THE EFFICIENCY CRITERION FOR SECURITIES REGULATION: INVESTOR WELFARE OR TOTAL SURPLUS?

Yoon-Ho Alex Lee*

Recent regulatory debates among legislators and legal scholars have centered on whether independent agencies should be subjected to a more rigorous cost–benefit analysis requirement than their current mandates, or alternatively, whether they should be required to conduct cost–benefit analyses that conform to the Office of Management and Budget's guidance under Circular A-4, as many executive agencies already do. This Article closely examines the way in which one particular agency—the Securities and Exchange Commission—conducts its economic analysis in rulemaking. The SEC's economic analysis, conducted pursuant to a statutory mandate to consider the effects on "efficiency, competition, and capital formation," is essentially an investor welfare analysis: it considers how the rule would benefit investors and then considers the out-of-pocket compliance costs that regulated entities would incur. Circular A-4, by contrast, recommends a total surplus approach: a rule's benefits and costs are considered from the perspective of all stakeholders in the affected sectors, without directly incorporating distributional effects. The current debates therefore raise an urgent policy question for the SEC with regard to the proper criterion of efficiency for its rules: whether it should continue to consider the costs and benefits of its rules from the perspective of investors only, or whether it should instead consider them from the perspective of total surplus. This Article raises four points in considering this

---

* Assistant Professor of Law, USC Gould School of Law. The Author would like to thank Robert Ahdieh, Scott Altman, Sam Erman, Jeffrey Gordon, Jonathan Greenstein, Bruce Kraus, Kim Krawiec, Jeffrey Lubbers, Jennifer Nou, Barak Orbach, Eric Posner, Connor Raso, Paul Rothstein, Sid Shapiro, Daniel Sokol, Carolyn Sissoko, Andrew Verstein, Abby Wood, and the participants at the USC Center for Law and Social Science Workshop, the Institute for Law and Economic Policy's 20th Annual Symposium, the 2014 Midyear AALS Workshop on Blurring Boundaries in Financial and Corporate Law, the 2014 National Business Law Scholars Conference, and the New Voices for Administrative Law Program at the 2015 AALS Meeting for providing helpful feedback. The Author also thanks Nandini Dasarathy and Rima Kundnani for their excellent research assistance, and for the generous support from the Linnie and Michael Katz Endowed Research Fellowship. The Author remains grateful to his wife Emily and daughter Elisha for their love and care, and to God for all His providence in the process in completing this work. All errors are mine.

question. First, because the two approaches provide conflicting standards as to the efficiency determination, arguments to impose additional burdens on the economic analysis for SEC rules are unlikely to be constructive unless parties can first agree upon the relevant efficiency criterion for securities regulation. The efficiency-criterion question must therefore be considered prior to the procedural question. Second, because Circular A-4 considers a broader spectrum of costs and benefits, those concerned exclusively with investors' economic welfare should have reasons to object to, rather than support, its application to SEC rules. Third, despite such reasons, there is nevertheless a case for preferring Circular A-4's approach because, if used properly, it offers several important benefits from a broader policy perspective. Finally, because the SEC has broad rulemaking authority and is not in fact constrained by an obligation to justify all of its rules on efficiency grounds, if the SEC seeks to protect investors' economic interests at the expense of other stakeholders, it should be both more transparent and aggressive in adopting such rules for non-efficiency purposes that would qualify as "compelling public needs."

TABLE OF CONTENTS

> *"We are fond of talking about 'progress'; that is a dodge to avoid discussing what is good . . . . As enunciated today, 'progress' is simply a comparative of which we have not settled the superlative . . . . Nobody has any business to use the word 'progress' unless he has a definite creed and a cast-iron code of morals. Nobody can be progressive without being doctrinal . . . . For progress by its very name indicates a direction; and the moment we are in the least doubtful about the direction, we become in the same degree doubtful about the progress."*
>
> — G.K. Chesterton[1]

1. G.K. CHESTERTON, HERETICS 33–36 (4th ed. 1905).

> *"There is only a perspective seeing, only a perspective 'knowing'; and the more affects we allow to speak about one thing, the more eyes, different eyes, we can use to observe one thing, the more complete will our 'concept' of this thing, our 'objectivity,' be."*
>
> — Friedrich Nietzsche[2]

INTRODUCTION

What is the proper criterion for evaluating the efficiency of a government regulation? The dominant framework used today is the Kaldor–Hicks criterion.[3] It states: "[A] policy should be adopted if and only if those who will gain *could* fully compensate those who will lose and still be better off."[4] Put differently, a regulation is "efficient" if the aggregate economic benefits exceed the aggregate economic costs, even though some market participants may be forced to bear costs on net while others reap benefits on net.

By construction, this criterion of efficiency is most relevant where a regulation is designed to correct a market failure. If the market cannot efficiently allocate resources on its own,[5] society is incurring an economic loss, and a carefully designed government intervention may bring about a gain. In such instances, however, it would be inconsistent to justify a regulation on the basis of an economic loss, without first considering whether the cost of implementing the regulation might not lead to an even greater loss on net.[6] Thus, for such regulations, there is an argument that the regulator should engage in a meaningful comparison of the aggregate economic benefits and the aggregate economic costs of regulation.[7]

---

2. Friedrich Nietzsche, *On the Genealogy of Morals*, *in* BASIC WRITINGS OF NIETZSCHE 437, 555 (Walter Kaufman ed. & trans., Modern Library ed. 2000) (1887) (emphasis omitted).

3. *See, e.g.*, Bruce Kraus & Connor Raso, *Rational Boundaries for SEC Cost-Benefit Analysis*, 30 YALE J. ON REG. 289, 300 (2013) ("Pareto optimality under the Kaldor-Hicks criterion . . . is the basis for most quantitative public policy analysis, including [the Office of Information and Regulatory Analysis's cost–benefit analysis].").

4. ANTHONY E. BOARDMAN ET AL., COST-BENEFIT ANALYSIS: CONCEPTS AND PRACTICE 29 (2d ed. 2001) (emphasis in original). This criterion also "provides the basis for the *potential Pareto efficiency rule*." *Id.* (emphasis in original).

5. *See, e.g.*, N. GREGORY MANKIW, PRINCIPLES OF ECONOMICS 779 (1997) (defining market failure as "a situation in which a market left on its own fails to allocate resources efficiently").

6. This logic is also spelled out in *Circular A-4*, OFFICE OF MGMT. & BUDGET (Sept. 17, 2003), http://www.whitehouse.gov/omb/circulars_a004_a-4 [hereinafter *Circular A-4*] ("[Each executive agency] should try to explain whether the action is intended to address a significant market failure or to meet some other compelling public need . . . . If the regulation is designed to correct a significant market failure . . . , [y]ou should show that a government intervention is likely to do more good than harm.").

7. *See* Richard A. Posner, *CBA: Definition, Justification, and Comment on Conference Papers*, *in* COST-BENEFIT ANALYSIS: LEGAL, ECONOMIC, AND PHILOSOPHICAL PERSPECTIVES 317–18 (Matthew D. Adler & Eric A. Posner eds., 2001) (explaining that in a particular sense, "cost-benefit analysis" simply denotes the "Kaldor-Hicks . . . concept of

Efficiency, of course, is not the only goal of our society. The government can also choose to address some "compelling public need"[8] through regulation even though its objective is unrelated—or even possibly contrary—to overall growth. Accordingly, if the government wants to promote distribution rather than growth, the Kaldor–Hicks criterion should be of little relevance, especially since "[s]trict use of the Kaldor-Hicks test means that information on how benefits and costs are distributed among groups is *ignored* in decision making."[9]

This Article focuses on one particular agency whose economic analysis in rulemaking has been in the spotlight as of late: the Securities and Exchange Commission ("SEC"). The SEC is tasked with regulating the federal market for securities. But what is the criterion for evaluating the efficiency of a securities regulation? In one sense, I have already answered this question. If the purpose of an SEC rule is to correct one or more market failures in the market for securities, then it would seem that the same Kaldor–Hicks criterion should apply. These market failures can include asymmetric information, adverse selection, moral hazard, agency problems, collective action problems, externalities, and others.[10] Thus, if the SEC wants to improve the efficiency of resource allocation by correcting or mitigating these market failures, there is a plausible argument that, to the extent feasible, the SEC should consider costs and benefits to justify its rules.[11]

On the other hand, if the purpose of an SEC rule is to further a compelling public need apart from efficiency objectives, then as long as the SEC is acting within its statutory authority, it should care less about ensuring that the rule's benefits exceed its costs, and more about justifying its regulatory objective as a compelling public need and seeking the most cost-effective manner of achieving that goal. Therefore, if an SEC rule is designed to promote distribution (e.g., to unsophisticated retail investors) rather than growth, the value of cost–benefit analysis ("CBA")—at least, as the concept is formally understood[12]—is not

---

efficiency"); BOARDMAN ET AL., *supra* note 4, at 456 (explaining that cost–benefit analysis is based on the Kaldor–Hicks criterion).

8. *See Circular A-4*, *supra* note 6.

9. BOARDMAN ET AL., *supra* note 4, at 456 (emphasis added). *See also* Kraus & Raso, *supra* note 3 ("Kaldor-Hicks assumes distributive effects are evened out somehow (or ignored) and focuses on net aggregate societal benefits instead.").

10. *See, e.g.*, STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS 26–30 (Robert C. Clark et al. eds., 3d ed. 2012).

11. One can argue that, for certain types of regulation, the sheer complexity of conducting a cost–benefit analysis may negate the value of undertaking it. Recent scholarship has indeed highlighted arguments against mandating cost–benefit analysis for financial regulation. *See, e.g.*, Jeffrey N. Gordon, *The Empty Call for Benefit-Cost Analysis in Financial Regulation*, 43 J. LEG. STUD. S351 (2014), *available at* http://ssrn.com/abstract=2378562; *see also* John C. Coates IV, *Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications*, 124 YALE L.J. 882 (2015). This line of argument against cost–benefit analysis does not imply that an agency should engage in rulemaking without considering costs and benefits altogether, but rather questions whether a formal cost–benefit analysis should be mandated and subjected to judicial review.

12. There are, however, alternative frameworks of cost–benefit analysis—not currently implemented by Circular A-4 or other government agencies—that try to take into consideration the value of distribution. *See infra* note 116.

entirely clear. Although some type of economic analysis may still be useful in charting out who would gain and who would lose on net, there should be no general expectation that the rule's benefits must exceed its costs. Distribution usually does not generate surplus, and the ideal of distributive justice is not a quantifiable economic benefit.

As it is, the SEC is not explicitly required by statute to consider the costs and benefits of its rules. Nor, as an independent agency, is it subject to the various executive orders requiring *executive* agencies to conduct cost–benefit analyses and submit them for approval to the White House Office of Management and Budget ("OMB").[13] Consequently, in considering the effects of its rules, the SEC does not have to adhere to the cost–benefit analysis framework suggested by the Office of Information and Regulatory Affair's ("OIRA") Circular A-4.[14] Instead, the SEC evaluates the economic effects of its rules according to what is known as the "ECCF provision"—a statutory mandate to "consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation"[15]—and its recently issued internal guidance document.[16]

In complying with the ECCF provision, the SEC purports to consider the "costs" and "benefits" of its rules. Nevertheless, the SEC takes a somewhat limited perspective of costs and benefits. For the most part, the SEC appears to consider how its rule will benefit investors at large and how much it will cost firms (or other regulated entities) to comply with the rule.[17] Phrased a little more formally, the SEC appears to be comparing the *quantitative and qualitative benefits that would accrue to investors* against the *out-of-pocket compliance costs to be incurred by*

13. In 1981, President Reagan issued an executive order requiring federal *executive* agencies to prepare a cost–benefit analysis for each of their proposed rules and to submit it for approval to the OMB. *See* Exec. Order No. 12,291 §§ 2(b), 3(c), 3 C.F.R. 127 (1981). Due to executive orders issued by subsequent presidents, this procedure has remained in effect for executive agencies (not including the SEC) ever since. *See* Exec. Order No. 12866, 3 C.F.R. 638 (1994); Exec. Order No. 13422, 72 Fed. Reg. 2703 (Jan. 18, 2007); Exec. Order No. 13497, 74 Fed. Reg. 6113 (Jan. 30, 2009); Exec. Order No. 13563, 70 Fed. Reg. 3821 (Jan. 18, 2011). For a general background on the implementation of these executive orders among executive agencies and various other statutory requirements applicable to independent agencies, see Maeve P. Carey, *Cost-Benefit and Other Analysis Requirement in the Rulemaking Process*, CONG. RES. SERV. (Dec. 9, 2014), *available at* http://fas.org/sgp/crs/misc/R41974.pdf.

14. *Circular A-4*, *supra* note 6. The Office of Information and Regulatory Affairs is part of the OMB and "play[s] a key role in coordinating review of Federal regulations to ensure adequate interagency review of draft rules and to avoid inconsistent, incompatible, or duplicative policies." *See Office of Information and Regulatory Affairs*, WHITE HOUSE, http://www.whitehouse.gov/omb/oira (last visited Feb. 21, 2015).

15. Exchange Act, 15 U.S.C. § 78c(f) (2012); Investment Company Act of 1940, 15 U.S.C. §§ 78c(f), 80a-2(c). For an excellent in-depth discussion of this provision and its implications, see Robert B. Ahdieh, *Reanalyzing Cost-Benefit Analysis: Toward A Framework of Function(s) and Form(s)*, 88 N.Y.U. L. REV. 1983 (2013).

16. *See* U.S. SEC. & EXCH. COMM'N, *Current Guidance on Economic Analysis in SEC Rulemakings*, U.S. SEC. & EXCH. COMM'N (Mar. 16, 2012), http://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf. See *infra* Part II.A for a more detailed discussion of this guidance document.

17. *See infra* Section II.A.

regulated entities (hereinafter, simply "compliance costs").[18] This approach to analyzing the rule's effects, while distinct from a formal cost–benefit analysis, is most likely a permissible construction of the statutory mandate, under the *Chevron* framework.[19] Nevertheless, the SEC cannot be said to be conducting a "cost-benefit analysis" as the term is commonly understood: it does not analyze aggregate benefits and aggregate costs to society, as Circular A-4 and other authorities on cost–benefit analysis recommend.[20] It would not even be correct to say that the SEC is following Circular A-4's guidance "in principle or spirit."[21] At best, the SEC can be seen as analyzing its rules' net effects on the economic welfare of its primary constituents: investors.[22]

Should the SEC, then, be encouraged to conduct economic analyses of its rules under Circular A-4's framework? Or should it instead continue under its current scheme, and simply be encouraged to do a more thorough job with it, such as exerting a greater effort to quantify the effects? Importantly, under which criterion, should the SEC consider its rule to be *efficient* or otherwise justified under the cost–benefit analysis? The underlying premise here is that a rule's

18. I use the term "compliance costs" to refer to the amount of money regulated entities will be spending to comply with regulation. Circular A-4 uses the term "private-sector compliance costs," which I interpret as consistent with my term "compliance costs." *See infra* notes 87–88 and accompanying text.

19. *See* Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 844–46 (1984). For more on the inherent ambiguity of the ECCF provision, see *infra* Part I.A.

20. As one textbook puts it:

> When we as individuals talk of costs and benefits, we naturally tend to consider only our *own* costs and benefits . . . . In cost-benefit analysis we try to consider *all of the costs and benefits to society as a whole*. For this reason, some people refer to CBA as *social* cost-benefit analysis.

BOARDMAN ET AL., *supra* note 4, at 2.

21. *See, e.g.*, Mary L. Schapiro, *Testimony Concerning Economic Analysis in SEC Rulemaking*, U.S. SEC. & EXCH. COMM'N (Apr. 17, 2012), http://www.sec.gov/news/testimony/2012/ts041712mls.htm#P29_7595 (stating that as an agency, the SEC strives to fulfill the basic elements of a good regulatory analysis under OMB Circular A-4 and that the SEC staff's guidance draws upon principles set forth in E.O. 12866 and 13563). Additionally, in a recent report the U.S. Government Accountability Office concluded as follows:

> While most financial regulators said that they attempt to follow OMB's guidance in principle or spirit, we found that they did not consistently follow key elements of the guidance in their regulatory analyses. We previously recommended that regulators should more fully incorporate the OMB guidance into their rulemaking policies.

U.S. GOV'T ACCOUNTABILITY OFFICE, GAO 13-101, DODD-FRANK ACT, AGENCIES' EFFORTS TO ANALYZE AND COORDINATE THEIR RULES 10 (Dec. 2012), http://www.gao.gov/assets/660/650947.pdf.

22. The relationship between investor welfare and the SEC's approach to analyzing costs and benefits is somewhat nuanced, however. For a more detailed discussion, see *infra* Part II.A.

efficiency determination should have some probative—though not necessarily determinative—value in policymaking.[23]

In this Article, I seek to address these questions by raising four points in particular. My first point is a Chestertonian critique[24] of the regulatory debate: that various arguments recently put forth to impose additional burdens on the economic analyses of SEC rules are unlikely to be constructive unless parties can first agree upon the efficiency criterion for securities regulation. Otherwise, parties may argue about a rule's efficiency on different terms, and calls to have the SEC justify its rules under a cost–benefit analysis may mean different things to different people. Therefore, demanding simply that the SEC should make sure to have the benefits of its regulation outweigh the costs is little different from shouting "I am for progress!" If parties cannot agree on the efficiency criterion, much of the discussions regarding "progress" (as the term is originally defined) in this regulatory state will be nonsensical. This is especially troublesome given that politicians and legislators often rely on the rhetoric of cost–benefit analysis merely as a strategic political tool.[25] But if we were to approach the dialogue with a little more candor, we would have to agree with the essence of Chesterton's aforementioned philosophy: nobody has any business to demand cost–benefit analysis unless he has a definite creed regarding what constitutes benefits and costs and a cast-iron framework for assessing them. The efficiency-criterion question must therefore be considered prior to the procedural question.

My second point is that, those who view the SEC's mission exclusively as protecting investors' economic welfare or financial interests (hereinafter "investor welfare") should not be quick to embrace the cost–benefit analysis framework recommended by Circular A-4. Instead, they must recognize the following points of inconvenience. First, compared to the SEC's current approach, Circular A-4's approach would make it more difficult for the SEC to justify, on efficiency grounds, any rule that seeks to increase investor welfare primarily by reducing managerial surplus.[26] Second, where compliance with regulation requires use of gatekeeper or vendor services, Circular A-4's approach would also include the positive effect on the service industry of such mandated demand as a benefit of the rule. These can include economic profits or producer surplus gained by such gatekeepers or vendors, as well as additional jobs created *at the expense of firms*

---

23. For instance, an administrable default principle might be that an "efficient" rule that falls within the agency's statutory authority need not otherwise qualify as a "compelling public need" for the agency to move forward with it. This position is also consistent with *Circular A-4*, *supra* note 6. *Cf.* Cass R. Sunstein & Adrian Vermeule, *Libertarian Administrative Law*, 82 U. CHI. L. REV. __ (forthcoming 2015) (manuscript at 34) ("[I]t would generally seem arbitrary for an agency to issue a rule that has net costs (or no net benefits), at least unless a statute requires it to do so.").

24. By "Chestertonian critique," I am referencing the point raised by G.K. Chesterton in the opening quote of this Article: that there can be no meaningful discussion of "progress" without a firm doctrine.

25. *See generally* Coates, *supra* note 11.

26. *See generally* Yoon-Ho Alex Lee, *SEC Rules, Stakeholder Interests, and Cost-Benefit Analysis*, 10 CAP. MARKETS L.J. (forthcoming 2015), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2541805.

and investors.[27] Likewise, under Circular A-4's approach, any SEC rule that seeks to save resources for firms and investors by relaxing previously mandated compliance would have to account for the resulting economic loss in the service industry. Third, concerning corporate-governance measures, Circular A-4's approach would offer no basis for systematically ignoring or otherwise discounting private benefits accruing to shareholders with special interests, such as unions or pension funds or hedge funds.[28] Fourth, Circular A-4's approach can have the tendency to reduce the value of investor protection in instances where an SEC rule might in turn decrease the surpluses of other general constituents—such as consumers or taxpayers—who *a priori* merit protection from the government as much as investors.[29] For some people, these aspects may provide reasons to conclude that Circular A-4's approach—however suitable it may be for certain executive agency actions—is wholly inappropriate for assessing the merits of SEC rules.

My third point is that, despite these inconvenient aspects, there are broad policy reasons to prefer Circular A-4's approach for defining the efficiency criterion—that is, even for securities regulation. Some of these reasons include the following. First, if the market-failure view of securities regulation is applicable—the only view that should trigger a discussion of efficiency at any rate—the approach under Circular A-4 is more logically consistent with the rationale for government intervention: mitigating society's overall economic losses. Second, Circular A-4's approach, by providing a more complete picture, will tend to promote greater transparency as to (1) whether an agency action is intended to promote growth or distribution and (2) the possibility of agency or legislative capture by interest groups.[30] Third, if used properly, Circular A-4's approach can expand the SEC's policy-choice set to save more resources for society. Fourth, because Circular A-4's approach would provide a comparability of cost–benefit analyses as reported across a wide array of agencies, it may be useful for overall budgeting and planning purposes.

My fourth and final point is that, unless further statutory requirements are imposed, the SEC should not feel compelled to adopt rules only where it can demonstrate efficiency under the Kaldor–Hicks criterion. The SEC has broad discretionary rulemaking authority that is not constrained by any obligation to promote efficiency.[31] Many SEC rules may serve compelling public needs or social purposes, while potentially decreasing total surplus. The efficiency criterion should matter only where an existing market failure and the resulting economic

27. *Id*. (manuscript at 7). *But see* Jonathan S. Masur & Eric A. Posner, *Regulation, Unemployment, and Cost-Benefit Analysis*, 98 VA. L. REV. 579, 585–603 (2012) (arguing that even executive agencies typically fail to take into consideration the impact of their regulation on jobs created or lost and proposing that a regulation's effect on employment should be a systematic part of cost–benefit analysis).

28. *See generally* Lee, *supra* note 26.

29. *See generally id.*

30. *See infra* Part III.

31. *See generally infra* Part I.A (discussing the SEC's ECCF provision which both contemplates "public interest" rulemaking and requires only that the SEC merely "consider . . . whether the action will promote efficiency . . . .").

inefficiency provides the primary basis for regulation. Therefore, if the SEC seeks to increase or protect investor welfare at the expense of other stakeholders, the SEC should be both more transparent and aggressive in adopting rules for non-efficiency purposes, instead of attempting to pass off such rules as "efficient" under the investor-welfare perspective.

The rest of the Article is organized as follows: Part I formalizes the efficiency-criterion inquiry by considering the relevant statutory provisions and placing them in the context of recent legislative developments. It also distinguishes this subject of inquiry from other tangential debates, which, while bearing some resemblance, nonetheless fall short of informing the issue. Part II contrasts Circular A-4's approach to evaluating rule efficiency with the SEC's approach. The SEC's approach (hereinafter the "investor welfare approach") is best interpreted as an analysis of the economic effects of a rule on investor welfare.[32] The SEC's approach is partly consistent with event studies used in financial economics, which tend to focus on stock prices and firm values. In contrast, Circular A-4's approach (hereinafter the "total surplus approach")[33] is more consistent with the conventional partial-equilibrium analysis under applied microeconomics.[34] Part II also discusses some of the ways in which the efficiency determination may be different depending on which framework is used to assess the rule's efficiency, and thereby establishes my first two points. Part III discusses some policy considerations that may favor the total surplus approach as defining the efficiency criterion for securities regulation, and establishes my third and fourth points.

I. MOTIVATING THE POLICY QUESTIONS

A. Statutory Framework and Court Challenges

When the federal securities laws were first enacted in 1933 and 1934, there were no statutory provisions that required the SEC to conduct economic analyses prior to its adoption of rules. Congress did not adopt the ECCF provision until 1996.[35] The provision reads as follows:

> Whenever . . . the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or

---

32. As mentioned above, see *supra* text accompanying note 22, this characterization needs to be caveated when the compliance costs are borne by intermediaries rather than issuers. *See also infra* Part II.A.

33. For the purposes of this Article, little substance will be lost by considering the Kaldor–Hicks criterion, the total surplus approach, and Circular A-4 as equivalents.

34. *Compare generally Circular A-4*, *supra* note 6, *with* BOARDMAN ET AL., *supra* note 4.

35. The Efficiency, Competition, and Capital Formation ("ECCF") provision was not the first time Congress amended a law to mandate economic analysis in rulemaking. In 1975, Congress added § 23(a)(2) to the Exchange Act, requiring the SEC to consider any burden "on competition" that rules it was considering promulgating under that Act might entail, and to state in the rule's release "the reasons for the Commission's determination that any burden on competition imposed by such rule or regulation is necessary or appropriate." Securities Acts Amendments of 1975, sec. 18, § 23(a)(2), 89 Stat. 97, 156 (codified at 15 U.S.C. § 78(w)(a)(2) (2012)).

> 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.[36]

Unfortunately, considered as a general mandate for the SEC to conduct a cost–benefit analysis for its rules, this directive is, at best, highly ambiguous. First, the prefatory conditional clause casts serious doubt as to whether the SEC is even required to consider these ECCF factors for the majority of its rules. The plain reading suggests that the SEC should do so only when it is "required to consider or determine whether an action is necessary or appropriate in the public interest."

But why would the SEC ever be "required" to make such a "public interest" determination? The answer is because the SEC's organic statutes typically grant rulemaking authority to the SEC as it deems "necessary or appropriate in the public interest *or* for the protection of investors."[37] In other words, if the SEC were to adopt a rule that is not necessary or appropriate for the protection of investors, then it must make a determination that its action is otherwise necessary or appropriate *in the public interest*. The ECCF provision, read in conjunction, indicates that as long as the SEC is engaging in rulemaking for the purposes of investor protection only, *no* ECCF considerations or analyses are necessary. Put differently, the SEC can engage in rulemaking to promote *either* investor protection *or* a more general "public interest" goal, but only the latter-type of rulemaking would require ECCF considerations. Indeed, scholars have previously argued that the SEC's rulemaking authority extends beyond investor protection purposes. For example, Professor Cynthia Williams in her celebrated article argues forcefully that the SEC's "public interest" provision grants the agency with statutory authority to mandate public-reporting companies to make disclosures that would promote corporate social transparency.[38]

This reading of the ECCF provision is not only natural, but also makes prima facie sense: as long as the SEC is seeking to protect investors, Congress will not always demand an "efficiency" justification for all of its actions; on the other hand, if the SEC were to go about promoting a more lofty and vague "public interest" goal, Congress will demand that the SEC give at least a consideration of the ECCF factors as a check on its rulemaking authority. In fact, the SEC has previously argued according to a similar line of reasoning in *American Equity Investment Life Insurance Co. v. SEC*.[39] In a rule challenge that involved a judicial review of its economic analysis carried out under the ECCF provision, the SEC argued that the challenge must fail because the SEC was not actually *required* to

---

36. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, § 106(a)(2), 110 Stat. 3416, 3424 (1996) (enacting Section 2(b) of the Securities Act). For an extensive discussion of the historical context of this adoption, see James D. Cox & Benjamin J.C. Baucom, *The Emperor Has No Clothes: Confronting the D.C. Circuit's Usurpation of SEC Rulemaking Authority*, 90 TEX. L. REV. 1811, 1818–24 (2011).

37. This phrase appears very frequently and verbatim throughout the SEC's organic statutes. *See, e.g.*, 15 U.S.C. § 78m (emphasis added).

38. *See generally* Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197 (1999).

39. 613 F.3d 166 (D.C. Cir. 2010).

conduct an ECCF analysis in adopting the subject rule.[40] The D.C. Circuit, however, dismissed the SEC's argument on the ground that, under the *Chenery* doctrine,[41] the SEC "must defend its analysis before the court upon the basis it employed in adopting that analysis."[42] In other words, as long as the SEC supplies *some* analysis as a ground for its regulation—whether or not it was required to do so—a court will review the agency's analysis under the "arbitrary or capricious" standard. Consequently, the court never addressed the proper scope of the ECCF provision and the SEC's obligation pursuant to it.

Second, even if the ECCF provision were to apply broadly to most of the SEC's rules, the provision on its face does not require a cost–benefit analysis or any other type of economic analysis, as such—much less require the SEC to justify its rules on efficiency grounds. The text merely requires the SEC to "consider" whether its action will promote efficiency. As has been observed, "by choosing the verb 'consider,'" Congress merely required "a thoughtful exploration of how [factors such as investor protection, efficiency, competition, and capital formation] are likely to interact if the initiative is adopted."[43] It has also been argued that "[the SEC] could *consider* [the ECCF factors] *without conducting* any such analysis."[44]

Third, even if an ECCF analysis were to be required, none of the organic statutes define any of the three concepts, including the most critical term "efficiency."[45] Neither the SEC nor the courts have ever explicitly interpreted "efficiency." In addition, contrary to what other scholars have argued,[46] even the

40. *See* Final Brief of the Securities and Exchange Commission, Respondent at 67–68, American Equity Investment Life Insurance Company v. SEC, 613 F.3d 166 (D.C. Cir. 2010) (No. 09-1021), *available at https://www.sec.gov/litigation/briefs/2009/americanequitybrief0409.pdf*.

41. SEC v. Chenery Corp., 318 U.S. 80, 87 (1943).

42. 613 F.3d at 177.

43. *See* Cox & Baucom, *supra* note 36, at 1839 (interpreting the verb "consider" from the ECCF provision to require only "a thoughtful exploration of how [investor protection, efficiency, competition, and capital formation] are likely to interact if the initiative is adopted"); *see also* Ahdieh, *supra* note 15, at 2001 ("[I]t is not obvious that [the ECCF provision] demands all that much of the SEC.").

44. Sunstein & Vermeule, *supra* note 23 (manuscript at 34) (emphasis added).

45. *See id.* at 1818–19 ("In introducing the Review Standard, Congress left undefined the terms 'consider,' 'efficiency,' 'competition,' and 'capital formation,' and, far more importantly, did not explain what level of consideration the SEC was required to give these items when engaged in rulemaking."); *see also* Kraus & Raso, *supra* note 3 ("Congress did not define the terms 'efficiency,' 'competition,' or 'capital formation.' 'Efficiency' has a plain and ordinary meaning: doing more with less.").

46. For this line of interpretation of *Business Roundtable*, see, e.g., Ahdieh, *supra* note 15, at 2008 ("Most clearly, in *Business Roundtable*, the court speaks of the need to 'weigh[] the rule's costs and benefits.'"); Sunstein & Vermeule, *supra* note 23 (manuscript at 32) ("*Business Roundtable* . . . went farther than any of its predecessors by imposing a presumptive obligation to perform quantified cost-benefit analysis."). It is not clear, however, that this is a fair reading of *Business Roundtable*. On its face, the court merely affirmed the SEC's "unique obligation" to consider the effect of its rule upon "efficiency, competition, and capital formation," and then went on to evaluate the analysis of costs and benefits, as provided by the SEC to fulfill its ECCF provision, under the "arbitrary and capricious" standard. Bus. Roundtable v. SEC, 647 F.3d 1144, 1148 (D.C.

D.C. Circuit's recent opinion in *Business Roundtable v. SEC*[47] did not interpret the ECCF provision as *requiring* the SEC to conduct a quantitative cost–benefit analysis as such. Indeed, "efficiency" can have multiple different meanings, and it is still not clear which meaning Congress intended to capture through the ECCF provision. To further complicate the matter, there are at least three different ways of reading the ECCF provision—each one reasonable—which give rise to three interpretations that directly conflict with, if not contradict, one another.

First, the ECCF provision is technically silent regarding considerations of "costs" and "benefits." If Congress really wanted the SEC to conduct a cost–benefit analysis, one might have thought that it would have just spelled that out. Indeed, Professor Robert B. Ahdieh remarks that "[t]he language of [the ECCF provision] is not that of conventional cost–benefit analysis," and that "[w]here Congress has sought such an analysis, it knows how to make itself clear."[48] It is reasonable therefore to conclude that although Congress did envision *some* type of economic analysis, such as a general competition analysis or a market failure analysis, *it did not necessarily intend one that would amount to a full-blown cost–benefit analysis.* This reading of the ECCF provision has many supporters among administrative legal scholars.[49] It would also be a sensible policy stance given the views by Professor Jeffrey N. Gordon[50] and Professor John C. Coates[51] that requiring a full-blown cost–benefit analysis for financial regulation would do more harm than good. Furthermore, this view may be how the SEC had originally interpreted the requirements of the ECCF provision given that it had traditionally separated its ECCF analysis from its cost–benefit analysis in its rule releases.[52]

Cir. 2011). At any rate, even if the opinion can be read to interpret the SEC's duty under the ECCF provision, there is a strong argument that the SEC is still free to make its own statutory interpretation that supersedes the court's interpretation as long as the court did not foreclose all other interpretations of this ambiguous mandate. *See* Nat'l Cable & Telecomm. Ass'n v. Brand X Internet Servs., 545 U.S. 967, 982 (2005) ("A court's prior judicial construction of a statute trumps an agency construction otherwise entitled to *Chevron* deference only if the prior court decision holds that its construction follows from the unambiguous terms of the statute and thus leaves no room for agency discretion.").

47. 647 F.3d 1144 (D.C. Cir. 2011).

48. Ahdieh, *supra* note 15, at 1990; *see also* American Textile Mfrs. Institute, Inc. v. Donovan, 452 U.S. 490, 510 ("When Congress has intended that an agency engage in cost-benefit analysis, it has clearly indicated such intent on the face of the statute.").

49. For example, this line of reading would be consistent with Cox and Baucom's reading of the ECCF provision referenced above. *See supra* note 40 and accompanying text; s*ee also* Ahdieh, *supra* note 15, at 2002 ("[L]egislative history . . . suggests Congress expected some kind of cost-benefit analysis under [the ECCF provision]"); Sunstein & Vermeule, *supra* note 23 (manuscript at 35–36) ("It is plausible to read this to require the agency to conduct *some kind* of analysis of how its rules affect efficiency, competition, and capital formation. But there is no reason to read into the ECCF obligation a further, distinct obligation to carry out quantified cost-benefit analysis, even presumptively, as long as doing so is 'feasible.'" (emphasis added)).

50. *See generally* Gordon, *supra* note 11.

51. *See generally* Coates, *supra* note 11.

52. For a brief description of the SEC's practice of including its cost–benefit analysis and ECCF analysis in its rule releases, see Kraus & Raso, *supra* note 3, at 301.

Second, the most commonly used notion of "efficiency" in economics is allocative efficiency.[53] Allocative efficiency is a term of art, referring to the state in which deadweight loss is minimized. Bruce R. Kraus and Connor Raso also posit this notion of efficiency as the most reasonable interpretation of the ECCF provision.[54] In fact, they go on to say that the three economic factors—efficiency, competition, and capital formation—point collectively to allocative efficiency.[55] But if Congress really intended to capture this specific notion of efficiency, the provision would effectively require a *total surplus cost–benefit analysis* consistent with Circular A-4's approach, rather than just any other type of economic analysis.[56] Under this interpretation, even if the SEC need not *justify* its rules on the basis of cost–benefit analysis, it would still be required to "consider" the effects on total surplus *in much the same way as Circular A-4 recommends*.

Third, the SEC is tasked with regulating the market for capital. The most relevant concept of "efficiency" in this context is the efficiency of capital markets, as in whether stock prices accurately "reflect" available information.[57] This interpretation of efficiency—also known as "price efficiency"—would certainly be well received by financial economists. Indeed, there is no question that much of what the SEC does through disclosure regulation is promoting price efficiency.[58] Interestingly, however, this reading of "efficiency" may direct the SEC to an entirely different direction: because Congress specifically enumerated factors for the SEC to consider in rulemaking, the list of which neither includes nor implicates a cost–benefit analysis, the SEC may potentially be *foreclosed from taking costs of regulation into consideration*.[59]

---

53. *See* BOARDMAN ET AL., *supra* note 4, at 56–57 (describing "allocative efficiency" as an equilibrium maximizing total surplus).

54. *See, e.g.*, Kraus & Raso, *supra* note 3, at 300–01.

55. *See id.*

56. Indeed, Kraus and Raso further remark that "the SEC could perhaps have complied with the ECCF amendments by bringing [its cost–benefit analysis] more in line with [the OIRA's cost–benefit analysis's] focus on economic efficiency." *Id.* at 301.

57. *See generally* Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970). There is another level of confusion even under this interpretation because there are at least two different versions of efficiency of capital markets. *See* Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 766–67 (1985).

58. *See, e.g.*, Amendment to Regulation SHO, 73 Fed. Reg. 61,690, 61,703 (Oct. 17, 2008) (discussing its regulation as promoting "price efficiency" in its ECCF analysis).

59. *See* Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43 (1983) ("Normally, an agency rule would be arbitrary and capricious . . . if the agency has relied on factors which Congress has not intended it to consider . . . ."); *see also* Whitman v. Am. Trucking Ass'ns, Inc., 531 U.S. 457, 469 (2001) (reading certain provisions of the Clean Air Act, which explicitly enumerate factors for the agency to consider in setting air standards and do not include costs, as prohibiting the agency from considering costs in implementation). In the case of the ECCF provision, I say the SEC may "potentially" be foreclosed from considering costs of regulation because it may still be possible for the SEC to consider costs by reading "capital formation" broadly to encompass cost considerations.

The upshot of the inherent statutory ambiguity, it would seem, is that the SEC should be entitled to *Chevron* deference in implementing its ECCF mandate.[60] For this reason, absent further statutory requirement, the SEC's current approach likely qualifies as a permissible manner of implementing the directive.

If we move away from the statutory text, however, there are at least plausible reasons to believe Congress may have intended something like a cost–benefit analysis under its ECCF directive. The legislative history of the 1996 amendments provides some support for this view. The House Commerce Committee Report states that in "[c]onsidering efficiency, competition, and capital formation, the Commission shall analyze the potential costs and benefits of any rule-making initiative, including whenever practicable, specific analysis of such costs and benefits."[61]

With all that being said, for much of the SEC's history, the SEC's economic analyses in rulemaking generally flew under the radar. Indeed, until quite recently, "the SEC has been fairly insulated from judicial review and constraint"[62] and few court decisions "have seriously questioned the validity of an SEC rule."[63] Consequently, few administrative law scholars had given much thought to understanding the costs and benefits of regulating financial markets.[64]

---

60. *See* Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837 (1984); *see also* Sunstein & Vermeule, *supra* note 23 (manuscript at n.211) (concluding that the SEC should deserve *Chevron* deference on interpreting the ECCF provision). Previously, Kraus and Raso had noted that *Chevron* might not apply to the ECCF provision because it "govern[s] agency procedures, not the actions of regulated entities." Kraus & Raso, *supra* note 3 (manuscript at n.230). This concern, however, may now be moot since the Supreme Court has since decided in *City of Arlington v. FCC*, 133 S. Ct. 1863 (2013) that *Chevron* applies even to ambiguities in statutes defining agency jurisdiction.

61. H.R. REP. NO. 104-622, at 39 (1996). The final version of NSMIA reported by the Conference Committee contained the provision proposed by the House. *See* H.R. REP. NO. 104-864, at 10 (1996). In presenting the Conference Report on the House floor, Rep. Bliley stated:

> Furthermore, the National Securities Markets Improvement Act *will require the SEC to conduct meaningful cost-benefit analysis of proposed rulemakings that directly affects all securities issuers*. Under this new provision, the SEC must weigh the cost of every rule they propose against the burden those rules would impose on the engine of our economy. This provision is simply common sense: meaningful regulation should not impose unnecessary burdens and costs.

CONG. REC. H12047 (Daily ed. Sept. 28, 1996) (statement of Rep. Bliley) (emphasis added). The House agreed to the Conference Report on H.R. 3005 on September 28, 1996, and the Senate agreed to the Conference Report on October 1, 1996. Public Law No. 104-290 was signed by the President on October 11, 1996.

62. Ahdieh, *supra* note 15, at 2004.

63. James D. Cox, *Premises for Reforming the Regulation of Securities Offerings: An Essay*, 63 LAW & CONTEMP. PROBLS. 11, 37 (2000).

64. Only recently, a very preliminary framework for understanding costs and benefits of financial regulation was provided by Eric A. Posner & E. Glen Weyl, *Benefit-Cost Analysis for Financial Regulation*, 103 AM. ECON. REV.: PAPERS & PROC. 393 (2013). *See also* Eric Posner & E. Glen Weyl, Benefit-Cost Paradigm for Financial Regulation

But all this changed by 2011. Beginning in 2005, the SEC lost a series of court challenges on rules of varying levels of significance.[65] The most serious blow came in 2011, when the SEC adopted the controversial "proxy access" rule.[66] Fully aware that well-organized interest groups would challenge its rule, the SEC supplemented its final rule release with its most heavily invested economic analysis to date, citing multiple peer-reviewed publications.[67] By some account, the SEC spent over $2 million to prepare its rule release and economic analysis.[68] But all that was to no avail. In *Business Roundtable v. SEC*[69]—a case described by Professor Cass R. Sunstein as "an excessively aggressive exercise of the power of judicial review, with undue second-guessing of the administrative record"—the D.C. Circuit vacated the SEC's rule once again on the ground that its analysis was "arbitrary and capricious."[70] Ever since this humiliating loss, there have been greater calls for the SEC to conduct more robust cost–benefit analyses, including several legislative initiatives. Although most legal scholars remain skeptical that a more stringent cost–benefit analysis requirement should be demanded of the SEC,[71] critics of the SEC likely feel vindicated in their position that the agency has never undertaken a serious effort to consider the costs and benefits of its rules,[72] despite the fact that executive agencies have been doing so for decades.

B. Legislative Developments After **Business Roundtable**

Congress wasted little time in responding to *Business Roundtable*. No fewer than three independent legislative efforts sought to impose a more stringent cost–benefit analysis requirement on the SEC's part (along with other independent agencies). First, the Financial Regulatory Responsibility Act of 2011 (reintroduced in 2013) sought to require enhanced economic analysis and justification of

---

(unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2346466.

65. *See generally* Am. Equity Inv. Life Ins. Co. v. SEC, 613 F.3d 166 (D.C. Cir. 2010); Chamber of Commerce of United States v. SEC (*Chamber II*), 443 F.3d 890 (D.C. Cir. 2006); Chamber of Commerce of U.S. v. SEC (*Chamber I*), 412 F.3d 133 (D.C. Cir. 2005).

66. For more detail on the proxy access rule, see generally Kraus & Raso, *supra* note 3, at 308–13. *But see* Bruce R. Kraus, *Economists in the Room at the SEC*, 124 YALE L.J. F. 280 (2015), *available at* http://www.yalelawjournal.org/forum/economists-in-the-room-at-the-sec (discussing the SEC's recent victory, on the economic analysis portion, in *Nat'l Ass'n of Mfrs. v. SEC*, 748 F.3d 359 (D.C. Cir. 2014), as "a quiet turning point for the court's attitude toward [the SEC's cost–benefit analysis].").

67. *See generally id.*

68. Ahdieh, *supra* note 15, at 2007 ("[T]he SEC devoted no less than $2.2 million to the preparation of its analysis.").

69. 647 F.3d 1144 (D.C. Cir. 2011).

70. Bus. Roundtable v. SEC, 647 F.3d 1144, 1148–49 (D.C. Cir. 2011).

71. *See generally* Kraus & Raso, *supra* note 3; Ahdieh, *supra* note 15; Cox & Baucom, *supra* note 36; Coates, *supra* note 11, at 917 n.116 ("The [*Business Roundtable*] decision provoked unusual agreement among legal commentators—all negative.").

72. *See, e.g.*, Kraus, *supra* note 66 ("When it first came down, [*Business Roundtable*] was brandished by opponents of financial regulation as evidence of the SEC's incompetence and lack of economic expertise.").

regulations proposed by federal banking, housing, securities, and commodity regulators.[73] Significantly, the bill would have prevented agencies from *proposing* rules unless the agency engaged in a serious quantitative and qualitative assessment of all relevant costs and benefits (and a special justification in case the quantified benefits do not outweigh the quantified costs).[74] Second, the Independent Agency Regulatory Analysis Act of 2012[75] (also reintroduced in 2013) sought to affirm the authority of the President to require independent agencies to comply with requirements applicable to executive agencies and to submit their analyses to the OIRA.[76] The bill would have effectively required independent agencies to conform to Circular A-4's guidance for their cost–benefit analysis. Former administrators of the OIRA supported it on the ground that it would enhance accountability and analytical rigor in the rulemaking process.[77] Third, the SEC Regulatory Accountability Act of 2013 sought to have the SEC's chief economist play a more prominent role in considering costs and benefits of regulation, and more importantly, require the SEC to specifically "choose the [regulatory] approach that maximizes net benefits."[78]

As of the time of this Article's publication, the future of the SEC's economic-analysis requirement in rulemakings remains uncertain. New statutory requirements, such as those being contemplated, may erode the level of discretion the SEC currently enjoys in conducting economic analysis. The SEC might also be compelled to conduct a quantitative cost–benefit analysis similar to those conducted by executive agencies. Whether subjecting the SEC's rules to OIRA oversight will have a salutary effect is far from clear. There are policy considerations as well as institutional considerations.[79]

Nevertheless, a momentum is undeniably in place for improving the SEC's economic analysis in rulemaking. The SEC itself responded by issuing a first-ever guidance document on its understanding of costs and benefits.[80] In

73. Financial Regulatory Responsibility Act of 2011, S. 1615, 112th Cong. (Sept. 22, 2011).

74. The bill was originally referred to the Senate Banking, Housing, and Urban Affairs committees on September 22, 2011 but was not enacted. It was re-introduced as S. 450 on March 5, 2013 as the Financial Regulatory Responsibility Act of 2013, S. 450, 113th Cong. (Mar. 5, 2013).

75. Independent Agency Regulatory Analysis Act of 2012, S. 3468, 112th Cong. (Aug. 1, 2012).

76. *See id.*

77. *See Press Release: Clinton, Reagan, Bush Administration Regulatory Chiefs Endorse Portman-Warner Reform Bill*, ROB PORTMAN: U.S. SENATOR FOR OHIO (Sep. 14, 2012), *available at* http://www.portman.senate.gov/public/index.cfm/press-releases?ID=e7963af9-94c4-48cd-9178-ad5a00242cc2.

78. SEC Regulatory Accountability Act of 2013, H.R. 1062, 113th Cong. (2013).

79. *See, e.g.*, Kraus & Raso, *supra* note 3, at 291 ("Extending OIRA oversight to independent agencies like the SEC, by contrast, would erode the agencies' independence from the White House and invite more critical judicial review.").

80. *See* U.S. SEC. & EXCH. COMM'N, *Current Guidance on Economic Analysis in SEC Rulemakings*, SEC (Mar. 16, 2012), http://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf. See *infra* Part II.A for a more detailed discussion of this guidance document.

addition, in recent years, it has repeatedly requested additional funding from Congress specifically to hire more financial economists who can provide assistance with "the rulemaking process by providing the Commission and staff with economic analysis and technical advice."[81]

C. Policy Questions

Before any debate on the cost–benefit analysis of SEC rules can proceed further, one critical point must be emphasized: a rule designed to protect investors may increase total surplus while decreasing investor welfare; conversely, it may increase investor welfare while decreasing total surplus.[82] This point follows from the fact that total surplus and investor welfare are simply two different welfare metrics. Likewise, what is beneficial to individuals as a whole may be different from what is beneficial to individuals *qua* investors—that is, in their capacity only as investors—and vice versa.

This is more than just a theoretical nicety. Many SEC rules have significant spillover effects on various stakeholders and other industries. In some cases, rules involve significant *transfers* between investors and other parties—offsetting payments among market participants that preserve total surplus.[83] Thus, what may appear as either a "benefit" or a "cost" from the perspective of investors might not otherwise affect total surplus, or even affect it in a contrary manner. Stakeholders can include managers, gatekeepers, vendors, employees, consumers, taxpayers, and others. In securities regulation, transfers are both ubiquitous and inevitable because of the uniquely complex structure of the market for securities.

The current legislative debates therefore trigger an important policy question:

> *Policy Question I: The Efficiency Criterion for Securities Regulation.* Should an SEC rule be considered efficient if its benefits outweigh its costs from the perspective of investor welfare only, or if its benefits outweigh its costs from the perspective of total surplus?[84]

---

81. U.S. SEC. & EXCH. COMM'N, *FY 2015 Congressional Budget Justification* 7, *available at* http://www.sec.gov/about/reports/secfy15congbudgjust.pdf ("For FY 2015, the SEC seeks to add 14 positions in DERA, primarily to hire financial economists to perform analyses and research in support of Commission activities."); U.S. SEC. & EXCH. COMM'N, *FY 2014 Congressional Budget Justification* 5, *available at* http://www.sec.gov/about/reports/secfy14congbudgjust.pdf ("For FY 2014, the SEC plans growth of 45 positions in the Division of Risk, Strategy and Financial Innovation (RSFI), primarily to hire financial economists to perform economic analyses and research in support of Commission rulemaking activity."); U.S. SEC. & EXCH. COMM'N, *FY 2013 Congressional Budget Justification* 46, *available at* http://www.sec.gov/about/secfy13congbudgjust.pdf ("[T]here is a need to hire more economists.").

82. There are, of course, two additional, less interesting categories: rules that increase both total surplus and investor welfare and rules that decrease both. These do not, however, present any dilemma in terms of the efficiency criterion.

83. *See* discussion *infra* Part II.D.

84. The answer need not necessarily be binary. For example, one can always demand that both conditions must be satisfied. Alternatively, it is also possible for the SEC

To the best of my knowledge, this question has never been formally raised. To be clear, the SEC is a creature of statutes and should just do what Congress tells it to do. Congress has authority to determine with specificity the desired balance of economic factors for each agency. There are cases where an agency's organic statute specifies the constituents whose interests are to be considered in the agency's economic analysis.[85] In such cases, it may be "arbitrary and capricious" for the agency to consider any *other* costs or benefits.[86] This is not the case presently with the SEC's organic statutes, however.[87] No further direction is given other than the ambiguous ECCF mandate.[88] On the other hand, when proponents of cost–benefit analysis demand more stringent economic-analysis requirements for the SEC, presumably, they do not mean simply that the SEC should take whichever ad hoc perspective it deems most advantageous to get its rule out each time.

The efficiency criterion question is related, but is not identical, to another important policy question:

> *Policy Question II: The Maximand for Securities Regulation.*[89] In discretionary rulemaking, should the SEC seek to maximize total surplus (by means reasonably designed to protect investors and by regulating transactions of securities) or only investor welfare (by the same means)?

Although scholars have debated the general purpose of securities regulation,[90] the question is seldom structured in this crude and dichotomous

---

to choose different perspectives for different rules. In the latter case, however, unless the SEC has a clear mechanism dictating the choice of perspective for each rule, there is a danger that it will arbitrarily choose whichever framework will facilitate rule adoption.

85. The Dodd–Frank Act, for example, established the Consumer Financial Protection Bureau and specifically directed the Bureau to "consider the potential benefits and costs of a regulation to consumers and covered persons, including the potential reduction of access by consumers to consumer financial products or services." Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1022(b)(2)(A), 124 Stat. 1376, 1980 (2010) (codified at 12 U.S.C. § 5512 (2012)).

86. *See* Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43 (1983) ("Normally, an agency rule would be arbitrary and capricious . . . if the agency has relied on factors which Congress has not intended it to consider . . . ."); *see also* Whitman v. Am. Trucking Ass'ns, Inc., 531 U.S. 457, 469–71 (2001) (reading certain provisions of the Clean Air Act, which explicitly enumerate factors for the EPA to consider in setting air standards and do not include costs, as prohibiting it from considering costs in implementation).

87. *See generally* Cox & Baucom, *supra* note 36, at 1818–19.

88. Another statutory provision, introduced in 1975, requires the SEC to consider any burden "on competition" of its rules. Securities Acts Amendments of 1975, 15 U.S.C. § 78(w)(a)(2) (2012). But to the extent that this provision entails consideration of the rules' effect on competition, which is already included under the ECCF provision, it does not shed any further light on the precise type of economic analysis the SEC should conduct in rulemaking.

89. "Maximand" is a mathematical term referring to the function that is to be maximized.

90. Of the general view that securities regulation should protect investors from fraudulent and manipulative activities, there are many. *See, e.g.*, Elaine A. Welle, *Freedom*

manner. The traditional view is that securities regulation is designed merely to prevent fraud and to provide information to the market for pricing purposes.[91] Nevertheless, the increasingly welfarist nature of SEC rules can no longer be ignored. For instance, recall that the proposed SEC Regulatory Accountability Act of 2013 sought to require the agency to choose the regulatory approach to "maximize the net benefits."[92] But what exactly would it mean to "maximize the net benefits?" If the "net benefits" are understood from the perspective of investors only, then the mandate would essentially be to maximize investor welfare. This view would be consistent with the idea that the SEC's regulatory objective should be limited to protecting investors' financial interests.[93] On the other hand, if the "net benefits" are understood from the perspective of all parties, then the mandate would be to maximize total surplus. This latter view is arguably more consistent with the structure and the language of the bill. For example, elsewhere, the bill also requires the SEC to tailor its regulation "to impose the least burden *on society*,"[94] which would require a consideration of the economic welfares of other parties, such as "market participants, individuals, businesses of differing sizes, and other entities (including [s]tate and local governmental entities) . . . ."[95] Because the bill specifically contemplates consideration of costs on other market participants, the natural interpretation of "net benefits" may be from the perspective of total surplus.

---

of Contract and the Securities Laws: Opting Out of Securities Regulation by Private Agreement, 45 WASH. & LEE L. REV. 519 (1999); Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385 (1990).

91. For example, in *Charles Hughes & Co. v. SEC*, 139 F.2d 434, 437 (2d Cir. 1943), an early case addressing the question of the purpose of securities regulation, the famous Circuit Court Judge Charles Clark wrote that "[t]he essential objective of securities legislation is to protect those who do not know market conditions from the overreachings of those who do" and that "it is the purpose of all legislation for the prevention of fraud in the sale of securities to preclude the sale of 'securities which are in fact worthless, or worth substantially less than the asking price.'" *Id.* at 437. In addition, Professor Elaine A. Welle writes that "[t]he goal [of securities regulation] has been to protect investors by prohibiting fraudulent and manipulative practices and by requiring disclosure of information material to investment decisions so as to provide investors and the marketplace with sufficient information to make informed investment decisions." Welle, *supra* note 90, at 534. Similarly, Professor Donald Langevoort states that "[t]he core of orthodox securities regulation can be stated simply: we want to promote stock price 'integrity.' That is to say, we want the price at which investors buy or sell securities to reflect fairly the truth about the issuer's current situation and insight about its prospects." Donald C. Langevoort, *Commentary: Stakeholder Values, Disclosure, and Materiality*, 48 CATH. U. L. REV. 93, 94 (1998).

92. SEC Regulatory Accountability Act of 2013, H.R. 1062, 113th Cong., § 2 (2013).

93. *See, e.g.*, Langevoort, *supra* note 91, at 98 ("I would resist any effort to redefine the Commission's objective away from the protection of the financial interests of investors . . . . "). It should be noted, however, that Professor Langevoort raised this view in a much narrower context—specifically, in contemplating the role of mandatory disclosure regulation as to stakeholders' interests.

94. H.R. 1062, § 2 (emphasis added).

95. *Id.*

Policy Question II, however, is beyond the scope of this Article. I raise it only to decouple it from Policy Question I. The two questions are not identical. The first goes to the criterion for efficient regulation as a (partial) constraint for agency actions. It asks in substance: under what conditions, can the SEC presume to have met its burden of moving forward with a rule and intervene in the market for capital? The second question, by contrast, goes to the regulatory objective, as in: what should the SEC be trying to achieve through its rules in general? As such, hybrid responses are not self-contradictory. One can imagine an SEC that is committed to maximizing investor welfare (say, even at the expense of other market participants) and yet does not feel entitled to move forward with a rule unless its overall effect on total surplus is non-negative. Alternatively, one can imagine an SEC that views its mission broadly as maximizing total surplus by means reasonably designed to protect investors, but concurrently feels that it owes a special duty towards investors as its constituents so that it will not move forward with any policy that would decrease their welfare. Because both of these policy approaches can be framed as well-defined constrained optimization problems, a response to one policy question does not necessitate a particular response to the other.

It may be tempting to respond to these questions by appealing to the familiar rhetoric that the general purpose of securities regulation is "investor protection." But unfortunately, investor protection is not itself a well-defined concept. What little consensus one can find in this concept is usually understood in a vacuum. Normative discussions regarding investor protection are often devoid of considerations of the complex structure of the market for capital and the reality of transaction costs.[96]

More importantly, responding to either Policy Question by appealing to this fluid concept may be something of a *petitio principii*. The rhetoric offers no indication as to whether investor protection is an *end* in and of itself or a *means* for promoting another ends, e.g., increasing total surplus. Certain investor protection measures are necessary for increasing total surplus. Fraud prevention, for example, protects investors but also reduces the cost of raising capital, and facilitating capital formation has always been an important objective for the SEC.[97] Certain other measures may seek to benefit investors as a class at the expense of other stakeholders. Undertaking these measures could thus mean a possible reduction of total surplus, while increasing investor welfare. Still other measures may take on a narrow notion of investor protection as a means to address social problems, rather than enhancing economic welfare: protecting investors *qua* social activists. These include mandated disclosures of information that may be of value only to a

---

96. For example, normative discussions usually point to the general ideal of preventing fraud or the importance of price accuracy, but do not discuss in detail the transaction costs necessary for achieving such ideals. *See generally* sources cited *supra* note 79.

97. The SEC's mission statement includes three elements: protecting investors, maintaining market integrity, and facilitating capital formation. *See The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, U.S. SEC. & EXCH. COMM'N (June 10, 2013), http://www.sec.gov/about/whatwedo.shtml#.VIi6wzGjOSo.

particular subgroup of investors.[98] Much like the words "gentleman"[99] or "liberalism,"[100] the term "investor protection" has lost much of its original meaning (if there ever was one).

D. Some Red Herrings

For the discussion of this Article, it will also be helpful to distinguish these two Policy Questions from other debates in law. Policy Question II is arguably reminiscent of two other maximand debates that are perennially raised: first, whether corporate law should seek to maximize shareholder welfare or stakeholder welfare;[101] and second, whether antitrust law should seek to maximize consumer surplus or total surplus.[102] All I need to point out is that, however settled these debates may be, they do not offer much in the way of answering Policy Question II, much less Policy Question I.

Take the corporate law debate. Because the boundary between securities regulation and corporate regulation can sometimes be blurry, it might seem as if the maximand debate for corporate law should directly inform the maximand debate for securities regulation. But it does not. The real question for corporate law must be framed in terms of whether corporate directors should owe duties to shareholders only or to all stakeholders.[103] There is no natural connection between the fiduciary duties corporate law should place on directors and managers and the policy objective the federal government should seek to maximize when intervening in the market for capital. Even if one may plausibly argue that corporations exist to maximize shareholder values subject to legal constraints, it by no means follows

---

98. *See, e.g.*, Conflict Minerals, 17 C.F.R. §§ 240, 249b (2012).

99. *See, e.g.*, C.S. LEWIS, MERE CHRISTIANITY xiii (1952) (describing how the word "gentleman" originally meant "one who had a coat of arms and some landed property" but has become a useless word that vaguely conveys a "nice" person).

100. *See generally* John C. Goodman, *Classical Liberalism vs. Modern Liberalism and Modern Conservatism*, NAT'L CTR. FOR POL'Y ANALYSIS (Sept. 8, 2008), http://www.freerepublic.com/focus/f-news/3174361/posts.

101. The discussion on this topic dates back to the dueling Harvard Law Review articles by Adolf A. Berle and E. Merrick Dodd in the early 1930s. *See generally* A.A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931); E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees*, 45 HARV. L. REV. 1145 (1932). For other sources, see R.E. FREEMAN, STRATEGIC MANAGEMENT: A STAKEHOLDER APPROACH (1984); Lynn Stout, *Bad and Not-So-Bad Arguments for Shareholders Primacy*, 75 S. CAL. L. REV. 1189 (2002).

102. For arguments favoring consumer surplus, see, e.g., Russell Pittman, Consumer Surplus as the Appropriate Standard for Antitrust Enforcement (June 2007) (unpublished manuscript), *available at* http://www.justice.gov/atr/public/eag/225696.pdf. For arguments in favor of the "total surplus" standard, see, e.g., Dennis W. Carlton, *Does Antitrust Need to Be Modernized?*, 21 J. ECON. PERSP. 155 (2007); Joseph Farrell & Michael L. Katz, *The Economics of Welfare Standards in Antitrust*, 2 COMPETITION POL'Y INT'L 3 (2006); Oliver E. Williamson, *Economies as an Antitrust Defense: The Welfare Tradeoff*, 58 AM. ECON. REV. 18, 18–36 (1968). For a discussion on the paradox of equating consumer surplus and consumer welfare, see Barak Y. Orbach, *The Antitrust Consumer Welfare Paradox*, 7 J. COMPETITION L. & ECON. 133 (2011).

103. *See generally* Dodd, *supra* note 101 (clearly providing the managers' duty aspect of the question); s*ee also supra* note 101.

that the federal government should exist to provide only such legal constraints as to have corporations maximize shareholder values.

In addition, some scholars have argued that for corporate law, the maximand is really one and the same because shareholders' and stakeholders' interests are compatible to a company's long-term efficiency.[104] The argument usually goes as follows: because managers seeking to maximize shareholder values in the long-run will have incentives to maintain good relations with stakeholders (through formal or informal contracts), maximizing long-term shareholder value will essentially approximate, and possibly equate to, maximizing stakeholder welfare.[105] However sustainable this argument may be, its central insight does not carry over to securities regulation. The crux of the argument is that managers who exercise discretion can make business judgments in the interest of shareholders that can also benefit stakeholders. It does not follow that the federal government mandating disclosures or circumscribing transaction limitations—which will necessarily limit managerial discretion—can play much of the same role in fostering good relations between corporations and stakeholders. Of course, the corporate law maximand debate is even less relevant when it comes to addressing the efficiency criterion question for securities regulation: corporate managers are seldom asked to justify their business decisions on the basis of an unassailable cost–benefit analysis.

Consider now the antitrust law debate. Both antitrust law and securities regulation deal with statute-based federal laws. But there still remain important differences. First, antitrust laws must apply broadly to product markets for all industries; by contrast, securities regulation applies only to the market for capital. This is critical because it suggests that the specific market structure of one industry should play a much more central role in responding to the maximand question for securities regulation. Second, the maximand debate for antitrust law arises most frequently in the context of merger reviews, where an efficiency defense might exist to rebut the argument that competition will be lessened. By contrast, the maximand debate for securities regulation addresses broad instances of rulemaking. Therefore, at a minimum, one must exercise caution before extrapolating a rationale from one debate to justify a position in the other. Finally, as with the corporate law debate, the antitrust law debate is a debate over the proper maximand, rather than one over the proper efficiency criterion.

For the remainder of this Article, my focus is on the efficiency criterion, not the maximand, for securities regulation. To do so, I provide a general description of cost–benefit analysis (as it is commonly understood) and discuss how it differs from the SEC's investor welfare analysis.

---

104. *See, e.g.*, Elena F. Perez Carrillo, *Corporate Governance: Shareholders' Interests and Other Stakeholders' Interests*, 4 CORP. OWNERSHIP & CONTROL 96 (2007) (arguing that shareholders and stakeholders interests are compatible and both contribute to corporate long-term efficiency and progress).

105. For a summary and a critique of this argument, see Stout, *supra* note 101, at 1195–99.

II. COST–BENEFIT ANALYSIS: PERSPECTIVES MATTER

Cost–benefit analysis is ultimately an exercise of capturing the aggregate economic effect of a government action in a given economy with just two categorical economic concepts, benefits and costs.[106] It is a daunting task. Uncertainties aside, there are usually too many moving parts and too many equations. But this is what a cost–benefit analysis must do in order to compare, even if only qualitatively, two different states of the economy.

Conducting a cost–benefit analysis in the context of financial regulation is thought to be especially challenging. This is because market participants' behavioral responses are thought to be particularly difficult to predict. In addition, the industry constantly seeks to game the system and innovates around regulation with more complex products.[107] As Professor Gordon writes, "[cost–benefit analysis] will not be helpful for rules in which the underlying system is not fixed but is substantially constructed through rulemaking and in which the ultimate system evolves through adaptation to the rules."[108] The financial system is also far more pervasive in our society than other industries; financial products affect nearly every activity of all citizens on a daily basis. Even the U.S. Government Accountability Office noted that "the difficulty of reliably estimating the costs of regulations to the financial services industry and the nation has long been recognized, and the benefits of regulation generally are regarded as even more difficult to measure."[109] For these reasons, some scholars argue that quantifying true costs and benefits is either meaningless or just altogether impossible in the context of financial regulation—and consequently, mandating a judicially reviewable cost–benefit analysis requirement is unwarranted.[110]

Although I am sympathetic to this view,[111] my inquiry in this Article remains orthogonal to the ability of a regulator to predict and assess economic effects. The unresolved debate over the value of a mandated cost–benefit analysis in financial regulation remains independent of the inquiry as to *which parties'* benefits and costs such an analysis, when possible, should entail. At any rate, the

---

106. BOARDMAN ET AL., *supra* note 4, at 2 ("In cost-benefit analysis we try to consider *all of the costs and benefits to society as a whole*.").

107. Economist Richard Bookstaber once commented that "[w]hen you observe the market, the very fact that you are observing it as a regulator almost guarantees that the people in the market will react as a military adversary and develop the best defense against it. They will try to find ways around it." Megan Barnett, *Is the SEC Fighting Last Year's War?*, FORTUNE (Dec. 23, 2010), http://finance.fortune.cnn.com/2010/12/23/is-the-sec-fighting-last-years-war/.

108. *See generally* Gordon, *supra* note 11, at 20.

109. *Reports to Congressional Addressees Dodd-Frank Act Regulations Implementation Could Benefit from Additional Analyses and Coordination*, U.S. GOVERNMENT ACCOUNTABILITY OFFICE 19 (Nov. 2011), http://www.gao.gov/new.items/d12151.pdf (citing GAO Report No. 08-32).

110. *See generally* Gordon, *supra* note 11; Coates, *supra* note 11.

111. *See, e.g.*, Yoon-Ho Alex Lee, *An Options Approach to Agency Rulemaking*, 65 ADMIN. L. REV. 881 (2013) (proposing an alternate mechanism of rulemaking in cases where there can be no reliable predictions regarding the future states).

wind is currently blowing in the direction of expecting more cost–benefit analyses, not less, from financial regulators.[112] For this reason, it is assumed for the purpose of this Article that some consideration of costs and benefits is both expected and theoretically possible for SEC regulations.

That said, in any normative discussions regarding cost–benefit analysis, it is important to keep in mind two properties of cost–benefit analysis. First, all cost–benefit analyses used in policymaking are ultimately *perspectivistic*: for each cost–benefit analysis, "[t]here is only a perspective seeing, only a perspective 'knowing.'"[113] Nietzsche's general statement about epistemology is particularly apt in the context of cost–benefit analysis. How so? As soon as one conceptualizes a cost–benefit analysis, there must be a clear idea of what types of effects are to be labeled as "costs" and what types of effects are to be labeled as "benefits." Each cost–benefit analysis by necessity takes on a certain fixed perspective in identifying costs and benefits, and factors lying outside the chosen perspective are ignored. This is mostly out of technical limitations. Some perspectives may be more inclusive than others, but I know of no workable framework that is complete or holistic.[114]

Second, once a perspective is fixed, the prevailing view is that cost–benefit analyses should be all about the size of the pie, not about its distribution. This qualification is of supreme importance. Some people may have an idealized vision of cost–benefit analysis as a single metric that can encapsulate multiple different ideals of our pluralistic society in an eminently equitable manner. Not so. As one textbook states unabashedly: "One goal, efficiency, underlies CBA."[115] It therefore makes sense that cost–benefit analysis is only applicable where the regulation is motivated by an existing-market failure and not an otherwise compelling public need. Economists often justify this characterization of cost–benefit analysis on their belief that distributional concerns are much more effectively addressed through taxation, rather than through a legal rule or a policy choice.[116] Alternatively, distributional goals can also be achieved by fixing an

---

112. *See infra* Part I.B.

113. This quote and the general idea of perspectivism as a branch of epistemology originate from Friedrich Nietzsche. *See* Nietzsche, *supra* note 2, at 5.

114. *See infra* Part II.C.

115. BOARDMAN ET AL., *supra* note 4, at 41. To be clear, this view of cost–benefit analysis poses a normative question—well beyond the scope of this Article—as to whether the government should be accorded *any* level of entitlement of moving forward with regulation merely because efficiency is gained.

116. There is a long list of academic articles discussing the superiority of taxation over policy choices in effecting distributions and discouraging the practice of incorporating distributional considerations directly into cost–benefit analysis. *See, e.g.*, Arnold C. Harberger, *On the Use of Distributional Weights in Social Cost-Benefit Analysis*, 86 J. POL. ECON. 87 (1978); Aanund Hylland & Richard Zeckhauser, *Distributional Objectives Should Affect Taxes But Not Program Choice or Design*, 81 SCANDINAVIAN J. ECON. 264 (1979); Louis Kaplow & Steven Shavell, *Why the Legal System Is Less Efficient Than the Income Tax in Redistributing Income*, 23 J. LEGAL STUD. 667 (1994); Louis Kaplow, *The Optimal Supply of Public Goods and the Distortionary Cost of Taxation*, 49 NAT'L TAX J. 513 (1996); Louis Kaplow & Steven Shavell, *Should Legal Rules Favor the Poor? Clarifying*

uncompromising target goal and inquiring how the goal can be met in the most *cost-effective* manner. Therefore, instead of attempting to refine the cost–benefit analysis framework to capture all types of social objectives, a more fruitful exercise may be to properly delineate the set of rules whose implementation decisions simply should not hinge on the efficiency determination under a formal cost–benefit analysis.

Of course, the case for not incorporating distributional considerations into cost–benefit analysis is even stronger where the statutory provision does not leave room for such discretion, as is the case with the ECCF provision. The SEC's duty is to consider the effect of its rules on "efficiency, competition, and capital formation." "Efficiency," as noted, can mean many things, but it seldom captures distribution. Rather, they are seen as two often-conflicting ideals.[117]

In the remainder of this Part, I compare and contrast the SEC's investor welfare approach and Circular A-4's total surplus approach. For prudential reasons, I limit my discussion to these two approaches only. Absent development of a readily applicable framework of cost–benefit analysis with broad appeal, the real policy question at the moment is *which* of these two makes most sense for SEC rulemaking.

A. SEC's Economic Analysis: The Investor Welfare Approach

As mentioned already, when the SEC conducts an economic analysis of its discretionary rules[118] pursuant to the ECCF provision, the agency appears to separately consider how its rules will benefit investors at large and then consider the compliance costs to be incurred by the regulated entities. Therefore, the SEC's

---

the Role of Legal Rules and the Income Tax in Redistributing Income, 29 J. LEGAL STUD. 821 (2000); Louis Kaplow, *On the (Ir)Relevance of Distribution and Labor Supply Distortion to Government Policy*, 18 J. ECON. PERSP. 159 (2004). For contrasting views, see generally Chris William Sanchirico, *Taxes Versus Legal Rules as Instruments for Equity: A More Equitable View*, 29 J. LEGAL STUD. 797 (2000); Olof Johansson-Stenman, *Distributional Weights in Cost-Benefit Analysis—Should We Forget About Them?*, 81 LAND ECON. 337 (2005).

117. The distinction may be a subtle one. The SEC may permissibly apply "investor welfare" to define its criterion of efficiency and seek to make sure investors do not incur net loss. The so-defined efficiency criterion may at times promote what amounts to a distribution viewed from the total surplus perspective. But I do not believe the SEC can explicitly promote distributional goals as part of its efficiency criterion.

118. This Section describes the SEC's cost–benefit analysis approach primarily for discretionary rulemaking, rather than mandatory rulemaking. This distinction can be important. Discretionary rules are those the SEC adopts pursuant to its broad statutory rulemaking authority; mandatory rules are those Congress specifically instructs the SEC to adopt and leaves the SEC with very narrow discretion. In the latter cases, Congress can further specify the specific benefits the SEC should consider in such rulemaking, and these may include benefits other than those that would accrue to investors. For example, Dodd–Frank required the SEC to adopt rules requiring public companies to disclose their use of certain minerals originating from the Republic of the Congo, the primary intended benefit of the regulation was to save lives in the Congo, rather than to protect investors. *See* Conflict Minerals, 77 Fed. Reg. 56,274 (Sept. 12, 2012), *available at* http://www.gpo.gov/fdsys/pkg/FR-2012-09-12/pdf/2012-21153.pdf.

typical ECCF analysis may be best seen as inquiring whether the *quantitative and qualitative benefits that would accrue to investors* justify *compliance costs*.[119] But there are significant caveats to this characterization.

First, it may be too generous to attribute a unified approach to the SEC's economic analyses. Historically, the SEC's approach has not been entirely consistent. Due to a shortage of in-house economists, the SEC's economic analyses were traditionally drafted by staff attorneys.[120] Staff attorneys, however, cannot be expected to understand the intricacies of financial markets or equilibrium behaviors. Rather, as lawyers, they would naturally gravitate more towards interpretations of statutory provisions and considerations explicitly mandated under the law. Consequently, with most rules, staff attorneys are more preoccupied with the far less consequential micro-cost calculations required under the Paperwork Reduction Act[121] than thinking about big-picture considerations of the effects on efficiency, competition, and capital formation. It also did not help that the agency had never issued a guidance document to advise its staff on conducting economic analyses until 2012.[122] But none of these really mattered for the SEC as long as its economic analyses were not subjected to judicial scrutiny.[123]

Second, although the 2012 guidance document streamlines the SEC's economic analyses and provides guidance much like Circular A-4, it is still written in ambiguous and tentative terms—perhaps deliberately so—with respect to one important area: specifically, which types of costs and benefits the agency should consider.[124] For example, "benefits" are not described in terms of any surpluses or metrics or even firm values. The document simply lists as "benefits" those instances where a market failure gets corrected—that is, intended *beneficial effects* of regulation.[125] In addition, while the guidance document appears to leave room for consideration of "transfers," the discussion is essentially buried in one footnote, and does not otherwise elaborate upon how to account for such transfers or instances in which transfers are likely. [126]

All of these factors make a systematic characterization of the SEC's economic analyses difficult. In addition, there is nothing particular in the new guidance document that explicitly contradicts the total surplus approach; but

---

119. *See generally* sources cited *supra* notes 120–28.

120. This practice has changed in the last couple of years. *See* Bruce R. Kraus, *Economists in the Room at the SEC*, 124 YALE L.J. F. 280 (2015).

121. The Paperwork Reduction Act of 1995, among other things, requires agencies to estimate the paperwork burden that arises from new regulation. *See* 44 U.S.C. 3506(c)(1)(B)(iii)(III) (2012). This type of burden calculation, however, cannot be considered as a general cost–benefit analysis.

122. *See Current Guidance on Economic Analysis in SEC Rulemakings,* U.S. SEC. & EXCH. COMM'N (2012), *available at* http://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf [hereinafter *SEC Guidance*].

123. *See* Cox & Baucom, *supra* note 36, at 1814 ("Until very recent years, SEC-adopted rules enjoyed a blissful existence before the D.C. Circuit.").

124. *See SEC Guidance*, *supra* note 122.

125. *See id.* at 8–9.

126. *See id*. at n.32.

neither does it openly embrace it. All in all, it remains to be seen how substantially the guidance document changes or redefines the typical way in which the SEC approaches cost–benefit analyses of its rules. A recent report by the SEC's Inspector General noted only a minor improvement, mostly in the SEC's practice of specifying the baseline of analysis.[127] Therefore, the discussion in this Part relates to the approach that was taken prior to issuance of the guidance document, which will likely persist for some time.

That being said, the SEC's approach of comparing benefits accruing to investors against compliance costs is a reasonable one. In one sense, this approach is consistent with the view of the SEC as an advocate for investors. If a rule is deemed to pass the cost–benefit analysis under this framework, the SEC would be adopting rules to protect and benefit investors while being mindful of what it might cost to provide such benefits. Furthermore, if the regulated entities are issuers, this approach will approximate to an analysis of investors' economic welfare: if we view investors as having ownership of the firm,[128] then the compliance costs—though initially borne by the firm—will eventually pass through to investors (especially equity shareholders).[129] Therefore, investors both reap benefits and bear costs of regulation in the end. Put differently, the costs and benefits of regulation are both being calculated from the perspective of the "representative (long-term) investor," one who has a long-term interest in the well-being of the firm but has no conflicting economic interest.

How does this approach work in practice? Take a common mode of SEC regulation: mandatory disclosure. In its economic analysis, the SEC would begin by considering the benefit to investors of having this type of information available. These are usually characterized conceptually in terms of transparency,[130] efficiency,[131] price efficiency,[132] reduced bid-ask spreads,[133] better informed investment decisions and allocation of capital,[134] improved ability to monitor the

---

127. *See generally Office of Inspector General, Office of Audits, Use of the Current Guidance on Economic Analysis in SEC Rulemakings*, U.S. SEC. & EXCH. COMM'N (2013), *available at* http://www.sec.gov/oig/reportspubs/518.pdf.

128. The conception of shareholders as "the owners of the business" is common in this literature. Nevertheless, this is not an entirely accurate description of shareholders' rights regarding their corporation. *See, e.g.*, Stout, *supra* note 101, at 1190–91.

129. This is only a first-order approximation, however. In some instances, it may be possible for part of compliance costs to be passed onto parties other than shareholders. Formally, one must consider whether the company can exercise some market power or bargaining power over other stakeholders.

130. *See, e.g.*, SEC Amendment to Municipal Securities Disclosure; Rule, 73 Fed. Reg. 76,104, 76,125 (Dec. 15, 2008) (citing "increased transparency" as a benefit of the rule).

131. *See id.* (citing "improved efficiency of filing" as a benefit of the rule).

132. *See, e.g.*, Amendment to Regulation SHO, 73 Fed. Reg. 61,690, 61,703 (Oct. 17, 2008) (discussing its regulation as promoting "price efficiency" in its ECCF analysis).

133. *See id.*

134. *See, e.g.*, Proxy Disclosure Enhancements; Final Rule, 74 Fed. Reg. 68,334, 68,354 (Dec. 23, 2009) (describing how investors will "potentially benefit from the ability to use this additional information in allocating capital across companies").

board,[135] and more effective governance opportunities.[136] These are all clear benefits to investors. The SEC would then provide estimates of compliance costs, based on information submitted by various regulated entities.[137] If a previous event provides a useful analogy, the SEC may also rely on published studies documenting the effects of relevant events.[138] In some cases, effects may be quantifiable. Because the economic welfare of the representative investor is closely tied to the market value of the firm, financial economists often examine changes in the stock prices of firms affected by regulation.[139] If one makes the heroic assumption that the stock market is *fundamentally efficient*,[140] then measuring stock-market reactions to announcements regarding regulation can allow for a quantifiable approach.

Now, suppose the regulated entities are not issuers but other market participants, such as broker-dealers or investment advisors. Then the story gets more complicated. This approach may or may not translate in a dollar-to-dollar manner to investor welfare. It will depend on the extent to which these entities can pass on their compliance costs back to investors. If the market for such regulated entities' services were perfectly competitive, then these entities would have been making zero economic profits prior to compliance.[141] In this case, as long as these market participants stay in the market, all additional expenses would therefore have to be passed on to others because the industry cannot exist with a (long-term) negative economic profit. In many cases, compliance costs can indeed be passed right back to investors, and the analysis would again amount to an investor welfare framework. Meanwhile, if these compliance costs are passed on to other market participants, then investors as a group would come out even better off than the net benefit analysis would suggest, but only at the expense of other market participants.[142] On the other hand, if a market for such services is characterized by market power, then these regulated entities would have been earning rent for their

---

135. *See id.*

136. *See, e.g.*, Facilitating Shareholder Director Nominations; Final Rule, 75 Fed. Reg. 56,668, 56,755 (Sept. 16, 2010) ("The availability of the new rules also may encourage shareholders who would not have previously considered conducting a proxy contest to take a greater role in the governance of their company . . . .").

137. *See, e.g.*, Conflict Minerals; Disclosure of Payments by Resource Extraction Issuers; Final Rules, 77 Fed. Reg. 56,274, 56,333-56,335 (Sept. 12, 2012) (discussing various compliance cost estimates submitted by entities).

138. For example, for the proxy access rule, the SEC partly analogized the effect of proxy access with the benefit of having a "hybrid board." *See* Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668, 56,760 (Sep. 16, 2010).

139. *See, e.g.*, Vidhi Chhaochharia & Yaniv Grinstein, *Corporate Governance and Company Value: The Impact of the 2002 Governance Rules*, 62 J. FIN. 1759 (2007); Peter Iliev, *The Effect of SOX Section 404: Costs, Earnings Quality, and Stock Prices*, 65 J. FIN. 1163 (2010).

140. According to one definition, "[a] stock market is fundamentally efficient if the prices reflect the underlying present discounted value of the return investors may expect from purchasing a security." CHOI & PRITCHARD, *supra* note 10, at 35.

141. *See, e.g.*, MANKIW, *supra* note 5, at 296 (1997) ("[C]ompetitive firms earn zero profit in the long run.").

142. An example of such a rule is the SEC's rule requiring registration of municipal advisors. *See* Lee, *supra* note 26, (manuscript at 13–15).

services. [143] In such cases, some compliance costs will likely be borne by the regulated entities and some will be passed on to investors (as well as possibly others). The extent to which these compliance costs will eventually pass on to various parties will depend on the relevant price-demand elasticity.[144] At any rate, here again, if not all costs are passed on to investors, then investors would come out better off. Therefore, if the SEC's analysis suggests aggregate benefits to investors are greater than compliance costs, this is certainly *sufficient* to ensure that investor welfare would come out net positive.

Although the investor welfare approach has an intuitive appeal, it also has some weaknesses. First, the concept of a representative investor appears to be more fictive than anything else. It is not clear whether there is ever an individual who can be classified as a representative investor—an investor with essentially no conflicting economic incentives.[145] Although the fact that there may not be any representative investor in practice does not necessarily invalidate the value of this framework, it does raise a possibility that the rule may not prove to benefit any concrete market participants in actuality. On a more fundamental level, one might also question whether favoring long-term shareholders' interests is necessarily consistent with the overall growth of firms. Professor Jesse M. Fried, for example, has argued that in cases where firms trade large volumes of their own shares—as is typical for most U.S. firms—policies favoring long-term shareholders' interests can have value-destroying effects.[146]

Second, the investor welfare approach usually ends up ignoring the regulation's economic effects on other market participants. Taken to an extreme, this approach might treat as economically equivalent the following two states of the world: in State A, the regulation would increase firm values by 1% and have virtually no effect on all other market participants; in State B, the regulation would increase firm values by 1% but would use $20 million of government revenues in enforcement, reduce each manager's salary by $100,000, and reduce the rent collected by monopoly service providers by half. But in State B, society uses up far more resources to arrive at the same level of benefits to investors as in State A.

Third, even among investors, this mode of analysis may be viewed as somewhat ad hoc in its choice of investors whose welfares are to be considered. Shareholders of brokerage companies, listing companies, or proxy-service companies are all just as much "investors" as those individuals purchasing shares through those companies. Yet, the SEC's analysis would normally consider only the economic welfare of the investors in their capacity as *consumers* of these

---

143. *See generally* MANKIW, *supra* note 5, at 316–20 (describing monopoly profits).

144. *See, e.g.*, *id.* at 125–27 (describing how elasticity affects who bears tax burden); *see also* Masur & Posner, *supra* note 27 (describing how the elasticities of the various factor markets can determine which parties end up bearing the cost of regulation).

145. *See, e.g.*, Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561 (2005) (disputing "the characterization of shareholders as having interests that are fundamentally in harmony with one another" and arguing that shareholders often have significant private interests).

146. *See* Jesse M. Fried, *The Uneasy Case for Favoring Long-Term Shareholders*, 124 YALE L.J. __ (forthcoming 2015).

services, and not in their capacity as *owners* of these services.[147] Whether such a distinction is warranted is not entirely obvious.

B. Circular A-4's Cost–Benefit Analysis: The Total Surplus Approach

Circular A-4 is the guidance document issued by the OIRA for use by executive agencies when they conduct cost–benefit analyses pursuant to executive orders.[148] This is not necessarily to say that executive agencies must conduct such analyses for all of their regulations,[149] or even that cost–benefit analysis, once conducted, must necessarily inform executive agencies' policy choices.[150] Nevertheless, by setting forth a framework that is widely applicable to all types of regulation, Circular A-4 establishes the common standard for cost–benefit analysis.

The cost–benefit analysis approach under Circular A-4 is best interpreted as a partial-equilibrium, total surplus approach. The framework takes into consideration within relevant sectors of the economy costs, benefits, and transfers. Although Circular A-4 does not use the term "partial equilibrium," the economic concepts used in Circular A-4 are consistent with conventional partial-equilibrium framework, which relies on a money metric to measure and aggregate surpluses.[151]

In its introduction, Circular A-4 states, "benefit-cost analysis provides decision makers with a clear indication of the most efficient alternative, that is, the alternative that generates the largest net benefits to society (*ignoring distributional effects*)."[152] Circular A-4 is therefore consistent with the Kaldor–Hicks criterion, in that the criterion of "efficiency" should remain neutral with respect to distributional effects. This does not, however, mean Circular A-4 advises each agency to simply ignore distributional effects.[153] It only advises that such

147. For example, in 2007, the SEC sought to ease the burden on the firms' delivery duties by relaxing the physical delivery requirement, which was previously mandated. The SEC switched to the electronic delivery regime, known as "notice-and-access." Because physical delivery became optional, firms no longer were required to spend so much money purchasing services from Broadridge, a publicly traded company that is in the business of facilitating such delivery. Although the release discusses the cost savings by client firms greatly, no discussion is included about the profits lost by Broadridge, which would affect the shareholders of Broadridge. *See generally* Shareholder Choice Regarding Proxy Materials, Exchange Act Release No. 56,135, 72 Fed. Reg. 42,222 (Aug. 1, 2007).

148. *See supra* note 14 and accompanying text.

149. The executive orders require cost–benefit analyses only for "economically significant" rules (defined in Section 3(f)) and only "to the extent permitted by law." *See, e.g.*, Exec. Order No. 13563, 76 Fed. Reg. 3821 (Jan. 18, 2011).

150. Courts have interpreted certain organic statutes as forbidding the agency from considering costs altogether. *See, e.g.*, Whitman v. Am. Trucking Ass'ns, Inc., 531 U.S. 457 (2001). In such cases, the executive order's mandate would not apply.

151. *Compare generally Circular A-4*, *supra* note 6, *with* BOARDMAN ET AL., *supra* note 4.

152. *Circular A-4*, *supra* note 6 (emphasis added).

153. *See id.*

considerations are not directly incorporated into the analysis of costs and benefits.[154]

To be sure, Circular A-4 clarifies that there can be other justifications for regulation than correcting market failures. For example, it states "regulation may be appropriate when you have a clearly identified measure that can make government operate more efficiently," or if the government intends "to redistribute resources to select groups," "to prohibit discrimination that conflicts with generally accepted norms within our society," or "to permit more personal freedom or promote other democratic aspirations." [155] Likewise, Circular A-4 FAQ memorandum from OIRA, which clarifies the scope of Executive Order 13,563, also says regulation may be justified where "there is a compelling public need."[156]

In a section titled "Other Benefits and Cost Considerations," Circular A-4 directs each agency to include the effects of the following:

> (1) private-sector compliance costs and savings;
>
> (2) government administrative costs and savings;
>
> (3) gains or losses in consumers' or producers' surplus;
>
> (4) discomfort or inconvenience costs and benefits; and
>
> (5) gains or losses of time in work, leisure, and/or commuting/travel settings.[157]

Let me make three observations here. First, by grouping consumers' surplus and producers' surplus together without any qualification, the framework appears to be placing them on an equal footing. Therefore, a loss in consumers' surplus would not be considered a social loss if it is compensated by an equal or greater increase in producer surplus. Second, the fact that Circular A-4 directs each agency to consider "private-sector compliance costs and savings" should not be interpreted to mean that Circular A-4 would consider those as necessarily "social" costs or savings. Even when there is a divergence between social costs and private-sector compliance costs, there are good reasons to consider compliance costs in a total surplus analysis. This is because firms' compliance costs can affect the behavior of the firms, including exiting the market and rendering the industry more concentrated. Third, the framework takes the government's administrative costs and savings into consideration. This, too, is a stark contrast from the SEC's

---

154. *See id.* ("Your regulatory analysis should provide a separate description of distributional effects (i.e., how both benefits and costs are distributed among sub-populations of particular concern) so that decision makers can properly consider them along with the effects on economic efficiency.").

155. *See id.*

156. OIRA, REGULATORY IMPACT ANALYSIS: FREQUENTLY ASKED QUESTIONS (FAQS) 2 (Feb. 7, 2011), *available at* http://www.whitehouse.gov/sites/default/files/omb/assets/OMB/circulars/a004/a-4_FAQ.pdf. E.O. 13,563 also specifies that "[w]here appropriate and permitted by law, each agency may consider . . . values that are difficult or impossible to quantify, including equity, human dignity, fairness, and distributive impacts." Exec. Order No. 13497, 74 Fed. Reg. 6113 (Jan. 30, 2009); Exec. Order No. 13563, 70 Fed. Reg. 3821 (Jan. 18, 2011).

157. *Circular A-4, supra* note 6.

approach, which has for long largely ignored the costs and benefits accruing to the agency itself from its rules.[158]

Elsewhere, Circular A-4 is even more explicit in its commitment to total surplus. It goes on to distinguish specifically between "costs" and "transfer payments." In its relevant part, the document reads:

> Distinguishing between real costs and transfer payments is an important, but sometimes difficult, problem in cost estimation. Benefit and cost estimates should reflect real resource use. Transfer payments are monetary payments from one group to another that do not affect total resources available to society. A regulation that restricts the supply of a good, causing its price to rise, produces a transfer from buyers to sellers. *The net reduction in the total surplus (consumer plus producer) is a real cost to society, but the transfer from buyers to sellers resulting from a higher price is not a real cost since the net reduction automatically accounts for the transfer from buyers to sellers . . . . You should not include transfers in the estimates of the benefits and costs of a regulation.* Instead, address them in a separate discussion of the regulation's distributional effects. Examples of transfer payments include the following: (1) scarcity rents and monopoly profits, (2) insurance payments, and (3) indirect taxes and subsidies. [159]

In short, Circular A-4 acknowledges monopoly profits and scarcity rents as transfers, rather than as costs of a regulation.[160] One textbook, subscribing to the same framework as Circular A-4, explains that "in a CBA any increase in producer surplus received by a monopolist that results from a government policy is counted as a benefit of the policy; therefore, benefits accruing to them 'count.'"[161] The agency's consideration of costs and benefits will thus need to acknowledge such transfers as not affecting total resources available to society. For this reason, the OIRA's 2013 report[162] on the costs and benefits of federal regulations specifically acknowledges that in 2012, "executive agencies promulgated 47 major rules, of

---

158. *See* Office of Inspector General, Office of Audits, *Follow Up Review of Cost-Benefit Analyses in Selected SEC Dodd-Frank Act Rulemakings*, U.S. SEC. & EXCH. COMM'N 37 (Jan. 27, 2012), *available at* http://www.sec.gov/about/offices/oig/reports/audits/2012/rpt499_followupreviewofd-f_costbenefitanalyses_508.pdf ("The SEC Rarely Addresses Internal Administrative Costs or Savings in the Cost-Benefit Analyses of Its Dodd-Frank Act Rulemakings.").

159. *Circular A-4*, *supra* note 6 (emphasis added).

160. This approach would be consistent, for instance, with the view that takes the social cost of monopoly as the deadweight loss triangle, rather than the deadweight loss triangle *plus* monopoly profit. *See infra* Part II.C.

161. *See, e.g.*, BOARDMAN ET AL., *supra* note 4, at 74.

162. OFFICE OF MGMT. & BUDGET, 2013 REPORT TO CONGRESS ON THE BENEFITS AND COSTS OF FEDERAL REGULATIONS AND UNFUNDED MANDATES ON STATE, LOCAL, AND TRIBAL ENTITIES 4 (2013), *available at* http://www.whitehouse.gov/sites/default/files/omb/inforeg/2013_cb/2013_cost_benefit_report-updated.pdf.

which 22 were 'transfer' rules,"[163] and go on to explain that these 22 rules were "rules that primarily caused income transfers, usually from taxpayers to program beneficiaries."[164]

Finally, in a section titled "Ancillary Benefits and Countervailing Risks," Circular A-4 directs agencies to "look beyond the direct benefits and direct costs of your rulemaking and consider any important ancillary benefits and countervailing risks."[165] It defines these concepts as follows:

> An ancillary benefit is a favorable impact of the rule that is typically unrelated or secondary to the statutory purpose of the rulemaking (e.g., reduced refinery emissions due to more stringent fuel economy standards for light trucks) while a countervailing risk is an adverse economic, health, safety, or environmental consequence that occurs due to a rule and is not already accounted for in the direct cost of the rule (e.g., adverse safety impacts from more stringent fuel-economy standards for light trucks).[166]

This section therefore encourages agencies to look beyond the primary purpose of regulation and consider as benefits or costs those economic effects that are "unrelated" to their regulatory objectives. For example, applied to an SEC rule, ancillary benefits would include benefits of the rule other than in the form of investor protection. This framework of cost–benefit analysis therefore takes the economy as *one large pocket*.

What, then, are some downsides of the total surplus approach as a welfare metric? By design, this approach specifically refrains from making any value judgment as to which market participants are more deserving of surpluses and which participants are less deserving. An economist conducting a total surplus analysis is not being asked to act as a judge or a moral philosopher. Often, he may find himself in an awkward position much like that of Nobel laureate Gary S. Becker, who once confessed some difficulty (no doubt to the horror of many) in seeing the social harm of theft on the ground that thieves merely facilitated wealth-preserving transfers.[167] Many would object to such a limited view of the social

---

163. *Id.*

164. *Id.* at 25. The report also notes that to the extent that transfers are not done in a lump-sum manner, there may be separate costs to the regulation in terms of a "deadweight loss." *See id.*

165. *Circular A-4, supra* note 6 (emphasis added).

166. *Id*.

167. In his Nobel Prize Lecture, Gary S. Becker wrote:

> In the early stages of my work on crime, I was puzzled by why theft is socially harmful since it appears merely to redistribute resources, usually from wealthier to poorer individuals. I resolved the puzzle . . . by recognizing that criminals spend on weapons and on the value of the time in planning and carrying out their crimes, and that such spending is socially unproductive . . . because it does not create wealth, only forcibly redistributes it.

Gary S. Becker, *The Economic Way of Looking at Life*, ECONOMIC SCIENCES 1992, at 38, 42 (Dec. 9, 1992), *available at* http://www.nobelprize.org/nobel_prizes/economic-sciences/laureates/1992/becker-lecture.pdf.

harm of theft on the ground that a welfare analysis should not consider thieves' unjust private gains as offsetting owners' unjust private losses. Few would be assuaged by the retort that this argument, rigorously considered, is premised on a value judgment concerning distribution, rather than on total resources available for society.

The total surplus approach, on the other hand, might be commended for providing a more comprehensive view of what is happening in the economy than the investor welfare approach. As a result, it may be seen as telling a more complete story than the investor welfare approach. Nevertheless, this is not to say the total surplus approach provides a *holistic* view of the economy. In the next Section, I provide a simple example to illustrate both (1) how the two frameworks would come out differently in theory, and (2) how each one comes short of capturing a holistic view of the economy, which must rely on a general-equilibrium model.

C. A Simple Illustration

The simplest way to illustrate the difference between the two frameworks is to consider the typical textbook illustration of monopoly. In the context of securities regulation, one might imagine either investors making use of a monopolistic brokerage service, or firms relying on some monopolistic vendor services.[168] Suppose the SEC were to devise a rule that seeks to make the subject service industry fully competitive at cost *K*. (*K* is not featured in the Figure, and for simplicity, I do not discuss the source of *K*.)

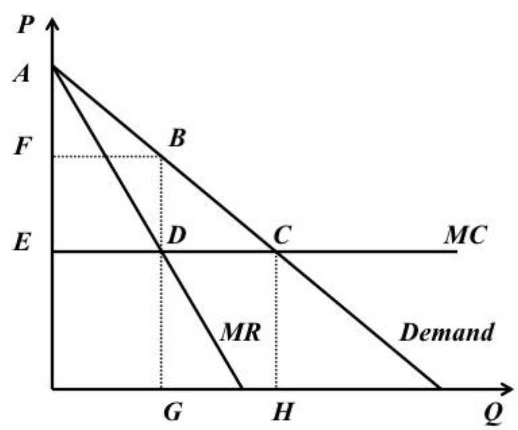

Figure 1. Partial Equilibrium Monopoly

Figure 1, *C* represents the competitive equilibrium, where the marginal cost curve crosses the demand curve. At this point, the competitive output level is *H*, and the competitive price is *E*. When the industry is monopolized, however, the producer will set output at the level where his marginal revenue equals the marginal cost of production. At this point, *G* is the monopoly level output, *F* is the monopoly price, and *BCD* is the familiar measure of deadweight loss.

168. This example is used for illustrative purposes only. In practice, however, SEC rules are more likely to go from a mandatory regime to a voluntary regime, or vice versa. A different type of analysis is warranted to understand the mandatory regime because the output level, in that case, will not be governed by the natural demand curve.

In this example, investors are the consumers of these services. A government regulation that seeks to render this industry perfectly competitive would shift the equilibrium from (*G*, *F*) to (*H*, *E*). Investors as a class certainly gain by going from the aggregate welfare level of *ABF* to *ACE*. Under the investor welfare approach, the regulation would be efficient as the area of *FBCE*, the overall increase in investor welfare, is greater than the compliance cost *K*.

The total surplus approach, however, would account—at a minimum—for the loss of monopoly profit, *FBDE*. Therefore, under this approach, the regulation will be efficient only if the deadweight triangle, *BCD*, is greater than the compliance cost *K*. Since *BCD* is obviously smaller than *FBCE*, if the value of *K* were to lie between these two area values, this is an instance of a regulation that is efficient only under the investor welfare approach but not under the total surplus approach.

Meanwhile, even the total surplus approach does not provide a complete picture of the economy for the following reasons. When the equilibrium shifts from (*G*, *F*) to (*H*, *E*), at least three other things are happening. First, to increase the output level from *G* to *H*, society needs to expend a greater amount of capital and labor. This diagram does not capture these additional factors. In some unusual cases, there might happen to be unused capital and labor that can accommodate these increases in production activities. But most likely, the additional capital and labor will come from another industry, which may then experience a contraction of its own supply curve. This will then adversely affect the consumer surplus of that other industry. Second, when the price level drops from *F* to *E*, for some investors, this price change frees up more money to spend. Specifically, investors who were previously paying *F* (investors who account for the *AB* segment of the demand curve) now find themselves with an additional amount of money (*F* minus *E*), and they will now spend this money elsewhere. Hence, in some other industry—perhaps in the market for complementary goods—there may be an expansion of the demand curve. Finally, those investors who previously could not afford the service (investors who account for the *BC* segment of the demand curve) now will spend *E* for this service. This amount of money must come out of some other areas in which they were previously spending—most likely, some inferior substitutes they were purchasing. Therefore, the demand curve of that substitute industry will be contracted. While these are secondary effects, there is no reason to believe that the magnitudes of these effects will necessarily be small.

This is not to say that a partial-equilibrium-based approach under Circular A-4 must necessarily neglect these effects. As mentioned already, Circular A-4 advises agencies to take into consideration ancillary benefits and countervailing risks.[169] Even textbooks discussing cost–benefit analysis under the partial-equilibrium framework discuss valuing costs and benefits in secondary markets.[170] But a partial-equilibrium-based approach still remains "partial" in that it does not consider all sectors of the economy *simultaneously*. To do so, one would need to abandon the concept of surplus based on the money metric, but make use of

169. *See supra* note 166 and accompanying text.
170. *See generally* BOARDMAN ET AL., *supra* note 4, at 103–19.

individual utility functions which account for consumption of multiple goods simultaneously.

The natural question then is, why not consider all such effects in a cost–benefit analysis? It certainly seems that such an approach, if possible, would be closest to a holistic welfare analysis of the economy. Unfortunately, the reasons are many as to why this analysis is generally not possible. First, from the theory perspective, solving for the new equilibrium requires solving multiple systems of equations simultaneously. These systems are known as an applied general-equilibrium model.[171] But to date, all attempts to solve applied general-equilibrium models on a general level have failed.[172] As it turned out, there is no guarantee that the equilibrium point is unique, or stable, or that the economy would even converge to an equilibrium point.[173] Because these challenges turned out to be unassailable, economists have largely abandoned the discipline of general-equilibrium theory. Second, even where one could solve for the new equilibrium, there is no generally accepted metric to compare the welfare of the two economies.[174] Concepts relying on the money metric, such as surpluses, are no longer meaningful under the general-equilibrium framework. Third, even if the first two conditions could be addressed, as a practical matter, the government never has enough data to characterize the effect of its action across all industries. Each agency struggles to gather enough data to understand even just the one industry it regulates.

For these and other reasons, a cost–benefit analysis in most cases employs only a partial-equilibrium or an even narrower perspective.[175] It is in this sense that

---

171. *See generally* JOHN B. SHOVEN & JOHN WHALLEY, APPLYING GENERAL EQUILIBRIUM 9–37 (1992).

172. For a background on the unfortunate demise of general-equilibrium theory, see generally Frank Ackerman, *Still Dead After All These Years: Interpreting the Failure of General Equilibrium Theory*, *in* THE FLAWED FOUNDATION OF GENERAL EQUILIBRIUM: CRITICAL ESSAYS ON ECONOMIC THEORY 14–31 (2004), *available at* http://digamo.free.fr/ackerman4.pdf.

173. Professor Frank Ackerman summarizes the failure of general-equilibrium theory as follows:

> In the 1970s, theorists reached quite strong, and almost entirely negative, conclusions about both the uniqueness and the stability of general equilibrium. There is no hope of proving uniqueness in general, since examples can be constructed of economies with multiple equilibria . . . . For stability, the results are, if anything, even worse . . . . Cycles of any length, chaos, or anything else you can describe will arise in a general equilibrium model for some set of consumer preferences and initial endowments.

See id. at 16.

174. *See generally* Yoon-Ho Alex Lee & Donald J. Brown, *Competition, Consumer Welfare, and the Social Cost of Monopoly*, *in* COMPUTATIONAL ASPECTS OF GENERAL EQUILIBRIUM THEORY: REFUTABLE THEORIES OF VALUE 47 (M. Beckmann et al., eds., 2008).

175. For limited examples of general-equilibrium analyses of government regulations, see, e.g., Michael Hazilla & Raymond J. Kopp, *Social Cost of Environmental Quality Regulation: A General Equilibrium Analysis*, 98 J. POL. ECON. 853, 853 (1990) (making a clear distinction between private cost and social cost); V. Kerry Smith & Jared C.

we must contend with the fact that all cost–benefit analyses used in policymaking are necessarily perspectivistic. As a result, there is a great deal of fragility to any established cost–benefit analysis framework. Turning away from the purely theoretical inquiry, I next discuss some practical implications for understanding the efficiency of SEC rules if the SEC were to adopt a total surplus approach.

D. Some Implications for SEC Rules

The foregoing analysis suggests that if the calls to have the SEC comply with a more stringent cost–benefit analysis requirement are to be taken seriously, or if the SEC were to become subjected to OIRA oversight, there will be immediate consequences for the agency in terms of how it would analyze the efficiency of its rules. In many instances, a rule's efficiency determination will be sensitive to the framework chosen. In a separate article,[176] I have explored this ramification in greater detail by closely examining some concrete SEC rules. In this Section, I briefly summarize some of the main points, by considering various stakeholder interests. To be clear, not every stakeholder's interest will be germane to every rule. Rather, to the extent that each SEC rule will likely affect the economic interests of some constituents other than investors, their interests need to be considered together in the cost–benefit analysis. The result is that a total surplus analysis may deem "efficient" a rule that may be net costly to investors and alternatively deem "inefficient" a rule that may be net beneficial to investors. In this Section, I highlight four different ways in which the total surplus approach and the investor welfare approach may lead to conflicting efficiency determinations.

First, if an SEC rule is designed to protect investors from managerial expropriations, a total surplus analysis should also consider the rule's effect on managers' economic interests.[177] Managers are themselves market participants and part of the economy. As a result, under Circular A-4's approach, the SEC's cost–benefit analysis would have to consider the rule's positive effect on investor welfare together with its potential adverse effect on the managers' economic interests. It follows that even if such a rule were to be effective in reducing managerial surplus and benefiting investors at large, it cannot be considered "efficient" under Circular A-4's approach unless it also increases the size of the total economy. More specifically, if a rule entails compliance costs but is designed primarily to facilitate a mere transfer from managers to investors, it will be inefficient even though investors may end up benefitting. Such regulation would instead have to be justified under a "compelling public need" ground—such as, for example, the need to reduce income inequality—rather than on the efficiency ground.

Carbone, *Should Benefit-Cost Analyses Take Account of General Equilibrium Effects?*, 23 RES. IN L. & ECON. 247, 253, 266 (2007). Hazilla & Kopp makes a clear distinction between private cost and social cost. *See* Hazilla & Kopp, *supra*, at 853. Smith & Carbone formalize cost–benefit analysis within the framework of general-equilibrium analysis and note that "no one has actually attempted to measure [the proper benefit measures under general-equilibrium]." Smith & Carbone, *supra*, at 253. The authors then concludes that "[t]he [general-equilibrium] effects of policy intervention cannot be ignored." *Id.* at 266.

176. Lee, *supra* note 26 (manuscript at 1).

177. *See generally id.* (manuscript at 4–6).

Second, where compliance with a rule requires use of gatekeeper or vendor services—such as credit rating agencies, proxy delivery services, or independent auditors—a total surplus approach would also count as benefits the beneficial economic effect of such mandated demand on the service industry.[178] These can include economic profits or producer surplus gained by such gatekeepers or vendors, as well as additional jobs created. More specifically, the economic cost of complying with regulation mandating use of vendor services should be recognized as the firms' compliance expenses less economic profits or producer surplus gained by such vendors, and the economic benefit should include additional jobs created in the service industry.[179] Likewise, any SEC rule that seeks to save resources for firms and investors by relaxing previously mandated compliance would have to account for the resulting economic loss in the service industry.

Consider, for example, the SEC's rules implementing § 404(b) of the Sarbanes–Oxley Act, which require firms to seek attestation from an independent auditor that there are no material weaknesses to the firms' internal controls over financial reporting.[180] During the early days of implementation, many believed the increased audit costs outweighed the benefits of the improved accuracy and transparency of financial reporting, especially for smaller firms.[181] At the same time, however, § 404(b) was a real boon for the auditors and the accounting industry.[182] Accordingly, under the total surplus approach, the overall efficiency of the auditor-attestation rule would be evaluated by examining both the impact on the firms of the increased audit costs and the economic profits and other benefits reaped by the accounting industry. The fact that some smaller firms may have found compliance too costly (and not worth the benefits) would not necessarily indicate the rule's inefficiency. In addition, even if the market reactions to rule implementation were negative for such firms' stocks, the rule may still prove to be efficient because stock price would not account for the benefits accruing to the accounting industry.[183]

---

178. *See generally id.* at 6–10.

179. For a general discussion of how an agency should consider the effect on regulation on employment, see Masur & Posner, *supra* note 27, at 585.

180. *See generally* Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers and Newly Public Companies, 71 Fed. Reg. 76,580 (Dec. 21 2006); Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers, 73 Fed. Reg. 38,094 (July 2, 2008); Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers, 74 Fed. Reg. 53,628 (Oct. 19, 2009).

181. *See generally* OFFICE OF ECONOMIC ANALYSIS, *Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements*, U.S. SEC. & EXCH. COMM'N 21 n.35 (Sept. 2009), http://www.sec.gov/news/studies/2009/sox-404_study.pdf. The SEC study also cites countless surveys conducted by professional associations detailing the cost of Section 404 compliance. *See id.*

182. *See generally* Lee, *supra* note 26 (manuscript at 8–10); *see also* Cindy R. Alexander et al., *The Economic Effect of SOX Section 404: A Corporate Insider Perspective*, 56 J. ACCT. & ECON. 267, 268–69 (2013) (documenting how corporate insiders' views on Section 404 compliance may have changed post-implementation).

183. *See* Lee, *supra* note 26 (manuscript at 10).

Third, if the SEC were to design a rule to promote more effective corporate governance by shareholders, Circular A-4's approach would offer no basis for ignoring or otherwise discounting private benefits accruing to shareholders with special interests—such as unions or pension funds or hedge funds—even if their actions may prove to be costly for the representative investor.

Consider, for example, the SEC's proxy access rule,[184] which was the subject rule of *Business Roundtable*.[185] The SEC sought to require firms to include in their proxy ballots the names of the director-candidates nominated by shareholders with significant economic ownership. The SEC rationalized that, by allowing shareholders with significant economic ownership to play a greater role in nominating and campaigning for director-candidates, the rule would allow the board to become more accountable to shareholders' interests.[186] But Business Roundtable, a group of over 100 Fortune 500 CEOs, challenged the rule on the ground that, as structured, the rule would essentially allow shareholders with special interests—such as union shareholders—to dominate the process.[187] They further argued that these shareholders would misuse the mechanism to promote their own private interests, such as by seeking to elect a director who would promote employee value rather than shareholder value, or otherwise using this new bargaining power to demand certain concessions from management.[188] If Business Roundtable's argument is correct, then the representative investor—say, a typical small shareholder—might actually come out worse off, rather than better off, as a result of the rule. The D.C. Circuit seems to have accepted this argument as successfully undermining the SEC's rationale to justify the rule under the investor welfare approach.[189] On the other hand, a cost–benefit analysis under Circular A-4's approach would treat as either a benefit or a transfer (if offset by a cost to other investors) whatever concessions union shareholders would gain as a result of the rule. Even if the proxy access rule may prove to be costly to the representative investor (itself not a clear proposition), it would not necessarily indicate the rule's inefficiency. Efficiency under Circular A-4 would not be determined solely by whether the rule increased share value or is otherwise beneficial to the representative investor. Instead, the SEC would inquire whether any possible loss on the representative investor's part is sufficiently compensated by the gains that would accrue to the employees as a result.

Fourth, Circular A-4's approach can have the tendency to reduce the value of investor protection in instances where SEC rules can in turn decrease the surpluses of other general constituents—such as consumers or taxpayers—who *a priori* merit protection from the government as much as investors. For example, when the SEC adopted a rule requiring registration of municipal advisors, as

---

184. *See* Facilitating Shareholder Director Nominations, Securities Act Release 9136, Exchange Act Release No. 62,764, 75 FR 56,668, 56,770 (Sept. 16 2010), *available at* http://www.sec.gov/rules/final/2010/33-9136fr.pdf.

185. 647 F.3d 1144 (D.C. Cir. 2011).

186. For a more detailed discussion of this rule, see generally Lee, *supra* note 26 (manuscript at 10–13).

187. *See id.* (manuscript at 11).

188. *See id.* (manuscript at 11–13).

189. *See Bus. Roundtable*, 647 F.3d at 1158.

mandated by the Dodd–Frank Act,[190] commenters expressed a concern that the rule would entail significant compliance costs, which could cause municipal advisors to exit the market, consolidate with other firms, or pass the costs incurred to comply with the regime on to clients. In the latter case, however, the compliance costs would initially pass onto the municipalities, but then eventually to consumers and taxpayers.[191] Therefore, the efficiency of such SEC rule should be evaluated based not only on the increased investor welfare but also on the loss of consumer surplus or the increased burden on taxpayers. Under the contemplated scenario, the aggregate economic cost would be at least as large as the compliance costs incurred by municipal advisors, but likely larger because each stage of passing on the costs can create a deadweight loss.[192] In short, even if the benefits of the registration requirement to investors were to exceed the initial compliance costs, whether the rule will in fact be efficient is unclear since the eventual cost of regulation might be greater than the compliance costs.

These examples demonstrate that if the SEC were to use Circular A-4 to analyze its rules, it would have to altogether change the notion of efficiency. They may also suggest that Circular A-4's framework might not be well-suited to assess the merits of SEC rules. In particular, those who view the SEC's mission narrowly as protecting investor welfare may view Circular A-4's approach as more of a nuisance than anything else. For my own purposes, I believe these analyses—tentative as they are—legitimize the original inquiry: what then is the proper criterion for evaluating the efficiency of an SEC rule? In the next Part, I argue that Circular A-4's approach can offer many benefits from broader policy considerations.

III. A CASE FOR THE TOTAL SURPLUS APPROACH

The analyses from Part II suggest that the two cost–benefit analysis frameworks can indeed differ significantly. But even if this were true, one is still left with the following question: why should we care about the choice of cost–benefit analysis framework? After all, the choice of framework matters only insofar as it sets forth the efficiency criterion, and the efficiency criterion matters only insofar as it may marginally increase the burden of the agency's justification of certain regulatory objectives as compelling public needs. One possible response is that the efficiency criterion would matter to the extent that it would distinguish the set of regulations the agency would adopt for efficiency purposes from those it would adopt for non-efficiency purposes, and thereby provide a clear picture of the policy grounds for agency rulemaking. For this reason, it is worth examining whether there is any value to having the SEC adopt Circular A-4's cost–benefit analysis framework.

---

190. *See* Registration of Municipal Advisors, Exchange Act Release No. 70,462, 67,469 (Sept. 20, 2013), *available at* http://www.gpo.gov/fdsys/pkg/FR-2013-11-12/pdf/2013-23524.pdf. For a more detailed discussion on this rule, see Lee, *supra* note 26, (manuscript at 13–15).

191. *See generally* Lee, *supra* note 26 (manuscript at 13–15).

192. *See id.* (manuscript at 15).

In this Part, I conclude that, despite certain apparent oddities of the exercises from Part II, the total surplus approach should not be summarily dismissed as being inappropriate for SEC rules. It is not my purpose here to fully weigh the pros and cons of the two cost–benefit analysis frameworks. My narrow claim is that reasonable policy grounds exist for the SEC to consider employing the total surplus approach in analyzing the economic effects of its rules.

Let me begin with some preliminary qualifications. First, neither framework has much to offer if one were to view the primary purpose of securities regulation as largely distributional, rather than correcting market failures. Second, none of my arguments are aimed at answering the maximand question, but only at evaluating the efficiency criterion. Third, the fact that I consider the total surplus approach a potentially useful framework for the SEC does not necessarily mean that I therefore believe the SEC should be subject to OIRA oversight. (An agency can, of course, choose to subscribe to the guidance of Circular A-4 without being subjected to any particular oversight.)

Before I consider the comparative merits of the total surplus approach, it might be worth asking why the SEC has traditionally favored the investor welfare approach. I can only speculate at this point, but I hazard several possible reasons. First, this practice may have stemmed from a confusion regarding the SEC's overall mission and its relation to the ECCF provision. For example, the SEC staff interpreting the statute may have simply been unsure whether it could legally consider costs and benefits accruing to parties other than investors. The staff may have interpreted its mission of "investor protection" as suggesting that the agency may protect only investors' financial interests. There is, however, little basis for such an interpretation, at least when it comes to the ECCF mandate. If anything, the language cautions against conflating "efficiency" and "investor protection" together. The ECCF mandate requires the SEC to consider the effect of its action on "efficiency . . . *in addition to the protection of investors*"[193]—thus, implying that these are two distinct concepts.

Second, there may be a pedagogical reason. Currently, the SEC's economic analysis is drafted by SEC staff attorneys and reviewed by its staff economists. But most of the staff economists are financial or accounting economists, rather than welfare economists or industrial-organization economists.[194] Cost–benefit analysis frameworks belong to welfare economics, whereas understanding the intricacy of competition and industry structure belongs to the field of industrial organization. Financial and accounting economists, by contrast, are trained to analyze firm values or stock prices more often than social welfare. Few studies within finance or accounting consider the costs and benefits

---

193. 15 U.S.C. §§ 78c(f), 80a-2(c) (2012) ("Whenever pursuant to this subchapter 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.") (emphasis added).

194. For the credentials of the SEC economists, see generally *Division of Economic and Research Analysis*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/divisions/riskfin/economistbios.shtml (last visited Jan. 25, 2015).

of regulation from the perspective of society at large. This, of course, means that the SEC economists may be better equipped to conduct its analyses under the investor welfare approach. It does not, however, address whether the SEC as an institution should not ultimately invest in more welfare economists and industrial organization economists.

Third, there may also be political reasons. For example, it is natural for the agency to want to come across as a zealous advocate for investors, but it might want to do so without having to take sides on any other distributional issues. In other words, the agency may want to highlight how its rules will benefits investors, but may not otherwise want transparency as to whether its rules will in fact reduce managerial surplus or otherwise facilitate rent-transfers to gatekeepers or vendors or reduce the surpluses of other constituents.

Taken collectively, these reasons may explain why the SEC has historically employed the investor welfare approach. But they come short of offering compelling reasons that it should continue to do so. On what possible grounds, then, might it be preferable to have the SEC employ the total surplus approach? At least a handful of policy reasons deserve serious consideration.

First, the total surplus approach seems more logically consistent with the traditional market-failure-based rationale for regulation. The woe of a market failure, as originally envisioned by classical economics, is not that certain parties may come out harmed, but that society is leaving money on the table. For example, writing in 1937, A.P. Lerner in his landmark article on monopoly stated that "[a] levy which involves a mere transference to buyer to monopolist cannot be said to be harmful from a social point of view unless it can be shown that the monopolist is less deserving of the levy than the people who have to pay it . . . ."[195] Instead, he noted that: "increasing the price of the monopolized commodity [causes] buyers to divert their expenditure to other, less satisfactory, purchases. This constitutes a loss to the consumer which is not balanced by any gain reaped by the monopolist, so that there is a net social loss."[196] Therefore, to the extent that cost–benefit analysis is primarily used for an efficiency justification, the total surplus approach certainly seems more appropriate.

Second, because the total surplus approach considers the effects of regulation on all relevant market participants, it has the potential to provide for greater transparency of government actions. The value of a cost–benefit analysis lies not only in ensuring efficiency but also in telling a story to the general public about how a government policy may affect the economy as a whole. Transparency, rather than obfuscation, is therefore key. For example, a total surplus analysis might provide greater clarity as to whether the government is promoting growth or distribution. The investor welfare approach partly obscures this distinction by passing off as efficient a rule that in fact does no more than facilitating a distribution to a particular group of constituents. In some cases, a rule that is efficient under the investor welfare approach may be increasing total surplus; in

195. A.P. Lerner, *The Concept of Monopoly and the Measurement of Monopoly Power*, 1 REV. ECON. STUD. 157, 157 (1937).

196. *Id.*

other cases, it may mean only that there is a transfer from other stakeholders to investors. But within the discipline of welfare economics and among general policy economists who conduct cost–benefit analyses, efficiency and distribution are already well-recognized concepts. The investor welfare approach simply introduces another concept that allows for obfuscation. In addition, a total surplus analysis might also promote a greater level of transparency that could expose the potential for legislative or agency capture.[197] For example, the fact that audit firms may be earning profits through § 404(b) audits may suggest at least a possibility that certain provisions of the Sarbanes–Oxley Act may be a result of extensive lobbying by audit firms. Likewise, the fact that union shareholders may seek private benefits through proxy access may hint that parties other than representative investors may have played a significant role in the rulemaking.

Third, the total surplus approach has the potential to expand the SEC's policy choice in ways that can benefit society at large. Note first that, in practice and for all intents and purposes, the total surplus approach will be unlikely to significantly restrict the SEC's policy choices it could justify under its current investor welfare approach. The SEC simply needs to be clear about whether it is justifying its rules under efficiency or under a compelling public need. There may indeed be good reasons, or even compelling reasons, as to why the government should promote distributions from managers to shareholders, insiders to outsiders, broker-dealers to investors, informed traders to uninformed traders, sophisticated investors to unsophisticated investors, etc. The SEC will always have the option of appealing to the general rubric of "investor protection." In fact, the general public may expect as much from the SEC. On the other hand, where a regulation, falling squarely within the SEC's statutory authority, actually increases total surplus and saves resources, it seems the SEC—whether or not it would always want to move forward with such a rule—*should* be able to appeal to efficiency proper as a legitimate ground for regulation even if investor welfare may be reduced. In this sense, if applied properly, the total surplus approach should not limit, but rather expand, the SEC's policy choice set and can permit additional ways to save resources for society.

Fourth, there is a benefit to having the SEC (as well as other independent agencies) adopt the more prevalent and widely practiced approach to considering costs and benefits. Cost–benefit analysis is in a sense a reporting standard for each agency to disclose the value of its action to the public, Congress, courts, and the White House. Because most executive agencies are already conducting their cost–benefit analyses under the total surplus approach, the total surplus approach would facilitate comparability across all agencies. A consistent reporting standard will provide a more comprehensive picture of regulation by all government agencies and may also be valuable for overall planning and budgeting purposes.

---

197. *But see* Wendy E. Wagner, *Administrative Law, Filter Failure, and Information Capture*, 59 DUKE L.J. 1321 (2010) (arguing that despite the added level of transparency provided the notice-and-comment process, the process of rulemaking can facilitate an agency to be captured by interest groups).

CONCLUSION

This Article illustrated the differences between the OIRA's Circular A-4 framework for considering costs and benefits of a regulation and the SEC's framework of economic analysis in rulemaking. The two frameworks indeed conflict significantly, not just on the margins. Consequently, any effort to impose a more rigorous cost–benefit analysis requirement for the SEC rules should be preceded by resolving the threshold inquiry concerning the proper criterion of efficiency for securities regulation. The investor welfare approach is more intuitive and easier to apply, but will tend to obscure or ignore certain significant economic effects. The total surplus approach is more difficult to apply, but is more consistent with the logic behind intervention, and will likely offer greater transparency. Meanwhile, it seems also important to question whether a cost–benefit analysis is the right tool to guide each instance of rulemaking for the SEC. There may be reasonable investor-protection rules that we as society may desire even though they fail to satisfy the Kaldor–Hicks efficiency criterion. In adopting such rules, the SEC should be transparent about the compelling public need it is addressing. Finally, although the scope of this Article was limited to the SEC's rules, one can imagine similar policy debates for other regulatory agencies tasked with protecting certain constituents, such as consumers, borrowers, depositors, and others. A future study might examine whether cost–benefit analyses undertaken by such other regulatory agencies present similar dilemmas.