

**Testimony of James A. Overdahl**  
**Vice President, National Economic Research Associates**  
**Before the Committee on Financial Services,**  
**Subcommittee on Oversight and Investigations,**  
**United States House of Representatives**  
**March 30, 2011**

Chairman Neugebauer, Ranking Member Capuano, and other members of the Subcommittee. I appear before you today in my current role as a Vice President of National Economic Research Associates, or NERA, and as a former Chief Economist of the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC). I thank you for allowing me a chance to share my observations about the role of economic analysis in the rulemaking process at these two regulatory agencies.

In my testimony today I will address three topics. First, I will describe the current role and importance of economic analysis in the rulemaking process at the SEC and CFTC. Second, I will describe some of the obstacles limiting the effective application of economic analysis to the process. Lastly, I will offer suggestions on how economic analysis can be better utilized to help craft cost-effective regulations, help enhance the accountability of regulatory agencies to the public, and help improve the overall transparency of the rulemaking process.

**I. The Current Role of Economic Analysis in the Rulemaking Process at the SEC and CFTC**

The economics programs at the SEC and CFTC are staffed with small, but dedicated, teams of high-quality economists. Over the years, the SEC and CFTC have become destinations for some of the nation's best financial economists who find these agencies to be outstanding places to apply their analytical skills to important problems. Although these economists play an important role in each commission's rulemaking process, they perform other roles too. Economists at both the SEC and CFTC provide litigation support in enforcement proceedings, gather data and conduct analysis about emerging market issues, and respond to abnormal market events, such as the 2008 financial crisis, or last year's "flash crash." Considering the scope of their responsibilities and the size of their staff, it is not possible for them to provide the same level of analysis for each proposed rule or regulatory action. Determining priorities and allocating the resources of the economics program at each agency is the job of the Chief Economist, who must consider the Chairman's priorities, the complexity of analysis required, the urgency of the rulemaking calendar, the likelihood of the rule being challenged in court, and the staff-to-staff working relationship with the drafters of the rule. These considerations have contributed to the inconsistent application of economic analysis across the rulemaking agenda at both the SEC and CFTC.

During my time at the SEC and CFTC, neither agency had a formal requirement for including economic analysis in the rulemaking process, aside from the cost-benefit requirements of the Paperwork Reduction Act (PRA). Neither the SEC nor CFTC requires that its economics staff have formal sign-off authority before proposed rules are recommended to the commissioners for a vote. Although the Administrative Procedure Act (APA) requires that federal regulatory agencies justify their exercise of rulemaking authority to avoid actions that are “arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law,” this language has not been regarded by either commission as a formal requirement for the application of economic analysis to the rulemaking process. However, recent court interpretations of how the APA’s language applies to the SEC’s administration of the rulemaking process has come to be regarded, at least at the SEC, as a requirement to responsibly consider the expected economic impact of proposed rules—at least for those rules likely to be challenged in court.<sup>1</sup> Individual statutes, such as the Securities Exchange Act of 1934, may also require regulators to consider other economic effects, such as whether a regulatory action will promote efficiency, competition, and capital formation.

Aside from the contribution economic analysis can have to satisfying procedural requirements, its broader contribution is to improving regulatory decision making. I found that commissioners at both the SEC and CFTC welcomed independent, data-driven economic analysis provided by commission staff. One reason for this welcoming attitude, I believe, is because interested parties constantly bombard commissioners with iron-clad arguments on all sides of all issues. Transparent analysis, combined with high-quality data and rigorous analysis clearly enhanced the ability of commissioners to ask better questions, better understand the trade-offs and consequences associated with a proposed rule, and make informed decisions. At times, commissioners made decisions that more heavily weighed considerations outside the realm of economic analysis. Even in these cases, the accountability and transparency of the process was improved by having on-the-record economic analysis because it forced commissioners to publicly consider the economic evidence and then provide a reasoned basis for their decision.

Economic analysis can be useful at all stages of the rulemaking process, including the very earliest stage of identifying, clarifying, and framing the economic issues that can possibly be addressed by a regulatory action. Once an issue is identified, economic analysis can be helpful in evaluating alternative regulatory responses and in determining whether these responses improve upon the existing situation or dominate market-based solutions.

Within the regulatory process the role of what I am calling “economic analysis” is often referred to as “cost-benefit analysis” or “regulatory impact analysis.” As my immediate predecessor at the SEC, Chester Spatt, has observed, the meaning applied to these terms is not universally shared among regulators.<sup>2</sup> As Professor Spatt has pointed out, a narrow interpretation would imply that economic analysis is limited to cases where regulatory impacts can be quantified in

---

<sup>1</sup> See *Chamber of Commerce of U.S. v. S.E.C.*, 412 F.3d 133 (D.C. Cir. 2005), and 443 F.3d 890 (D.C. Cir. 2006); *Am. Equity Investment Life Ins. Co. v. S.E.C.*, 572 F.3d 923 (D.C. Cir. 2009), and 2010 WL 2813600 (D.C. Cir. July 12, 2010); and *NetCoalition v. S.E.C.*, 2010 WL 3063632 (D.C. Cir. August 6, 2010).

<sup>2</sup> See Chester S. Spatt, “Economic Analysis and Cost-Benefit Analysis: Substitutes or Complements?” March 15, 2007. Available at <http://www.sec.gov/news/speech/2007/spch031507.htm>.

dollars, such as out-of-pocket compliance costs. Under this interpretation, the analysis would involve toting up and comparing dollar costs and dollar benefits attributable to a proposed rule. However, a broader interpretation, shared by many regulators and judges, goes beyond what is readily quantifiable and includes qualitative factors associated with a proposed rule. Under a broader interpretation, economic analysis can enhance the regulator's understanding of the trade-offs, potential effects and unintended consequences of their actions, including identifying potential changes in behavior by market participants. The value of economic analysis to the regulator derives from its capacity to provide a clear, credible, and coherent framework for articulating the reasoned basis for regulatory action.

For the regulator, failure to adequately consider relevant economic evidence leaves an adopted rule vulnerable to a court challenge on the grounds that the agency's action lacked a reasoned basis. In recent years, the courts have identified weaknesses in the application of economic analysis to SEC regulatory decisions, resulting in rules being sent back to regulators for further consideration. The message from the courts has been that regulators' economic arguments need to be adequately supported—that vigorous assertion is not a substitute for rigorous economic analysis. Because the SEC has begun to take note of this heightened judicial scrutiny, economic analysis has come to be regarded as an important component for bolstering the Commission's arguments and ensuring that adopted rules have a sufficiently reasoned basis so as to be less vulnerable to court challenges under the APA.

## **II. Obstacles Limiting the Effective Application of Economic Analysis to the Rulemaking Process**

Although there currently are no formal requirements for including economic analysis in the rulemaking process at either the SEC or CFTC, there have been attempts to formalize such requirements in the past. These attempts have foundered for a variety of reasons. First, the requirements were not institutionalized, but simply reflected the preferences of individual chairmen. When these chairmen left, the requirements were discontinued or simply forgotten. Second, the commissions were simply overtaken by events. For example, while I was at the SEC, there was a serious attempt to roll out a systematic approach for incorporating economic analysis in the rulemaking process. However, the financial crisis of 2008 diverted the Commission's attention to more urgent matters. Third, in my opinion, the rulemaking divisions of the SEC and CFTC have never fully bought into the idea of applying rigorous economic analysis to the rules they were drafting. In some cases, particularly in cases where good working relationships existed between the economics staff and the staff of the operating divisions, the process worked well. Economists were routinely included at an early stage and their analyses were welcomed and integrated into the process. In other cases, those in the operating divisions who "held the pen" in drafting rules would take a proprietary view and regard the rules as their turf. In these cases, intruders were not welcome until the process was sufficiently far along so that the rule would be recommended to the Commission with only superficial (and last minute) input from the economics staff.

Another obstacle to effectively applying economic analysis to the rulemaking process has been a lack of relevant data. In my view, this problem is related to the fact that economists are often not

consulted in the rulemaking process with sufficient lead time to locate or generate useful data. Without useful data, the power of economic analysis is severely degraded.

Often, the SEC and CFTC have relied on public comments to supply data and analysis. Although public comments can be extremely valuable to providing some types of information, they rarely include the type of data and analysis that can truly inform the process and serve as a substitute for the Commission conducting its own analysis. Often, the most useful information from public comments is that which addresses compliance costs associated with proposed rules. To draw out this type of data, both the SEC and CFTC will often pose specific questions on these topics in proposed rules. As with Commission staff, members of the public also require sufficient lead time to locate useful data and conduct meaningful analysis of proposed rules. The time constraints of the public comment process often limit the ability of the public to provide useful analysis for the record before the comment period expires.

Another problem in obtaining useful data and analysis from the public are constraints imposed under the Paperwork Reduction Act (PRA) that limit the ability of regulators to survey members of the public who may possess useful data and information relevant to a proposed rule. The PRA requires OMB approval of surveys involving more than nine entities. The time required to gain OMB approval of a survey design that would include a larger group of respondents can take nearly as long as the Commission's rulemaking process itself. As a result, the SEC and CFTC rarely use surveys of more than nine people in forming cost estimates for proposed rules. This limitation necessarily reduces the quality of cost estimates. Both the SEC and CFTC will rely on the public comment process to challenge the cost estimates published as part of the proposed rule. A related problem involves the confidentiality of cost data supplied to the regulator to inform the rulemaking process. Businesses in a position to supply useful data and analysis often do not do so because they do not want to publicly disclose information that could deprive them of a competitive advantage.

I will note that the quality of information supplied through the public comment process has improved in response to recent court decisions. I have found that parties affected by proposed rules now regard the notice and comment rulemaking process as if it was part of a legal proceeding. Affected parties are increasingly using the comment process as an opportunity to place on the public record factual information about likely compliance costs and suggested alternative means of meeting the objectives of regulators. Because of the potential for litigation, parties commenting on proposed rules are directing their comments not only to the members of the regulatory commission involved in adopting rules, but also to the judges who may be reviewing the public record for rules that are challenged through the courts. Because the outcome of recent court challenges to federal rules have turned on the adequacy of the economic support considered by regulators when they adopted new rules, parties submitting comments to the public record are paying particular attention to the quality of their economic arguments.

### **III. Suggestions on How Economic Analysis Can Be Better Utilized to Craft Regulations**

In closing, I would like to offer a few suggestions on how economic analysis can be better utilized to help craft cost-effective regulations, help enhance the accountability of regulatory agencies to the public, and help improve the overall transparency of the rulemaking process.

First, economic analysis needs to be included in the rulemaking process at an early stage. It is at the early stages where a rule's "term sheet" is developed by the rulemaking division. The term sheet is a high level overview describing the proposed rule and identifying the market problem the rule is designed to address. I believe it would be useful at this stage to also include a high level economic review of both the rule and the problem. This review would be performed before the term sheet advances outside of the division proposing the rule. This review should include some analysis indicating whether the rule is likely to be a major or minor rule in terms of its economic impact. Determining at early stage whether a rule is likely to be major or minor can help devote sufficient resources to analyzing rules likely to have a major economic impact. An early review would provide lead time for the economics team to assess the complexity of the analysis required and to begin gathering data that could be applied to analyzing the proposed rule.

In the past the SEC has attempted to include economic analysis in an early-stage term-sheet review. However, this type of review was never institutionalized and the process foundered. Institutionalizing such a review, in my view, will likely require a formal policy adopted by each commission to guide the rulemaking process. A formal policy would help provide some consistency to the process. Crafting such a formal policy holds the potential for making an already cumbersome process even more cumbersome. However, without sufficient lead times, regulators cannot effectively use economic analysis to help them identify and frame problems, evaluate alternatives, and have data-driven analyses available to inform their deliberations.

Another way to improve the quality of economic analysis is to improve the data collection process. One way to do this would be to streamline the process by which regulators can survey firms for information about potential compliance costs. Another way to do this is to allow a process where firms could confidentially disclose to the regulator cost information that would be useful in evaluating the potential impact of a rule. Another way to gather data is for the regulator, whenever possible, to run pilot programs that can generate useful data for analysis. In the past, such pilot programs have proven useful to the deliberations of regulators. Finally, those providing public comments on proposed rules can improve the process by paying particular attention to the quality of their economic arguments and by providing data and analysis when appropriate.

Even in a rulemaking process that includes rigorous economic analysis, there will always be considerable uncertainty about a rule's economic impact. Therefore, it may be helpful to have an ongoing post-adoption review of rules to determine the actual economic impact of a rule's implementation.

I believe it would be helpful for financial regulatory agencies to develop a guide for the use of economic analysis in their rulemaking procedures. The Financial Services Authority (FSA) has produced such a guide that could serve as a useful starting point for developing a similar guide

for the United States.<sup>3</sup> I believe that such a guide would be more helpful than current OMB guidance or the guidance offered in current or past executive orders that are difficult to apply directly to financial market regulation. I believe that such guidance can be useful to providing consistency to the process both across the rulemaking agenda and across time. Since the guidance would apply to independent regulatory agencies, each agency would need to independently adopt such guidance in their own internal policies and procedures.

In the end, economic analysis is more than about satisfying procedural requirements for regulatory rulemaking. Improving the power and consistency of economic analysis at regulatory agencies, like the SEC and CFTC, is important because it will enhance the ability of regulators to make informed decisions. An added benefit is that it will also help enhance the overall transparency and accountability of the rulemaking process.

I look forward to your questions.


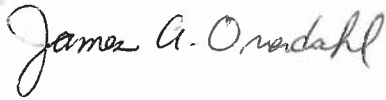
---

<sup>3</sup> See Financial Services Authority Central Policy, “Practical Cost-Benefit Analysis for Financial Regulators” June, 2000, available online at: <http://www.fsa.gov.uk/pubs/foi/cba.pdf>

United States House of Representatives  
Committee on Financial Services

“TRUTH IN TESTIMONY” DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

<b>1. Name:</b>  James A. Overdahl	<b>2. Organization or organizations you are representing:</b>  National Economic Research Associates
<b>3. Business Address and telephone number:</b>  	
<b>4. Have <u>you</u> received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?</b>  <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No	<b>5. Have any of the <u>organizations you are representing</u> received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?</b>  <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
<b>6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.</b>          	
<b>7. Signature:</b>  	

*Please attach a copy of this form to your written testimony.*