cost-Benefit Analysis
CF	Division of Corporation Finance
Current Guidance	Current Guidance on Economic Analysis in SEC Rulemakings
Dodd-Frank	Dodd-Frank Wall Street Reform and Consumer Protection Act
ECCF	Efficiency, Competition, and Capital Formation
EDGAR	Electronic Data Gathering, Analysis, and Retrieval
E.O.	Executive Order
Exchange Act	Securities Exchange Act of 1934
FOIA	Freedom of Information Act
FINRA	Financial Industry Regulatory Authority
GAO	Government Accountability Office
HDR	HDR Engineering, Inc.
House Oversight Committee	U.S. House of Representatives Committee on Oversight and Government Reform
IM	Division of Investment Management
JOBS Act	Jumpstart Our Business Startups Act
NMS	National Market System
OGC	Office of the General Counsel
OIG	Office of Inspector General
OMB	Office of Management and Budget
OS	Office of the Secretary
PCAOB	Public Company Accounting Oversight Board
PRA	Paperwork Reduction Act
RSFI	Division of Risk, Strategy, and Financial Innovation
SEC or Commission	U.S. Securities and Exchange Commission
SRO	Self-Regulatory Organization
Subcommittee on TARP	Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs
TARP	Troubled Assets Relief Program
TM	Division of Trading and Markets

Scope and Methodology

This evaluation is limited to the requirements that are specified in the Current Guidance. To determine whether each rule within the scope of our review followed the Current Guidance, we developed measures on the basis of both the requirements expressly stated in the Current Guidance and also components based on the discussion of each requirement in the Current Guidance.

The Current Guidance stipulates certain elements to be contained in the public documents, while others do not have a specific location or type of document specified or required. Therefore, some requirements and the components are evaluated against documentation in rule releases as available in the *Federal Register*. Other requirements and components may be evaluated against documentation collected during fieldwork. Still other others may be evaluated against both.

Our evaluation did not seek to assess the SEC staff's professional judgment in the rulemakings reviewed in this report. Instead, the evaluation is based on our observations noted during our review consistent with our methodological approach and the objectives of this report. Specifically, we assessed the presence or lack of certain required or recommended components in the release texts and, in the case of rules selected for indepth review, supporting documents.

Scope. This evaluation focused on the requirements in the Current Guidance and on proposed, final, and interim final temporary[77] rules that were issued between March 16, 2012,[78] and November 30, 2012. We reviewed laws, regulations, and policies applicable to economic analysis by Federal agencies in general, including specific requirements for administrative agencies of the Federal Government.

Methodology. To meet the first objective of determining whether the SEC rules followed the Current Guidance, including the four "[s]ubstantive requirements" as well as the requirement of "enhanced integration of economic analysis" into the rulemaking process, we reviewed the Current Guidance and SEC rules[79] that

[77] The SEC issues interim final temporary rules when the requirement for a rule is urgent and the Commission cannot follow the normal course of the rulemaking process such as collecting comments from the public.

[78] OGC and RSFI internally circulated the Current Guidance to the rulemaking divisions on March 16, 2012.

[79] Our scope consisted of all rules with the exception of 10 technical rules and 1 rule that was completed prior to the Current Guidance, but was released after March 16, 2012. The rules excluded were: Release No. IA-3418 "Political Contributions by Certain Investment Advisers: Ban on Third-Party Solicitation (extension of compliance date)," Release No. 33-9287A "Technical Amendment to Net Worth Standard for Accredited Investors," Release No. 33-9303 "Adoption of Updated EDGAR Filer Manual," Release No. 33-9309 "Investment Company Advertising: Target Date Retirement Fund Names and Marketing (Reopening of Comment Period)," Release No. 33-9353 "Adoption of Updated EDGAR Filer Manual," Release No. 33-9364

were published from March 16, 2012, to November 30, 2012. We also interviewed Commission staff to determine how they prepared the economic analyses for the rules that we reviewed and their use of the Current Guidance. Lastly, we reviewed emails between rulewriting teams and RSFI, comments RSFI made on draft economic analyses, term sheets, internal memoranda RSFI prepared for rules, etc., and met with RSFI staff and rulewriting teams to discuss the coordination between the rulewriting teams and RSFI for conducting economic analysis under Requirement 5 of the Current Guidance.

We identified five overarching requirements in separate sections within the Current Guidance. The five requirements were identified from express statements in the Current Guidance. The first four are numbered and discussed under “A. Substantive requirements for economic analysis in the SEC rulemaking,” while the fifth is discussed under “B. Enhanced integration of economic analysis into the rulemaking process and rule releases.”

We then examined each of these sections to extract one or more components. The sections were further examined to extract definitions of these requirements and components supported directly by the text of the Current Guidance or text of reference documents directly cited in the Current Guidance (or both). Table 4 in Appendix VII lists each of the 20 components, including direct language from the Current Guidance, if it is useful and succinct. Each component is made up of one or more objective measures that can be used to determine whether the economic analysis of a particular rule meets the component. Those measurements are also extracted directly from the Current Guidance or from other documents cited in the Current Guidance. Those measures were examined to determine if the source requirements for measurement were likely to be the public text of the rule itself, a non-public source document, or a document that was unlikely to be available. This determination was based on the content of each individual measure.

To assess whether the Commission ensured that self-regulatory organizations under its jurisdiction[80] followed the Current Guidance, we interviewed SEC staff in TM, OGC, the Office of the Chief Accountant, and RSFI. We specifically asked whether the Commission requires the SROs to apply the Current Guidance to their rule filings. Further, we reviewed the relevant sections of the Exchange Act.

“Adoption of Updated EDGAR Filer Manual,” Release No. 34-66910 “Amendments to Financial Responsibility Rules for Broker-Dealers (Reopening of Comment Period),” Release No. IA-3403 “Technical Amendment to Rule 206(4)-5: Political Contributions by Certain Investment Advisers,” Release No. 34-67405 “Extension of Interim Final Temporary Rule on Retail Foreign Exchange Transactions,” and Release No. 34-67901 “Extension of Temporary Registration of Municipal Advisors.” We also excluded Release No. 33-9308 “Exemptions for Security-Based Swaps Issued by Certain Clearing Agencies” from the evaluation because it was completed prior to the introduction of the Current Guidance.

[80] These organizations include FINRA, other SROs, and the PCAOB.

To determine if the Current Guidance is effective, our second objective, we used a two-step approach. First, we interviewed Commission staff from RSFI as well as from the rulemaking offices and divisions of the Commission about the effectiveness of the Current Guidance. For the second step, we reviewed the findings from those interviews and noted any patterns or requirements for which a notable portion of the rules that we reviewed did, or did not, follow the Current Guidance.

To determine if all SEC rulemaking divisions and offices use a consistent methodology for economic analysis, our third objective, we grouped the rules reviewed in this evaluation by sponsoring office or division and then noted whether or not there were any notable differences or patterns across those groupings.

For our fourth objective, to determine if further improvements are needed for the SEC's rulemaking processes and procedures, we interviewed RSFI and Commission rulewriting teams, and also reviewed the Current Guidance, OMB Circular A-4, and rules published by other Federal agencies.

We asked rulewriting teams and RSFI for suggestions on how the Current Guidance could be improved, if at all. We discussed the merits and drawbacks of potential improvements, on the basis of the requirements for Federal administrative agencies in OMB Circular A-4. We also reviewed the requirements of the Current Guidance against OMB Circular A-4 on topics about which SEC staff raised concerns.

Internal Controls. For our evaluation, we assessed the Commission's internal controls significant to our objectives on the basis of OMB Circular A-123, *Management's Responsibility for Internal Control*. That circular states, "Management is responsible for developing and maintaining internal control activities that comply with the following standards…control environment, risk assessment, control activities, information and communication, and monitoring." The internal controls that we assessed included: 1) the Chief Economist's review and concurrence process for economic analysis; 2) OGC's review of rulemakings to ensure that the Commission addressed legal requirements; and 3) the rulewriting division's internal review process, such as the preparation of the economic analysis by staff attorneys, and senior management's (associate directors, deputy directors, and directors) review of the economic analysis.

Information Systems Controls. We did not rely on computer processed data; therefore, we did not assess information systems controls.

Judgmental Sampling. To identify our sample, we used judgmental sampling because of the small universe of rules in our scope. Between March 16, 2012, and November 30, 2012, the Commission proposed or adopted 23 rules, consisting of 5 proposed rules, 16 final rules, and 2 interim final temporary rules.

Out of the 23 rules, 10 rules were classified as "interpretative rules, general statements of policy, or rules of agency organization, procedure, or practice,"[81] or included in the release text an affirmative finding that "notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest."[82] We excluded those 10 rules from our review. Excluding technical rules, the interim final temporary rules, and Release No. 33-9308 (which was completed prior to the circulation of the Current Guidance), the remaining 12 rules were included in the substantive rules subset.

We identified seven rules, from among the substantive rules, for analysis to determine whether or not they followed the process requirement in the Current Guidance. This required us to review evidence other than the public documents, including term sheets, memoranda, draft analyses, meeting notes and minutes, and other correspondence.

The sampled rules that we evaluated in greater depth, to determine if they followed the process requirement, represent a fair cross-section of the substantive rules. However, this sample focuses on the rules published in the middle or at the end of the evaluation period. It generally excludes extensions of existing rules, except where noted in Table 2.

We selected our sample using the criteria and standards enumerated below. The rules that we select to evaluate: 1) should be less than half of all substantive rules identified; 2) should primarily include new regulations, as opposed to extensions of existing regulations or a change in compliance dates, since those earlier analyses were likely begun and even completed before the Current Guidance was published; 3) must be selected from both the middle and later periods of the timeframe to target rules more likely to have been prepared in full consideration of the Current Guidance to determine if they followed the process requirement; 4) should include representation from those SEC divisions that frequently issue rules and also from at least one SEC division that infrequently issues rules; 5) should include those that were found to have an economic analysis beyond the required PRA assessment, as well as rules that did not include an economic analysis beyond the PRA assessment; and (6) should include at least one (of two possible) that was not a "Dodd-Frank" rulemaking, meaning a rule not intended to implement some aspect of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).

Table 2 describes the rules that we included in the subset of the 12 substantive rules analyzed for evidence beyond the public rulemaking documents.

[81] Administrative Procedure Act (5 U.S.C. Subchapter II) § 553(b).

[82] Id.

Table 2: Listing of Rules Analyzed for Evidence Outside of Public Rulemaking Documents

Release No.	Date	Proposed Rule Title/Description *(as on SEC website)*	Sponsoring Divisions
33-9330	June 20, 2012	Listing Standards for Compensation Committees	CF
34-67457	July 18, 2012	Consolidated Audit Trail	TM
33-9338	July 18, 2012	Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping	TM
33-9354	August 29, 2012	Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings	CF
34-68071	October 18, 2012	Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers	TM
IA-3483	October 9, 2012	Temporary Rule Regarding Principal Trades with Certain Advisory Clients	Investment Adviser Regulation Office, IM
IC-30268	November 19, 2012	Purchase of Certain Debt Securities by Business and Industrial Development Companies Relying on an Investment Company Act Exemption	Investment Company Rulemaking Office, IM

Source: HDR Generated.

Prior Reviews: The SEC OIG has conducted two reviews of the SEC’s economic analysis in rulemakings since June 2011. Both reports were prepared in response to a Congressional request.

- *Report of Review of Economic Analyses Performed by the Securities and Exchange Commission in Connection with Dodd-Frank Act Rulemakings*, SEC OIG, June 13, 2011.

- *Follow-Up Review of Cost-Benefit Analyses in Selected Dodd-Frank Act Rulemakings*, Report No. 499, January 27, 2012.

Both reports concluded that systematic cost-benefit analyses were being conducted for SEC rulemakings, but noted some potential deficiencies and one made several recommendations for improvement.

The Current Guidance was prepared, in part, to address the noted deficiencies and incorporate the recommendations where feasible. As noted in Report No.

516, the OIG found that the recommendations in SEC OIG Report No. 499 were appropriately addressed in the Current Guidance.

Criteria

Administrative Procedure Act of 1946, 5 U.S.C. § 501 et seq. Provides minimal procedural standards that Federal administrative agencies must follow. With respect to rulemaking, the APA requires agencies to give the public advance notice of the contents of a proposed rule and to offer members of the public an opportunity to express their views on the proposed rule. The APA also provides that courts may set aside any rule found to be "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law."

Current Guidance on Economic Analysis in SEC Rulemakings. Provides guidance on economic analysis and broadly outlines best practices in conducting economic analysis. Discusses four elements of a good regulatory economic analysis and other factors necessary for a comprehensive economic analysis.

Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law No. 111-203, July 21, 2010. Reformed the financial regulatory system, including how financial regulatory agencies such as the SEC operate, and mandated that the SEC 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.

Office of Management and Budget (OMB) Circular A-4, Regulatory Analysis, Sept. 17, 2003. Provides OMB's guidance to Federal agencies on developing cost-benefit analyses required under E.O. 12866 and related authorities.

Paperwork Reduction Act of 1980, 44 U.S.C. § 3501 et seq. Gave authority over the collection of certain information to OMB and mandated that Federal agencies obtain an OMB control number before promulgating a form that will impose an information collection burden on the general public. Also required agencies to solicit and review public comments on the information collection requirements of proposed rules, to evaluate the need for information collection, and provide an estimate of the information collection burden.

Securities Act of 1933, Securities Exchange Act of 1934, Investment Company Act of 1940, and Investment Advisers Act of 1940. Contain provisions that require the Commission, when it is engaged in rulemaking under those Acts and is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

Securities Exchange Act of 1934, Section 23(a)(2), 15 U.S.C. § 78w(a)(2). Requires the SEC to consider the effect on competition of any rule promulgated under the Exchange Act.

List of Recommendations

Recommendation 1:

In consultation with the rulemaking divisions and offices, the Division of Risk, Strategy, and Financial Innovation (RSFI) should develop a general outline of economic considerations that discusses the substantive requirements for economic analyses in rule releases. Topics covered should include defining a baseline, explaining any quantification in the release, or explaining the reasons why benefits or costs (or both) could not be quantified. RSFI should also create a checklist that rulewriting teams can use when drafting rule releases. The checklist should clearly identify which elements of the *Current Guidance on Economic Analysis in SEC Rulemakings* must be included in public documents and which elements are recommended for inclusion in public documents, but are not required.

Recommendation 2:

The Division of Risk, Strategy, and Financial Innovation, in consultation with the Office of the General Counsel, should document the policies and procedures on how the *Current Guidance on Economic Analysis in SEC Rulemakings* applies to extensions of existing rules.

Recommendation 3:

In consultation with the rulemaking divisions and offices, the Division of Risk, Strategy, and Financial Innovation should consider developing a management control, such as a guide, to facilitate greater consistency in presentation of economic analyses in proposing and adopting release texts. If developed, this guide would include sections identified as the four substantive requirements in the *Current Guidance on Economic Analysis in SEC Rulemakings*.

Recommendation 4:

The Office of the General Counsel (OGC) should consider options for allowing the Division of Risk, Strategy, and Financial Innovation (RSFI) to include confidential information in the SEC's rules without releasing it to the public. The OGC and RSFI should prepare a memorandum that documents a process that they have vetted, to describe any potential new approaches to handling such information.

Recommendation 5:

The Division of Risk, Strategy, and Financial Innovation should examine the feasibility of presenting costs per example firm and benefits per average beneficiary where feasible for rule releases for which overall costs and benefits cannot be estimated. The results of this examination should be factored into the *Current Guidance on Economic Analysis in SEC Rulemakings* or its implementing procedures.

Recommendation 6:

The Office of the General Counsel and the Division of Risk, Strategy, and Financial Innovation should consider revising the *Current Guidance on Economic Analysis in SEC Rulemakings* to apply different levels of analysis for rules having different degrees of impact, remove reference to cost-benefit analysis, and specify procedures to be used for extensions of temporary rules.

Requirements of the Current Guidance

The requirements of the Current Guidance are presented in Sections A and B and consist of five major areas. Section A covers requirements on "substantive requirements for economic analysis in SEC rulemaking," and it includes four major requirements that rulemaking staff are to follow. Section B covers a requirement for "Enhanced integration of economic analysis into the rulemaking process and rule releases."

The Current Guidance's substantive requirements are summarized below:[83]

1. *Clearly identify the justification for the proposed rule*. This section indicates that rule releases must include a discussion of the need for regulatory action and how the proposed rule will meet that need. Included in the section is more specific guidance about including a discussion in the public rule documents:

    - Stating the need for the rule (i.e., Congressional direction, market failure, etc.) and how the proposed rule will meet that need.

2. *Define the baseline against which to measure the proposed rule's economic impact.* This section focuses on the baseline against which the economic consequences of proposed rules should be measured, which should be the "best assessment of how the world would look in the absence of the proposed action."[84] Elements of this section include:

    - ensuring that a well-developed baseline is articulated in the public rule documents;
    - discussing the baseline either at the beginning of the economic analysis section or as part of a general introduction to the economic issues that will be considered throughout the release;
    - developing the baseline with both the rulewriting staff and the RSFI economists;
    - clearly stating and describing any assumptions used in the baseline;

[83] Current Guidance, pgs. 4-15.

[84] Id, p. 6.

- consistently using the baseline throughout;
- including the baseline in the existing state (i.e., in absence of the rule) of ECCF;
- clearly specifying uncertain aspects of the baseline; and
- including both economic attributes of the relevant market and the existing regulatory structure, including (where relevant) state law in the baseline.

3. *Identify and discuss reasonable alternatives to the proposed rule.* This section discusses what constitutes reasonable alternatives to the rule being considered, including:

    - that the release includes and considers reasonable potential alternatives that are actually available to the SEC (i.e., the Commission has the authority to implement);
    - that both more stringent and less stringent alternatives could be considered;
    - that proposing releases should solicit public comment on alternatives; and
    - that the adopting release considers reasonable alternatives raised by public commenters.

4. *Analyze the economic consequences of the proposed rule and the principal regulatory alternatives.* This section addresses issues about analyzing and potentially estimating the likely economic costs and benefits of the proposed (or final) rule. Multiple subsections address issues including:

    - identifying and describing the most likely economic benefits and costs of the proposed rule and alternatives;
    - quantifying (i.e., measuring) the potential impact of the rule to the extent feasible;
    - monetizing (i.e., attaching a dollar value to) the potential quantified impact of the rule if practicable;
    - ensuring that assumptions used are clearly stated and described;

- identifying sources or methodology used to estimate costs and benefits (or both);
- clearly specifying those aspects of estimation that are uncertain;
- including both the economic impacts attributable to Congressional mandates and those resulting from an exercise of the Commission's discretion for rulemakings directed from statutes;
- explaining why elements that are not quantified cannot be quantified;
- addressing significant ancillary economic consequences;
- addressing any contrary data or predictions;
- framing costs and benefits neutrally and consistently; and
- considering the effects on ECCF.

In addition to substantive requirements on how to conduct economic analysis in SEC rulemakings, the Current Guidance also contains a procedural requirement that the analysis should be incorporated throughout the rulemaking process, from the beginning of policymaking to final decisions. Section B of the Current Guidance covers the procedural requirement for "Enhanced integration of economic analysis into the rulemaking process and rule releases." Those coordination and procedural requirements include:[85]

- fully integrating RSFI economists at the pre-proposal stage of the rulemaking process;
- involving RSFI economists throughout the course of writing proposed or final rules;
- preparing an explanation of the policy and economic rationale for the regulation during the pre-proposal stage;
- preparing a high-level discussion, during the pre-proposal stage, of the likely elements of the economic analysis, including economic benefits and costs, which specifies any data needs and is circulated among the rulewriting team;

[85] Current Guidance, pgs. 15-17.

- preparing, for proposing releases, a substantially complete analysis of the most likely economic consequences (prepared by or in consultation with RSFI economists);

- discussing, in proposing releases, any existing studies or data that bear on the proposal;

- including, in proposing releases, specific requests for comment on the economic analysis or additional quantitative information (or both);

- formally circulating to the Commission for action RSFI's concurrence on the economic analysis supporting the final draft of proposed rules;

- participating at meetings with commenters or other interested parties who specifically address comments on the economic analysis (participation by RSFI economists);

- including, in final rule releases, an economic analysis addressing any significant policy alternatives suggested by commenters that are not recommended for adoption;

- including, in final rule releases, an economic analysis addressing any other comments received about the economic effects of proposed rules and realistic alternative approaches;

- including, in final rule releases, an economic analysis addressing any new data provided by commenters;

- developing, for final rule releases, in close consultation with RSFI economists, a complete economic analysis of final rules addressing comments and alternatives from the public comment period; and

- formally circulating to the Commission for action RSFI's concurrence on economic analysis supporting the final draft of final rules.

Substantive Rules Examined

Table 3: SEC Rules HDR Identified in Its Sample for Substantive Review

Release Number	Release Date	Release Name	Sponsoring Divisions	Release Type	Statutory Authority
33-9330	June 20, 2012	Listing Standards for Compensation Committees	CF	Adopting	Dodd-Frank
33-9338	July 18, 2012	Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping	TM	Adopting	Dodd-Frank
33-9354	August 29, 2012	Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings	CF	Proposing	JOBS Act
34-66868	April 27, 2012	Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant"	TM	Adopting	Dodd-Frank
34-67286	June 28, 2012	Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies; Technical Amendments to Rule 19b-4 and Form 19b-4 Applicable to All Self-Regulatory Organizations	TM	Adopting	Dodd-Frank
34-67457	July 18, 2012	Consolidated Audit Trail	TM	Adopting	1934 Exchange Act
34-67716	August 22, 2012	Conflict Minerals	CF	Adopting	Dodd-Frank
34-67717	August 22, 2012	Disclosure of Payments by Resource Extraction Issuers	CF	Adopting	Dodd-Frank
34-68071	October 18, 2012	Capital and Margin Requirements for SBSDs and MSBSPs	TM	Proposing	Dodd-Frank
34-68080	October 22, 2012	Clearing Agency Standards	TM	Adopting	Dodd-Frank
IA-3483	October 9, 2012	Temporary Rule Regarding Principal Trades with Certain Advisory Clients	Investment Adviser Regulation Office, IM	Proposing	Dodd-Frank
IC-30268	November 19, 2012	Rule 6A-5, Purchase of Certain Debt Securities by Business and Industrial Development Companies Relying on an Investment Company Act Exemption	Investment Company Regulation Office, IM	Adopting	Dodd-Frank

Source: HDR Generated.

Requirements, Components, and Current Guidance Reference

Table 4: Requirements and Components

Requirement No.	Component No.	Requirement	Component
1		The release "[c]learly identif[ies] the justification for the proposed rule." (p. 5)	
	1.1		Rule releases "include a discussion of the need for regulatory action and how the proposed rule will meet that need." (p. 5)
	1.2		Where a cited justification for the rule is a statutory directive, includes a discussion of any justification cited by Congress for need for regulatory action.[86]
2		There is a defined baseline against which the proposed rule's economic impact is measured.	
	2.1		"The economic consequences of proposed rules . . . should be measured against a baseline, which is the best assessment of how the world would look in the absence of the proposed action." (p. 6)
	2.2		"The baseline being used should be specified either at the beginning of the economic analysis section or as part of a general introduction to the economic issues that will be considered throughout the release" and should "clearly describe the assumptions that underlie the descriptions of the relevant baseline and detail those aspects of the baseline specification that are uncertain." (p. 7)
	2.3		"Rulewriting staff should work with the RSFI economists to describe the state of the world in the absence of the proposed rule." (p. 7)
3		The rule release "identif[ies] and discuss[es] reasonable alternatives to the proposed rule." (p. 8)	
	3.1		The release identifies and discusses "reasonable potential alternatives to the approach in the proposed rule." (p. 8)
	3.2		Proposed rule releases "should also solicit public comment" on the alternatives and their analysis. (p. 9)

[86] The Current Guidance states that, "[a]lthough [RSFI and OGC] conclude that the Commission is not obligated to identify a justification for rulemaking beyond a Congressional mandate, there may be circumstances in which it could be useful to do so. For example, where Congress has itself stated that the mandate to engage in rulemaking is premised on a market failure or other compelling social need, the rulemaking release may identify that justification (and attribute it to Congress) in its description of the statutory mandate and explain how the rule (including any discretionary choices the Commission is making in the rulemaking) responds to the market failure or other compelling need that Congress identified." p. 6, Footnote 19. While we recognize that this statement does not impose an additional requirement on SEC rulemakings, it highlights an important difference from OMB Circular A-4's requirements.

Requirement No.	Component No.	Requirement	Component
4		There is an analysis of “the economic consequences of the proposed rule and the principal regulatory alternatives.” (p. 9)	
	4.1		“[R]ulewriting staff should work with the RSFI economists” to develop the economic analysis. (p. 9)
	4.2		The analysis identifies and describes “the most likely economic benefits and costs of the proposed rule and alternatives.” (p. 9)
	4.3		The analysis “quantif[ies] those expected benefits and costs to the extent possible.” (p. 9)
	4.4		The analysis “describe[s] the measurement approach used, include references to statistical and stakeholder data if available, and specif[ies] the timeframe analyzed.” (p. 13)
	4.5		The analysis “identif[ies] and discuss[es] uncertainties underlying the estimates of benefits and costs.” (p. 12)
	4.6		The analysis “[e]xplains why costs and benefits cannot be quantified.” (p. 13)
	4.7		The analysis “support[s] predictive judgments and clearly address[es] contrary data or predictions.” (p.14)
	4.8		The economic analysis “combine[s] the economic analysis considering costs and benefits with consideration of the effects on efficiency, competition, and capital formation” in the rule release.” (p. 14)
5		Economic Analysis is integrated into the rulemaking process and the rule release.	
	5.1		Economic analysis is used to assist with key policy choices in the rulewriting process. (p. 14)
	5.2		The RSFI economists are involved in the rulemaking process in the “pre-proposal stage.” (p. 15)
	5.3		The RSFI economists are involved in the rulemaking process in the “proposing stage.” (p. 16)
	5.4		The RSFI economists are involved in the rulemaking process in the “comment period.” (p. 16)
	5.5		The RSFI economists are involved in the rulemaking process in the “adopting stage.” (p. 16)

Source: HDR Generated from the Current Guidance.

Management Comments

MEMORANDUM

To:	Jacqueline Wilson, Assistant Inspector General for Audits Office of Inspector General
From:	Craig M. Lewis, Director, Division of Risk, Strategy, and Financial Innovation Anne K. Small, General Counsel
Re:	Management's Response to the Office of Inspector General's Draft Report, *Use of the Current Guidance on Economic Analysis in SEC Rulemakings*, Report No. 518, dated May 24, 2013
Date:	May 31, 2013

I. <u>Overview</u>

Thank you for the opportunity to respond to the Office of Inspector General's (OIG) Formal Draft Report No. 518 entitled *Use of the Current Guidance on Economic Analysis in SEC Rulemakings,* dated May 24, 2013 ("Report"). The Division of Risk, Strategy, and Financial Innovation ("RSFI") and the Office of the General Counsel ("OGC") submit this memorandum in response to the Report.

The Report contains six recommendations, and you have requested that we indicate whether or not we concur with the recommendations. As discussed in further detail below, we concur with the recommendations.

II. <u>General Comments</u>

As described in the Report and in companion OIG Report No. 516, on March 16, 2012, OGC and RSFI circulated to the staff of the SEC rulemaking divisions and offices a memorandum entitled "Current Guidance on Economic Analysis in SEC Rulemakings" (the "Current Guidance"). Then-Chairman Mary Schapiro directed the rulemaking divisions and offices to follow this guidance. The Current Guidance was developed in part in response to recent court decisions and reports of the U.S. Government Accountability Office (GAO) and the SEC's OIG, and was designed to enhance the Commission's ability to perform high-quality economic analysis in support of SEC rulemaking.

We believe that staff of the rulemaking divisions and offices, as well as RSFI and OGC, have been highly committed to effective implementation of the Current Guidance as part of our continuing efforts to conduct sound economic analyses in Commission rulemaking. The findings of the Report confirm our own observations that the Current Guidance has strengthened and improved both the content of and the process for economic analysis in Commission rulemakings.

In particular, we are pleased that the Report found that all of the rules examined followed the spirit and intent of the Current Guidance, and that all the rules evaluated integrated the economic analysis into the rulemaking process. Additionally, the Report's conclusion that all the rules evaluated had economic analyses that identified and described the most likely economic benefits and costs of the proposed rule and alternatives, highlights our commitment to incorporating high-quality economic analysis into Commission rulemaking.

The Report also determined that the SEC's use of the Current Guidance has been effective in incorporating economic analysis into the rulemaking process. Again, this finding confirmed our own observations that the Current Guidance has increased the integration of RSFI economists and economic analysis into the rulemaking process. Additionally, the Current Guidance is used agency-wide, and thus we are pleased that the Report found no notable differences in economic methodologies in support of rulemakings across rulemaking divisions.

We appreciate that the Report noted some areas for possible improvements to the presentation of economic analysis in rule releases, which we commit to carefully study and implement where appropriate. In this regard, we make two general observations.

First, we are striving to improve how all of our rules are presented generally and we continue to evaluate how best to present the economic analysis in rule releases. In considering how economic analysis is incorporated in Commission rules, we believe it is important to retain the flexibility provided by the Current Guidance, which states: "[t]his guidance—while broadly outlining best practices—is intended to allow for flexibility in the context of any particular rulemaking."[1] Specifically, we believe that the flexibility incorporated into the Guidance is essential to permit RSFI economists and other Commission staff to exercise professional judgment to address the varied, complex economic issues that arise in the course of Commission rulemaking and to ensure that the rule release provides the Commission and the public with a clear, transparent explanation of the likely economic consequences of Commission action. For example, there may be rules for which, in the professional judgment of RSFI's economists and other Commission staff, the most effective and approachable way to present the economic analysis is

[1] Current Guidance on Economic Analysis in SEC Rulemakings, p. 2.

to integrate it throughout the release. As OIG Report 499 recognized, a more integrated approach can improve the presentation of economic analysis by reducing redundancy; it can also provide a context that may make that analysis—and the role it plays in agency decisionmaking—more understandable.

Second, as stated in the Report, the Current Guidance consists of five major elements: four substantive requirements and one process requirement. The Report notes that for the purposes of your evaluation you divided those requirements into discrete "components" based on your reading of the discussion of each of those requirements in the Current Guidance. The Report acknowledges that "[a] component is not a term defined or used in the Current Guidance; [and that you] developed the concept of a component solely to facilitate [y]our evaluation." We understand that for the purposes of conducting an audit assessing adherence to the Current Guidance it may have been useful to divide the Current Guidance into individually-assessable "components" that you applied uniformly to each of the rules you examined. But we believe it would be contrary to sound rulemaking practice and efforts to produce high-quality economic analysis for the Current Guidance to be applied in a mechanistic or inflexible way. It is critical for RSFI economists and other staff to have sufficient flexibility to allow for the exercise of professional judgment as to what is appropriate in any individual rulemaking to ensure that the economic analysis is robust, transparent, and tailored to the unique economic considerations of each rule.

III. Response to Recommendations

Recommendation 1: In consultation with the rulemaking divisions and offices, the Division of Risk, Strategy, and Financial Innovation (RSFI) should develop a general outline of economic considerations that discusses the substantive requirements for economic analyses in rule releases. Topics covered should include defining a baseline, explaining any quantification in the release, or explaining the reasons why benefits or costs (or both) could not be quantified. RSFI should also create a checklist that rulewriting teams can use when drafting rule releases. The checklist should clearly identify which elements of the Current Guidance on Economic Analysis in SEC Rulemakings must be included in public documents and which elements are recommended for inclusion in public documents, but are not required.

RSFI concurs with this recommendation. We agree that developing additional staff training materials concerning economic analysis will assist the SEC staff in following the Current Guidance and developing robust, transparent economic analyses. The staff has now had over a year's experience in using the Current Guidance, and we can draw on that experience, as well as the findings contained in the Report, in helping to determine what additional topics may need to be addressed in supplemental materials. Because several of the recommendations below, as well

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as the recommendation in OIG Report No. 516, call for the development of various materials, the staff will explore developing a combined package of supplemental materials for applying the Current Guidance.

With regard to the suggestion for a checklist to be used in drafting rule releases, we acknowledge that a checklist may provide a useful drafting tool. Importantly, however, while the Current Guidance directs that the four substantive requirements and one procedural requirement must be followed in every case, it does not mandate a single approach to fulfilling those requirements in each rulemaking. Rather, the Current Guidance allows RSFI economists and the rulewriting teams to tailor the economic analysis to fit the unique circumstances of each rule. We will therefore work to implement this recommendation in a way that maintains the integrated involvement of RSFI economists and avoids creating a "check-the-box" approach to performing economic analysis in rulemakings.

Recommendation 2: The Division of Risk, Strategy, and Financial Innovation, in consultation with the Office of the General Counsel, should document the policies and procedures on how the Current Guidance on Economic Analysis in SEC Rulemakings applies to extensions of existing rules.

RSFI and OGC concur with this recommendation. We agree that this is a topic that should be included as part of the supplemental materials noted in our response to Recommendation 1.

Recommendation 3: In consultation with the rulemaking divisions and offices, the Division of Risk, Strategy, and Financial Innovation should consider developing a management control, such as a guide, to facilitate greater consistency in presentation of economic analyses in proposing and adopting release texts. If developed, this guide would include sections identified as the four substantive requirements in the Current Guidance on Economic Analysis in SEC Rulemakings.

RSFI concurs with this recommendation, as we believe it is worthwhile to consider the potential value of developing such a guide. As indicated above, however, the Guidance notes that it allows for flexibility; in each particular rule the staff must make professional judgments about the best way to present the relevant economic analysis to ensure that the analysis is presented in a clear, transparent manner. Thus, while the broad topics reflected in the suggested guide are likely to be part of the economic analysis in any given rulemaking, we are concerned that imposing a single rigid template for presenting that analysis could in particular cases make it less accessible and useful to the Commission and the public. We will consider how best to implement this recommendation while maintaining needed flexibility as we develop the supplemental materials noted in our response to Recommendation 1.

Recommendation 4: The Office of the General Counsel (OGC) should consider options for allowing the Division of Risk, Strategy, and Financial Innovation (RSFI) to include confidential information in the SEC's rules without releasing it to the public. The OGC and RSFI should prepare a memorandum that documents a process that they have vetted, to describe any potential new approaches to handling such information.

OGC and RSFI concur with this recommendation.

Recommendation 5: The Division of Risk, Strategy, and Financial Innovation should examine the feasibility of presenting costs per example firm and benefits per average beneficiary where feasible for rule releases for which overall costs and benefits cannot be estimated. The results of this examination should be factored into the Current Guidance on Economic Analysis in SEC Rulemakings or its implementing procedures.

RSFI concurs with this recommendation. We will consider whether this topic should be included as part of the supplemental materials noted in our response to Recommendation 1.

Recommendation 6: The Office of the General Counsel and the Division of Risk, Strategy, and Financial Innovation should consider revising the Current Guidance on Economic Analysis in SEC Rulemakings to apply different levels of analysis for rules having different degrees of impact, remove reference to cost benefit analysis, and specify procedures to be used for extensions of temporary rules.

OGC and RSFI concur with this recommendation. We agree that the topics noted merit further consideration, and we will also consider the extent to which they may be appropriately addressed as part of the supplemental materials noted in our response to Recommendation 1.

OIG's Response to Management Comments

We are pleased that RSFI and OGC concurred with the six recommendations in our report and are encouraged that the SEC will take the steps needed to fully implement the recommendations. We believe that the full implementation of these recommendations will serve to further improve the SEC's use of the Current Guidance in future rulemakings.

Based on our review of RSFI and OGC's joint response to this report, we would like to address certain statements in that response. RSFI and OGC state that our report found "all" the rules HDR examined during its evaluation followed the spirit and intent of the Current Guidance. While HDR found that the rules examined largely followed the spirit and intent of the Current Guidance, it is important to note HDR determined that certain rules did not fully follow some of the Current Guidance's requirements. For example, the report identifies improvements that can be made related to defining the baseline condition used in analysis, integration of ECCF in the baseline definition, and in discussing limitations experienced when attempting to quantify economic impacts. HDR found that, for the most part, the need for improvement is related to the presentation of collected and developed information in the release texts and not a failure to develop the required information.

Finally, the OIG agrees with management that our "components" approach was useful in conducting this evaluation. However, the OIG disagrees with RSFI and OGC's statement that the use of "components" in this report implies use of the Current Guidance in a "mechanistic or inflexible way" or that it compromises RSFI and OGC's perceived need for flexibility in rulemaking economic analysis. HDR's enumeration of assessable components did not in any way change the meaning of the Current Guidance. In fact, the components were derived directly from language in the Current Guidance.

Moreover, we have not recommended in our report that RSFI or OGC adopt a "components" approach to applying the Current Guidance. As noted in Recommendations 1 and 3, we believe that sound management controls can be helpful to the Commission in ensuring the Current Guidance is fully followed for each rulemaking, while also allowing for flexibility.

Audit Requests and Ideas

The Office of Inspector General welcomes your input. If you would like to request an audit in the future or have an audit idea, please contact us at:

U.S. Securities and Exchange Commission
Office of Inspector General
Attn: Assistant Inspector General for Audits (Audit Request or Idea)
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