RE-ANALYZING COST-BENEFIT ANALYSIS: TOWARD A FRAMEWORK OF FUNCTION(S) AND FORM(S)

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For decades, the Securities and Exchange Commission has voluntarily evaluated the costs and benefits of its proposed rules. Since 1996, it has separately complied with the statutory mandate of Section 106 of the National Securities Market Improvement Act to "consider, in addition to the protection of investors, whether [an] action will promote efficiency, competition, and capital formation."[1]

Until recently, however, the courts have shown little inclination to question those assessments.

Over a series of recent cases—culminating in its decision in Business Roundtable v. SEC—the D.C. Circuit has demonstrated a dramatic change of heart.[2] Reviewing a new rule authorizing shareholder access to the proxy to nominate board members—a rule that was heatedly debated over at least a decade, that was substantially revised in the face of public comment, and that was explicitly authorized by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010—the court held that the SEC's more than seventy-five pages of analysis fell short of the requirements of Section 106.

Especially coming in the traditionally insulated realm of financial regulation, the court's seemingly high bar for the conduct of cost-benefit analysis generated significant controversy—and concern. The shareholder proxy access rule was thus the first of nearly a hundred delegations to the SEC enumerated in the Dodd-Frank Act—among other regulatory undertakings it mandates. If Business Roundtable is to be taken at face value, then, the implementation of Dodd-Frank—including future rulemaking on the Volcker Rule, on securitization, and on derivatives trading—may be in significant jeopardy.

The analysis of Section 106 in Business Roundtable may thus offer a

1 National Securities Market Improvement Act of 1996 § 106, 15 U.S.C. § 77b(b) (2006).
2 Business Roundtable v. SEC, 647 F.3d 1144 (D.C. Cir. 2011).

valuable opportunity to define the proper scope of cost-benefit analysis in financial regulation. Yet it is also useful more broadly. With its extension of cost-benefit analysis beyond the conventional universe of environmental law, occupational health and safety, and other areas of risk regulation, Section 106 and its interpretation in Business Roundtable also offer an occasion to begin defining a framework for analyzing cost-benefit analysis more generally.

Scholarly assessment of cost-benefit analysis has tended to focus on its normative wisdom. Perhaps for that very reason, it has commonly approached it as a fairly singular phenomenon. This begins with the assumption of efficiency—loosely defined, if at all—as the implicit function of cost-benefit analysis. To similar effect, it has ordinarily been evaluated as a particular method of regulatory decision-making, rather than as an umbrella encompassing an array of related, but distinctly operationalized, approaches to analyzing the "costs" and/or "benefits" of alternative regulatory choices. Especially if cost-benefit analysis is to find relevance beyond risk regulation, however, we will need to be more ecumenical as to both its functions and its forms.

To that end, I begin by offering a typology of the potential functions of cost-benefit analysis—both dissecting its asserted "efficiency" benefits and outlining a set of non-efficiency functions it might also be understood to serve. Further, I outline a framework for evaluating the appropriate form of cost-benefit analysis in any given setting. With this framework of potential functions and forms, in turn, it becomes possible to properly evaluate the consideration of efficiency, competition, and capital formation under Section 106.

In financial regulation, as elsewhere, cost-benefit analysis may foster efficient ends or be paralyzing. Once we more fully appreciate the range of functions it may serve, and the varied forms it may take, we become that much more likely to apply it in ways that encourage the former, and avoid the latter.

I

THE FUNCTION(S) OF COST-BENEFIT ANALYSIS

An understanding of the increasingly varied universe of cost-benefit analysis requirements faced by regulatory agencies—and of the demands of Section 106 in particular—must begin with a more systematic framework than has previously been offered, of the multiple potential functions of cost-benefit analysis in any given case. To what ends do we engage in such analysis? What purposes should it be understood to serve?

A. Efficiency Functions of Cost-Benefit Analysis

Dissecting the generalized assertion of efficiency as the purpose of cost-benefit analysis, one might identify three distinct species of efficiency such analysis could serve. At the most basic level, cost-benefit analysis might be understood to promote allocative efficiency in rulemaking—maximizing the return on our investments in regulatory compliance and enforcement. Minimally, this might involve the preclusion of regulatory initiatives as to which the latter investments outweigh any potential benefits. More ambitiously, cost-benefit analysis might be argued to yield Pareto-optimal outcomes, in which the aforementioned regulatory costs are expended in such a way as to yield the greatest possible benefit.

Cost-benefit analysis may also serve a distinct efficiency function, in the face of bounded rationality. Both among the general public and regulators themselves, cognitive biases including framing effects, anchoring, and loss aversion may distort decision-making. Overestimation of the risk of cancer, and underestimation of the cost of avoiding it, for example, may distort public preferences as to environmental protection standards. Agency officials may generate their own cognitive biases, meanwhile, including given their single-minded orientation to their own agency's discrete and insular mandate.

In the face of such biases, cost-benefit analysis may serve a salutary purpose. Both in its information-revelation function and in its requirement of a more systematic weighting of costs and benefits, it may help to reduce the prospect that misperceptions of facts will impact regulatory choices—thereby enhancing the efficiency of regulatory decision-making.

Cost-benefit analysis might lastly be seen to promote efficiency in helping to shape agency priorities. It might be hoped, thus, that cost-benefit analysis would serve to highlight potential targets for regulatory initiative that would otherwise go overlooked.[3]

B. Non-Efficiency Functions of Cost-Benefit Analysis

Beyond dissecting the generalized claim of efficiency into more precise efficiency functions, it is important to recognize a range of purposes of cost-benefit analysis not grounded in any promise of efficiency. While less commonly acknowledged, let alone explored, these may be important functions of cost-benefit analysis—including in financial regulation.

At the most basic level, cost-benefit analysis can be understood as simply a device to contract the amount of regulatory activity. With its most prominent expansions during the earliest days of President Ronald

3 Cost-benefit analysis is most commonly assumed to reduce the scope of regulatory initiative. In its priority setting function, however, it may do just the opposite.

Reagan's first term in office and the mid-1990's Contract with America, some anti-regulatory function for cost-benefit analysis seems indisputable.

It might also be understood as a means to promote the generalized well-being of the public, even if its capacity to promote formal efficiency is more limited than its advocates would suggest. As it turns out, thus, neither Pareto nor Kaldor-Hicks efficiency may be practicable goals for cost-benefit analysis to achieve.[4] By fostering movement toward somewhat improved outcomes, though, it may nonetheless improve well-being.

Beyond the foregoing, a related pair of non-efficiency functions of cost-benefit analysis might be increased transparency in rulemaking and enhanced agency monitoring by executive and/or legislative authorities. By disclosing information about regulatory priorities and choices, cost-benefit analysis may minimally help to enhance public awareness—and thereby increase agency accountability. Separately, it might also reduce informational asymmetries that characterize the principal-agent relationship between the political branches of government and agencies, fostering better alignment of agency action with democratic demands. In each of these ways, cost-benefit analysis may also help to reduce interest group influence.

Finally—and importantly, as to Section 106—cost-benefit analysis may sometimes serve as a means for the legislative or executive branch to demand agency consideration of particular factors, in their decision-making. While the organic statutes of regulatory agencies commonly include such enumerated factors, cost-benefit analysis requirements may be an alternative means to those ends—perhaps especially where the political consensus for an explicit change in the enumerated considerations would be difficult to achieve. This might be the case, in particular, where the factors to be added can be understood to cut against the emphasis or orientation of the existing statutory framework—as might plausibly be said of Congress' addition of Section 106 to the organic statutes of the SEC.

II

THE FORM(S) OF COST-BENEFIT ANALYSIS

Having outlined a broader range of potential functions of cost-benefit analysis than is commonly considered, it is important to recognize a broader range of forms that cost-benefit analysis might take as well. Depending on a number of variables, cost-benefit analysis could look very different in any given case than conventional accounts would appear to admit.

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4 *See* Matthew D. Adler & Eric A. Posner, *Rethinking Cost-Benefit Analysis*, 109 YALE L.J. 165, 188–89 (1999).

As to the source of law that stands behind an agency's conduct of cost-benefit analysis, to begin, one might expect at least some variation in the form of any cost-benefit analysis, depending on whether it is legally required, is merely authorized, or is entirely voluntary. Choices of form might further be impacted by whether the relevant source of law is statutory or regulatory, and whether it is directed to a particular agency or is more generally applicable. Each of these factors may speak to the nature of the obligation to conduct cost-benefit analysis, the form the latter takes, and the nature of any review that follows.

The nature of the agency engaged in the analysis might also be relevant to its form. In assessing questions of form, for example, we might consider whether the relevant regulator is an independent or executive agency. Minimally, this might impact the scope of review. But it might also speak to the relevant obligation of the agency as procedural versus substantive—i.e., as requiring the agency simply to conduct the relevant analysis, or to align its rulemaking with its findings. One might also have different expectations for cost-benefit analysis by independent agencies, given their more limited size, budgets, and mandates.

Turning from the agency conducting the analysis to the nature of the question to be analyzed, the complexity of the underlying issue, as well as any distributional features of either the question itself or of any cost-benefit analysis of it, can be expected to impact the form that analysis will take. Focusing on the distributional dimension, significant informational asymmetries, or even mere wealth differentials, may reduce the validity of relevant preference functions—and of any conclusions cost-benefit analysis derives from those preferences. Certain calculations of costs/benefits, meanwhile, may themselves have a distributional quality. Under Section 106, for example, the promotion of "capital formation" does not serve all investors equally, but primarily advances the interests of institutions—perhaps even at the expense of retail investors. This distributional quality must minimally impact the scope of any judicial review, but might also be expected to impact the nature of the agency's obligation.

Finally, the form of cost-benefit analysis might be expected to vary, based on features of the particular variables to be considered. This begins with whether the agency is tasked to weigh "costs" and "benefits" alone, or whether the calculus involves two or more distinct variables—be they "efficiency, competition, or capital formation," or otherwise. The quantifiability of the variables might be a further question, with less tractable ones counseling less formal cost-benefit analysis, for fear such formality may obscure relevant uncertainties. Lastly, the form of cost-benefit analysis can be expected to vary, where the variables cannot be measured on the same scale, such that they cannot readily be weighed against each another—as opposed to simply being considered in conjunction.

III

COST-BENEFIT ANALYSIS IN FINANCIAL REGULATION: AN ANALYSIS OF SECTION 106

Having outlined a framework for more systematically evaluating a varied universe of cost-benefit analysis' functions and forms, how might we situate Section 106 within that framework? As a preliminary matter, one might question whether Congress intended that provision to mandate cost-benefit analysis at all. While the language of Section 106 does not speak explicitly of costs and benefits, it does seem to hint at the latter. That hint is strengthened, in turn, by the provision's legislative history. And as applied by the SEC and evaluated by the courts, it has essentially been read in that fashion.

More important, then, may be the question of whether—whatever Congress' intent—we should evaluate the provision as a form of cost-benefit analysis. Within the conventional conception of cost-benefit analysis as simply a tool of efficiency, it is not easy to do so. This is minimally suggested by the text of Section 106 itself. More fundamental, however, is the disconnect between the analysis it prescribes and what would be necessary for a truly efficiency-enhancing evaluation of the SEC's regulatory choices. The indeterminate nature of "efficiency, competition, and capital formation" as factors to be considered, the requirement merely to "consider" these factors, and the absence of any demand for (or possibility of) SEC balancing among the relevant factors—all counsel against an understanding of Section 106 as primarily directed to increased efficiency.

But this approach assumes too narrow a role for cost-benefit analysis. As suggested above, cost-benefit analysis may serve a variety of functions beyond promoting efficiency. In certain circumstances, cost-benefit analysis requirements may serve simply to force agencies to consider particular factors in their rulemaking. It is this function that resonates most closely with the mandate of Section 106.

It best fits, to begin, with the provision's mandate of mere "consideration," rather than "determination," "calculation," or even "analysis." More broadly, it is suggested by the contrast with statutes that explicitly speak of weighing "costs" against "benefits." The language of Section 106, by comparison, reads like an enumeration of factors for SEC consideration—with even "investor protection" not presented as a particularly countervailing variable, and the balance of variables capable of cutting both ways, as to many regulatory choices.

The enumeration of factors to consider is, to be sure, a more modest function than others enumerated above. Yet this too is consistent with the nature of Section 106's adoption and incorporation into the organic statutes of the SEC. That it is modest, more importantly, does not make it minor. To the contrary, much of administrative law is built around the requirement that agencies properly evaluate the factors enumerated by Congress.

As described above, this function can properly be understood—in appropriate cases—as a species of cost-benefit analysis. Where, as with Section 106, the factors to be added to the mix will often cut against outcomes favored under the current analysis, Congress may find adoption of a carefully designed cost-benefit analysis requirement effective to advance its goals, yet far more politically palatable. With the adoption of Section 106, thus, Congress might be understood to have slipped in a requirement that the SEC's longstanding pursuit of the benefits of investor protection theretofore be reconciled with its associated costs—in efficiency, competition, and capital formation.

If this is the properly understood function of Section 106, what further can we extrapolate from the above framework, as to the application of Section 106 in practice, and as to the scope of any ensuing review? In turn, we might consider the nature of the SEC's obligation under Section 106, the nature of the analysis it conducts, and the nature of any subsequent review.

A. The Nature of the SEC's Obligation

There can be little doubt that Section 106 imposes some obligation on the SEC. In light of the purpose of Section 106, its language, and the nature of the variables it enumerates, however, that obligation is properly understood to be limited. More precisely, it is procedural rather than substantive—mandating that the SEC consider the factors indicated, but not that it align its ultimate regulatory choices with that analysis.

The SEC's purely procedural obligation under Section 106 is suggested, to begin, by the provision's reference to mere "consider[ation]" of the factors. That this choice of verbiage meant something can be divined both from Section 106's separate reference to the SEC's duty to "consider or determine" the consistency of proposed rules with the public interest, and from application of that same formulation to the SEC's analysis of "efficiency, competition, and capital formation"—in an earlier version of the language.[5]

The suggested function of Section 106—to enumerate additional factors for SEC consideration—also favors a procedural interpretation of the SEC's obligation. Likewise, the distributional concerns that arise under

5 *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, 1821 (2012).

Section 106. While the SEC might reasonably be expected to explore considerations of efficiency, competition, and capital formation in its rulemaking, the distributional implications of prioritizing even among those factors, let alone between them and its traditional mandate of investor protection, counsel against an interpretation of Section 106 to dictate the results of that rulemaking.

B. The Nature of the SEC's Analysis

In defining the appropriate nature of SEC analysis under Section 106, three aspects might be highlighted: First, any attempt to rigidly quantify the variables at issue is ill-advised. Second, the SEC should avoid any attempt to balance the enumerated factors against one another. Finally, cost-benefit analysis under Section 106 should be designed to attend carefully to the distributional dynamics at work.

The significant utility of quantification in cost-benefit analysis goes without saying. Several factors counsel against it, however, in the context of Section 106. As above, this begins with the provision's lack of explicit reference to "costs" or "benefits." More generally, both the indeterminate nature of Section 106's factors and their complexity undercut the possibility of their reduction to precise values. The multiplicity of factors adds further to this difficulty.

Beyond the challenges of quantification, it may be of limited relevance to an analysis under Section 106. This begins with the fact that Section 106 is not directed to the realm of risk regulation—where the conventional emphasis on quantification may have greatest force. Greater flexibility in the form of cost-benefit analysis might also be appropriate, given the new application of the practice that Section 106 represents.

The diminished relevance of quantification rests most significantly, however, on the distinct function of cost-benefit analysis under Section 106. However we precisely define the function of Section 106, the aforementioned reduction of cognitive biases and facilitation of agency monitoring are particularly difficult to reconcile with the context and nature of Section 106. Yet it is as to those functions that quantification is at the acme of its importance.

The poor fit of a "balancing" approach to Section 106 likewise begins with the language itself. Most critically, that language does not juxtapose "investor protection" and "efficiency, competition, and capital formation" in a way that suggests the balancing of one against the other. Rather, the new factors are to be considered "in addition to" investor protection. Beyond that, a balancing of the particular variables enumerated in Section 106 is not readily accomplished. Investor protection, competition, and capital formation may be efficient or inefficient, for example, depending on the circumstances. Competition may sometimes enhance investor protection, meanwhile, while undercutting it at other times.

This points to a final characteristic of cost-benefit analysis under Section 106, as we situate it within the above framework: Both the status quo equilibrium against which SEC rules are directed and Section 106's analysis of those rules exhibit strong distributional characteristics. Cost-benefit analysis under Section 106 must be designed to attend to the latter. The evaluation of relevant costs and benefits may require appropriate discounting, for example, to address any distortions associated with the skewed distribution of assets and/or information. Enhancements directed to investor protection or capital formation need to be carefully weighed, meanwhile, in light of their skewed distribution of benefits to retail investors and sophisticated investors, respectively.

C. The Nature of Review

Beyond the SEC's conduct of cost-benefit analysis under Section 106, what insight can the above framework offer as to the nature of any ensuing review? At the broadest level, one might expect such review to be more political than legal in nature.[6] As elsewhere, this begins with the text. Mere "consideration" lends itself less naturally to judicial review, than to political accountability. The indeterminate nature of the factors to be considered favors the same conclusion, as does the inability to simply balance them against one another. The distributional implications of the analysis, finally, also favor a more political approach to its review.

Given the statutory mandate of SEC consideration of efficiency, competition, and capital formation, some degree of judicial review is appropriate. Any such review should be circumspect, however, and highly deferential. Such deference is consistent with the traditionally limited judicial constraint on the SEC, as well as its expertise and independent nature. That the obligation to consider efficiency, competition, and capital formation comes by way of legislative initiative, rather than executive order—and in legislation specifically directed to the SEC—offers further grounds for such deference. A high degree of deference, finally, is also favored by the complexity and distributional character of SEC analysis under Section 106. If courts ever owe deference to administrative agencies, it is when they grapple with the difficult normative choices that arise in such circumstances.

CONCLUSION

In its analysis of Section 106, the D.C. Circuit got it both right and wrong. It correctly evaluated the provision as a species of cost-benefit

6 *See* Eric A. Posner, *Controlling Agencies with Cost-Benefit Analysis*, 68 U. CHI. L. REV. 1137, 1187–90 (2001).

analysis, notwithstanding its distinct prose. Yet it failed to recognize the distinct functions of the cost-benefit analysis mandated by that prose. It thus held the SEC to a standard of analysis ill-suited to Section 106's true purpose, and demanded a form of analysis at least difficult to reconcile with the provision, if not directly contrary to its mandate. The court questioned the SEC's conclusions—notwithstanding the lack of any requirement that such conclusions even be offered. And it offered simplistic critiques of the complex calculus Section 106 requires.

The lessons of Business RoundTable may be as important for cost-benefit analysis generally, however, as for Section 106 particularly. In actual application, the form of cost-benefit analysis can be expected to vary significantly from one setting to the next. This may hold true even where the identical legislative or executive mandate is imposed on one agency versus another. More importantly, across diverse statutes and regulations, cost-benefit analysis will necessarily take different forms. Given as much, it is essential that we evaluate cost-benefit analysis not against some platonic ideal, but in its particular context. Only when we do so can it properly be judged.