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Statement No. 316

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Statement of the Shadow Financial Regulatory Committee on

Improving the Regulatory Process and Financial Cost-Benefit Analysis

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In the aftermath of the District of Columbia Circuit Court of Appeals ruling this summer (which the SEC has decided not to challenge), the SEC is now being forced to reconsider its rule-making process. The court overturned the SEC's proxy access rule (see Shadow Committee Statement No. 297, "Proxy Access and the Market for Corporate Control," September 13, 2010) on grounds of an inadequate cost-benefit analysis, reinforcing other unfavorable appellate court decisions along similar lines.

The SEC now is seeking public comment on how to improve its process for retrospective reviews of existing rules. One of the central economic challenges confronting all regulators, in an environment in which a flood of new rules are being issued, is to ensure that the regulations meet the challenge of improving the operation of our economy, while meeting the standards of judicial review. In the recent decision, the court expressed its skepticism and characterized the quality of mandated cost-benefit analyses at the SEC in the following manner:

> "Here the Commission inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to

substantial problems raised by commenters."

Adding to judicial dissatisfaction with the prevailing agency rule-making process, Congress also has expressed frustration. This has led to Congressional requests for Inspector General reports from the various financial regulators.

There are numerous ways in which the process might be improved. For example, any release adopting a final rule could be required to include a statement of those verifiable consequences that the rule is expected to achieve. This would greatly enhance the accountability of the regulator for its decisions and focus its attention on empirical analysis of the impact of the requirement being imposed by the rule.

An excellent example of a rule-making process that captures the spirit of such a requirement can be found in the SEC's 2007 repeal of longstanding up-tick restrictions on short sales. This rule had been thought to inhibit short sales, which tend to be very unpopular with management and politicians. To investigate the consequences of a potential repeal, the SEC conducted statistical studies using data it generated in a controlled experiment designed to determine the policy's impact. Among the important findings of these studies were that short interest and volatility were not substantially altered by the imposition of the up-tick requirement and that considerable trading costs were being imposed because of the importance of short sales to the provision of liquidity to the market by dealers.

Unfortunately, in the midst of the recent financial crisis, political considerations led the SEC to ban short selling entirely on financial stocks in 2008 while the TARP legislation was under consideration. The then-chairman of the SEC said as he was leaving office that he regarded the ban on short-selling as the worst decision during his chairmanship. Sadly, in the face of the current sovereign debt crisis some EU members have gone down the same path of banning short sales for reasons of political expediency.

When data are insufficient or lacking, the SEC's short-sale experience suggests that an agency could generate the needed data from pilot projects or gradual phase-ins of a new regime. This is definitely feasible in the area of financial market trading. For example, determination of appropriate reporting lags for bond market transactions in TRACE utilized this technique.

The SEC recently announced that it is going to conduct a retrospective review of its existing regulations, as the President has required. The SEC is now seeking comment on how to conduct such reviews. It is never too late to conduct empirical work to measure what has been achieved and what costs (both estimated and unintended) were imposed, as compared what was claimed or estimated at the time of the release. An advantage of retrospective analysis is that one is examining actual rather than projected events and can undertake a "before and after" comparison analysis. Sunset provisions in regulations would force regulators regularly to conduct the studies that the President is requiring in this instance.

The centrality of effective regulation to the economy highlights the importance of allocating sufficient staffing resources to pursue reasonable cost-benefit analysis. The skills required for such work complement those required to write regulations, and are particularly important in sorting out beneficial regulations from inefficient and ineffective ones.

Using these approaches and generating data to test the effects of SEC decisions on a consistent basis would enhance the credibility of the entire regulatory endeavor, both domestically and globally.