

# The Empty Call for Benefit-Cost Analysis in Financial Regulation

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## Abstract

"Benefit-cost analysis" as applied to financial regulation is a serious category mistake that has the potential to stymie regulation aimed at the reduction of systemic risk in favor of privileging a status quo that we know is unstable. Benefit-cost analysis, which gained prominence from its applications in health, safety, and environmental regulation, contemplates an omniscient social planner who can calculate costs and benefits generated by a system that is essentially stable, because it rests on natural constraints, in particular the laws of chemistry, biology, and physics. By contrast, finance is a constructed system, created by financial regulation itself and subsequent adaptations. Any non-trivial new rule would change the system of finance in ways that are hard to foresee and thus would undercut the value of a prior calculation of benefits and costs. Instead, optimal financial regulation policy should be understood as based on a series of trade-offs of values that are normatively derived, for example: the desire to achieve the economic benefits from the free flow of capital and the ready availability of credit as balanced against the risks of systemic distress and the associated economic disruption. These value trade-offs will produce subsidiary principles of pragmatic design, for example: minimize the extent to which financial institution can free-ride on systemic stability costs paid by others; provide regulators with sufficient information to observe the build-up of imbalance in the financial system and the power to make regulatory modifications accordingly. Rather than insist on a meaningless, if not misleading, benefit cost analysis that seems not required by any substantive regulatory statute, a reviewing court should apply rationality review to a regulatory agency's application of pragmatic judgment.

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Keywords: Benefit-cost analysis, financial regulation, Glass-Steagall, money market funds, judicial review

JEL Classifications: G28, K23, P1

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# The Empty Call for Benefit-Cost Analysis in Financial Regulation

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## ABSTRACT

“Benefit-cost analysis” as applied to financial regulation is a serious category mistake that has the potential to stymie regulation aimed at the reduction of systemic risk in favor of privileging a status quo that we know is unstable. Benefit-cost analysis, which gained prominence from its applications in health, safety, and environmental regulation, contemplates an omniscient social planner who can calculate costs and benefits generated by a system that is essentially stable, because it rests on natural constraints, in particular the laws of chemistry, biology, and physics. By contrast, finance is a constructed system, created by financial regulation itself and subsequent adaptations. Any non-trivial new rule would change the system of finance in ways that are hard to foresee and thus would undercut the value of a prior calculation of benefits and costs. Instead, optimal financial regulation policy should be understood as based on a series of trade-offs of values that are normatively derived, for example: the desire to achieve the economic benefits from the free flow of capital and the ready availability of credit as balanced against the risks of systemic distress and the associated economic disruption. These value trade-offs will produce subsidiary principles of pragmatic design, for example: minimize the extent to which financial institution can free-ride on systemic stability costs paid by others; provide regulators with sufficient information to observe the build-up of imbalance in the financial system and the power to make regulatory modifications accordingly. Rather than insist on a meaningless, if not misleading, benefit cost analysis that seems not required by any substantive regulatory statute, a reviewing court should apply rationality review to a regulatory agency’s application of pragmatic judgment.

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# The Empty Call for Benefit-Cost Analysis in Financial Regulation

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*This draft: Dec. Dec. 24, 2013*

## INTRODUCTION

The idea of “benefit-cost analysis” (BCA) as applied to financial regulation is a serious category mistake that has the potential to stymie regulation aimed at the reduction of systemic risk in favor of privileging a status quo that we know is unstable. As a legal matter, benefit-cost analysis is not required by the applicable statutes that govern rule-making by the principal financial regulatory agencies, the Federal Reserve Board, the Office of the Controller of the Currency, the Securities Exchange Commission, and the Federal Deposit Insurance Corporation. It was not bolted on by the Dodd-Frank Act, which requires dozens of rule-makings within a compressed time frame. Indeed, in requiring a collaborative rule-making process in Dodd-Frank, in which as many as five independent agencies are often required to jointly promulgate a common rule, Congress has obviously privileged values other than instrumental rationality and coherence. On occasion the courts, particularly the DC Circuit U.S. Court of Appeals, has latched onto benefit-cost analysis as the pretext to strike down an SEC rule that it disfavored as unwarranted SEC turf expansion, but a recent DC Circuit decision, *ICI v. CFTC*,<sup>2</sup> appears to signal that it would take a more deferential approach in reviewing the implementation of the Dodd-Frank Act by the financial regulatory agencies. The court endorsed the pragmatics of the CFTC’s approach to assessing the consequences of its proposed rule.

The most serious problem with benefit-cost analysis in the financial regulatory realm is that for any non-trivial problem it is conceptually wrong-headed. It misunderstands the origins and utility of benefit-cost analysis and, in particular, the difference between “natural” and “constructed” systems. Benefit-cost analysis has as its core metaphor an omniscient social planner who can calculate costs and benefits from a system that is essentially stable, because the natural constraints are themselves stable. A “natural” system generates prices (costs and benefits) that do not change (or change much) no matter what the central planner does. The toxicity of a particular chemical, the health effects of a particular atmospheric emission does not change if the planner reduces the permitted disclosure level, nor does the statistical value of life or some other benefit measure like Quality-Adjusted-Life-Years.

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<sup>2</sup> 720 F.3d 370 (D.C. Cir. 2013).

For the financial sector, the system that generates costs and benefits is not a natural system but rather a system constructed by the pattern of financial regulation itself and by the subsequent processes of adaptation and regulatory arbitrage. We simply do not have the foresight to forecast how that system will evolve. Thus the omniscient social planner metaphor has no useful place in financial regulation. To be sure, the relevant parties will attempt to imagine the system that will result from a given set of rules and changes in rules, but any non-trivial rule, to call for a “benefit-cost analysis” that is any way like the mechanism commonly applied in the health and safety area is a counterproductive exercise.

Instead of a weighing of costs and benefits, financial regulation necessarily is based on a series of trade-offs of values that are normatively derived, for example: the desire to achieve the economic benefits from the free flow of capital and the ready availability of credit but balanced against the risks of systemic distress and the associated economic disruption. These value trade-offs may in turn produce subsidiary principles of pragmatic design, for example: minimize the extent to which financial institution can free-ride on systemic stability costs paid by others; provide regulators with sufficient information to observe the build-up of imbalance in the financial system and the power to make regulatory modifications accordingly. The values that may go into the trade-offs, the principles of pragmatic design, and regulatory implementation all will be controversial, but benefit-cost analysis does not offer an alternative way through this thicket. Thus the basic claim of this paper is straightforward: that benefit-cost analysis as it has come to be used in the modern administrative state is virtually useless in the setting of optimal financial regulation and simply gets in the way of the genuinely hard work to be done.

This paper is organized as follows. Part I briefly describes the origins and canonical use of BCA in the health and safety area, with a reference to some of the controversies. The application of BCA depends upon costs and benefits provided by “nature” and largely impervious to the regulatory regime itself. Part II outlines the basic claim: that financial markets are jointly produced by rules and the response to rules and thus for non-trivial rules, BCA does not provide a useful guide to administrative action. Part II also provides an extended example based on the regulatory creation of money market mutual funds. Part III discusses the legal framework that governs financial regulatory agency deliberation and shows that this framework does not require BCA. To be sure, recent cases reviewing SEC rule-making in the corporate governance area have seemed to import a BCA requirement, but this is probably because of the Court’s particular aversion to the SEC’s encroachment in an area of traditional state authority. A recent case suggests that the courts will be more deferential to the regulatory agencies’ tasks under Dodd-Frank in light of the undeniable failures of the prior financial regulatory regime. Part IV defends the regulatory principle of “pragmatic judgment” that protects the regulatory decisions of well-informed regulators operating in good faith to advance a reasonable set of regulatory objectives in the financial regulatory area. Moreover, financial regulation is hardly static. Processes of innovation, regulatory arbitrage, and political oversight are constantly at work, constraining the regulators and reshaping regulation, for good and ill.

## 1. THE ORIGINS OF BENEFIT-COST ANALYSIS

Benefit-cost analysis begins with the tort system. A manufacturer designs and produces a product that while in normal use is associated with a serious, even fatal accident. For example, a riding lawn mower tips over while traversing a rocky incline; the rider's leg is caught in the whirring blades; the femoral artery is breached, and the ambulance does not arrive in time. Suit is brought against the manufacturer. Whether under a negligence standard or strict liability, the manufacturer is called to take cost-justified precaution in the design and out-fitting of the lawn-mower in light of the potential for such accidents. But what are the benefits? Presumably the avoided medical expenses and avoided loss of life, but how much? These benefits are quantified by the black box of the jury, weighing pecuniary losses (lost wages) and non-pecuniary losses (pain and suffering, lost consortium). By aggregating independent jury determinations, experienced attorneys come to know what a case is "worth," and so cases commonly settle without a trial. The manufacturer now has important data for its cost-justified design and production process, an internal benefit-cost analysis designed to mitigate the cost of accidents.

The tort system is highly imperfect. Many think it underdeters in the safety realm, because high litigation costs and the power imbalances between commercial injurer and the individual injured party mean that many injuries are unredressed, allowing manufacturers to externalize costs. Certain problems are simply beyond the capacity of the tort system even if attorneys were free. Classic examples are workplace health problems and general environmental externalities. A population of employees is exposed to chemicals in the production process. Assume that the incidence of a particular cancer is higher among the employees than occurs in the general population. The general causation issues are quite difficult, scientifically and epidemiologically. The separate legal requirement of "proximate causation" for a particular employee seeking damages from a particular defendant may create an insurmountable barrier. Successful litigation becomes even harder with each additional factual complication, for example, an employee work career at different employers in the same or related industry, using somewhat different chemicals. Thus the injury costs of toxic chemicals will be insufficiently internalized by manufacturers or employers.

Consider the case of a community that is downwind of a cement plant and is on occasion inundated with fumes and particulates. Litigation to redress these problems may be difficult not only because of free rider problems in funding the litigation but because different citizens are differently affected by the emissions. In part this is because of the vagaries of wind pattern; in part because of the different susceptibilities. Or perhaps the emissions from the cement plant cause damage because of other ambient emissions, a threshold effect or an interaction effect. Suppose insistence on a zero emission standard would mean closing the plant, which employs many citizens in the local community. How can a court grapple with the benefit-cost questions involved in deciding, in effect, how much abatement the plant should achieve?

The inadequacies of the tort system in producing the optimal level of consumer product safety or workplace health and safety or environmental amenities have led to the adoption of statutes and the creation of regulatory bodies tasked with developing and enforcing standards of care and protection. One immediate consequence is to centralize within the government difficult questions of benefits and costs that were previously resolved in a disaggregated way through the judicial system, especially the jury, or not resolved at all. Because these decisions are now to be made by the state, they must adhere to practices of bureaucratic regularity and accountability. Because these determinations are centralized, they will have high saliency and the regulator needs a way to defend their legitimacy. Because these determinations have distributional implications as well as efficiency, the regulator needs a mechanism that finds a neutral way to resolve those questions.

Moreover, often the popular momentum that leads to regulation of health, safety, and environmental problems will produce statutes that overshoot the mark. For example, a workplace health and safety statute may prescribe that “no” employee shall suffer “any” health hazard because of a job.<sup>3</sup> Such a standard is plainly infeasible in a modern industrial economy.

Benefit-cost analysis has been seen as the answer to the various problems of centralized health, safety, and environmental regulation. BCA has appeal from several normative perspectives. (See Adieh (2013), with citations.) From an efficiency perspective, (i) BCA can appropriately conserve on the use of scarce resources by subjecting regulation to a proportionality test; (ii) it can serve as a heuristic constraint on behavioral biases in decision-making; (iii) it can help policy-makers create priority rankings for problems that might be addressed. From a “good government” perspective, (i) BCA may bring more transparency to the administrative process and thus perhaps greater legitimacy; (ii) it can mitigate Congress-Regulator agency problems both ex ante and ex post: ex ante, since Congress can specify the framework within which benefits and costs ought to be assessed; ex post, since Congress can evaluate the Regulator’s performance against the framework criteria or against other criteria of social (or political) value. From a non-efficiency perspective, (i) BCA can limit the pace of government regulation because of the required fact-finding and analysis; indeed, a more thorough regulatory analysis may well open up more grounds for contestation before a reviewing court. (ii) From a somewhat different non-efficiency perspective, BCA can open an avenue for the use of “objective” rather than “subjective” measures of value to promote a general welfarist agenda.

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<sup>3</sup> See *Industrial Union v. American Petroleum Instit.*, 448 U.S. 607 (1980) (“*Benzene*”) (interpreting Section 6(b)(5) of the Occupational Safety and Health Act of 1970, which requires regulation “which most adequately assures, to the extent feasible, on the basis of the best available evidence, that no employee will suffer material impairment of health or functional capacity even if such employee has regular exposure to the health hazard by such standard for the period of his working life”); *Industrial Union Dept., AFL-CIO v. Marshall*, 448 U.S. 607 (1980) (“*Cotton Dust*”)(deferring to agency’s “feasibility analysis”).

In light of this versatility, BCA has been embedded in the regulatory system through a series of Executive Orders that have survived largely intact through the recent presidencies of both political parties<sup>4</sup> and through the creation of a centralized BCA monitor, the Office of Information and Regulatory Affairs in the Office of Management and Budget.<sup>5</sup> The pervasiveness of benefit-cost analysis doesn't mean that it is without controversy, particularly on the benefit side. Almost by convention, the health, safety, environmental agencies have measured benefits in terms of the value of statistical life as reflected by utility tradeoffs in compensating differential studies, rather than "human capital" approaches based on lost wages, or in terms of "life years," which might seem to track the long latency of many health problems. Benefits that occur in the future are to be discounted to present value to compare with costs that may be incurred upfront, although the discount rate is itself normatively contestable. Among other deep problems, how are we to account for the lives of the yet-unborn, generations in the future, in the assessment of environmental benefits? What about benefits that resist quantification? Revesz (2014).

Because quantification is controversial, benefit-cost adherents are happiest when the benefits and costs can be converted into "life-life" comparison. So take the case of babies in airplanes, held in parental arms. On rare occasion, rapid deceleration or an abrupt descent will provide a moment in which Newtonian mechanics trumps parental gravity and a baby may go flying. Why not require that babies be strapped into appropriate flight seats for the duration, like we now do with automobiles? A life-life BCA variant provides us with the tools to reach the correct response: reject the proposed rule, because more babies will perish were it adopted. Airlines will surely charge for the second seat; some fraction of families will substitute away from air travel to an automobile, a much less safe mode of transportation.

Cases in the health, safety, and environmental areas carry a common theme: that the inputs to the cost-benefit calculation are fundamentally exogenous to the process of determination. Analysts may disagree about a dose response curve, for example, but the particular determination about the acceptable exposure level does not change the health hazard of the substance. A rule does not change the toxicity in fact. Determination of benefits by observing revealed preference in employees' wage demands in jobs of different risk does not generally change the wages demanded.<sup>6</sup> The costs of a regulation similarly derive from physical processes outside of the BCA process. Yes, it is common for industry to overestimate costs, and as the declining permit costs for SO<sub>2</sub> emissions demonstrate, properly designed schemes can give parties strong incentives to reduce the cost of emission or hazard abatement. Regulation may lead to substitution effects, for example, a shift to natural gas in electricity generation as the

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<sup>4</sup> E.O. 12,291 (1981); E.O. 12866, 58 Fed. Reg. 51,735 (Sept. 30, 1993); E.O. 13,563, 76 Fed. Reg. 3821 (Jan. 21, 2011).

<sup>5</sup> By the Paperwork Reduction Act of 1980.

<sup>6</sup> Health and safety regulation may well have a distributive aspect that will make employees wealthier and thus on a higher isoquant in the safety-wage trade-off. That is, health and safety regulation may itself increase the value of statistical life on the basis of which benefits are determined. This element of endogeneity is likely to be small.

environmental hazards of coal-fired plants are internalized. But the ultimate costs themselves derive from industrial chemistry, physics, and engineering whose principles do not change no matter what the regulation.

## 2. THE FINANCIAL SYSTEMS AS CONSTRUCTED BY RULES AND ADAPTATIONS TO RULES

By contrast, the financial system is not a “natural” system. It is constituted by rules and the adaptation to rules. A modern financial system that intermediates massive capital flows through specialized functional actors operating in diverse markets is profoundly a regulatory construction. Yes, early financial system may have arisen spontaneously, through the cooperation of parties in commercial life, and even without governments. E.g., Sugden (1989). Small group dynamics, kinship and clan networks, and non-legal sanctions may hold together rudimentary financial systems, even over a distance. Certain financial capacities can be provided by specialized private actors even without the support of an advanced regulatory apparatus, e.g., Gorton (1985) (clearinghouses). Yet the scale, complexity, speed, and anonymity of a modern financial system can be created only through a system of rules. Pistor (2013). Moreover, it is not only the rules but the adaptation to them, including the regulatory arbitrage, that creates the system of finance. These continuous second order effects make the benefits and costs of rule adoption impossible to quantify in a meaningful way. Changes in an important rule will change the system of finance not just through direct, immediate effects but through the subsequent adaptations. Indeed, benefit-cost analysis will encourage a myopic focus on what is measurable in a time frame in which they can be measured. This is of course a distraction from the important policy question about the advantages and pathologies of the emergent financial system.

### 2.1. Glass-Steagall and the Rise of Market-based Credit-Intermediation

Take briefly the example of the separation of commercial banking from investment banking that was a signature result of the Banking Act of 1933, the Glass-Steagall Act.<sup>7</sup> Although this separation was designed to reduce systemic risk by limiting the stock market speculation of banks, it is not hard to trace a path from this regulatory intervention to the financial crisis of 2007-09. Glass-Steagall insisted on free-standing investment banks, which could make their success only through securities markets not through banking. These investment banks quickly learned credit markets were more profitable than equity markets: firms issue equity only infrequently but are constantly in need of credit. Thus investment banks were powerfully incentivized to develop market-based mechanisms of credit intermediation, which became effective substitutes for bank-based credit. Credit-intermediation by investment banks grew on top of separate legislative decisions to limit the geographic reach of banks and to structure retirement savings so as to create large private capital pools. Gilson and Gordon (2013).

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<sup>7</sup> Building out this sketch is a focus of current work.

For competitive reasons, commercial banks felt compelled to follow the investment banks down the market path. Glass-Steagall's separation of commercial from investment banking collapsed well before its formal repeal in the Financial Services Modernization Act of 1999 (commonly known as Gramm-Leach-Bliley). Market-based credit intermediation turned out to be much harder to monitor than bank-based credit intermediation, and more fragile in many respects. The key point is this: The regulatory changes of Glass-Steagall created a new financial system; the shape of this new financial system was not foreseen and was not foreseeable. The new regulation not only constrained some behaviors but also unleashed a process of adaptation and innovation; we are only now coming to fuller awareness of this new financial system and its distinctive hazards. Benefit-cost analysis would have offered an impoverished set of analytic tools to evaluate Glass-Steagall and the subsequent adaptive responses.

## 2.2. Money Market Funds, the S&L Crisis of the 1980s, and the Rise of Shadow Banking

Consider another case of a regulatory change with far-reaching effects that no benefit-cost analysis would have captured: money market mutual funds ("MMFs"), created by SEC rule-making in the mid-1970s and early 1980s. Birdthistle (2010). Money market funds are styled as mutual funds but with a twist. Their assets consist mostly of publicly issued debt securities, but as mutual funds, they have no liabilities – the right hand of their balance sheet is all shareholder equity, which is redeemable by investors at the net asset value of the fund's portfolio, marked to market daily. The twist is that by regulatory design, this net asset value (NAV) is fixed at par in most credit market conditions and the funds are allowed to market themselves on that basis. The "fixedness" of net asset value is a function of the high credit quality and short maturities required of portfolio securities and an accounting convention that permits the fund to use "penny rounding" to report \$1.00 NAV so long as the portfolio value does not dip below \$0.995. The "fixedness" also crucially relies on the SEC's practice of routinely waiving the Investment Company Act's prohibitions on conflicted transactions to permit sponsors to swap out or guarantee defaulted or value-reduced securities in the fund's portfolio. (Gordon & Gandia 2013); Investment Company Act Rule 17a-9.

The benefits that produced the regulatory sanction of MMFs were immediately obvious. Because of high inflation, and the Federal Reserve's clamping down on the money supply, wholesale money market rates were much higher than the yield on bank deposits, capped by "Reg Q," a Depression-era artifact designed to suppress bank competition for deposits. MMFs gave retail customers access to much higher money market rates yet daily liquidity and apparently the same security as an insured bank deposit. What were the costs?

### 2.2.1. *The S&L Crisis*

The costs became obvious only later: the savings and loan crisis, price tag of around \$350 billion, and, subsequently, the instability associated with the shadow banking system, one of the elements of the financial crisis of 2007-09, costs still accumulating. Here is the causal chain.

Until the 1970s, banking in the United States was an inherently safe business. Reg Q capped the amount that banks could pay on deposits, and so banks could earn a reliable spread against their assets.<sup>8</sup> The advent of money market funds gave depositors an exit option and of course they did en masse at a time of a high money market rates. Savings and loans, specifically chartered to finance residential real estate, were particularly hard hit, because their assets consisted disproportionately of long term mortgages, which were yielding less than prevailing short term rates. The liberalization of Reg Q to permit depository institutions to compete for retail deposits with MMFs (per the Depository Institutions Deregulation and Monetary Control Act of 1980) did not solve the problem because now the S&Ls were earning a negative spread.

The next step was to grant the S&L's power to engage in businesses that were potentially more lucrative than residential mortgage lending, namely, commercial real estate and the holding of other credit assets, in particular high yielding debt securities (aka "junk bonds"). Garn–St Germain Depository Institutions Act of 1982. The theory: new powers would create higher yielding assets, deposit insurance would insure a flow of relatively low cost funds, and profits from this positive spread would cover the losses on the residential mortgage book. It didn't work out that way. The competition for retail deposits triggered by the advent of MMFs stirred to life the monstrous moral hazard associated with deposit insurance.<sup>9</sup> The new owners of underwater S&Ls were incited to take the predictable gambles with ruinous results. White (1991).

The point of this story is not to villainize MMFs, or to charge up the entire cost of the S&L debacle to the MMF account. Among other things, rather than expand S&L powers, the entire insolvent industry could have been liquidated and closed down in the early 1980s for approximately \$15 billion from the S&L deposit insurance fund. Rather than face that politically embarrassing result, regulators and political actors preferred forbearance and various measures to let the industry "grow" out of its problem. Here is the point: benefit-cost analysis as conventionally conceived is not a useful framework for anticipating the new financial system that will be reconstituted by a non-trivial rule and the reactions to it. The relevant question is not, what are the benefits, what are the costs, but: how will the financial system change? What are the new opportunities, functions, and pathologies?

### 2.2.2. *The Rise of Shadow Banking*

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<sup>8</sup> The wisecrack that banking was a "3-6-3" business was not altogether wrong characterization: pay depositors 3%, lend out at 6%, leave the office at 3 pm.

<sup>9</sup> Reg Q and deposit insurance should be understood as companion, indeed complementary, pieces of the Glass Steagall Act of 1933. Reg Q limited the capacity of banks to compete for deposits, which also limited their need to make risky loans to earn and profit. This gave banks a franchise value that reduced their incentive to make risky loans as well, since bank failure would destroy the rent stream. Thus deposit insurance could function as a kind of mutual insurance against exogenous shock that abruptly changed the expected loan default rate, for example, a drought in an agricultural community in which the bank funded the cost of planting. Bank competition for deposits changes the bank's incentives and the effect of deposit insurance.

The role of MMFs in the development of the shadow banking further illustrates the point that benefit-cost analysis as would conventionally understood would provide a poor guide to wise exercise of regulatory discretion by financial system regulators. MMFs began as a retail product but in the 1990s began attracting an increasing share of short funds from institutions looking for liquidity, safety, and cash management, in particular non-financial corporations, municipalities, and asset managers. This development is depicted in Figure 1 below. There are many consequences. The most obvious, revealed in the near-collapse of

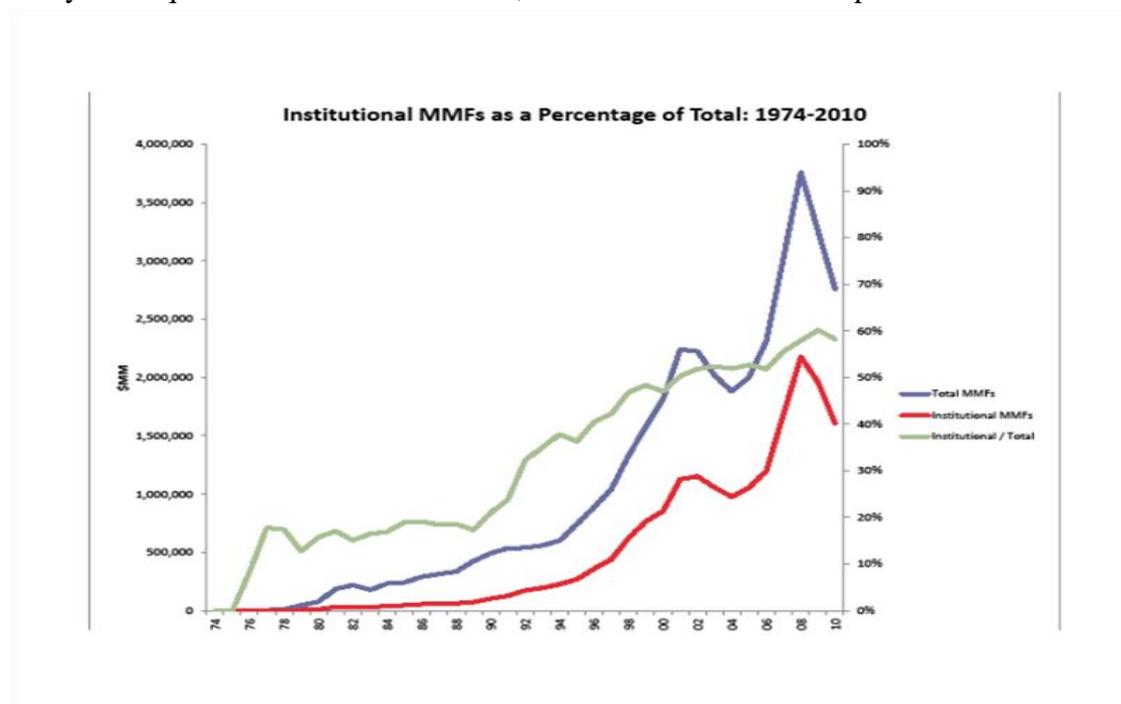


Fig 1. Source: Fed Flow of Funds.

the then \$3.5 trillion MMF industry in fall 2008, is that the growth of MMFs had created a financial intermediary outside the official banking system that bore credit risk without capital, had no lender of last resort, and thus was exposed to runs at times of financial distress. (Gordon & Gandia 2013)

Another consequence, more subtle, is that the very rules designed to make MMFs more stable made other parts of the financial system less stable. As noted above, the SEC required MMFs to hold short term maturities to enhance credit quality and liquidity and thereby reduce the chance that a fund would “break the buck.” Such a requirement increased the supply of short term finance. Non-financial firms were thus encouraged to try to fund long-term projects by rolling over short term commercial paper. Financial institutions developed deep reliance on MMF finance because they were well suited to engage in the maturity transformation that MMFs could not. At times of financial distress, in anticipation of possible runs by their investors, MMFs withdrew funding from the firms, financial and non-financial, that had grown reliant on MMF finance; these firms then faced immediate liquidity problems. The rules that created

money market funds and the way that other institutions adapt have created a new system of finance. The framework and the tools of BCA are an inadequate way to face these issues.

The SEC's recent MMF reform proposals illustrate the limited utility of BCA in the financial regulatory realm. One of the proposals is for floating NAV for institutional prime funds while permitting fixed NAV for retail prime funds. In the effort to comply with the mandate of its particular benefit-cost statute, the SEC first outlines some of the "qualitative costs and benefits" of the retail exemption to its floating NAV proposal.

"Because we do not know how attractive such funds would be to retail investors, we cannot quantify these qualitative benefits or costs. However, we can quantify the operational costs that money market funds, intermediaries, and money market service providers might incur in implementing and administering the retail exemption to the floating NAV requirement that we are proposing today."<sup>10</sup>

These costs, and the basis for them, take up nearly a page in the Federal Register. Such costs, and other "operational" costs discussed elsewhere in the SEC's proposal, are rounding errors to serious consideration of the matters at stake. Because they are in fact quantifiable, a kind of Gresham's Law may apply, in which trivial data drives out the hard work of analysis.<sup>11</sup>

### 3. THE LEGAL FRAMEWORK FOR THE PRAGMATICS OF FINANCIAL REGULATORY ACTION

The argument thus far is that the financial system is not a "natural" system. It is constituted by regulation, a "constructed" system. The regulatory consequences are profound: benefit-cost analysis is not conceptually fitted for financial regulation because of the way that regulation constitutes finance. A non-trivial regulatory change to mitigate purported shortcomings will change the system of finance. While the regulator presumably will employ experience and pragmatics in promulgating rules that will fashion this counterfactual world, the conventional tallying of benefits and costs is not realistic. It's not just that measuring the purported benefits is elusive – valuation of incremental reductions in systemic risk from a given regulatory change seems like an inherently speculative exercise. And likewise for assessment of purported costs in incrementally lower GDP or some other economic output variable over a significant time period. The key point is that the system itself is not stable: parties will adapt in light of the regulation, the system of finance will change, and with it, the benefits and costs of the regulation in question. There are no anchoring principles of chemistry, biology, or physics in

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<sup>10</sup> See SEC Money Market Fund Reform; Amendments to Form PF, Securities Act Rel. No. 33-9408, 78 Fed. Reg. 36834, 36,865 (June 19, 2013).

<sup>11</sup> A similar example is provided by the OCC's benefit-cost analysis of the so-called "Standardized Option" of the Basel II accords, which would give small to medium-sized banks the right to opt-in to an adjusted risk-weighting variant of Basel I. The OCC quantifies "explicit" "implementation costs" associated with tracking, preserving, and retrieving data to comply with the proposed rule, which, depending critically on the number of banks that opt-in; these costs are estimates at \$73.7 million. The benefits relating to a more stable and efficient banking system, are merely listed and extolled. A negligible effect on the supply and cost of credit is simply assumed. OCC (2008).

finance. The attempt to apply the BCA methodologies employed in health, safety and environment regulation to financial regulation is inherently faulty and may lead regulators to focus on precisely the wrong questions.

Nevertheless the GAO (GAO 2012, GAO 2011) various academics (Abdiah 2013, Rose & Walker, 2013a, 2013b; Sherwin 2006), and some Courts<sup>12</sup> have argued that the legal framework governing financial regulation requires benefit-cost analysis on the traditional model. Close examination of the relevant statutes suggests this is not true. In general, the agency-specific statutes require the agency to consider a range of relevant factors but do not require a quantification of “costs” and “benefits” as is commonly found in genuine BCA statutes<sup>13</sup> and do not call for an explicit weighting of the identified considerations, which often may be cross-cutting.<sup>14</sup> Moreover, unlike an executive branch agency, independent agency decision-making is not unitary. Adoption of a regulation requires a majority vote among commissioners of different parties who have been separately nominated by a President and confirmed by the Senate for fixed terms. Such a body is structurally designed to produce outputs different from a centralized social planner. This point applies even more forcefully for the many regulations to be promulgated under Dodd-Frank as joint products of five different agencies. The Administrative Procedure Act, which is generally applicable to agency rule-making, contains an “arbitrary or capricious” test, which, fairly applied, should require no more than minimum rationality.<sup>15</sup>

### 3.1 The Financial Regulatory Agencies and the Applicable Legal Frameworks

#### 3.1.1 Federal Reserve Board

To be more precise, rule-making by the Federal Reserve Board is not subject to any general statute requiring economic analysis. Board of Governors (2011). Particular statutory provisions may identify factors that the Board must consider in rule-making, however. So in implementation of Dodd-Frank, the Board may be called to address certain “considerations, assessments, policy goals, or substantive requirements” in its rulemaking. *Id.* For example, in considering the level of risk-retention in mortgage underwriting the Board (along with the other financial regulatory agencies that are to jointly issue the rule) is required to take account of the “potential impact of the risk retention obligations on the access of consumers and businesses to

<sup>12</sup> Most notably *Business Roundtable v. SEC*, 647 F.3d 1144 (DC Cir 2011). See also *Chamber of Commerce v. SEC*, 412 F.3d 133 (DC Cir. 2005); *American Equity Life Ins. v. SEC*, 613 F.3d 166 (DC Cir. 2010).

<sup>13</sup> Compare, e.g., the Safe Drinking Water Act Amendments of 1996, § 103, Pub. L. 104-182 (1996) (to set contaminant level, requiring findings on the “[quantifiable and nonquantifiable health risk benefits ... and costs for which there is factual basis in the rulemaking record]”; Unfunded Mandates Reform Act, 2 USC §§ 1532-38 (requiring “qualitative and quantitative assessment of the anticipated costs and benefits”).

<sup>14</sup> Bartlett (2013) also discusses the limited extent to which financial regulatory agencies are subject to BCA review of proposed regulations via the Office of Information and Regulatory Affairs (“OIRA”) in the executive branch Office of Management and Budget.

<sup>15</sup> This could be buttressed by the courts’ reluctance to intervene in administrative decision-making where there are no “meaningful standards” for review, see *Heckler v. Chaney*, 470 U.S. 821, 830 (1985).

credit on reasonable terms” to assess the allocation of risk retention obligations between originators and securitizers. Dodd-Frank, § 941.

Three narrowly targeted provisions apply to all administrative agencies including the Board: the Paperwork Reduction Act,<sup>16</sup> which requires evaluation of a proposed rule’s paperwork burden, the Regulatory Flexibility Act,<sup>17</sup> which requires evaluation of a proposed rule’s impact on small entities, and the Congressional Review Act,<sup>18</sup> which requires the agency to report whether a proposed rule will produce a \$100 million or more annual impact on the economy and, therefore, constitute a “major rule.” The Congressional Review Act does not specifically require an economic or cost-benefit analysis. However, if a cost-benefit analysis is completed, it must be submitted to both houses of Congress and the Comptroller General, along with materials related to the rulemaking, before the rule can take effect.

### *3.1.2 Federal Deposit Insurance Corporation (“FDIC”)*

The FDIC is subject to the same constraints as the Federal Reserve Board. Thus apart from the narrowly tailored paperwork/small business impact provisions, the FDIC is not subject to mandatory quantification. To fulfill the mandates under the various statutory provisions that it administers, the FDIC gathers qualitative and quantitative information. Office of Inspector General FDIC (2011).

### *3.1.3 Office of the Comptroller of the Currency (“OCC”)*

Dodd-Frank changed the OCC’s status from an executive branch agency, as bureau with the U.S. Treasury Department, to an independent agency. Before the change, the OCC was subject to a BCA requirement as administered by the Office of Management and Budget. Barlett (2013). Like other agencies, OCC is subject to the trinity of targeted provisions referred to above. The statutes pursuant to which it draws its regulatory power, such as the National Bank Act and the International Lending Supervision Act, do not require economic analysis of proposed regulatory actions.<sup>19</sup>

### *3.1.4 Financial Stability Oversight Council (“FSOC”)*

Although a coordinating body in many respects, the FSOC also has independent regulatory functions under Title I of Dodd-Frank. In particular, it has power to designate a nonbank financial institution as “systemic,” which brings it under the Fed’s supervision, and power to make “recommendations” to functional regulatory agencies for “more stringent”

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<sup>16</sup> 44 U.S.C § 3501 et seq.

<sup>17</sup> 5 U.S.C § 601-612.

<sup>18</sup> 5 U.S.C. § 801 et seq.

<sup>19</sup> Indeed, in the case of the International Lending Supervision Act of 1983, Congress intended to shield the OCC from judicial second guessing of both its general capital requirements and its determination that a particular bank was under-capitalized. See, e.g., *Frontier State Bank Oklahoma City v. FDIC*, 702 F.3d 588 (10<sup>th</sup> Cir. 2012); Barlett 2013.

regulation. For the determination that the consequences of financial distress at a particular nonbank financial firm make it “systemic,” Section 113 of Dodd-Frank sets out 10 specific “considerations” and well as a catchall – “any other risk-related factors that the Council deems appropriate,” Dodd-Frank, § 113(a)(2). Judicial review of the determination “shall be limited” to whether the determination was “arbitrary and capricious.” *Id.*, § 113(h). The list of multiple, potentially cross-cutting, considerations as well as the catchall shows that Congress did not contemplate a benefit-cost analysis.

### 3.1.5 *Commodities Future Trade Commission (“CFTC”)*

Of the financial regulatory agencies, the CFTC is subject to the most explicit benefit-cost regime. Section 15(a) of the Commodities Exchange Act<sup>20</sup> requires that the CFTC “consider” the costs and benefits of a proposed rule, but then sets out several objectives to guide that consideration:

- A) considerations of protection of market participants and the public;
- (B) considerations of the efficiency, competitiveness, and financial integrity of futures markets;
- (C) considerations of price discovery;
- (D) considerations of sound risk management practices; and
- (E) other public interest considerations.<sup>21</sup>

Given the broad “considerations” that are to guide the CFTC’s determinations, one should not expect a benefit-cost analysis in the conventional sense. Each of these considerations defy easy quantification, and the trade-offs among them are even more conjectural. As I will argue below, statutes of this sort call for regulatory pragmatics rather a fanciful effort at quantification.

### 3.1.6 *Securities Exchange Commission*

The SEC is rather famously subject to Section 3(f) of the 1934 Securities Exchange Act, added by section 106 of the National Securities Markets Improvement Act of 1996, which requires the Commission to “also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.”<sup>22</sup> The comparison with the CFTC statute undercuts the claim that this particular statutory provision calls for a detailed BCA process. Indeed, the provision is reminiscent of state corporate law “constituency statutes,” in which boards are told to “consider” various stakeholder concerns in addition to shareholder value. Such statutes are roundly criticized as giving boards excessive discretion, because the relevant

<sup>20</sup> 7 U.S.C. § 19 (added by the Commodity Futures Modernization Act of 2000).

<sup>21</sup> For discussion of how the CFTC has conducted benefit-cost analyses and exercised its guided consideration, see Office of Inspector General CFTC (2011).

<sup>22</sup> 15 U.S.C. § 78c(f).

determinations and discretionary weightings confound objective quantification. Thus in light of the extensive deliberation by two different Commissions over shareholder proxy access over a multi-year period and the extensive analysis in the proposing release, the assertion by the court in *Business Roundtable v. SEC* (2011)<sup>23</sup> that the decision was “arbitrary and capricious” for its failure “adequately to assess the economic effects of a new rule” itself seems an arbitrary and capricious conclusion.

The shareholder proxy access rule is a regulation that defies ready economic quantification precisely because of its potential to modify the prevailing corporate governance paradigm and thus the level of agency costs in an economy of firms in which diffuse ownership is reconcentrating. Gilson and Gordon (2013). The benefits from the rule derive from a policy judgment about the desirable features of a regime that the rule would foster. The “tell” in the opinion is the criticism that the Commission “arbitrarily ignored the effect of the final rule upon the total number of election contests... Without this crucial datum has no way of knowing whether the rule will facilitate enough election contests to be of net benefit.”<sup>24</sup> But this shows the limits of a simplistic conception of BCA. The point of the rule is to change the governance regime. In this new regime, management behavior may change merely because of the greater potential for proxy contests even if the actual number does not increase. The SEC got caught up in the weak empirics of counterfactual projection instead of defending the normative regulatory judgments out of which the rule emerged and showing how it “considered” “efficiency, competition, and capital formation” along with investor protection.

### 3.2 D.C. Circuit Court Review

In my view, the various recent decisions of D.C. Circuit Court of Appeals striking down SEC rules on purported BCA grounds are far more intelligible on a different principle: the Court’s resistance to the SEC’s expansion of its rule-making in areas traditionally dominated by state law. In *Chamber of Commerce v. SEC* (2011),<sup>25</sup> the Court struck down an SEC rule that imposed governance requirements on mutual fund boards -- a supermajority of independent directors and an independent chair – despite the fact that funds are, as a governance matter, organized under state law. In *American Equity Inv. Life. Ins. Co. v. SEC* (2010),<sup>26</sup> the Court struck down an SEC rule that supplanted traditional state authority to define an “annuity” for purposes of an exemption under the federal securities laws that was granted in light of the traditional state autonomy in insurance regulation. In *Business Roundtable* itself, the proxy access rule in question plainly trenched on the domain of state corporate governance. What the Court appears to be saying is: in order to expand regulation into these non-SEC-traditional/state-law domains, the SEC needs a compelling case on the benefit-cost dimension, otherwise its rule-making is an arbitrary and capricious power grab.

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<sup>23</sup> 647 F.3d 1144 (DC Cir 2011).

<sup>24</sup> 647 F.3d. at 1153.

<sup>25</sup> 412 F.3d 133 (D.C. Cir. 2005)

<sup>26</sup> 613 F.3d 166 (D.C. Cir. 2010).

On this reasoning, the DC Circuit should take a different view on SEC regulation in its traditional areas of autonomy and, by extension, rule-making by the financial regulatory agencies in their implementation of the Dodd-Frank Act. This hypothesis is consistent with the most recent decision of the DC Circuit on rule-making under Dodd-Frank, *Inv. Co. Inst. v. CFTC*. (2013).<sup>27</sup> The CFTC rule at issue in the case required the registration as “commodity pool operators” of various investment companies that had already registered with the SEC and that had previously been exempt from such CFTC registration under a prior CFTC rule. In sustaining the rule, the Court rejected strenuous challenges to the agency’s assessment of benefits and costs. The Court said the CFTC had sufficiently considered (and found wanting) the protections in the SEC regime, noting that in the prior cases rejecting SEC rule-making cited above, the agency had by contrast failed to consider the protections of the state regimes it was encroaching upon. The Court permitted the CFTC to ignore, in assessing this particular rule, “hypothetical costs that may never arise” from a regulatory regime that was not yet complete, because “it would be quite literally impossible to calculate the costs of an unknown regulation.” 720 F.3d at 378. In response to an objection that the CFTC had not quantified “the benefits of data collection in preventing future financial crises,” the Court asserted,

“[t]he law does not require agencies to measure the immeasurable. CFTC’s discussion of unquantifiable benefits fulfills its statutory obligation to consider and evaluate potential costs and benefits. .... Where Congress has required a ‘rigorous, quantitative economic analysis,’ it has made that requirement clear in the agency’s statute, but it has imposed no such requirement here.” *Id.* (omitting citations)

The Court also rebuffed a claim that the CFTC had not collected the market data that commentators had suggested, on the ground that the CFTC had “adequately considered costs and benefits of the rule given this uncertainty,” and noting that the objection to the data gathering function of registration amounted to a “catch-22”:

“In essence, the appellants are challenging the very method for obtaining the data they want on the ground that the CFTC has not obtained the data they want.” 720 F.3d at 380.

Thus *Inv. Co. Inst. v. CFTC* is important on a number of dimensions. First, despite the statutory call for the determination and then “consideration” of costs and benefits, the Court is relaxed about the rigor of the CFTC’s approach and accepts the premise that many of the benefits that the CFTC obviously highly values in its consideration will be impossible of quantification. These factors do not undermine the legitimacy of the agency’s rule-making. Second, the author of the opinion is Judge Sentelle, who also authored *American Equity Inv. Life. Ins. Co* and was

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<sup>27</sup> 720 F.3d 370 (D.C. Cir. 2013).

on the panel in *Business Roundtable*. So the difference in outcome and tone is not a happenstance of the judicial draw.

Third, the critical distinguishing feature of *Inv. Co. Inst. v. CFTC* is apparent at the outset:

“In 2010, the Commission began shifting back to a more stringent regulatory framework. This shift came in the wake of the 2007-2008 financial crisis, which may attributed to poorly regulated derivatives markets, when Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act ... [which] repealed several statutory provisions that had excluded certain commodities transactions from CFTC oversight.” 720 F.3d at 373.

In other words: There was a problem with a prior approach, which may have contributed to the financial crisis; Congress gave the CFTC the power to take remedial action so that such a crisis would not recur. And further, implicitly: This is different from the rule-makings in the prior SEC cases, in which an agency with no new regulatory mandate and no exigency goes looking for problems to solve.

*Inv. Co. Inst. v. CFTC* therefore provides a basis for optimism that the DC Circuit will not interfere with rulemaking that implements Dodd-Frank by the financial regulatory agencies, even the SEC. Judge Sentelle’s opinion seems a harbinger of the pragmatics of financial regulatory action and review rather than a strait-jacketed insistence on “measuring the unmeasurable.”

#### 4. THE PRAGMATICS OF REGULATORY JUDGMENT

The claim is that benefit-cost analysis as conventionally understood will be a non-informative, even anti-informative, guide to the fashioning of non-trivial rules financial regulation. This is because such rules will create a new financial system and thus change the assumptions on the basis of which the purported cost and benefits were calculated. The examples of Glass-Steagall and money market funds show how the financial system reconstructs itself in response to regulatory change. Even less grand regulations can have far-reaching reconstructive effects, as illustrated by purportedly risk-reducing measures undertaken in the run-up to the financial crisis. Basel II, for example, promulgated a system of risk-weighted assets for the assessment of capital charges, based on historical default rates. Among the immediate effects: the massive over-production of assets – such as residential mortgages – that had been historically low risk. The regulation itself transformed the riskiness of the asset class.<sup>28</sup> More generally, regulatory benchmarks inevitably become a management target; the exogenous becomes endogenous.

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<sup>28</sup> This is of course a demonstration of the “Lucas critique” (Lucas 1976) of the effort to forecast the consequences in quantitative terms of regulatory policy change

How then should a regulator regulate? The emptiness of benefit-cost analysis does not mean that the regulator should give up on the project of applied consequentialism, trying its best to project the new regime and its consequences. But the critical judgments ought to not to be made on the basis of benefit-cost analysis, but rather in light of normative principles that the regulator is prepared to defend as undergirding a sound financial system and that may be in competition with one another. For example, consider two strong normative principles: one, the desire to achieve the economic benefits from the free flow of capital and the ready availability of credit; the other, the desire to avoid serious risk of systemic distress. The need to devise trade-offs across these principles may in turn produce subsidiary principles of pragmatic design, for example: minimize the extent to which financial institution can free-ride on systemic stability costs paid by others; provide regulators with sufficient information to observe the consequences of their rules; establish regulatory panopticons with authority only to observe the financial system as it evolves and the non-exclusive responsibility of sounding the alarms; grant regulators the power to make regulatory modifications.

To a significant extent these principles are already reflected in the emerging regulatory regime. Take one example, the “stress tests” administered by the Federal Reserve Board for large financial institutions per Dodd-Frank. Dodd-Frank §165(i); Tarullo (2013); Board of Governors (2012). The Fed subjects balance sheets that are compliant with applicable capital requirements to stress scenarios to see the impact on capital levels and other measures of financial stability. If the Fed regards the outcomes as unsatisfactory, it will require the firm to accumulate additional capital through restrictions on dividend payouts or stock repurchases. One critical feature is that the stress scenarios are not spelled out in advance to avoid giving the firm a specific benchmark to manage towards. The dynamism in such a regime is inconsistent with the stationarity implicit in conventional BCA.

## CONCLUSION

Benefit-cost analysis aims to solve serious problems of governance. Among other things, BCA can conserve on scarce resources; it can provide a disciplined approach to tough policy choices; the form and appearance of neutrality in BCA may help the regulator gain legitimacy in its rule-making. Nevertheless BCA will not be helpful for rules in which the underlying system is not fixed but is substantially constructed through rule-making and in which the ultimate system evolves through adaptation to the rules. A different regulatory model is necessary based on the pragmatics of regulatory judgment.

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