U.S. Securities and Exchange Commission

Office of Inspector General

Office of Audits

Follow-Up Review of Cost-Benefit Analyses in Selected SEC Dodd-Frank Act Rulemakings

January 27, 2012
Report No. 499

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

OFFICE OF
INSPECTOR GENERAL

MEMORANDUM

January 27, 2012

To: Craig Lewis, Director, Division of Risk, Strategy, and Financial Innovation
Meredith Cross, Director, Division of Corporation Finance
Robert W. Cook, Director, Division of Trading and Markets
Eileen Rominger, Director, Division of Investment Management
Mark D. Cahn, General Counsel, Office of the General Counsel

From: H. David Kotz, Inspector General, Office of Inspector General (OIG)

Subject: *Follow-up Review of Cost-Benefit Analyses in Selected SEC Dodd-Frank Act Rulemakings*, Report 499

This memorandum transmits the U.S. Securities and Exchange Commission OIG's final report detailing the results on our follow-up review of cost-benefit analyses in selected SEC Dodd-Frank Act rulemakings. This review was conducted as a follow-up of a congressional request.

The final report contains 6 recommendations which if fully implemented should enhance how the Commission conducts cost-benefit analyses in Dodd-Frank rulemakings. The respective offices concurred with 5 of the report's 6 recommendations. Your written response to the draft report is included in the appendices.

Within the next 45 days, please provide the OIG with a written corrective action plan that is designed to address the report's agreed-up recommendations. The corrective action plan should include information such as the responsible official/point of contact, timeframes for completing required actions, and milestones identifying how you will address each recommendation.

Should you have any questions regarding this report, please do not hesitate to contact Noelle Maloney, Deputy Inspector General, at x-6035. We appreciate the courtesy and cooperation that you and your staff extended to OIG.

Attachment

cc: James R. Burns, Deputy Chief of Staff, Office of the Chairman
Luis A. Aguilar, Commissioner
Troy A. Paredes, Commissioner
Elisse B. Walter, Commissioner
Daniel Gallagher, Commissioner
Jeff Heslop, Chief Operating Officer, Office of Chief of Operations
Paula Dubberly, Deputy Director, Policy and Capital Markets, Division of Corporation Finance
Brian A. Bussey, Associate Director, Office of Derivatives Policy and Trading Practices, Division of Trading and Markets
Heather Seidel, Associate Director, Office of Market Supervision, Division of Trading and Markets
Robert E. Plaze, Deputy Director, Division of Investment Management
Richard A. Levine, Associate General Counsel, Office of Associate General Counsel (Legal Policy) 2, Office of the General Counsel
Adam W. Glass, Chief Counsel, Division of Risk, Strategy, and Financial Innovation

Follow-Up Review of Cost-Benefit Analyses in Selected SEC Dodd-Frank Act Rulemakings

Executive Summary

Background. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) was signed into law on July 21, 2010.[1] The law reformed the financial regulatory system, including how financial regulatory agencies operate. Among other things, the Dodd-Frank Act required the U.S. Securities and Exchange Commission (SEC or Commission) to undertake a significant number of studies and rulemakings, including regulatory initiatives addressing derivatives; asset securitization; credit rating agencies; hedge funds, private equity funds, and venture capital funds; municipal securities; clearing agencies; and corporate governance and executive compensation. Although the Dodd-Frank Act mandated specific rulemakings, it gave the SEC varying degrees of discretion to determine the content of particular rules.

On May 4, 2011, the SEC Office of Inspector General (OIG) received a letter from several members of the U.S. Senate Committee on Banking, Housing, and Urban Affairs requesting that the Inspector General review the economic analyses performed by the SEC in connection with six specific rulemaking initiatives undertaken pursuant to the Dodd-Frank Act.[2]

On June 13, 2011, we released a report on the results of our initial assessment of the cost-benefit analyses conducted for these six rulemakings (referred to hereafter as phase I). We concluded that the SEC had conducted a systematic cost-benefit analysis for each of the six rules, but found that the level of involvement of the Division of Risk, Strategy, and Financial Innovation (RiskFin) varied considerably from rulemaking to rulemaking. In addition, the phase I review found a lack of macro-level analysis and a lack of quantitative analysis on

[1] Pub. L. No. 111-203 (July 21, 2010).
[2] The six regulatory initiatives were Credit Risk Retention, 76 Fed. Reg. 24090 (proposed Mar. 31, 2011) (to be codified at 17 C.F.R. pt 246); Clearing Agency Standards for Operation and Governance, 76 Fed. Reg. 14472 (proposed Mar. 3, 2011) (to be codified at 17 C.F.R. pt. 240); Registration and Regulation of Security-Based Swap Execution Facilities, 76 Fed. Reg. 10948 (proposed Feb. 2, 2011) (to be codified at 17 C.F.R. pts. 240, 242, and 249); Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, 76 Fed. Reg. 8068 (proposed Jan. 26, 2011) (to be codified at 17 C.F.R. pts. 275 and 279); Registration of Municipal Advisors, 76 Fed. Reg. 824 (proposed Dec. 20, 2010) (to be codified at 17 C.F.R. pts. 240 and 249); and Conflict Minerals, 75 Fed. Reg. 80948 (proposed Dec. 15, 2010) (to be codified at 17 C.F.R. pts. 229 and 249).

the impact of the rules. In the report on phase I, we stated our intention to further analyze these areas.[3]

This follow-up, or phase II, analysis, examined the economic analyses performed by the SEC in connection with the following five Dodd-Frank Act rulemakings:

- Shareholder Approval of Executive Compensation and Golden Parachute Compensation, 76 Fed. Reg. 6010 (Jan. 25, 2011) (to be codified at 17 C.F.R. pts. 229, 240, and 249)
- Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 Fed. Reg. 4489 (Jan. 20, 2011) (to be codified at 17 C.F.R. pts. 229, 232, 240, and 249)
- Issuer Review of Assets in Offerings of Asset-Backed Securities, 76 Fed. Reg. 4231 (Jan. 20, 2011) (to be codified at 17 C.F.R. pts. 229 and 230)
- Reporting of Security-Based Swap Transaction Data, 75 Fed. Reg. 64643 (interim final temporary rule, Oct. 13, 2010) (to be codified at 17 C.F.R. pt. 240)
- Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information, 75 Fed. Reg. 75208 (proposed Nov. 19, 2010) (to be codified at 17 C.F.R. pts. 240 and 242)[4]

For this report, as for our phase I report, we retained an expert, Albert S. Kyle, to assist with our review of SEC cost-benefit analyses in Dodd-Frank Act rulemakings. Professor Kyle is the Charles E. Smith Chair Professor of Finance at the University of Maryland's Robert H. Smith School of Business.

Objectives. The overall objectives of our review were to

- assess whether the SEC is performing cost-benefit analyses for rulemaking initiatives that are statutorily required under the Dodd-Frank Act in a consistent manner across SEC divisions and offices and in compliance with applicable federal requirements and

- determine whether problematic areas exist where rigorous cost-benefit analyses were not performed for rulemaking initiatives and where improvements are needed and best practices can be identified to enhance the overall methodology used to perform cost-benefit analyses.

[3] *See Report of Review of Economic Analyses Conducted by the Securities and Exchange Commission in Connection With Dodd-Frank Act Rulemakings* (June 13, 2011); http://www.sec-oig.gov/Reports/AuditsInspections/2011/Report_6_13_11.pdf.
[4] In phase II, we also examined and discuss, as appropriate, several of the Dodd-Frank Act rulemakings we addressed in phase I.

Results. Although the SEC is not subject to an express statutory requirement to conduct cost-benefit analyses for its rulemakings, it is subject to statutory requirements to consider factors such as the effects on competition and the needs of small entities.[5] It generally must also provide the public with notice of and opportunity to comment on its rulemakings. Moreover, SEC Chairmen previously committed to Congress that the SEC would conduct cost-benefit or economic analyses in connection with its rulemaking activities, and it has consistently performed such analyses in its rulemakings. According to senior SEC management, the SEC shares the goals of and adheres to many of the requirements of executive orders that call for executive agencies to perform cost-benefit analyses for rulemakings, and SEC staff use internal compliance guidance that provides a detailed overview and an extensive list of best practices for use by SEC rulemaking divisions and offices in preparing cost-benefit analyses.

In the course of our review, we learned that when questions arose in 2010 about the extent to which cost-benefit analyses should be conducted for Dodd-Frank Act rulemakings, rulemaking teams and RiskFin consulted with the then–SEC General Counsel. On September 27, 2010, following these consultations, the former General Counsel, in a memorandum to rulemaking teams and RiskFin, provided his views on a framework for approaching economic analyses for Dodd-Frank Act rulemakings. The memorandum advised the following approach with respect to which rulemakings or portions of rulemakings should discuss and quantify costs and benefits:

> Where the Commission has a degree of discretion, the release should identify the discretion the Commission is exercising, the choices being made, and the rationale for those choices. To the extent that the Commission is exercising discretion, the release should discuss the costs and benefits of the choices proposed or adopted, including where possible, a quantification of the costs and benefits. With respect to those choices made by Congress, the release generally should cite to the legislative record to support and explain the benefits Congress intended by enacting the provision, but only as a matter of citation and not as a matter of assertion by the Commission.
>
> Where the Commission has no discretion, the release should say so. Because the Commission is making no policy choices, there are no choices to analyze or explain. [6]

[5] *See* 15 U.S.C § 77b(b), 15 U.S.C. § 78c(f), 15 U.S.C. § 80a(2), 15 U.S.C. § 80b-2(c), 15 U.S.C. § 78w(a)(2), 5 U.S.C. §§ 603(a), 604(a), 605(b).

[6] Memorandum from David M. Becker, General Counsel, Thoughts About Best Practices in Drafting Economic Analysis Sections of Releases for Dodd-Frank Related Rulemakings (Privileged and Confidential) (Sept. 27, 2010).

Based upon our review of the specific cost-benefit analyses performed for the rulemakings selected, we identified several significant issues. We did find overall that SEC rulemaking teams consistently adhered to internal policies for preparing cost-benefit analyses and, as a result, the cost-benefit analyses followed a systematic process from inception to completion. Nonetheless, we found that the extent of quantitative discussion of cost-benefit analyses varied among rulemakings and that none of the rulemakings examined in our phase II review attempted to quantify either benefits or costs other than information collection costs as required by the Paperwork Reduction Act. In addition, our expert, Professor Kyle, opined on the crucial role that economists play in ensuring that cost-benefit analyses incorporate both qualitative and quantitative information.

Significantly, we also found that in its cost-benefit analyses for Dodd-Frank Act rulemakings, the SEC generally focused on discretionary components—portions of rulemakings in which the Commission is able to exercise choice. Professor Kyle opined that in addition to satisfying statutory requirements, a cost-benefit analysis is intended to inform the public and other parts of government, including Congress, of the effects of alternative regulatory actions. While the September 2010 memorandum from the former General Counsel took the view that where the SEC has no discretion, there are no choices to explain, OMB Circular A-4, which provides guidance to executive agencies on conducting cost-benefit analyses required by Executive Order 12866, specifies that the baseline agencies should establish for use in defining the costs and benefits of an alternative "normally will be a 'no action' baseline." Therefore, to the extent that the SEC performs cost-benefit analyses only for discretionary rulemaking activities, in the opinion of Professor Kyle, the SEC may not be fulfilling the essential purposes of such analyses—providing a full picture of whether the benefits of a regulatory action are likely to justify its costs and discovering which regulatory alternatives would be the most cost-effective.

In addition, based on our examination of several Dodd-Frank Act rulemakings, the review found that the SEC sometimes used multiple baselines in its cost-benefit analyses that were ambiguous or internally inconsistent. For example, in the SEC's interim final temporary rule for registration of municipal advisors, portions of the cost-benefit analysis assumed as a baseline a minimal registration process that would allow municipal advisors to continue their usual activities with limited disruption. However, other parts of the cost-benefit analysis assumed that municipal advisers would be required to cease their advisory activities in the absence of a registration process, resulting in a shutdown of the municipal advisory market. Our review also found that there was often considerable overlap between the cost-benefit analyses and efficiency, competition, and capital formation sections of the releases for Dodd-Frank Act regulations, and that redundancy could be reduced by combining these two sections.

Further, we found that some SEC Dodd-Frank Act rulemakings lacked clear, explicit explanations of the justification for regulatory action. Specifically, some of the rulemakings that were premised on market failure alluded to market failure but did not explicitly cite it as a justification or fully discuss it. Other rulemakings included language that erroneously suggested a market failure justification and contained no compelling alternative rationale in support of the action. OMB Circular A-4 identifies market failure as one of several possible justifications for federal agency regulation. In discussing this point, the circular provides that an agency must demonstrate that proposed action is necessary before recommending regulatory action, citing Executive Order 12866's requirement that agencies "promulgate only such regulations as are required by law, are necessary to interpret the law, or are made necessary by compelling need, such as material failures of private markets to protect or improve the health and safety of the public, the environment, or the well being of the American people."[7] According to Professor Kyle, a more focused discussion of market failure in cost-benefit analyses would lay out the rationale for regulation more clearly to Congress, the general public, and the SEC itself.

Finally, the review found that although some of the SEC's Dodd-Frank Act rulemakings may result in significant costs or benefits to the Commission itself, internal costs and benefits were rarely addressed in the cost-benefit analyses. According to Professor Kyle, considering internal administrative costs and benefits is consistent with the purposes of a cost-benefit analysis, however, and provides a more complete picture of economic costs and benefits associated with government regulation.

Summary of Recommendations. Based on the results of our review, we are making the following recommendations:

1. SEC rulewriting divisions and RiskFin should consider ways for economists to provide additional input into cost-benefit analyses of SEC rulemakings to assist in including both quantitative and qualitative information to the extent possible.

2. The Office of the General Counsel, in consultation with RiskFin, should reconsider its guidance that the SEC should perform economic analyses for rulemaking activities to the extent that the SEC exercises discretion and should consider whether a pre-statute baseline should be used whenever possible.

3. SEC rulemaking teams should generally use a single, consistent baseline in the cost-benefit analyses of their rulemakings related to a particular topic. The baseline being used should be specified at the beginning of the cost-benefit analysis section. If multiple baselines are appropriate, such as for evaluating alternative

[7] *See* OMB Circular A-4**,** Regulatory Analysis (Sept. 17, 2003), at 3-4.

approaches or explaining the SEC's use of discretion, they should also be explained and justified.

4. SEC rulewriting divisions should consider discontinuing the practice of drafting separate cost-benefit analysis and efficiency, competition, and capital formation sections and instead provide a more integrated discussion of these issues in rule releases.

5. The Commission should consider directing rulemaking teams to (a) explicitly discuss market failure as a justification for regulatory action in the cost-benefit analysis of each rule that is based in whole or in part on perceived market failure or (b) in the absence of market failure, demonstrate a compelling social purpose that justifies regulatory action.

6. SEC rulemaking teams should consider including internal costs and benefits in the cost-benefit analyses of rulemakings.

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Background and Objectives

Background

On May 4, 2011, the U.S. Securities and Exchange Commission (SEC or Commission) Office of Inspector General (OIG) received a letter from several members of the U.S. Senate Committee on Banking, Housing, and Urban Affairs (Senate Banking Committee) requesting that the Inspector General review the economic analyses performed by the SEC in connection with rulemaking initiatives undertaken pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).[8] The letter stated that on February 15, 2011, the same Senate Banking Committee members had sent a letter to the SEC, Commodity Futures Trading Commission (CFTC), Board of Governors of the Federal Reserve System (Federal Reserve), Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency, in response to concerns raised by Commissioners at both CFTC and the SEC about economic analyses at their agencies.

The May 4, 2011, letter further stated that a CFTC OIG report released on April 15, 2011, raised issues that confirmed the concerns regarding the CFTC rulemaking expressed in the committee's February 15, 2011, letter. As a result, the May 4, 2011, letter asked that the SEC OIG, along with the CFTC, Federal Deposit Insurance Corporation, Federal Reserve, and Department of the Treasury OIGs, conduct reviews of the economic analyses being performed for rulemakings required under the Dodd-Frank Act. The letter asked that the SEC OIG's review focus on the cost-benefit analyses prepared by the SEC for six specific Dodd-Frank Act regulatory initiatives.[9]

On June 13, 2011, we released a report on the results of our initial assessment of the cost-benefit analyses conducted for these six rulemakings (referred to hereafter as phase I). We concluded that the SEC had conducted a systematic cost-benefit analysis for each of the six rules, but found that the level of involvement of the Division of Risk, Strategy, and Financial Innovation (RiskFin), whose responsibilities include providing economic analyses of proposed Commission actions, varied considerably from rulemaking to rulemaking. In addition, the phase I review found two areas of potential deficiency in the cost-

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

[9] The six regulatory initiatives were Credit Risk Retention, 76 Fed. Reg. 24090 (proposed Mar. 31, 2011) (to be codified at 17 C.F.R. pt 246); Clearing Agency Standards for Operation and Governance, 76 Fed. Reg. 14472 (proposed Mar. 3, 2011) (to be codified at 17 C.F.R. pt. 240); Registration and Regulation of Security-Based Swap Execution Facilities, 76 Fed. Reg. 10948 (proposed Feb. 2, 2011) (to be codified at 17 C.F.R. pts. 240, 242, and 249); Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, 76 Fed. Reg. 8068 (proposed Jan. 26, 2011) (to be codified at 17 C.F.R. pts. 275 and 279); Registration of Municipal Advisors, 76 Fed. Reg. 824 (proposed Dec. 20, 2010) (to be codified at 17 C.F.R. pts. 240 and 249); and Conflict Minerals, 75 Fed. Reg. 80948 (proposed Dec. 15, 2010) (to be codified at 17 C.F.R. pts. 229 and 249).

benefit analyses—a lack of macro-level analysis and a lack of quantitative analysis on the impact of the rules. In the report, we stated our intention to further analyze these areas, as well as RiskFin's collaboration on and involvement with the economic analyses for rulemakings.[10] This report presents the results of our follow-up analysis.

For our phase I report and this phase II follow-up report, we retained an expert, Albert S. Kyle, to assist with our review of SEC cost-benefit analyses in Dodd-Frank Act rulemakings. Professor Kyle is the Charles E. Smith Chair Professor of Finance at the University of Maryland's Robert H. Smith School of Business. He is an expert on many aspects of capital markets and has conducted significant research on such topics as informed speculative trading, market manipulation, price volatility, and the information content of market prices, market liquidity, and contagion. He has also worked as a consultant on finance topics for several government agencies in addition to the Commission, including the Department of Justice, the Internal Revenue Service, the Federal Reserve, and CFTC.

Dodd-Frank Act

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

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

The Dodd-Frank Act required the SEC to undertake a significant number of studies and rulemakings, including regulatory initiatives addressing derivatives; asset securitization; credit rating agencies; hedge funds, private equity funds, and venture capital funds; municipal securities; clearing agencies; and corporate governance and executive compensation. The act imposed deadlines for numerous rulemakings. Although the Dodd-Frank Act mandated specific

[10] *See Report of Review of Economic Analyses Conducted by the Securities and Exchange Commission in Connection With Dodd-Frank Act Rulemakings* (June 13, 2011); http://www.sec-oig.gov/Reports/AuditsInspections/2011/Report_6_13_11.pdf.

rulemakings, it gave the SEC varying degrees of discretion to determine the content of particular rules.

Statutes, Orders, Guidance, and Policy Related to Performance of Cost-Benefit or Economic Analyses

Although the SEC is not subject to an express statutory requirement to conduct cost-benefit analyses for its rulemakings, it is subject to statutory requirements to consider factors such as the effects on competition and the needs of small entities.[11] It generally must also provide the public with notice of and opportunity to comment on its rulemakings. In addition, according to senior SEC management, the SEC shares the goals of and adheres to many of the requirements of executive orders that call for executive agencies to perform cost-benefit analyses for rulemakings even though, as an independent agency, the SEC is not bound by these executive orders.

Statutes. The National Securities Markets Improvement Act of 1996 (NSMIA) amended the Securities Act of 1933 (Securities Act), the Securities Exchange Act of 1934 (Exchange Act), and the Investment Company Act of 1940 to provide that whenever the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, "the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation." The Gramm-Leach-Bliley Act of 1999 amended the Investment Advisers Act of 1940 to include the same requirement to consider efficiency, competition, and capital formation.[12] In addition, Section 23(a)(2) of the Exchange Act requires the Commission to consider the effect on competition of any rule promulgated under the act, stating that a rule shall not be adopted if it would impose a burden on competition that is not necessary or appropriate in furtherance of the purposes of the act.[13]

The Administrative Procedure Act of 1946 (APA) established a notice-and-comment rulemaking process which requires agencies to publish proposed rulemakings in the Federal Register, provide opportunity for interested persons to submit written comments, and give a concise general statement of the basis and purpose of the final rule.[14] Under the APA, the courts can, among other things, set aside a rule found to be "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law."[15]

[11] *See* 15 U.S.C § 77b(b), 15 U.S.C. § 78c(f), 15 U.S.C. § 80a(2), 15 U.S.C. § 80b-2(c), 15 U.S.C. § 78w(a)(2), 5 U.S.C. §§ 603(a), 604(a), 605(b).
[12] 15 U.S.C. § 77b(b), 15 U.S.C. § 78c(f), 15 U.S.C. § 80a(2), 15 U.S.C. § 80b-2(c).
[13] 15 U.S.C. § 78w(a)(2).
[14] 5 U.S.C. § 553(b)-(c).
[15] 5 U.S.C. § 706(2)(A).

The Paperwork Reduction Act (PRA) and the Regulatory Flexibility Act set forth specific requirements applicable to the rulemaking process. The PRA requires agencies to solicit and review public comments on the "collection of information" requirements of proposed rules.[16] The PRA also requires, among other things, that agencies evaluate the need for the collection of information and provide a "specific, objectively supported estimate of burden."[17] The Regulatory Flexibility Act requires agencies to consider the needs of small entities in evaluating proposed and final rules for all rules subject to notice and comment under the APA and to describe the impact of proposed and final rules on small entities, unless the agency head "certifies that the rule will not, if promulgated, have a significant economic impact on a substantial number of small entities."[18]

Executive Orders and OMB Guidance. Executive Order 12866, Regulatory Planning and Review (EO 12866),[19] Executive Order 13563, Improving Regulation and Regulatory Review (EO 13563),[20] and Office of Management and Budget (OMB) Circular A-4, Regulatory Analysis (OMB Circular A-4),[21] discuss requirements and regulatory principles, including cost-benefit analyses of proposed rules and regulations.

EO 12866, which was issued by President Clinton on September 30, 1993, was designed to ensure a regulatory system that, among other things, "improves the performance of the economy without imposing unacceptable or unreasonable costs on society." EO 12866 contains 12 "Principles of Regulation," which call for executive agencies, to the extent permitted by law and where applicable, to

- identify the problem to be addressed and assess its significance;
- examine whether existing regulations (or other law) have created or contributed to the problem a new regulation is intended to correct and should be modified to achieve the intended goal of regulation more effectively;
- identify and assess available alternatives to direct regulation;
- in setting regulatory priorities, consider, to the extent reasonable, the degree and nature of risks posed by substances or activities under their jurisdiction;
- design regulations in the most cost-effective manner to achieve the regulatory objective;
- assess both the costs and benefits of the intended regulation, and propose or adopt a regulation only upon a reasoned determination that the benefits justify its costs;

[16] 44 U.S.C. §§ 3506(c)(2)(A), 3507(a)(1).
[17] 44 U.S.C. § 3506(c)(1)(A)(i) and (iv).
[18] 5 U.S.C. §§ 603(a), 604(a), 605(b).
[19] Exec. Order No. 12866, Regulatory Planning and Review, 58 Fed. Reg. 51735 (Sept. 30, 1993).
[20] Exec. Order No. 13563, Improving Regulation and Regulatory Review, 76 Fed. Reg. 3821 (Jan. 18, 2011).
[21] OMB Circular A-4, Regulatory Analysis (Sept. 17, 2003).

- base decisions on the best reasonably obtainable information concerning the need for, and consequences of, the intended regulation;
- identify and assess alternative forms of regulation and, to the extent feasible, specify performance objectives;
- wherever feasible, obtain input from appropriate state, local, and tribal officials before imposing regulatory requirements that might significantly or uniquely affect those entities;
- avoid inconsistent, incompatible, or duplicative regulations;
- tailor regulations to impose the least burden on society, consistent with obtaining the regulatory objectives; and
- draft regulations in simple and easy-to-understand language.[22]

EO 12866 also requires that OMB review agency rulemakings to ensure that these principles are followed and that one agency's decisions do not conflict with the policies or actions of another agency.[23]

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

- Explain how the actions required by the rule are linked to the expected benefits. For example, indicate how additional safety equipment will reduce safety risks. A similar analysis should be done for each of the alternatives.
- Identify a baseline. Benefits and costs are defined in comparison with a clearly stated alternative. This normally will be a "no action" baseline: what the world will be like if the proposed rule is not adopted. Comparisons to a "next best" alternative are also especially useful.
- Identify the expected undesirable side-effects and ancillary benefits of the proposed regulatory action and the alternatives. These should be added to the direct benefits and costs as appropriate.[24]

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

SEC Policy and Guidance. EO 12866 and EO 13563 apply to agencies as defined in 44 U.S.C. § 3502(1) with the exception of independent regulatory agencies, which are listed at 44 U.S.C. § 3502(5). The SEC is an independent

[22] Exec. Order No. 12866 at 51735-36.
[23] *Id*. at 51737.
[24] OMB Circular A-4 at 2-3.

regulatory agency and, as such, is not bound by EO 12866 or EO 13563. Nevertheless, SEC Chairmen have made a commitment to Congress that the SEC will conduct cost-benefit or economic analyses in connection with its rulemaking activities. Specifically, according to Office of the General Counsel (OGC) officials, former SEC Chairman Arthur Levitt stated that there was an expectation that the SEC would perform cost-benefit analyses as part of the rulemaking process.[25] In fact, the Commission's current rulemaking procedures are closely aligned with the requirements of EO 12866, EO 13563, and OMB Circular A-4, as indicated by the following statement on the SEC's website:

> While [EO 13563] does not apply to independent agencies like the Commission, we share its goals, and many of our existing practices are consistent with those described in the Order. For example, we take into account benefits and costs in our rulemakings, assess alternative regulatory approaches, afford the public a meaningful opportunity to comment on our proposed regulations through the Internet, and coordinate our rulemakings with other agencies to harmonize regulations.[26]

Further, during a March 15, 2011, hearing before the House Appropriations Committee's Subcommittee on Financial Services and General Government, SEC Chairman Mary Schapiro stated that while EO 13563 does not apply to independent agencies, the SEC does much of what it requires, including conducting cost-benefit analyses and trying to make accommodations for smaller businesses.[27] She further stated that the SEC planned to form a small Business Advisory Committee and review rules that have been on the books for a long time to determine whether the SEC can provide relief to small businesses.[28] The SEC Compliance Handbook, prepared by OGC and last revised on October 1, 1999, includes the following points in its overview of cost-benefit analysis for SEC rulemakings:

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[25] Interview with members of SEC OGC on May 17, 2011.

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

[27] *Budget Hearing—Securities and Exchange Commission: Hearing Before the Fin. Serv. and Gen. Gov't Subcommittee of the H. Comm. on Appropriations,* 112th Cong. (Mar. 15, 2011) (testimony of SEC Chairman Mary Schapiro), Federal News Service, Inc. transcript at 26-27.

[28] *Budget Hearing—Securities and Exchange Commission: Hearing Before the Fin. Serv. and Gen. Gov't Subcommittee of the H. Comm. on Appropriations,* 112th Cong. (Mar. 15, 2011) (testimony of SEC Chairman Mary Schapiro), Federal News Service, Inc. transcript at 27. Further, in a March 2011, speech, Commissioner Troy Paredes commented on the importance of cost-benefit analysis: "[T]he Commission must engage in rigorous cost-benefit analysis when fashioning the securities law regime. A demanding cost-benefit analysis that permits us to make informed tradeoffs across a range of potential outcomes is the best way of achieving the common good, of ensuring that the benefits of regulation outweigh the costs." Troy Paredes, Commissioner, SEC, Remarks Before the 27th Annual NABE Economic Policy Conference (Mar. 8, 2011), http://www.sec.gov/news/speech/2011/spch030811tap.htm, at 4 (footnote omitted).

- The proposing release should identify possible direct and indirect costs and benefits for members of the industry, relevant market segments, and types of investors and issuers. It should also discuss any available data and solicit comments and additional data.

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

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

- RiskFin must concur in any numbers used in the cost-benefit analysis, and all numbers should be verified.

- The rulemaking divisions are primarily responsible for generating quantitative and qualitative information that forms the basis of a cost-benefit analysis. RiskFin may be able to provide data and analysis if it is consulted early in the process.[29]

The Compliance Handbook also includes the following best practices, among others, for use by SEC rulemaking divisions and offices in preparing cost-benefit analyses:

- At the proposing stage, the cost-benefit analysis should be tentative and should not reach any conclusions. As comments are received, the cost-benefit analysis should be refined.

- Rulemaking teams should schedule meetings with OGC and RiskFin early in the comment period to establish a workplan for gathering data and identifying possible costs and benefits.

- Some qualitative analysis may be included in the proposing release, but no "preliminary beliefs" or "preliminary conclusions" should be included.

- The proposing release should include quantitative data only if the data have been verified in some way or were derived from an independent source.

[29] *See* Compliance Handbook at 38-39.

- The proposing release should include a request for comments soliciting data and views on costs and benefits.

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

- Estimated compliance costs included in the adopting release must be verified (e.g., by surveying up to nine members of the affected industry segment).

- A complete cost-benefit analysis should consider macro costs, such as anticipated changes in market behavior, as well as micro costs, such as paperwork burdens.

- A cost-benefit analysis should consider both direct costs, such as costs incurred by a market participant subject to a rule, and indirect costs, such as costs incurred by customers or clients of the market participant.

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

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

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

- It is preferable to monetize costs and benefits when verifiable estimates are available. However, effects that cannot be fully monetized or quantified should be described.

- If a regulation includes a number of distinct provisions, the benefits and costs of the different provisions should be evaluated.

- All compliance costs should be verified. If a survey is used to gather industry data on compliance costs, OGC and RiskFin

should be involved in formulating the survey, and both RiskFin and the rulemaking division should retain the data retrieved for use in future rulemakings.

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

- The adopting release should include a cost-benefit analysis that goes beyond the cost-benefit analysis in the proposing release and further analyzes in some detail the costs and benefits identified. The adopting release should also summarize and respond to any comments relating to costs or benefits, regardless of whether a comment was expressly directed to the cost-benefit section of the proposing release.

- Backup documentation should be prepared and retained to support the SEC's cost-benefit analysis. The backup documentation includes any data or studies relied upon in the cost-benefit analysis. It also includes internal memoranda that memorialize conversations with, or information received from, outside persons about anticipated compliance costs or benefits.

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

- OGC provides advice on the sufficiency and appropriate form of a cost-benefit analysis.[30]

As discussed earlier, the SEC, an independent regulatory agency, is not expressly required to conduct cost-benefit analyses for its rulemakings, but there is an expectation that it will do so.[31] When questions arose in 2010 about the extent to which cost-benefit analyses should be conducted for Dodd-Frank Act rulemakings, rulemaking teams and RiskFin consulted with the then–SEC General Counsel. On September 27, 2010, following these consultations, the former General Counsel provided a memorandum to rulemaking teams and RiskFin entitled "Thoughts About Best Practices in Drafting Economic Analysis Sections of Releases for Dodd-Frank Related Rulemakings." The memorandum provided his views on a framework for approaching economic analyses for Dodd-Frank Act rulemakings:

[30] Compliance Handbook at 37-47.
[31] *See* Compliance Handbook at 37.

> The Commission engages in economic analyses to inform its exercise of discretion in crafting rulemaking. The Commission sets forth its analyses in releases to explain its rationale for the choices it proposes or adopts in light of the discretion it is exercising. The first task, therefore, in drafting the economic analysis sections of a release is to identify the extent to which the Commission is exercising discretion. That Congress intended the Commission to engage in rulemaking does not necessarily mean the Commission has no discretion with respect to the content of the rule. We need to be candid with ourselves and the public on this point.
>
> Where the Commission has a degree of discretion, the release should identify the discretion the Commission is exercising, the choices being made, and the rationale for those choices. To the extent that the Commission is exercising discretion, the release should discuss the costs and benefits of the choices proposed or adopted, including where possible, a quantification of the costs and benefits. With respect to those choices made by Congress, the release generally should cite to the legislative record to support and explain the benefits Congress intended by enacting the provision, but only as a matter of citation and not as a matter of assertion by the Commission.
>
> Where the Commission has no discretion, the release should say so. Because the Commission is making no policy choices, there are no choices to analyze or explain.
>
> Applying these principles takes good faith, judgment, and wisdom. In some instances reasonable persons may differ, and in all instances we are happy to discuss any differences of opinion.[32]

Objectives

The overall objectives of our review were to

- assess whether the SEC is performing cost-benefit analyses for rulemaking initiatives that are statutorily required under the Dodd-Frank

[32] Memorandum from David M. Becker, General Counsel, Thoughts About Best Practices in Drafting Economic Analysis Sections of Releases for Dodd-Frank Related Rulemakings (Privileged and Confidential) (Sept. 27, 2010). In a May 2011 speech, then–SEC Commissioner Kathleen Casey disagreed with this approach: "By limiting our cost-benefit analysis to those measures over which the Commission has full discretion, we fail to consider *all* the costs and benefits that will result from a particular regulatory action, whether or not that action was undertaken at the direct command of Congress, or through the exercise of our own judgment. . . . This is not to say that we should adopt an approach to cost-benefit analysis that is inappropriately rigid in the opposite direction." Kathleen Casey, Commissioner, SEC, Proposed Rules for Nationally Recognized Statistical Rating Organizations, SEC Open Meeting (May 18, 2011), at 2-3 (emphasis in original), http://www.sec.gov/news/speech/2011/spch051811klc.htm.

Act in a consistent manner across SEC divisions and offices and in compliance with applicable federal requirements and

- determine whether problematic areas exist where rigorous cost-benefit analyses were not performed for rulemaking initiatives and where improvements are needed and best practices can be identified to enhance the overall methodology used to perform cost-benefit analyses.

Findings and Recommendations

Finding 1: The SEC Takes a Systematic Approach to Performing Cost-Benefit Analyses

> SEC rulemaking teams consistently adhere to internal policies for preparing cost-benefit analyses. As a result, the cost-benefit analyses follow a systematic process from inception to completion.

NSMIA provides that the SEC shall consider whether an action will promote efficiency, competition, and capital formation (ECCF) whenever the Commission "is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest."[33] Additionally, Section 23(a)(2) of the Exchange Act requires the Commission to consider the impact that any rule promulgated under the act would have on competition.[34] This provision states that a rule shall not be adopted if it would impose a burden on competition that is not necessary or appropriate in furtherance of the purposes of the act.[35] Moreover, although the SEC, an independent regulatory agency, is not expressly required to conduct cost-benefit analyses, SEC Chairmen have made a commitment to Congress that the Commission will conduct cost-benefit or economic analyses for its rulemakings.

For our phase II review, we selected five Dodd-Frank Act rulemaking initiatives to determine whether the SEC consistently and systematically prepared a cost-benefit analysis for each rulemaking. We examined the following five rulemakings:

- Shareholder Approval of Executive Compensation and Golden Parachute Compensation, 76 Fed. Reg. 6010 (Jan. 25, 2011) (to be codified at 17 C.F.R. pts. 229, 240, and 249)
- Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 Fed. Reg. 4489 (Jan. 20, 2011) (to be codified at 17 C.F.R. pts. 229, 232, 240, and 249)
- Issuer Review of Assets in Offerings of Asset-Backed Securities, 76 Fed. Reg. 4231 (Jan. 20, 2011) (to be codified at 17 C.F.R. pts. 229 and 230)

[33] *See, e.g.,* 15 U.S.C. § 77b(b).
[34] 15 U.S.C. § 78w(a)(2).
[35] *Id.*

- Reporting of Security-Based Swap Transaction Data, 75 Fed. Reg. 64643 (interim final temporary rule, Oct. 13, 2010) (to be codified at 17 C.F.R. pt. 240)
- Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information, 75 Fed. Reg. 75208 (proposed Nov. 19, 2010) (to be codified at 17 C.F.R. pts. 240 and 242)

We found that the SEC included a cost-benefit analysis section in the proposing releases for all five rulemakings and in the adopting releases for all of the completed rulemakings. In the case of Regulation SBSR, the SEC had not published an adopting release when we conducted our fieldwork; therefore, we focused our analysis related to Regulation SBSR on the proposing release.

Our finding that the SEC consistently included cost-benefit analysis sections in its proposing and adopting releases was consistent with what we found during our phase I review. During phase I, at the request of the Senate Banking Committee, we examined the following six SEC Dodd-Frank Act rulemakings:[36]

- Credit Risk Retention, 76 Fed. Reg. 24090 (proposed Mar. 31, 2011) (to be codified at 17 C.F.R. pt. 246)
- Clearing Agency Standards for Operation and Governance, 76 Fed. Reg. 14472 (proposed Mar. 3, 2011) (to be codified at 17 C.F.R. pt. 240)
- Registration and Regulation of Security-Based Swap Execution Facilities, 76 Fed. Reg. 10948 (proposed Feb. 2, 2011) (to be codified at 17 C.F.R. pts. 240, 242, and 249)
- Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, 76 Fed. Reg. 8068 (proposed Jan. 26, 2011) (to be codified at 17 C.F.R. pts. 275 and 279)
- Registration of Municipal Advisors, 76 Fed. Reg. 824 (proposed Dec. 20, 2010) (to be codified at 17 C.F.R. pts. 240 and 249)
- Conflict Minerals, 75 Fed. Reg. 80948 (proposed Dec. 15, 2010) (to be codified at 17 C.F.R. pts. 229 and 249)

In addition, in this phase II review, as in the phase I review, we found that the extent of quantitative discussion of costs and benefits in the cost-benefit analyses for the rulemakings reviewed varied and that qualitative information on costs and benefits was generally discussed at greater length than quantitative information. Specifically, we found the following in the proposed and final rule releases that we examined in phase II:

- None attempted to quantify benefits.

[36] In this phase II review, we also examined and discuss, as appropriate, several of the Dodd-Frank Act rulemakings we addressed in phase I.

- All attempted to quantify the estimated PRA burden.
- None attempted to quantify non-PRA costs.
- Some used quantitative data to describe the market affected by the rulemaking.

The lack of quantitative discussion might have resulted from the fact that the analysis—consistent with OGC guidance—addressed only the costs and benefits of discretionary portions of the rulemaking and did not address the statutorily mandated portions. In addition, the SEC Compliance Handbook notes that the benefits of SEC rules "are generally difficult to quantify" and that in many cases it will not be possible to do so. In such cases, it says, "[a] detailed qualitative assessment of the anticipated benefits will thus be necessary."[37]

We also found during our phase II review that RiskFin economists were involved in preparing or commenting on the cost-benefit analyses for the rulemaking releases that we examined. We obtained copies of the comments provided by RiskFin economists to the rulemaking teams and noted that they provided substantive comments for each rulemaking. For example, our review of e-mails and drafts of the adopting release related to disclosure requirements for asset-backed securities[38] found that RiskFin economists provided multiple sets of comments to the rulemaking team during the process of finalizing the cost-benefit analysis section. We also found that the rulemaking divisions—the Division of Trading and Markets, the Division of Investment Management, and the Division of Corporation Finance—work closely with OGC, which also provides comments to rulemaking teams on the release drafts during the rulemaking process.

As we found during our phase I review, the SEC rulemaking divisions appeared to adhere to the guidance in the SEC Compliance Handbook. Specifically, each proposing release included a solicitation for comments from the public, including comments on the cost-benefit analysis section of the release. For example, the proposing release for the rulemaking on shareholder approval of executive compensation and golden parachute compensation asked for "estimates of the costs and benefits [described in the proposing release], as well as any costs and benefits not already defined, that may result from the adoption of these proposed amendments" and for "qualitative feedback on the nature of the benefits and costs described . . . and any benefits and costs we may have overlooked."[39] We also found that the cost-benefit analyses in the proposing releases that we reviewed were informational in nature and avoided conveying an impression that the Commission had reached any conclusions.

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[37] Compliance Handbook at 42. A recent Government Accountability Office report on Dodd-Frank Act implementation also commented on the difficulty of reliably estimating the cost of regulations to the financial services industry and the nation and noted that the benefits of regulation generally are regarded as even more difficult to measure. Government Accountability Office, *Dodd Frank Act Regulations: Implementation Could Benefit From Additional Analyses and Coordination*, GAO-12-151 (Nov. 10, 2011), at 19.
[38] 76 Fed. Reg. 4489.
[39] Shareholder Approval of Executive Compensation and Golden Parachute Compensation, 75 Fed. Reg. 66590, 66613 (proposed Oct. 18, 2010).

We found that both the proposing and adopting releases of the rulemakings we reviewed included descriptions of the markets to which the rules apply. The market description usually appeared in a section near the beginning of the release, and a section specifically devoted to cost-benefit analysis typically appeared near the end of the release.

In analyzing the cost-benefit analyses in both our phase I and II reviews, the OIG's expert, Professor Kyle, has opined that the role of economists is crucial in ensuring that cost-benefit analyses incorporate both qualitative and quantitative information. Economists provide particular expertise when research is needed to formulate quantitative measurements of costs and benefits based on how a market operates. In addition, the recent court decision in *Business Roundtable and Chamber of Commerce v. Securities and Exchange Commission* (known as the proxy access case) suggests that courts expect a sophisticated level of cost-benefit analysis in SEC rulemakings.[40] While we found that economists do play a significant role in the SEC's cost-benefit analyses, more extensive involvement of economists, in the opinion of Professor Kyle, would assist the SEC in conducting even more thorough analyses. According to Professor Kyle, economists at the SEC have a high level of expertise, but this expertise is being stretched thin. In addition, Professor Kyle believes that quantitative aspects of cost-benefit analyses would be greatly facilitated if SEC economists already had empirical expertise in relevant areas at the outset of regulatory initiatives, since developing expertise in specific data areas may take years.

Recommendation 1:

Securities and Exchange Commission rulewriting divisions and the Division of Risk, Strategy, and Financial Innovation (RiskFin) should consider ways for economists to provide additional input into cost-benefit analyses of Securities and Exchange Commission rulemakings to assist in including both quantitative and qualitative information to the extent possible.[41]

Management Comments. The Division of Corporation Finance (CF), Division of Investment Management (IM), RiskFin, Division of Trading and Markets (TM), and OGC concur with this recommendation. See appendix VI for management's full comments.

[40] *See Business Roundtable and Chamber of Commerce v. Securities and Exchange Commission*, 647 F.3d 1144 (D.C. Cir. Jul. 22, 2011), which vacated the SEC's shareholder access rule, Rule 14a-11, as being arbitrary and capricious because the SEC had failed to assess the economic effects of the rule adequately. The rule would have required that public companies under certain circumstances include in their proxy materials shareholder-proposed nominees to the board of directors.

[41] If the rulewriting divisions and RiskFin determine that it is not possible to quantify costs and benefits, they should explain why and present any relevant quantitative information, along with a discussion of the strengths and weaknesses of qualitative information provided. OMB Circular A-4 at 27.

OIG Analysis. We are pleased that CF, IM, RiskFin, TM, and OGC concur with this recommendation. See appendix VII for our full response to management's comments.

Finding 2: The SEC's Focus on Discretionary Rulemaking Activities May Not Always Serve the Broadest Purposes of Cost-Benefit Analyses

> In the cost-benefit analyses for its Dodd-Frank Act rulemakings, the SEC generally focuses on discretionary components—portions of rulemakings in which the Commission is able to exercise choice. This focus on discretionary components may not provide a complete picture of the costs and benefits of implementing the statute.

According to Professor Kyle,[42] in addition to satisfying statutory requirements and nonstatutory best practices, a cost-benefit analysis is intended to inform the public and other parts of government, including Congress and the regulating entity itself, of the effects of alternative regulatory actions.[43] By restricting its cost-benefit analyses to discretionary elements of Dodd-Frank Act rulemakings, the SEC is implicitly assuming that it can achieve these purposes without examining the costs and benefits of mandatory elements of Dodd-Frank Act rulemakings.

As discussed earlier in this report, although the SEC, an independent regulatory agency, is not expressly required to conduct cost-benefit analyses for its rulemakings,[44] there is an expectation that it will do so.[45] In addition, NSMIA requires that the SEC consider ECCF in certain rulemakings.[46] Under the PRA, the SEC is also required to evaluate the need for collection of information proposed in rulemakings and to provide a specific estimate of the burden imposed by information collection requirements.

When questions arose within SEC rulemaking teams and RiskFin about how to conduct cost-benefit analyses for Dodd-Frank Act rulemakings, the former SEC General Counsel provided guidance stating that the SEC "engages in economic analyses to inform its exercise of discretion in rulemaking." Based on this

[42] In this report, Professor Kyle is not expressing an opinion that SEC practice with respect to cost-benefit analyses for Dodd-Frank Act rulemakings is inconsistent with legal requirements.
[43] *See* OMB Circular A-4 at 2.
[44] *See* discussion in the background section of this report of EO 12866 and EO 13563 and their applicability to independent regulatory agencies.
[45] *See* Compliance Handbook at 37.
[46] *See, e.g.,* 15 U.S.C. § 77b(b).

rationale, the guidance states, "To the extent that the Commission is exercising discretion, the release should discuss the costs and benefits of the choices proposed or adopted, including where possible, a quantification of the costs and benefits." The guidance also states that when the Commission has no discretion, it is making no policy choices, and "there are no choices to analyze or explain."[47] OMB Circular A-4, which provides guidance to executive agencies on conducting cost-benefit analyses required by EO 12866, specifies that agencies should establish a baseline for use in defining the costs and benefits of an alternative and that the baseline "normally will be a 'no action' baseline."[48] Moreover, the circular recommends that when substantial portions of a rule simply restate statutory requirements that would be self-implementing even in the absence of the regulatory action, the agency "should use a pre-statute baseline."[49] Circular A-4 also states, "If you are able to separate out those areas where the agency has discretion, you may also use a post-statute baseline to evaluate the discretionary elements of the action."[50] To the extent that the SEC performs cost-benefit analyses only for discretionary rulemaking activities, in the opinion of Professor Kyle, the SEC may not be fulfilling the essential purposes of such analyses—providing a full picture of whether the benefits of a regulatory action are likely to justify its costs and discovering which regulatory alternatives would be the most cost-effective.[51]

According to Professor Kyle, the following hypothetical example illustrates the potential importance of using a pre-statute baseline for cost-benefit analyses: Congress mandates a new rule but gives the SEC discretion to exempt small firms from the rule. A cost-benefit analysis of applying the rule to all firms shows that (1) the benefits of the new rule have a value equal to 1 percent of the market capitalization of each firm and (2) the costs of complying with the rule are $1 million for each firm, regardless of its size. These results create a rationale for exempting small firms because although the benefits for firms with capitalization greater than $100 million exceed the $1 million compliance cost, the benefits for firms with capitalization below $100 million do not. In this example, it would be difficult or impossible to justify exempting firms with market capitalization below $100 million without addressing the mandatory portions of the rule in the cost-benefit analysis.

Moreover, it is often difficult to describe incremental costs and benefits of going from the statutory mandate to a reasonable alternative without also describing how the pre-statute state of the world differs from the statutory mandate. One way to calculate the incremental costs and benefits of a reasonable alternative and a statutory mandate is to describe the costs and benefits of the reasonable

[47] Memorandum from David M. Becker, General Counsel, Thoughts About Best Practices in Drafting Economic Analysis Sections of Releases for Dodd-Frank Related Rulemakings (Privileged and Confidential) (Sept. 27, 2010).
[48] OMB Circular A-4 at 2.
[49] OMB Circular A-4 at 15-16.
[50] OMB Circular A-4 at 16.
[51] *See* OMB Circular A-4 at 1-2.

alternative relative to the pre-statute baseline, then subtract out the incremental costs and benefits of the statutory mandate relative to the pre-statute baseline.

The SEC's Use of a Post-Statute Baseline

We examined two Dodd-Frank Act rulemakings that considered only the costs and benefits of discretionary components—in other words, that used a post-statute baseline—in their cost-benefit analyses.

Shareholder Approval of Executive Compensation and Golden Parachute Compensation (Final). Section 951 of the Dodd-Frank Act amended the Exchange Act by adding Section 14A, which requires that companies conduct a separate shareholder advisory vote to approve the compensation of executives (also known as "say-on-pay") and a separate shareholder advisory vote to determine how often a shareholder advisory vote on executive compensation will be conducted. In addition, Section 14A requires that companies soliciting votes to approve mergers or acquisitions disclose certain "golden parachute" compensation arrangements and, in certain circumstances, conduct a separate shareholder advisory vote to approve such arrangements. The Dodd-Frank Act assigned the SEC responsibility for promulgating regulations to implement golden parachute disclosure compensation arrangements. The SEC issued its final rule implementing Section 951's requirements on January 25, 2011.

The final rule goes beyond a minimal implementation of the Dodd-Frank Act requirements in a number of respects, including the following:

- It requires enhanced disclosures about how the issuer has taken into account the mandated advisory votes.
- It clarifies that companies required to conduct annual mandatory votes under the Troubled Asset Relief Program need not conduct redundant say-on-pay or frequency votes.
- It delays for two years requiring say-on-pay and frequency votes for small companies.
- It clarifies the ability of shareholders to make proposals relating to executive compensation.
- It requires both narrative and tabular disclosure on golden parachute compensation.
- It broadens the required golden parachute disclosures to include the full scope of such arrangements.

The introduction to the cost-benefit analysis section of the rule contains the following language:

> We are sensitive to the costs and benefits imposed by the rule and form amendments we are adopting. The discussion below focuses on the costs and benefits of the amendments made by the

> Commission to implement the Act within its permitted discretion, rather than the costs and benefits of the Act itself.[52]

In effect, this approach involves examining costs and benefits relative to a post-Dodd-Frank Act baseline rather than a pre-Dodd-Frank Act baseline. Other SEC rulemakings that include aspects mandated by the Dodd-Frank Act contain similar language.

The Shareholder Approval of Executive Compensation and Golden Parachute Compensation rule's cost-benefit analysis is consistent with the approach described. The adopting release's discussion of costs and benefits is confined to the costs and benefits of the provisions that go beyond the requirements of the act. It does not discuss the costs and benefits of say-on-pay votes, frequency votes, or disclosures and votes on golden parachute compensation that are mandated by the Dodd-Frank Act. For example, the rule provides a two-year deferral for small companies to conduct say-on-pay and frequency votes in order to allow them to observe how the rules operate for other companies and to prepare better for implementation of the rules.[53] Because the Commission did not analyze the costs and benefits of the statutorily mandated say-on-pay and frequency vote provisions, however, it is not possible to understand how the Commission concluded that a temporary deferral for small companies was justified. It is difficult to understand how the SEC is using its discretion on this issue without also understanding the SEC's thinking concerning the effects of the mandatory provision requiring say-on-pay votes. In some cases, the additional analysis necessary to address mandatory Dodd-Frank Act provisions may not be difficult to undertake. For example, the rule also broadens the statutorily mandated golden parachute disclosures to include the full scope of such arrangements. It is likely that the costs and benefits of such fuller disclosures are very similar to the costs and benefits of mandatory provisions, and discussion of these discretionary costs and benefits would therefore have very similar content to discussion of the mandatory provisions. Thus, addressing the statutorily mandated disclosures in the cost-benefit analysis would likely impose no significant additional analytical burden on rulemaking teams.

The rule contains a separate ECCF section, which, like the cost-benefit analysis, uses a post-statute baseline. The discussion does not evaluate the effects of the Dodd-Frank Act's requirements on ECCF but instead addresses how the differences between the rule and the requirements specified in the act affect ECCF.[54]

The approach to measuring costs mandated by the PRA differs from the approach used in the cost-benefit analysis. First, according to the September

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[52] 76 Fed. Reg. 6010, 6037, http://federalregister.gov/a/2011-1971.
[53] SEC Adopts Rules for Say-on-Pay and Golden Parachute Compensation as Required Under Dodd-Frank Act (press release) (Jan. 25, 2011), http://www.sec.gov/news/press/2011/2011-25.htm.
[54] *See* 76 Fed. Reg. 6010, 6040, http://federalregister.gov/a/2011-1971.

2010 guidance from the former SEC General Counsel, "in connection with releases where the Commission exercises no discretion, OMB has recently taken the position that, if a rule contains [or amends?] a collection of information, we must publish a PRA analysis with burden estimates and solicit comments on that analysis."[55] Second, the PRA covers only costs related to information disclosure. Therefore, although the PRA estimate in such cases does use a pre-statute baseline, it addresses only costs related to the information disclosure, as indicated by the following statement in the adopting release for the Shareholder Approval of Executive Compensation and Golden Parachute Compensation rule: "We estimate the annual incremental paperwork burden for all companies to prepare the disclosure that would be required under both Exchange Act Section 14A and our rule amendments to be approximately 24,942 hours of company personnel time and a cost of approximately $7,841,200 for the services of outside professionals."[56]

Because of the post-statute baseline used by the SEC in performing cost-benefit analyses for Dodd-Frank Act rulemakings and addressing ECCF, along with the limited scope of PRA requirements, the Shareholder Approval of Executive Compensation and Golden Parachute Compensation rule lacks a complete analysis of costs and benefits using a pre-statute baseline.

Issuer Review of Assets in Offerings of Asset-Backed Securities (Final). Section 945 of the Dodd-Frank Act amended Section 7 of the Securities Act to require the Commission to issue rules requiring any issuer of an asset-backed security to "(1) perform a review of the assets underlying the asset-backed security; and (2) to disclose the nature of the review. . . ."[57] Since performing a review and disclosing the nature of the review are required by the act, the cost-benefit analysis for the Issuer Review of Assets in Offerings of Asset-Backed Securities rule—consistent with the approach described above—does not include an analysis of the costs and benefits of performing a review and disclosing the nature of the review.[58] Instead, the cost-benefit analysis discusses the incremental costs and benefits of provisions that go beyond the minimal requirements of the Dodd-Frank Act, in effect using a post-statute baseline against which to measure costs and benefits. The introductory portion of the cost-benefit analysis section of the adopting release for the Issuer Review of Assets in Offerings of Asset-Backed Securities rule makes this clear with the following language: "The discussion below focuses on the costs and benefits of the amendments made by the Commission to implement the Act within the

[55] Memorandum from David M. Becker, General Counsel, Thoughts About Best Practices in Drafting Economic Analysis Sections of Releases for Dodd-Frank Related Rulemakings (Privileged and Confidential) (Sept. 27, 2010).
[56] 76 Fed. Reg. 6010, 6039, http://federalregister.gov/a/2011-1971.
[57] 15 U.S.C. § 77g(d).
[58] *See* Memorandum from David M. Becker, General Counsel, Thoughts About Best Practices in Drafting Economic Analysis Sections of Releases for Dodd-Frank Related Rulemakings (Privileged and Confidential) (Sept. 27, 2010).

Commission's permitted discretion and related amendments not required by the Act, rather than the costs and benefits of the [Dodd-Frank] Act itself."[59]

The rule interprets the Dodd-Frank Act requirements narrowly:

1. They are applicable only to registered transactions, not private transactions.
2. Required reviews may be conducted by third parties, provided that the third party is named in the registration statement and consents to being named as an expert. (Being named as an expert imposes additional liability on the third party.)

The rule also goes beyond the minimal requirement in the following ways:

1. It imposes a minimum standard on the review. The minimum review standard is a flexible, principles-based standard that does not specify the type of review an issuer must perform, but instead requires that the review "be designed and effected to provide reasonable assurance that the disclosure in the prospectus regarding the assets is accurate in all material respects."[60]
2. In addition to requiring disclosure of the nature of the review, it requires that the findings and conclusions of the review itself be disclosed—specifically, disclosures regarding the assets included in the pool that do not meet underwriting criteria and the identity of the entity that determined that the assets should be included.[61]

The cost-benefit analysis section of the release discusses the costs and benefits of excluding private transactions, use of third parties, requiring a minimum standard, and requiring that findings be disclosed.[62] It does not discuss the costs and benefits of the Dodd-Frank Act's requirement for issuers to perform a review of the underlying assets and disclose the nature of the review.

As previously noted, according to Professor Kyle, a key purpose of cost-benefit analysis is to inform public debate and Congress. Professor Kyle believes, however, that the public and Congress may be primarily interested in the costs and benefits of the regulation relative to a pre-statute baseline, not in the distinction between discretionary and nondiscretionary costs and benefits. If the SEC's analysis indicated that the costs of the mandatory provisions of the Issuer Review of Assets in Offerings of Asset-Backed Securities rule are much greater than their benefits, both Congress and the public might use this information to consider whether to seek to weaken or repeal the mandatory provisions. On the other hand, if the SEC's analysis indicated that the benefits of the mandatory

[59] 76 Fed. Reg. 4231, 4241.
[60] 76 Fed. Reg. 4231, 4234.
[61] 76 Fed. Reg. 4231, 4238.
[62] 76 Fed. Reg. 4231, 4241-2.

provisions of the regulation are much greater than the costs, both Congress and the public might use this information to consider strengthening those provisions. In this sense, informing Congress and the public requires examining the costs and benefits of mandatory Dodd-Frank Act provisions. In addition, in the future, it is possible that the SEC will attempt empirical studies of the costs and benefits of various Dodd-Frank Act regulations, for the purpose of suggesting modifications to them. Such studies are likely to use a pre-statute baseline which includes the costs and benefits of mandatory Dodd-Frank Act provisions. One possible use of such studies would be to compare actual outcomes of regulations with the outcomes predicted in the SEC's cost-benefit analysis. For such a comparison to be meaningful, the SEC's cost-benefit analysis for the final rule would also need to include the costs and benefits of mandatory Dodd-Frank Act provisions.

According to Professor Kyle, another purpose of cost-benefit analysis is to help inform the regulating entity's—the SEC's, in this case—internal decision-making. In the Issuer Review of Assets in Offerings of Asset-Backed Securities rule, the SEC chose to go beyond the Dodd-Frank Act provisions by adding additional requirements. On the one hand, in Professor Kyle's view, it is possible that the modest increases in transparency mandated by the Dodd-Frank Act would lead to large benefits for investors, which would suggest that making the mandate for transparency even stronger could lead to further benefits. On the other hand, it is possible that the modest increases in transparency mandated by the statute would lead to negligible benefits for investors, in which case discretionary strengthening of disclosure requirements might only lead to benefits if the strengthening operates through a different incentive mechanism. It is difficult to understand how the SEC can make informed, logical, and consistent decisions with respect to additional requirements without first analyzing the costs and benefits of mandated provisions of the regulation.

The ECCF section of the rule asserts that the rule will improve ECCF, also relative to a post-statute baseline.[63] It does not discuss the effect on ECCF of the Dodd-Frank Act requirement that issuers conduct a review of assets in offerings of asset-backed securities.

The PRA cost estimates in the final rule, consistent with OMB and SEC guidance, use a pre-statute rather than a post-statute baseline. However, only costs related to information collection are taken into account for PRA purposes.

[63] 76 Fed. Reg. 4231, 4242.

Recommendation 2:

The Office of the General Counsel, in consultation with the Division of Risk, Strategy, and Financial Innovation, should reconsider its guidance that the Securities and Exchange Commission (SEC) should perform economic analyses for rulemaking activities to the extent that the SEC exercises discretion and should consider whether a pre-statute baseline should be used whenever possible.

Management Comments. RiskFin and OGC generally concur with this recommendation. See appendix VI for management's full comments.

OIG Analysis. We are pleased that RiskFin and OGC generally concur with this recommendation. See appendix VII for our full response to management's comments.

Finding 3: The SEC Has Sometimes Used Multiple Baselines in Its Cost-Benefit Analyses for Dodd-Frank Act Rulemakings in an Inconsistent or Ambiguous Manner

The cost-benefit analyses of some Dodd-Frank Act rulemakings have used multiple baselines that are difficult to define or internally inconsistent.

We examined several Dodd-Frank Act rulemakings, discussed below, that used multiple baselines in their cost-benefit analyses that are ambiguous or internally inconsistent.

Temporary Registration of Municipal Advisors (Interim Final Temporary) and Registration of Municipal Advisors (Proposed)

Section 975 of the Dodd-Frank Act amended section 15B of the Securities Act to make it unlawful for municipal advisors to carry out their advisory activities unless they registered with the SEC by October 1, 2010.[64] Despite this provision, the Act did not specifically require the SEC to set up a registration process by a particular date. On September 1, 2010, the SEC adopted an interim final temporary rule for registration of municipal advisors, which was to expire on

[64] 15 U.S.C. § 78o-4.

December 31, 2011.[65] Upon expiration of the interim final temporary rule, municipal advisors would have to cease their activities unless the SEC had established a valid registration process effective after that date.

According to Professor Kyle, the multiple baselines used in the cost-benefit analyses of both the releases for the interim final temporary rule and the proposed rule are ambiguous and internally inconsistent. One approach assumes as a baseline a minimal registration process that allows municipal advisors to continue their usual activities with limited disruption. This alternative is consistent with the idea that Congress intended for the SEC to create a registration process collecting minimal information. Another approach assumes that municipal advisors would be required to cease their advisory activities in the absence of a registration process, resulting in a shutdown of the municipal advisory market. This alternative is consistent with the idea that the Dodd-Frank Act gives the SEC discretion to shut down the market for municipal advisory services by choosing not to create a registration process. Neither of these alternatives constitutes a pre-statute baseline, which would consist of a market for municipal advisory services functioning without an SEC registration process—essentially how it functioned before enactment of the law. Such an approach may be consistent with the SEC's practice of considering only discretionary action in its cost-benefit analyses. The absence of an explicit congressional requirement to set up a registration process by a particular date contributes to the ambiguity concerning how to define a post-statute baseline that incorporates the requirements of the Dodd-Frank Act.

To some extent, the interim final temporary rule's cost-benefit analysis appears to use as a baseline a nonfunctioning municipal advisory service market because it cites a functioning market as a benefit of the registration process created as follows:

> Absent such means to register, municipal advisors would have to cease providing municipal advisory services, which may have a significant adverse impact on their businesses and on municipal entities and obligated persons engaged in issuing municipal securities or other activities for which they obtain the advice of a municipal advisor. . . . The interim final temporary rule is designed to provide a method by which municipal advisors may continue to provide municipal advisory services to municipal entities and obligated persons without violating Section 15B(a)(2) of the Exchange Act.[66]

Other parts of the cost-benefit analysis of the interim final temporary rule, however, use a minimal registration process as a baseline and do not assume

[65] In December 2011, the interim final temporary rule was amended to extend the expiration date to September 30, 2012. *See* 76 Fed. Reg. 80733.
[66] 75 Fed. Reg. 54465, 54474.

that the SEC has discretion with respect to establishing a registration process. Instead, they cite incremental benefits associated with requirements that assume the existence of a functioning market for municipal advisors and that go beyond the minimal requirements. For example, the interim final temporary rule requires that registrants provide useful information about disciplinary history to regulators, investors, municipal entities, and the investing public. The cost-benefit analysis cites as a benefit of this requirement that municipal entities and others will be more fully informed when choosing a municipal advisor. The rule also requires that municipal advisors provide their information in a standardized format; a benefit cited for this requirement is that use of a standardized format lowers the costs for municipal entities when they compare municipal advisors.[67]

The ECCF section of the interim final temporary rule contains language that is incompatible with a baseline that assumes that the SEC has discretion about whether to create a registration process for municipal advisors: "The temporary registration of municipal advisors will facilitate the Congressional mandate to register municipal advisors and establish an efficient system to provide information to the Commission, the public, and municipal entities."[68] The idea that the Dodd-Frank Act includes a congressional mandate to set up a registration process is inconsistent with the assumption that the SEC has discretion not to create such a process.

As in the case of the interim final temporary rule, according to Professor Kyle, there is ambiguity with respect to the appropriate cost-benefit analysis baseline for the proposed rule. In addition to the two baselines that appear to be used in the interim final temporary rule (a minimal registration process and a shutdown of the market for municipal advisory services), there is another potential baseline—the temporary registration process set up by the interim final temporary rule. Each of these three baselines differs from the pre-statute business-as-usual with no registration baseline.

In the proposing release, the introduction to the economic analysis section does contain language suggesting that the SEC evaluates costs and benefits associated with its use of discretion, rather than with statutory mandates, but the language differs from what appears in other rules. The proposing release for the Registration of Municipal Advisors rule states as follows:

> The Commission is sensitive to the costs and benefits imposed by its rules. The discussion below focuses on the costs and benefits of the decisions made by the Commission to fulfill the mandates of the Dodd-Frank Act within its permitted discretion, rather than the costs and benefits of the mandates of the Dodd-Frank Act itself. However, to the extent that the Commission's discretion is exercised to realize the benefits intended by the Dodd-Frank Act or

[67] 75 Fed. Reg. 54465, 54474.
[68] 75 Fed. Reg. 54465, 54475.

> to impose the costs associated with the Dodd-Frank Act, the two types of benefits and costs are not entirely separable. Accordingly, the PRA hourly burden estimates made in accordance with the requirements of the PRA, and their corresponding dollar cost estimates, are included in full below, although a portion of the cost to register is attributable to the requirements of the Dodd-Frank Act and not to the specific rules proposed by the Commission.[69]

According to Professor Kyle, this language does not provide a clear, consistent baseline for the Commission's analysis of costs and benefits. It indicates that the analysis focuses on discretionary SEC decisions rather than on Dodd-Frank Act mandates, but that the discretionary and mandatory costs may be impossible to fully separate. In addition, the language states that a portion of the PRA costs included in the PRA burden estimates are attributable to provisions mandated by the Dodd-Frank Act rather than to SEC rulemaking. Both of these assertions imply that the Dodd-Frank Act requires creation of a minimal registration process and that the SEC's analysis of costs and benefits uses a post-statute baseline—one that assumes the existence of a statutorily mandated minimal registration process—to the extent possible but that inclusion of some costs arising from the mandated provisions is unavoidable.

Among the provisions of the proposed rule that go beyond creating a minimal registration process are the requirements that registrants provide information in a standard format, provide information concerning disciplinary history and potential conflicts, and make their books and records open for SEC inspection. The proposed rule also provides for sanctions for false and misleading statements by municipal advisors.

Professor Kyle believes that the discussion of costs and benefits in the economic analysis section of the proposing release does not seem to include the costs and benefits of the minimal registration system assumed to be mandated by the Dodd-Frank Act. The discussion of benefits does point out that some states already require municipal advisor registration, in comparison with which the proposed SEC registration system offers incremental benefits. In these respects, the rule consistently uses a minimal registration process against which to compare the costs and benefits of the SEC's use of its discretion to go beyond the minimal requirements in its proposed rule.

Unlike the temporary rule release, the proposing release does not include any reference to the assumption that municipal advisors would cease their advisory activities if the temporary registration process were not extended beyond its expiration date or if a permanent registration system were not adopted by that date.

[69] 76 Fed. Reg. 824, 872.

Reporting and Dissemination of Security-Based Swap Information (Proposed)

The cost-benefit analysis section of the SEC's proposing release for the Reporting and Dissemination of Security-Based Swap Information (Regulation SBSR) rule, issued on November 19, 2010, does not contain language stating that the costs and benefits discussed are only those resulting from the SEC's use of its discretion. The proposed regulation was developed in response to the Dodd-Frank Act requirement that the SEC adopt rules providing for (1) reporting security-based swaps to a registered swap data repository (SDR) or the SEC and (2) real-time public dissemination of security-based swap transactions, volume, and pricing information.[70] Proposed Regulation SBSR consists of a set of reporting and related rules for security-based swap transactions to address this requirement.

According to Professor Kyle, establishing cost-benefit analysis baselines for proposed Regulation SBSR is complicated because its rules interact with many other rules, some of which have not been officially promulgated. The release for Proposed Regulation SBSR does not make clear whether issues involving definitions, coordination with other agencies, and international coordination would affect baselines for the cost-benefit analysis or are raised only in the context of discussing regulatory boundaries from a legal perspective. Sections of the release other than the cost-benefit analysis discuss the proposed regulation's dependence on other regulations, such as those that define key terms. The release also mentions that fair and open access to reported swap data is the subject of a separate rulemaking and discusses coordination of regulations with CFTC and other regulators, as well as issues associated with international coordination and competition.

Proposed Regulation SBSR contains the following 13 individual proposed rules:

A. Rule 900: Definitions of terms
B. Rule 901: Reporting of trades to SDRs (and then to the SEC)
C. Rule 902: Public reporting of some information about trades by SDRs
D. Rule 903: Reference codes
E. Rule 904: Operating hours
F. Rule 905: Error corrections
G. Rule 906: Other duties
H. Rule 907: Policies and procedures
I. Rule 908: Jurisdictional matters
J. Rule 909: Registration of SDR as securities information processor (SIP)
K. Rule 910: Implementation timetable

[70] 75 Fed. Reg. 75208, 75209.

L. Rule 911: Phase-in
M. Amendments to Rule 31: Fees

The cost-benefit analysis section of the release examines costs and benefits of each of the 13 rules separately. Examining the costs and benefits of rules separately is consistent with guidance in OMB Circular A-4.[71]

In its cost-benefit analysis of individual rules, according to Professor Kyle, the release does not state clearly which of the other 12 rules are to be considered in place as baselines for the purpose of measuring incremental costs and benefits of the specific rule being analyzed. One possible interpretation is that the costs and benefits are incremental—that is, rule 900 assumes that none of the other listed rules is in place, rule 901 assumes that rule 900 is in place, rule 902 assumes that rules 900 and 901 are in place, and so on.

For costs, it is clear that the costs of some of the proposed rules are incremental costs based on other rules also being proposed. For benefits, there are potential unintended consequences associated with implementing some rules but not others. For example, if rule 905 did not require errors to be corrected and there was no penalty for reporting erroneous data, then market participants might intentionally engage in sloppy reporting, undermining the benefits of rules 901 and 902. An illustration of this point concerns rule 908, which pertains to the application of Regulation SBSR to cross-border swap transactions and to non-U.S. persons.[72] The cost-benefit analysis states that because the SEC does not have discretion to extend the reach of U.S. law to foreign jurisdictions, there are no costs or benefits other than those inherent in the Dodd-Frank Act. According to Professor Kyle, this represents an important inconsistency in the proposing release's use of pre-statute baselines. It is possible that the proposed rules might induce U.S. swap trading to migrate to foreign jurisdictions. This incentive might be mitigated to the extent that the SEC coordinated its regulations with foreign jurisdictions, but the proposing release's cost-benefit analysis does not address this issue. To do so would require that the cost-benefit analyses for the other proposed rules incorporate a baseline assumption about whether U.S. law does or does not apply to foreign jurisdictions, as a result of which derivatives trading may or may not move offshore.

Proposed Regulation SBSR has a separate ECCF section, which contains the following statement:

> The Commission preliminarily believes that public availability of transaction and pricing data for [security-based swaps], as required by the Dodd-Frank Act and implemented by proposed Regulation SBSR, would promote efficiency, competition, and capital formation by reducing information asymmetries, lowering transaction costs,

[71] OMB Circular A-4 at 17.
[72] *See* 75 Fed. Reg. 75208, 75287.

> and encouraging market participation from a larger number of firms.[73]

In this manner, the ECCF section alludes to benefits of the proposed rules, but does not analyze or state in any detail the specific sources of such benefits.

The analysis of PRA costs is also disaggregated by individual rule into costs related to definitions, reporting obligations, public dissemination, coding requirements, operating hours, error correction, policies and procedures, jurisdictional matters, registration of SDRs as securities information processors, and phase-in rules. The costs reported in the cost-benefit analysis section are disaggregated similarly, and they resemble the PRA costs.

Recommendation 3:

Securities and Exchange Commission (SEC) rulemaking teams should generally use a single, consistent baseline in the cost-benefit analyses of their rulemakings related to a particular topic. The baseline being used should be specified at the beginning of the cost-benefit analysis section. If multiple baselines are appropriate, such as for evaluating alternative approaches or explaining the SEC's use of discretion, they should also be explained and justified.

Management Comments. CF, IM, RiskFin, TM, and OGC concur with this recommendation. See appendix VI for management's full comments.

OIG Analysis. We are pleased that CF, IM, RiskFin, TM, and OGC concur with this recommendation. See appendix VII for our full response to management's comments.

Finding 4: Some Dodd-Frank Act Rulemakings Combine Their Cost-Benefit Analysis and ECCF Sections, and This Approach Reduces Redundancy

There is considerable overlap between the cost-benefit analysis and ECCF sections of the releases for Dodd-Frank Act regulations. In some releases, these sections have been combined, thereby reducing redundancy.

Most of the proposing and adopting releases for rules implementing the Dodd-Frank Act have similar structures. They begin with sections that describe the

[73] 75 Fed. Reg. 75208, 75280.

legal basis for the rule, the market the rule regulates, the content of the proposed or final rule, and reasons for choices made in determining the rule's content. They conclude with separate sections containing PRA cost estimates, the cost-benefit analysis, and a discussion of the rule's effect on ECCF. Although the cost-benefit analysis and the discussion of ECCF are usually in separate sections, these sections often repeat information that appears elsewhere in the document. For example, the description of the market, which appears at the beginning of the document, is also a fundamental component of both the cost-benefit analysis and the ECCF discussions. In addition, the ECCF section typically repeats or summarizes information that appears in the cost-benefit analysis section.[74]

According to Professor Kyle, combining the cost-benefit analysis and ECCF sections helps eliminate redundancy in the text of the rulemakings. Two of the SEC's Dodd-Frank Act rule releases—the proposing release for the Credit Risk Retention rule and the proposing release for the Registration of Municipal Advisors rule—deviated from the typical structure and combined the cost-benefit analysis and ECCF sections into one integrated section. The proposing release for the Credit Risk Retention rule contains a section called Commission Economic Analysis instead of separate cost-benefit analysis and ECCF sections.[75] Although the proposed Credit Risk Retention rule is a joint rule of six agencies, the wording of the Commission Economic Analysis section (as well as the name of the section) indicates that it consists of the SEC's analysis alone. The section contains language that usually appears separately in the cost-benefit analysis section and the ECCF section, and its description of the statutory framework combines information that would normally appear in the separate sections. The proposing release for the Registration of Municipal Advisors rule also combines material that would otherwise be in separate cost-benefit analysis and ECCF sections into a single section called Economic Analysis.[76]

We understand that for the past several months RiskFin has been considering whether to recommend the combination of the cost-benefit analysis and ECCF sections in all SEC rulemakings.

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[74] In *Business Roundtable and Chamber of Commerce v. Securities and Exchange Commission* (the "proxy access rule" case), 647 F.3d 1144, 1148 (D.C. Cir. 2011), the court ruled that the SEC failed to adequately consider the proxy access rule's effect on efficiency, competition, and capital formation. The adopting release for the rule at issue contained both a cost-benefit analysis section and an ECCF section. In its discussion of costs and benefits, the court cited the ECCF section infrequently, but frequently cited the cost-benefit analysis section and also frequently cited other sections of the adopting release. In this sense, according to Professor Kyle, the court's ruling equated ECCF with cost-benefit analysis and recognized that cost-benefit analysis material is contained not only in the cost-benefit analysis section but also in other sections of the rule. The court's use of the information suggests that it might be reasonable for the SEC either to combine the cost-benefit analysis and ECCF sections into a single section or to spread the ECCF and cost-benefit analysis material throughout the rule rather than devoting specific sections to these topics.
[75] 75 Fed. Reg. 75,208, 75177.
[76] *See* 76 Fed. Reg. 824, 872-878.

Recommendation 4:

Securities and Exchange Commission rulewriting divisions should consider discontinuing the practice of drafting separate cost-benefit analysis and efficiency, competition, and capital formation sections and instead provide a more integrated discussion of these issues in rule releases.

Management Comments. CF, IM, RiskFin, TM, and OGC concur with this recommendation. See appendix VI for management's full comments.

OIG Analysis. We are pleased that CF, IM, RiskFin, TM, and OGC concur with this recommendation. See appendix VII for our full response to management's comments.

Finding 5: Dodd-Frank Act Rulemakings Lack Adequate Discussion of Market Failure or Other Justification for Regulation

The SEC's Dodd-Frank Act rulemakings lack clear, explicit explanations of the justification for regulatory action. Some of the rulemakings for which market failure is a justification allude to market failure but do not explicitly cite it as a justification or fully discuss it. Other rulemakings include language that erroneously suggests a market failure justification and contain no compelling alternative rationale in support of the action.

OMB Circular A-4 identifies market failure as one of several possible justifications for federal agency regulation. Specifically, the circular provides that an agency must demonstrate that proposed action is necessary before recommending regulatory action, citing EO 12866's requirement that agencies "promulgate only such regulations as are required by law, are necessary to interpret the law, or are made necessary by compelling need, such as material failures of private markets to protect or improve the health and safety of the public, the environment, or the well being of the American people."[77] OMB Circular A-4 also notes that EO 12866 requires each agency to "identify the problem that it intends to address (including, where applicable, the failures of private markets or public institutions

[77] OMB Circular A-4 at 3-4 (quoting EO 12866). The circular also states that if the regulatory intervention results from a statutory or judicial directive, the agency should describe the specific authority for its proposed action, the extent of discretion available to the agency, and the regulatory instruments the agency might use. The circular does not indicate, however, that this is all the information that should be included when a regulatory intervention results from a statutory or judicial directive, nor does it suggest that regulations required by law and regulations designed to address a significant market failure are mutually exclusive.

that warrant new agency action)" and to assess the significance of the problem.[78] The Circular then states the following:

> Thus, you should try to explain whether the action is intended to address a significant market failure or to meet some other compelling public need such as improving governmental processes or promoting intangible values such as distributional fairness or privacy. *If the regulation is designed to correct a significant market failure, you should describe the failure both qualitatively and (where feasible) quantitatively.* You should show that a government intervention is likely to do more good than harm. For other interventions, you should also provide a demonstration of social purpose and the likelihood of effective action.[79]

There are three major types of market failure:

1. Externality. An externality arises when a market participant's choice has uncompensated effects on others. For example, a negative externality arises when one participant chooses to pollute the environment but does not have to pay for the costs imposed on others as a result of the choice.
2. Market power. Firms use market power when they reduce their output below what would be offered in a competitive industry in order to obtain higher prices. A market is considered competitive if each participant has too little market power to influence prices.
3. Inadequate or asymmetric information. Information asymmetry arises when one market participant has access to information to which other market participants do not have access.[80]

A number of the SEC's Dodd-Frank Act rulemakings refer to benefits resulting from improved information or reduction in information asymmetries. However, according to Professor Kyle, the rule releases do not explicitly spell out a market failure theory predicting that government regulation can lead to benefits that exceed the costs. A more focused discussion of market failure in cost-benefit analyses would lay out the rationale for regulation more clearly to Congress, the general public, and the SEC itself.

The following are examples of the use or nonuse of market failure as a justification for Dodd-Frank Act rulemakings.

[78] OMB Circular A-4 at 4 (quoting EO 12866).
[79] OMB Circular A-4 at 4 (emphasis added).
[80] *See* OMB Circular A-4 at 4-5.

Proposed Regulation SBSR

According to Professor Kyle, although the provisions of proposed Regulation SBSR address market failure—information asymmetries and market power—the proposal does not explicitly cite or adequately discuss market failure as a justification for the regulation.

The cost-benefit analysis section of the release for Proposed Regulation SBSR contains the following statement: "By reducing information asymmetries, post-trade transparency has the potential to lower transaction costs, improve confidence in the market, encourage participation by a larger number of market participants, and increase liquidity in the [security-based swap] market."[81] Although this statement does not explicitly assert a market failure theory based on information asymmetries, according to Professor Kyle, it does imply that a market failure theory could be built on the idea of information asymmetries.

The proposal outlines a theory that dealers intermediating "natural longs" and "natural shorts" could not efficiently do so unless they were allowed to keep information about the size (and perhaps direction) of their intermediating trades private during the period when they are trying to hedge positions acquired as part of the intermediation process.[82] It also outlines a contrasting theory that prompt reporting would encourage uninformed dealers to be willing to provide liquidity.[83] According to Professor Kyle, these two theories are not consistent with one another, and the proposal does not offer theories or empirical evidence to support which of the conflicting theories is correct. At a minimum, a theory should explain why the costs and benefits associated with applying a set of reporting rules to large trades are not proportional to the costs and benefits associated with applying the same rules to small trades. The proposed rule does not develop enough of a market failure theory to distinguish between competing hypotheses about allowing later reporting of large trades. Instead of developing such a theory, the proposed rule solicits comments.

Professor Kyle believes that in the context of security-based swap trading, there are many different kinds of information that might be private, including information about the fundamental value of the asset, what others believe the fundamental value to be, the quantities and prices of recent trades, the identities of counterparties to recent trades, bid and offer prices quoted by competitors, and the quality of information to which potential counterparties might have access. For this reason, developing a market failure theory based on information asymmetries is very complex.

In addition to information asymmetries, according to Professor Kyle, there are important elements of market power in security-based swap trading that may

[81] 75 Fed. Reg. 75208, 75224.
[82] 75 Fed. Reg. 75208, 75225-75226.
[83] 75 Fed. Reg. 75208, 75226.

affect the competitiveness of the industry. Large dealers may have concentrated market shares of trading volumes. Furthermore, there are clear economies of scale in security-based swap trading that might enable a firm to exercise market power. Similarly, there are clear efficiencies in having one set of data standards for reporting security-based swaps. Dealers may also play an important role in the governance of SDRs. If large dealers are also owners of SDRs, the issues of monopoly power become even more complex. Professor Kyle pointed out that the release for proposed Regulation SBSR pays little attention to the interaction between information asymmetries, monopoly power, and economies of scale. The proposing release, however, does address the issue of pricing of services of SDRs. It recognizes that the pricing of SDR services has monopoly components and that high prices might redistribute resources from market participants to vendors of data standards or SDR services.

Issuer Review of Assets in Offerings of Asset-Backed Securities

According to Professor Kyle, the adopting release for the Issuer Review of Assets in Offerings of Asset-Backed Securities rule does not explicitly present a market failure justification for the regulation, but its ECCF section suggests that the market may not have supplied an adequate amount of information—a potential indication of market failure. The ECCF section of the adopting release defines the economic problem being addressed as follows:

> As a result of the financial crisis and subsequent events, the market for securitization has declined due, in part, to perceived uncertainty about the accuracy of information about the pools backing the [asset-backed securities] and perceived problems in the securitization process that affected investors' willingness to participate in these offerings. Greater transparency of the review performed on the underlying assets would decrease the uncertainty about pool information and, thus, should help investors price these products more accurately.[84]

According to Professor Kyle, however, this logic does not suggest a market failure theory. On the contrary, unless there are regulations preventing securitizers from being transparent about the reviews they conduct, the adopting release's definition of the problem could be a preamble to a non-market failure theory explaining why market forces should give securitizers incentives to be appropriately transparent about their review processes, without being required to do so by government regulation. In addition, in the absence of a market failure justification, the rule lacks a clear discussion of a "compelling social purpose" for the regulation, as called for in OMB Circular A-4.[85]

[84] 76 Fed. Reg. 4231, 4242 (footnote omitted).
[85] OMB Circular A-4 at 4.

Credit Risk Retention. Like the adopting release for the Issuer Review of Assets in Offerings of Asset-Backed Securities rule, according to Professor Kyle, the proposing release for the Credit Risk Retention rule does not develop an explicit market failure theory to justify the regulatory action but uses language that suggests a market failure theory—adverse selection based on private information. The proposed rule does not address a market failure, however, and it provides no compelling alternative justification for regulatory action.

The proposed rule contains a discussion of misaligned incentives and lack of discipline in the origination process:

> When properly structured, securitization provides economic benefits that lower the cost of credit to households and businesses. However, when incentives are not properly aligned and there is a lack of discipline in the origination process, securitization can result in harm to investors, consumers, financial institutions, and the financial system. During the financial crisis, securitization displayed significant vulnerabilities to informational and incentive problems among various parties involved in the process.[86]

Section 15G of the Exchange Act, as added by Section 941 of the Dodd-Frank Act, addresses the problem of misaligned incentives by requiring that securitizers retain an economic interest in the credit risk of the assets they securitize.[87] Instead of having its own market failure analysis, the proposing release for the Credit Risk Retention rule refers to the analysis in the legislative history of the Dodd-Frank Act.[88] The proposing release also cites a report to Congress on risk retention by the Federal Reserve, which discusses incentive problems associated with securitizations.[89]

In Professor Kyle's opinion, the idea that a regulation mandating credit risk retention aligns incentives of securitizers with investors is not a market failure theory. A market failure theory is based on the idea that government regulation can address an economic problem more effectively than can market forces operating free of government intervention. Operating free of government intervention, investors can demand credit risk retention or some other protective mechanisms by avoiding securitizations in which the securitizer does not retain an appropriate level of credit risk to align incentives efficiently. Thus, according to Professor Kyle, the proposing release for the Credit Risk Retention rule does not spell out a market failure theory that explains how government regulation can solve a problem better than unregulated markets, and the proposed rule does not create a new protective mechanism that unregulated market forces do not

[86] 76 Fed. Reg. 24090, 24095 (footnotes omitted).
[87] 15 U.S.C. § 78o-11.
[88] 76 Fed. Reg. 24090, 24095-24096.
[89] 76 Fed. Reg. 24090, 24095. The report cited is Board of Governors of the Federal Reserve System, *Report to the Congress on Risk Retention* (October 2010), *http://federalreserve.gov/boarddocs/rptcongress/securitization/riskretention.pdf*.

already make available. Further, the proposing release does not discuss a "compelling social purpose" that would otherwise explain the need for regulatory action.

Recommendation 5:

The Commission should consider directing rulemaking teams to (a) explicitly discuss market failure as a justification for regulatory action in the cost-benefit analysis of each rule that is based in whole or in part on perceived market failure or (b) in the absence of market failure, demonstrate a compelling social purpose that justifies regulatory action.

Management Comments. Management does not concur with this recommendation primarily because of uncertainty about the recommendation's scope and meaning. See appendix VI for management's full comments.

OIG Analysis. Management's response indicates, among other things, that discretionary rulemakings may often not be premised on market failure, and that OMB Circular A-4 does not recommend that an agency provide market failure justifications for statutorily mandated rulemakings. However, our recommendation does not suggest that market failure is the sole acceptable justification for rulemaking. Instead, it provides that in instances when market failure is the justification for a rulemaking, the Commission should consider having the rulemaking teams explicitly discuss market failure.

In addition, the management response appears to takes the position that where rulemaking is based on a statutory requirement, the Commission should never articulate market failure as a basis for the rule and that to do so would "disregard the law." However, OMB Circular A-4 states, based on Executive Order 12866, that the agency should try to explain whether the regulatory action is intended to address a significant market failure or to meet some other compelling public need. The circular does not state that an agency should do this only in situations where there is no statutory directive requiring the agency to promulgate regulations.

We are neither suggesting that the SEC staff discuss market failure in situations where market failure has no nexus to the proposed regulatory action nor advocating an approach that it is in any way contrary to OMB Circular A-4. Rather, recommendation 5 is designed to promote adherence to OMB Circular A-4's guidance.

See appendix VII for our full response to management's comments.

Finding 6: The SEC Rarely Addresses Internal Administrative Costs or Savings in the Cost-Benefit Analyses of Its Dodd-Frank Act Rulemakings

> Although some of the SEC's Dodd-Frank Act rulemakings may result in significant costs or benefits to the Commission itself, internal costs and benefits are not always addressed in the cost-benefit analyses. Considering internal administrative costs and benefits is consistent with the purposes of a cost-benefit analysis, however, and provides a more complete picture of economic costs and benefits associated with government regulation.

Several of the SEC's Dodd-Frank Act rules will result in significant economic costs or benefits to the SEC itself. A number of the rules cite improved government regulation as a potential benefit. In some cases, improved government regulation could result from the SEC's incurring lower costs to achieve the same benefits; in other cases, it could involve the SEC's incurring significant new costs to achieve new benefits.

Considering internal costs and savings in cost-benefit analyses is consistent with guidance in OMB Circular A-4, which states that estimates of government administrative costs and savings should be included in cost-benefit analyses when they are significant.[90] Doing so is also consistent with the key purpose of cost-benefit analysis cited in OMB Circular A-4:

> A good regulatory analysis is designed to inform the public and other parts of the Government (as well as the agency conducting the analysis) of the effects of alternative actions. Regulatory analysis sometimes will show that a proposed action is misguided, but it can also demonstrate that well-conceived actions are reasonable and justified.[91]

According to Professor Kyle, using a pre-Dodd-Frank Act baseline that includes internal SEC costs in the cost-benefit analysis would allow the SEC to more fully inform Congress and the public about the SEC's strategy for achieving the aims of the act and the resource implications of different regulatory choices. Understanding internal administrative costs or benefits could also help SEC rulewriting teams choose among possible regulatory alternatives. Moreover, specifying internal administrative costs in cost-benefit analyses would inform Congress of the resources that the SEC expects to need to implement Dodd-

[90] OMB Circular A-4 at 37.
[91] OMB Circular A-4 at 2.

Frank Act mandates and clarify which benefits would not be achieved if the SEC's budget did not include the necessary resources.

Senior SEC management confirmed that the Commission does not consider internal administrative costs in its cost-benefit analyses for Dodd-Frank Act rulemakings, but said that SEC administrative costs associated with the rulemakings are incorporated in budget submissions to Congress.
A June 2011 report by the CFTC OIG addressed the issue of considering internal costs in Dodd-Frank Act rulemakings.[92] The report found that internal implementation costs were not calculated for the cost-benefit analyses of the four proposed rules examined. According to CFTC management, "staff labor necessary to implement Dodd-Frank had been calculated overall by each Division, and these quantified estimates were included in CFTC budget submissions, but the cost to implement each regulation had not been quantified."[93] The report also noted that the rulemakings contained no estimates of opportunity costs—that is, the extent to which implementation of Dodd-Frank Act rules might diminish CFTC regulatory efforts in other areas.[94] CFTC has recently issued guidance for conducting cost-benefit analyses of Dodd-Frank Act rules that directs staff to "consider the costs of implementation during its consideration of each final rulemaking."[95]

Two examples of the SEC's failure to consider internal costs in its Dodd-Frank Act rulemakings identified by Professor Kyle are discussed below.

Registration of Municipal Advisors (Proposed)

The proposing release for the Registration of Municipal Advisors rule does not consider internal SEC costs in its cost-benefit analysis. (The cost-benefit analysis for the interim final temporary rule also did not consider SEC costs.) The proposing release refers to the intent of Section 15B of the Exchange Act, as amended by the Dodd-Frank Act, to "strengthen oversight" of the municipal securities market[96] and to efficiencies resulting from provision of otherwise more costly information to municipal entities and the investing public.

According to Professor Kyle, carrying out the legislative intent to strengthen oversight of the municipal securities market presumably will require that the SEC expend resources on oversight. For example, the SEC will incur the costs of setting up an information technology infrastructure, purchasing equipment, and

[92] CFTC OIG, *A Review Of Cost-Benefit Analyses Performed by the Commodity Futures Trading Commission in Connection With Rulemakings Undertaken Pursuant to the Dodd-Frank Act* (June 13, 2011).
[93] *A Review Of Cost-Benefit Analyses Performed by the Commodity Futures Trading Commission in Connection With Rulemakings Undertaken Pursuant to the Dodd-Frank Act* at 24-25.
[94] *A Review Of Cost-Benefit Analyses Performed by the Commodity Futures Trading Commission in Connection With Rulemakings Undertaken Pursuant to the Dodd-Frank Act* at. 24-25.
[95] *A Review Of Cost-Benefit Analyses Performed by the Commodity Futures Trading Commission in Connection With Rulemakings Undertaken Pursuant to the Dodd-Frank Act* at 25.
[96] 76 Fed. Reg. 824, 879.

hiring staff to handle the registration of numerous municipal advisors. It is likely that the SEC could quantify these costs based on costs it has incurred for registration of other types of entities.[97] Challenging registrations and performing inspections would also require SEC staff time. The effect on enforcement costs is uncertain. It is possible that decreases in SEC staff devoted to investigating securities law violations by municipal advisors would be appropriate if municipal advisor registration reduces the costs of investigating cases. On the other hand, increases in staff in this area might be required if the SEC uses the municipal advisor registration process to obtain information that would allow it to bring more cases or larger, more complex cases against municipal advisors.

Reporting and Dissemination of Security-Based Swap Information (Proposed)

The release for proposed Regulation SBSR cites "Improved Commission Oversight" as an overarching benefit of the regulation.[98] According to the proposing release, reporting of security-based swap transactions should "provide the Commission and other regulators a better understanding of the current risks in the [security-based swap] market" and would, for example, help SEC staff analyze the security-based swap market as whole "in a manner that is not possible currently."[99]

The rules contained in proposed Regulation SBSR require that detailed data on swap contracts be reported to SDRs. Some of these data are to be made public. Confidential data components are to be made available to the SEC but not reported publicly. Using the confidential and public swap data to improve Commission oversight requires that the Commission incur costs to analyze the data, including new computer hardware and software systems that protect the confidentiality of the data while simultaneously making the data available for analysis. In addition, the SEC requires a staff of economists, statisticians, and information technology professionals to make such a system work to achieve the benefits of improved oversight over the security-based swap market. According to Professor Kyle, although the proposing release did not address such costs, it should be possible to estimate them in a reasonable manner and to spell out the nature of some of the benefits expected to be realized from improved oversight. Such benefits might include identification of fraud or potential systemic risks or improved ability to analyze market events, such as the "flash crash," after they have occurred.

[97] To the extent that the SEC takes on an oversight role normally provided by state governments, these expenditures can be viewed as transfers of resources from the federal government to the states, not costs. However, to the extent that these expenditures are incremental to expenditures by state and local governments, they are costs to the SEC for the purpose of cost-benefit analysis.
[98] 75 Fed. Reg. 75208, 75262.
[99] 75 Fed. Reg. 75208, 75262.

Recommendation 6

Securities and Exchange Commission rulemaking teams should consider including internal costs and benefits in the cost-benefit analyses of rulemakings.

Management Comments. CF, IM, RiskFin, TM, and OGC generally concur with this recommendation. See appendix VI for management's full comments.

OIG Analysis. CF, IM, RiskFin, TM, and OGC generally concur with this recommendation. See appendix VII for our full response to management's comments.

Abbreviations

APA	Administrative Procedure Act of 1946
CF	Division of Corporation Finance
CFTC	Commodity Futures Trading Commission
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act
ECCF	efficiency, competition, and capital formation
EO	Executive Order
Exchange Act	Securities Exchange Act of 1934
Federal Reserve	Board of Governors of the Federal Reserve System
IM	Division of Investment Management
NSMIA	National Securities Markets Improvement Act of 1996
OGC	Office of the General Counsel
OIG	Office of Inspector General
OMB	Office of Management and Budget
PRA	Paperwork Reduction Act
RiskFin	Division of Risk, Strategy, and Financial Innovation
SDR	swap data repository
SEC or Commission	U.S. Securities and Exchange Commission
Securities Act	Securities Act of 1933
Senate Banking Committee	Senate Committee on Banking, Housing, and Urban Affairs
TM	Division of Trading and Markets

Scope and Methodology

Scope. The scope of our review included examining the SEC's methodology for conducting cost-benefit analyses for Dodd-Frank Act rulemaking initiatives for the period from July 2010 through April 2011 and a sample of cost-benefit analyses prepared for rules being promulgated under the Dodd-Frank Act from July 2010 through April 2011.

As of the completion of our fieldwork, one of the five rulemaking initiatives included in our review had only reached the stage of the proposing release. For that rulemaking, we examined the cost-benefit analysis and comments received from external parties presented in the proposing release.

Our review also included an evaluation of the formal cost-benefit analysis presented in each proposing or adopting release, as well as term sheets and outlines prepared by RiskFin, as applicable. We also looked at statutory requirements to perform cost-benefit analyses for rulemakings and at the general extent to which the SEC's rulemaking procedures meet the intent of EO 12866, EO 13563, and OMB Circular A-4.

We conducted our review at the SEC's Washington, D.C., headquarters.

Methodology. We interviewed staff members of the various rulemaking divisions and offices—the Division of Corporation Finance, the Division of Trading and Markets, and the Division of Investment Management—and of RiskFin and OGC to understand each office's or division's role and involvement in the rulemaking process. We also gathered information concerning internal policies and procedures that governed how each office or division involved in the rulemaking process should perform cost-benefit analyses. We researched federal guidance pertaining to the SEC that addressed the form or substance of what is to be included in cost-benefit analyses for rulemakings. Our expert subsequently reviewed the SEC's cost-benefit analyses in selected Dodd-Frank Act rulemakings to determine whether there were areas in which improvements could be implemented to strengthen SEC cost-benefit analyses.

Prior Coverage. OIG report: *Report of Review of Economic Analyses Performed by the Securities and Exchange Commission in Connection With Dodd-Frank Act Rulemakings*, June 13, 2011.

Use of Specialist. We retained an expert, Albert S. Kyle, to assist with our review of SEC cost-benefit analyses in Dodd-Frank Act rulemakings. Professor Kyle is the Charles E. Smith Chair Professor of Finance at the University of Maryland's Robert H. Smith School of Business. He is an expert on many aspects of capital markets and has conducted significant research on such topics

as informed speculative trading, market manipulation, price volatility, and the information content of market prices, market liquidity, and contagion. He has also worked as a consultant on finance topics for several government agencies in addition to the Commission, including the Department of Justice, the Internal Revenue Service, the Federal Reserve, and CFTC.

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."

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.

National Securities Markets Improvement Act of 1996. Revised various provisions of the federal securities laws and specifically amended the Securities Act, the Exchange Act, and the Investment Company Act of 1940 to provide that when the Commission is engaged in rulemaking and is required to determine whether an action is necessary or appropriate in the public interest, the Commission will consider, in addition to protection of investors, whether the action will promote efficiency, competition, and capital formation.

Gramm-Leach-Bliley Act of 1999. Removed barriers in the market among banking, securities, and insurance companies and specifically amended the Investment Advisers Act of 1940 to provide that when the Commission is engaged in rulemaking and is required to determine whether an action is necessary or appropriate in the public interest, the Commission will consider, in addition to protection of investors, whether the action will promote efficiency, competition, and capital formation.

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

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.

Regulatory Flexibility Act of 1980, 5 U.S.C. § 601 et seq. Required agencies to consider the needs of small entities in evaluating proposed and final rules for all rules subject to notice and comment under the APA and to describe the impact of proposed and final rules on small entities, unless the agency head certifies that the rule will not have a significant economic impact on a substantial number of small entities.

Executive Order 12866, Regulatory Planning and Review, 55 Fed. Reg. 51735, Sept. 30, 1993. Required executive branch agencies to provide OMB with an assessment of the potential costs and benefits of any significant regulatory action.

Executive Order 13563, Improving Regulation and Regulatory Review, 76 Fed. Reg. 3821, Jan. 18, 2011. Reaffirmed the principles of EO 12866, including the principle that executive agencies must propose or adopt a regulation only after determining that its benefits justify its costs**.**

OMB Circular A-4, Regulatory Analysis, Sept. 17, 2003. Provides OMB's guidance to federal agencies on developing cost-benefit analyses required under EO 12866 and related authorities.

Office of the General Counsel, SEC, Compliance Handbook, revised Oct. 1, 1999. Provides guidance applicable to SEC rulemaking and includes guidance specific to developing cost-benefit analyses.

Office of the General Counsel, SEC, Memorandum from David Becker: Thoughts About Best Practices in Drafting Economic Analysis Sections of Releases for Dodd-Frank Related Rulemakings, Sept. 27, 2010. Advised that SEC Dodd-Frank Act rulemaking teams, in drafting the economic analysis sections of rule releases, generally include only discretionary, nonmandatory components of rulemakings in cost-benefit analyses.

List of Recommendations

Recommendation 1:

Securities and Exchange Commission rulewriting divisions and the Division of Risk, Strategy, and Financial Innovation (RiskFin) should consider ways for economists to provide additional input into cost-benefit analyses of Securities and Exchange Commission rulemakings to assist in including both quantitative and qualitative information to the extent possible.[100]

Recommendation 2:

The Office of the General Counsel, in consultation with the Division of Risk, Strategy, and Financial Innovation, should reconsider its guidance that the Securities and Exchange Commission (SEC) should perform economic analyses for rulemaking activities to the extent that the SEC exercises discretion and should consider whether a pre-statute baseline should be used whenever possible.

Recommendation 3:

Securities and Exchange Commission (SEC) rulemaking teams should generally use a single, consistent baseline in the cost-benefit analyses of their rulemakings related to a particular topic. The baseline being used should be specified at the beginning of the cost-benefit analysis section. If multiple baselines are appropriate, such as for evaluating alternative approaches or explaining the SEC's use of discretion, they should also be explained and justified.

Recommendation 4:

Securities and Exchange Commission rulewriting divisions should consider discontinuing the practice of drafting separate cost-benefit analysis and efficiency, competition, and capital formation sections and instead provide a more integrated discussion of these issues in rule releases.

[100] If the rulewriting divisions and RiskFin determine that it is not possible to quantify costs and benefits, they should explain why and present any relevant quantitative information, along with a discussion of its strengths and weaknesses. OMB Circular A-4 at 27.

Recommendation 5:

The Commission should consider directing rulemaking teams to (a) explicitly discuss market failure as a justification for regulatory action in the cost-benefit analysis of each rule that is based in whole or in part on perceived market failure or (b) in the absence of market failure, demonstrate a compelling social purpose that justifies regulatory action.

Recommendation 6:

Securities and Exchange Commission rulemaking teams should consider including internal costs and benefits in the cost-benefit analyses of rulemakings.

Congressional Request

United States Senate
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
WASHINGTON, DC 20510–6075

May 4, 2011

Elizabeth A. Coleman
Inspector General
Federal Reserve Board
20th and Constitution Avenue, NW
Stop 300
Washington, D.C. 20551

H. David Kotz
Inspector General
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

A. Roy Lavik
Inspector General
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

The Honorable Jon T. Rymer
Inspector General
Federal Deposit Insurance Corporation
3501 N. Fairfax Drive
Arlington, VA 22226

The Honorable Eric M. Thorson
Inspector General
The Department of Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Inspectors General:

We write to ask each of you to initiate a review of the economic analysis performed by the regulatory agency under your supervision. Our request arises from our concern that regulatory agencies are conducting rulemakings to implement Dodd-Frank without adequately considering the costs and benefits of their rules and the effects those rules could have on the economy.

On February 15, 2011, we sent a letter to that effect to each regulatory agency.[1] We were troubled by the concerns raised by Commissioners at both the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) about economic analysis at their agencies. We noted that the rules adopted under the Dodd-Frank Act will have a long-term effect on job creation and economic growth, and will affect how consumers and businesses obtain credit, allocate capital, and manage risk.

[1] http://crapo.senate.gov/documents/Dodd-FrankLetterFeb-11.pdf

On April 15, 2011, the Office of the Inspector General for the CFTC issued an investigative report entitled "An Investigation Regarding the Cost-Benefit Analyses Performed by the Commodity Futures Trading Commission in Connection with Rulemakings Undertaken Pursuant to the Dodd-Frank Act."[2] Unfortunately, the report found a number of troubling issues with CFTC rulemaking that confirm the concerns expressed in our February 15, 2011 letter. Here are just a few examples:

- The report found that legal formalities trumped economic analysis in the rulemaking process. This was exemplified by the fact that the Office of General Counsel took a dominant role over the Office of Chief Economist in drafting cost-benefit analyses. The CFTC Inspector General described this situation as "odd" for an agency that regularly engages in economic analysis. (Page iv.)

- The report found that CFTC staff considered economic analysis to be merely an administrative task, rather than a substantive part of rulemaking. The CFTC Inspector General discovered that team members commonly referred to the economic analysis as the regulation's "caboose." (Page 15.)

- The report found that the CFTC's rulemaking process does not comply with the President's Executive Order 'Improving Regulation and Regulatory Review.' For example, the CFTC Inspector General concluded that "nobody quantified internal costs associated with rulemaking." (Page 15.)

- The report found that CFTC staff expressed "frustration" and "confusion" about the difference between cost-benefit analysis and the required Paperwork Reduction Act statement. The CFTC Inspector General described the level of staff confusion as "troublesome." (Page 21.)

We are concerned that these rulemaking issues documented by the CFTC Inspector General's Report are not unique to the CFTC and are impeding the agencies' ability to understand the economic effects of their proposed rules. Therefore, we request that you conduct a review of the economic analyses performed by the regulatory agency under your supervision and prepare a written report of your findings.

Please include in your report 1) a description of any statutory or other requirements to perform economic analysis, 2) a description of any internal policies, procedures, and guidance that the agency uses to ensure rigor and consistency in the economic analysis of its proposed rules, 3) an assessment of the degree to which the relevant staff of the agency understand and follow statutory and the agency's own requirements, 4) an assessment of the degree to which the agency complies with these requirements, 5) a description of any discretionary economic analysis that the agency voluntarily

[2] http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/oig_investigationreport.pdf. The Office of the Inspector General for the Commodity Futures Trading Commission undertook the investigation at the request of Representative Frank D. Lucas, Chairman, House Committee on Agriculture, and Representative K. Michael Conaway, Chairman, Subcommittee on General Farm Commodities and Risk. http://agriculture.house.gov/pdf/letters/cftc_inspectorgeneral110311.pdf

undertakes on a regular or *ad hoc* basis in order to ensure that its rulemaking is effective and efficient, 6) an assessment of the relevant qualifications of the staff who conduct economic analysis, and 7) a review of the economic analysis, if any, conducted in connection with the agency's rulemakings, with particular emphasis on:

A. The quantitative methodologies the agency uses to evaluate the costs and benefits of proposed rules and the effects those rules could have on job creation and economic growth.

B. The qualitative methods the agency uses to categorize or rank the effects of proposed rules.

C. The extent to which the agency considers alternative approaches to its proposed rules.

D. The extent to which the agency examines the costs, benefits, and economic impact of reasonable alternatives to its proposed rules.

E. The extent to which the agency seeks public input and expertise in evaluating the costs, benefits, and economic impact of its proposed rules, and the extent to which the agency incorporates the public input into its rule proposals.

F. The extent to which the economic analysis performed by the agency with respect to its proposed rulemakings is transparent and the results are reproducible.

In light of the unprecedented number of rule proposals that have been issued since the enactment of Dodd-Frank, we recommend that you limit your review of the agency's use of economic analysis in rulemakings to your agency's proposed rules listed in Attachment A. Based on your review, please make recommendations on how to improve the rigor and consistency of the agency's economic analysis. Please also describe any additional steps that the agency would have to take if it were subject to Executive Orders 13563 and 12866 and associated Office of Management and Budget (OMB) guidance.[3]

Finally, we ask that you assess the extent to which your agency is considering the cumulative burden of all Dodd-Frank rulemakings on market participants and the economy.

Thank you for your consideration of this request. We respectfully ask that you respond by June 13, 2011.

[3] Executive Order 13563, Improving Regulation and Regulatory Review (January 18, 2011), Executive Order 12866, Regulatory Planning and Review (October 4, 1993), and OMB Circular A-4, Regulatory Analysis (September 17, 2003) http://www.whitehouse.gov/omb/inforeg_regmatters

Sincerely,

Richard Shelby

Mike Crapo

Roger F. Wicker

Pat Toomey

Jerry Moran

Jim DeMint

Mike Johanns

Claire McCaskill

Boozman

David Vitter

Attachment A
List of Rules for Review

Commodity Futures Trading Commission

1. Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions, April 27, 2011, 76 FR ____ (2011)
2. Risk Management Requirements for Derivatives Clearing Organizations, 76 FR 16588 (Mar. 24, 2011)
3. Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 76 FR 6715 (Feb. 8, 2011)
4. Core Principles and Other Requirements for Swap Execution Facilities, 76 FR 1214 (Jan. 7, 2011)

Federal Deposit Insurance Corporation

1. Credit Risk Retention, 76 FR 24090 (April 29, 2011)
2. Risk-Based Capital Standards: Advanced Capital Adequacy Framework – Basel II; Establishment of a Risk-Based Capital Floor, 75 FR 82317 (Dec. 30, 2010)
3. Margin and Capital Requirements for Covered Swap Entities, April 12, 2011, 76 FR ____ (2011)

Federal Reserve Board

1. Credit Risk Retention, 76 FR 24090 (April 29, 2011)
2. Risk-Based Capital Standards: Advanced Capital Adequacy Framework – Basel II; Establishment of a Risk-Based Capital Floor, 75 FR 82317 (Dec. 30, 2010)
3. Margin and Capital Requirements for Covered Swap Entities, April 12, 2011, 76 FR ____ (2011)
4. Regulation Z; Truth in Lending (April 19, 2011). 76 FR ___ (2011)
5. Financial Market Utilities, 76 FR 18445 (April 4, 2011)

Office of the Comptroller of the Currency

1. Credit Risk Retention, 76 FR 24090 (April 29, 2011)
2. Risk-Based Capital Standards: Advanced Capital Adequacy Framework – Basel II; Establishment of a Risk-Based Capital Floor, 75 FR 82317 (Dec. 30, 2010)
3. Margin and Capital Requirements for Covered Swap Entities, April 12, 2011, 76 FR ____ (2011)

Securities and Exchange Commission

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

Management Comments

MEMORANDUM

To: H. David Kotz, Inspe tor General
Office of Inspector General

From: Mark Cahn, General Counsel
Robert Cook, Director, Division of Trading and Markets
Meredith Cross, Director, Division of Corporation Finance
Craig Lewis, Director, Division of Risk, Strategy, and Financial Innovation
Eileen Rominger, Director, Division of Investment Management

Cc: Mary Schapiro
Chairman

Re: Management's Response to the Office of Inspe tor General's Draft Report, *Follow-Up Review of Cost-Benefit Analyses in Selected SEC Dodd-Frank Rulemakings*, Report No. 499, dated January 13, 2012.

Date: January 25, 2012

I. Introduction

The Divisions of Corporation Finance (CF), Investment Management (IM), Risk, Strategy, and Financial Innovation (RSFI), and Trading and Markets (TM) and the Office of the General Counsel (GC) submit this memorandum in response to the Office of Inspector General's (OIG) Draft Report No. 499 entitled *Follow-Up Review of Cost-Benefit Analyses in Selected SEC Dodd-Frank Rulemakings*, dated January 13, 2012 ("Final Draft Report"). Thank you for the opportunity to respond to the Final Draft Report.

The Final Draft Report contains six recommendations, and you have requested that we indicate whether or not we concur with these recommendations. We generally concur with each of the recommendations, with the exception of Recommendation 5. We have provided additional comments below explaining our disagreements with certain portions of the analysis or conclusions in the Final Draft Report that we believe are inaccurate or unfounded.

II. General Comments

The staff takes very seriously the task of performing cost-benefit analyses in connection with Commission rulemaking. We understand the legal requirements

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relevant to our consideration of economic effects, and agree that careful evaluation of these economic effects is an essential part of our rulemaking work. Staff in the rulemaking divisions greatly values the input and assistance from our economist colleagues in RSFI. We work closely with one another to integrate economic analysis into the Commission's rulemaking process.

We are therefore pleased that the Final Draft Report recognizes the staff's commitment to conducting sound cost-benefit analysis in Commission rulemaking. We particularly appreciate the Final Draft Report's findings that rulemaking teams consistently adhere to internal policies for preparing cost-benefit analyses and that the staff follows a systematic process in performing cost-benefit analyses. We also appreciate that the Final Draft Report recognizes that RSFI economists play a significant role in Commission cost-benefit analyses and that Commission practices are in accordance with legal requirements. We welcome the several constructive recommendations for improvements to existing practices that are provided in the Final Draft Report.

Nevertheless, we believe that the Final Draft Report misconstrues and unduly emphasizes the impact of a memorandum written in September 2010 by the Commission's then-General Counsel, David Becker ("September 2010 memorandum"). Citing the opinion of the expert retained by OIG, Professor Kyle, the Final Draft Report appears to view the September 2010 memorandum as setting forth a bright-line policy, which it does not. The staff's view is that the approach described in that memorandum requires the exercise of judgment in determining the degree to which discretionary rule choices can be made independently of rule provisions that are statutorily mandated.

The general approach set forth in the September 2010 memorandum is that the Commission primarily engages in economic analysis to inform its own exercise of discretion in decision making – that is, to help it make the best choice from the range of choices available to it in crafting rules, and to explain these choices to the public, Congress, and the courts. The Final Draft Report suggests that this approach is flawed because it does not accomplish what, in the opinion of Professor Kyle, is an essential purpose of cost-benefit analysis: informing Congress about the economic consequences of its legislative judgments.

We believe Professor Kyle's opinion fails to appreciate both the practical limitations on the scope of cost-benefit analysis a regulator can conduct, and the distinct roles of Congress and administrative agencies. We think it is entirely sensible in Dodd-Frank rulemaking for the staff to focus its attention and the Commission's limited resources on matters that the Commission has the authority to decide. Accordingly, the staff seeks to use cost-benefit analysis to help the Commission make appropriate and informed decisions on these matters, to explain

why the Commission's choices are rational, and to inform the public, Congress, and the courts about **these** choices. Informing Congress about the wisdom of decisions it has already made by revisiting legislative cost-benefit judgments could be a potential secondary benefit, but it is not the core principle driving cost-benefit analysis in Commission rulemaking.

Moreover, where Congress has clearly expressed its will, we do not believe the Commission should undertake lightly an exercise that may be seen as second-guessing the wisdom of Congressional action. Professor Kyle's view also fails to acknowledge that Congress has many other ways to obtain information about the effects of its legislation and of the regulations it directs agencies to write. These include legislative hearings, oversight hearings, fact-finding investigations, Congressional Budget Office analyses, and reports by the Government Accountability Office or other agencies. The Dodd-Frank Act itself contains numerous provisions requiring follow-up studies and evaluations concerning the effectiveness of implementation of various statutory provisions.[1]

By using the September 2010 memorandum as the lens through which all aspects of the Commission's Dodd-Frank cost-benefit analyses are viewed, the Final Draft Report reaches a number of flawed conclusions and criticisms. For example, in a discussion of the degree to which various cost-benefit analyses quantified costs and benefits of rule releases (p. 14), the Final Draft Report attributes a lack of quantitative discussion to "the fact that the analysis – consistent with OGC guidance – addressed only the costs and benefits of discretionary portions of the rulemaking and did not address the statutorily mandated portions." This is a non sequitur. The staff acknowledges that the degree of quantification of costs and benefits in economic analyses varies. This is because, as authorities such as the GAO have repeatedly noted, it can be quite difficult to estimate reliably the costs – and even more so, the benefits – of financial regulations.[2] These costs and benefits are

[1] *See, e.g.*, Dodd-Frank Act Section 952(b) (requiring the SEC to conduct and submit to Congress a study and review of the use of compensation consultants and the effects of such use); Dodd-Frank Act Section 922(d) (requiring the Inspector General of the SEC to conduct a study and submit a report to Congress on the whistleblower protection program established by the Dodd-Frank Act and Commission regulations); Dodd-Frank Act Section 1502(d) (requiring reports from the Comptroller General to Congress assessing the effectiveness of newly-added Section 13(p) of the Securities Exchange Act in promoting peace and security in the Democratic Republic of the Congo and adjoining countries, and also requiring reports from the Secretary of Commerce to Congress assessing the accuracy of independent private sector audits and other due diligence processes described under Section 13(p)).

[2] *See* Government Accountability Office, GAO-12-151, *Dodd-Frank Act Regulations: Implementation Could Benefit From Additional Analysis and Coordination* (2011), at 19; GAO 08-32, *Financial Regulation: Industry Trends Continue to Challenge the Federal Regulatory Structure* (2007), at 3-4, 12-13. *See also* Office of Management and Budget, Circular A-4 at 26-27 (noting that some important benefits and costs "may be inherently too difficult to quantify or monetize given current data and methods"). In addition, as GAO recently noted, much of the data needed for

equally difficult to measure whether they result from discretionary or non-discretionary portions of rules.

Thus, while we appreciate the several constructive recommendations contained in the Final Draft Report, we have also provided comments indicating our disagreement with critiques that we believe are inaccurate or unfounded.

III. Responses to Recommendations

Recommendation 1: Securities and Exchange Commission rulewriting divisions and the Division of Risk, Strategy, and Financial Innovation should consider ways for economists to provide additional input into cost-benefit analyses of Securities and Exchange Commission rulemakings to assist in including both quantitative and qualitative information to the extent possible.

CF, IM, TM, RSFI, and GC concur with this recommendation. The staff is already consulting with RSFI economists at the earliest stages of the rulemaking process, and we continue to seek additional methods of bringing more economic expertise into rulemaking.

Recommendation 2: The Office of the General Counsel, in consultation with the Division of Risk, Strategy, and Financial Innovation, should reconsider its guidance that the SEC should perform economic analyses for rulemaking activities to the extent that the SEC exercises discretion and should consider whether a pre-statute baseline should be used whenever possible.

As noted in our general comments, we do not agree with Professor Kyle's opinion that the Commission should always devote its limited resources to performing a de novo analysis of the costs and benefits of legislative judgments that Congress has already made and the Commission has no discretion to disregard. Nor do we agree with the corollary that a pre-statute baseline is always appropriate, particularly in cases such as the mandatory rulemakings to implement the Dodd-Frank Act. When Congress has directed that the Commission shall adopt particular rules through statutory provisions that do not give it the discretion to do otherwise, we question how much it would benefit the Commission's decision making on those rules to devote the additional resources necessary to analyze the costs and benefits of the statutory provision itself. Nevertheless, because we recognize that the issues are complex and require the continued exercise of judgment, GC and RSFI generally concur with the recommendation that we should continue to consider the appropriate approach to take in cost-benefit analyses for future individual Dodd-Frank rulemakings.

detailed quantification of costs is possessed by private industry participants and can be difficult to obtain. *See* GAO 12-151 at 20.

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For example, we recognize that it is sometimes difficult to isolate the incremental effects of our discretionary actions, and in these instances it is important to consider the overall impact of the statute as well. Thus, in proposed Regulation SBSR, the staff tailored its assessment of costs and benefits to reflect the new regulatory regime that Dodd-Frank established, and the baseline was considered to be the absence of an SBS reporting requirement (the regulatory status quo before the adoption of Dodd-Frank). This contrasts with some Dodd-Frank rulemakings where the Commission rulemaking simply followed an express statutory directive and the Commission exercised literally **no** discretion.[3]

We also appreciate that where a statute directs rulemaking with certain mandatory components but also gives the agency some discretion, an awareness of the economic consequences of the required aspects of the rule is important for making discretionary choices. The Final Draft Report, however, appears to suggest that the Commission cannot make informed and logical decisions about its discretionary choices without engaging in a complete cost-benefit analysis of the statutorily mandated provisions. For the reasons discussed above, we disagree. Rather, we believe the appropriate approach, which the staff has taken in recent and ongoing Dodd-Frank rulemakings, is to seek to understand and acknowledge the economic impacts of the mandatory components of rules, not in an effort to determine whether the benefits of Congress's choices justify their cost, but to provide a context for the Commission to analyze the incremental economic effects of its own decision making in those areas in which it is exercising discretion.

In the staff's view, the greatest challenge faced in conducting cost-benefit analysis is reliably quantifying the costs and benefits of a proposed rule and the alternatives to that rule. While the Final Draft Report is critical of the fact that the cost-benefit analyses in the rules reviewed did not contain quantifications of all costs and benefits, the Report never seriously acknowledges how difficult this task is, nor does it provide any constructive suggestions in this regard. To the contrary, to support the conclusion that a pre-statute baseline is always appropriate, the Final Draft Report (p. 17) uses an oversimplified hypothetical example in which Professor Kyle assumes that the staff possesses perfect information and the ability to quantify costs and benefits with precision. Because these assumptions are flawed, so too is the conclusion.

Recommendation 3: SEC rulemaking teams should generally use a single, consistent baseline in the cost-benefit analyses of their rulemakings related to a particular topic. The baseline being used should be specified at the beginning of the cost-benefit analysis section. If multiple baselines are appropriate, such as for

[3] *E.g.*, Removal from Regulation FD of the Exemption for Credit Rating Agencies, Rel. No. 33-9146, 75 FR 61050 (Oct. 4, 2010).

evaluating alternative approaches or explaining the SEC's use of discretion, they should also be explained and justified.

While we believe that the Final Draft Report's discussion oversimplifies the issues surrounding the selection of the appropriate baseline, CF, IM, TM, RSFI, and GC concur with this recommendation as a general best practice. As has been previously communicated to the OIG, however, the staff disagrees with many of the criticisms of specific rule proposals contained in this section of the Final Draft Report.

Recommendation 4: SEC rulewriting divisions should consider discontinuing the practice of drafting separate cost-benefit analysis and efficiency, competition, and capital formation sections and instead provide a more integrated discussion of these issues in rule releases.

CF, IM, TM, RSFI, and GC concur in this recommendation. As noted in the Final Draft Report, some Dodd-Frank rulemakings have begun to use the approach described. Staff is continuing to consider ways to provide a more integrated discussion of economic issues in rule releases.

Recommendation 5: The Commission should consider directing rulemaking teams to (1) explicitly discuss market failure as a justification for regulatory action in the cost-benefit analysis of each rule that is based in whole or in part on perceived market failure or (2) in the absence of market failure, demonstrate a compelling social purpose that justifies regulatory action.

The staff does not concur in this recommendation, in large part because we are uncertain about its scope and meaning.[5] Among other things, it is not clear to us whether this recommendation is directed to Dodd-Frank mandated rulemaking, all rulemaking, or only discretionary rulemaking.

With respect to discretionary rulemaking, our view is that discussion of market failure or other justification for rulemakings is already a standard practice. Often the justification does not fit easily under a "market failure" approach. Many Commission rules, for example, provide exemptive relief from statutory prohibitions, and those rulemakings are not typically premised on market failure. Moreover, the staff believes that the situation is very different when the Commission is conducting rulemaking because of a statutory mandate. If the impetus for a rulemaking is a statute requiring the Commission to act, rather than the Commission's own assessment that there is an existing market failure that should be addressed, then it is not clear how the Commission would go about describing the market failure. The

[5] Although Recommendation 5 is directed to "the Commission," in this response we treat it as if it were phrased as a directive to the Commission's rulemaking divisions.

legislative record mayor may not provide clear evidence that Congress believed it was addressing a market failure by the statutory provision requiring rulemaking. Nevertheless, Congress's action must be taken as evidencing its considered conclusion that there was some problem that it intended to address through the mandated rules. Professor Kyle's opinion as described in the Final Draft Report appears to be that if the staff cannot articulate its own version of a market failure theory, then the Commission should not write rules implementing Congress's direction – in other words, it should disregard the law.

Contrary to suggestions in the Final Draft Report, OMB Circular A-4 does not support the position that the Commission must provide market failure justifications for its mandatory Dodd-Frank Act rulemaking. Circular A-4 notes that before recommending regulatory action, an agency must demonstrate that the action is necessary. A statutory mandate is one reason why action may be necessary. The agency's assessment of a market failure is another, separate reason.[6]

Thus, contrary to Professor Kyle's view, when there is a statutory directive requiring the agency to promulgate regulations, the agency need not also set forth its own market failure justification for the regulatory action. The SEC releases do sometimes discuss market failures that the statute may be attempting to address; for example, as the Final Draft Report notes, the Credit Risk Retention proposing release discussed the problem of misaligned incentives, relying in part on the statute's legislative history (although the Final Draft Report also erroneously suggests that this discussion inadequately describes a market failure). But in this situation, the justification for the agency's regulatory action arises from the statutory mandate, not from the agency's assessment of a market failure.

Ultimately, if Recommendation 5 is simply intended to mean that the Commission should state its justification for regulatory action – when it is market failure, discuss market failure; when it is something else (including a statutory mandate), discuss that something else – then the staff agrees that this is clearly a sensible practice. But in the context of the surrounding discussion in the Final Draft Report, it appears that the Report and Professor Kyle are recommending a different approach, which the staff believes is not appropriate and, contrary to the Final Draft Report's suggestion, not consistent with Circular A-4.

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[6] Circular A-4 provides 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." Circular A-4 at 3-4. Additionally, Circular A-4 quotes from Executive Order 12866, stating that agencies "should promulgate only such regulations as are required by law, are necessary to interpret the law, *or* are made necessary by compelling need, such as material failure of private markets to protect or improve the health and safety of the public, the environment, or the well being of the American people." E.O. 12866, quoted in Circular A-4 at 3, emphasis added. These statements make clear that a statutory mandate and a market failure are alternative possible justifications for a regulation.

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Recommendation 6: SEC rulemaking teams should consider including internal costs and benefits in the cost-benefit analyses of rulemakings.

CF, IM, TM, RSFI, and GC generally concur that, depending on the significance of the internal costs and benefits of a rule, it can be appropriate to consider them in the cost-benefit analysis. The staff's general practice has been not to consider administrative costs or savings in cost-benefit analyses because such costs and benefits typically are not a significant or material component of the overall costs and benefits of a rule. In addition, in some cases internal benefits, such as benefits to the Commission's ability to engage in oversight or enforcement activities, result more broadly in benefits to the markets or to investors, which may be equally or more important.

The economic analysis in one Dodd-Frank mandated rulemaking, the Whistleblower Rules,[8] did include a discussion of internal costs and benefits to the operation of the affected SEC programs. In that case, the effect of the rules on internal SEC enforcement operations was a significant issue raised by the rules and was the subject of public comment on the proposed rules. Not all rules present this situation, however, and the degree of consideration given to internal costs and benefits will differ depending on their importance in a particular rulemaking.

[8] Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, Rel. No. 34-64545, 76 FR 34300 (June 13, 2011).

OIG Response to Management Comments

The Office of Inspector General (OIG) is pleased that the Divisions of Corporation Finance (CF), Investment Management (IM), Risk, Strategy, and Financial Innovation (RiskFin), and Trading and Markets (TM) and the Office of the General Counsel (OGC) have concurred with five of the six recommendations addressed to the respective divisions and office. We are also encouraged that CF, IM, RiskFin, TM, and OGC welcome the constructive recommendations for improvements to existing practices that are contained in the OIG's report.

We are, however, disappointed in some of the assertions contained in the management response to the OIG's report, as well as with the statement in the response that management does not concur with recommendation 5, which simply asks the Commission to "consider" directing the agency's rulemaking teams to provide a fuller discussion in the cost-benefit analyses regarding market failure or, alternatively, a compelling social purpose as a justification for regulatory action. Discussed below are the particular areas of disagreement as reflected in the management response, in order of their appearance.

The management response asserts that the OIG report "misconstrues and unduly emphasizes the impact" of the September 2010 memorandum prepared by the SEC's then-General Counsel, David Becker ("Becker memorandum"), which the response asserts is not a "bright-line policy." Yet the focus of the analysis in the OIG's report is not the language of the Becker memorandum itself, but rather the approach utilized by the SEC rulemaking teams in the cost-benefit analyses we reviewed, which dovetailed with the approach outlined in the Becker memorandum. For example, the introduction to the cost-benefit analysis section of the adopting release for the Shareholder Approval of Executive Compensation and Golden Parachute Compensation rule stated the following: "The discussion below focuses on the costs and benefits of the amendments made by the Commission to implement the Act within its permitted discretion, rather than the costs and benefits of the Act itself."[101] Similarly, the introduction to the cost-benefit analysis section of the adopting release for the Issuer Review of Asset-Backed Securities rule stated that the discussion in the cost-benefit analysis "focuses on the costs and benefits of the amendments made by the Commission to implement the Act within the Commission's permitted discretion and related amendments not required by the Act, rather than the costs and benefits of the [Dodd-Frank] Act itself."[102] Thus, our analysis describes and comments on the impact of the rulemaking teams following the Becker memorandum's overarching guidance—that is, in instances where the

[101] 76 Fed. Reg. 6010, 6037.
[102] 76 Fed. Reg. 4231, 4241.

Commission is making no policy choices, "there are no choices to analyze or explain."[103]

The management response also states that Professor Kyle's opinion with respect to the proper scope of cost-benefit analyses fails to appreciate the pertinent practical limitations and the distinct roles of Congress and administrative agencies. The response also states that SEC staff use cost-benefit analyses to help the Commission make appropriate and informed decisions on the matters the Commission has the authority to decide, and informing Congress about the wisdom of decisions it has already made is not and should not be the core principle driving SEC cost-benefit analyses. While we appreciate management's perspective and acknowledge that the Commission is subject to resource limitations with respect to performing cost-benefit analyses for Dodd-Frank Act rulemakings, we disagree that the Commission's primary reason for engaging in economic analysis of rulemaking alternatives should be "to inform its own exercise of discretion in decision making." We concur with Professor Kyle's opinion that "in addition to satisfying statutory requirements and nonstatutory best practices, a cost-benefit analysis is intended to inform the public and other parts of government, including Congress and the regulating entity itself, of the effects of alternative regulatory actions." This opinion is consistent with OMB Circular A-4, which states that "[a] good regulatory analysis is designed to inform the public and other parts of government (as well as the agency conducting the analysis) of the effects of alternative actions."[104]

The management response further labels as a "non sequitur" the report's statement that lack of quantitative discussion in the cost-benefit analyses of Dodd-Frank Act rulemakings "might have resulted" from the fact that the analyses addressed only discretionary components. While we appreciate the challenges involved in arriving at quantitative estimates of costs and benefits of SEC rulemakings, we continue to believe that the failure to address the mandatory components in cost-benefit analyses may hinder efforts to rationally quantify costs and benefits. As the report explains, "it is often difficult to describe incremental costs and benefits of going from the statutory mandate to a reasonable alternative without also describing how the pre-statute state of the world differs from the statutory mandate. One way to calculate the incremental costs and benefits of a reasonable alternative and a statutory mandate is to describe the costs and benefits of the reasonable alternative relative to the pre-statute baseline, then subtract out the incremental costs and benefits of the statutory mandate relative to the pre-statute baseline."

The management response states that while OGC and RiskFin generally concur with the OIG report's recommendation 2 regarding using a pre-statute baseline

[103] Memorandum from David M. Becker, General Counsel, Thoughts About Best Practices in Drafting Economic Analysis Sections of Releases for Dodd-Frank Related Rulemakings (Privileged and Confidential) (Sept. 27, 2010).
[104] OMB Circular A-4 at 2.

for economic analyses, management does not agree that the SEC "should always devote its limited resources" to performing a de novo analysis of the costs and benefits of legislative judgments. The response also states that management does not agree with "the corollary that a pre-statute baseline is always appropriate . . . ." However, recommendation 2 states that OGC, in consultation with RiskFin, "should consider whether a pre-statute baseline should be used whenever possible." It does not recommend that a pre-statute baseline be used in every circumstance. Moreover, as Professor Kyle noted, by performing cost-benefit analyses only for discretionary rulemaking activities, the SEC may not be providing a full picture of whether an action is likely to justify its costs and which regulatory alternatives would be the most cost-effective. Further, the recommendation is consistent with the guidance in OMB Circular A-4, which states that the baseline agencies use in defining costs and benefits will "normally be a 'no action' baseline"[105]—that is, a pre-statute baseline.

The management response is also critical of a hypothetical example used by Professor Kyle in the report's discussion of pre-statute baselines, referring to it as "oversimplified" and based upon "flawed" assumptions. As the report makes clear, however, the purpose of Professor Kyle's example was to illustrate why the use of a pre-statute baseline is potentially important; the example was not intended to represent a typical quantification of costs and benefits.

The management response further states that the Commission staff does not concur with recommendation 5 primarily because it is uncertain about the recommendation's scope and meaning. The response indicates that discretionary rulemakings may often not be premised on market failure, and that OMB Circular A-4 does not recommend that an agency provide market failure justifications for statutorily mandated rulemakings. However, the OIG recommendation does not suggest that market failure is the sole acceptable justification for rulemaking. Instead, it provides that in instances when market failure is the justification for a rulemaking, the Commission should consider having the rulemaking teams explicitly discuss market failure. As the report states, when market failure is not the justification for proposed regulation, the cost-benefit analysis should refer to the compelling social purpose that justifies the regulatory action, such as, according to OMB Circular A-4, "improving governmental processes or promoting intangible values such as distributional fairness or privacy."[106]

The management response appears to takes the position that where rulemaking is based upon a statutory requirement, the Commission should never articulate market failure as a basis for the rule and that to do so would "disregard the law." However, management provides no support for the concept that an agency is

[105] OMB Circular A-4 at 2.
[106] OMB Circular A-4 at 4. We also disagree with management's characterization of the discussion of the problem of misaligned incentives in the Credit Risk Retention release as a discussion of a market failure. According to Professor Kyle, misaligned incentives would not necessarily constitute a market failure.

prohibited from discussing its views on market failure as a justification for regulatory action whenever Congress has passed a law to address the problem at issue. OMB Circular A-4 states, based on Executive Order 12866, that the agency should try to explain whether the action is intended to address a significant market failure or to meet some other compelling public need.[107] OMB Circular A-4 does not state that an agency should do this only in situations where there is no statutory directive requiring the agency to promulgate regulations.

The OIG's report is not suggesting that the SEC staff discuss market failure in situations where market failure has no nexus to the proposed regulatory action. Nor is the OIG report advocating an approach that it is in any way contrary to OMB Circular A-4. Rather, the OIG's recommendation is designed to promote adherence to OMB Circular A-4's guidance.

Therefore, we hope that SEC management reconsiders its decision not to agree to even "consider" whether to include an explicit discussion of market failure in the SEC's cost-benefit analyses in rulemakings based on perceived market failure, including those mandated by the Dodd-Frank Act. We believe that implementation of our recommendation would further inform the Commission, the public, and Congress about the bases for the pertinent rules.

[107] OMB Circular A-4 at 4.

Audit Requests and Ideas

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U.S. Securities and Exchange Commission
Office of Inspector General
Attn: Assistant Inspector General, Audits (Audit Request/Idea)
100 F Street, N.E.
Washington D.C. 20549-2736

Telephone: 202-551-6061
Fax: 202-772-9265
E-mail: oig@sec.gov

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