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The Efficiency Criterion for Securities Regulation: Investor Welfare or Cost-Benefit Analysis?

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Abstract

Recent regulatory debates have centered on whether independent agencies should be subjected to a more rigorous cost-benefit analysis requirement than their current requirements. For example, the Financial Regulatory Responsibility Act of 2011 sought to prevent financial regulators from proposing rules unless the agency engages in a quantitative and qualitative assessment of all relevant costs and benefits. In addition, the Independent Agency Regulatory Analysis Act of 2012 sought to require independent agencies to comply with requirements applicable to executive agencies, which would include the requirement to conduct cost-benefit analysis that conforms to the Office of Management and Budget’s Circular A-4’s guidance. The purpose of this Article is to closely examine the way in which one particular agency – the Securities and Exchanges Commission (the “SEC”) – conducts its economic analysis in rulemaking. Currently, the SEC, in rulemaking, largely compares benefits that would accrue to investors against out-of-pocket compliance costs by regulated entities. Circular A-4, by contrast, recommends a total surplus approach, whereby benefits and costs are considered from the perspective of all immediately identifiable parties. The current legislative debates therefore raise an urgent policy question for the SEC: whether the agency, in engaging in rulemaking, should consider the costs and benefits of its rules from the perspective of society as a whole, or instead consider the costs and benefits from the perspective of investor welfare only. It should be noted in particular that regulatory measures of investor protection justifiable under Circular A-4’s cost-benefit analysis basis may not necessarily improve investor welfare, and vice versa. What, then, should be the proper criterion by which to evaluate the efficiency of a securities regulation? By examining a handful of SEC’s major rulemakings, I argue
that before there can be any meaningful discussions regarding whether to require the SEC to conduct a more stringent cost-benefit analysis, there must first be a consensus regarding the efficiency criterion of SEC rules. I also suggest certain benefits of having the SEC subscribe to the total surplus approach.
The Efficiency Criterion for Securities Regulation: Investor Welfare or Cost-Benefit Analysis?

Yoon-Ho Alex Lee¹

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ABSTRACT

Recent regulatory debates have centered on whether independent agencies should be subjected to a more rigorous cost-benefit analysis requirement than their current requirements. For example, the Financial Regulatory Responsibility Act of 2011 sought to prevent financial regulators from proposing rules unless the agency engages in a quantitative and qualitative assessment of all relevant costs and benefits. In addition, the Independent Agency Regulatory Analysis Act of 2012 sought to require independent agencies to comply with requirements applicable to executive agencies, which would include the requirement to conduct cost-benefit analysis that conforms to the Office of Management and Budget’s Circular A-4’s guidance. The purpose of this Article is to closely examine the way in which one particular agency—the Securities and Exchange Commission (the “SEC”)—conducts its economic analysis in rulemaking. Currently, the SEC, in rulemaking, largely compares benefits that would accrue to investors against out-of-pocket compliance costs by regulated entities. Circular A-4, by contrast, recommends a total surplus approach, whereby benefits and costs are considered from the perspective of all immediately identifiable parties. The current legislative debates therefore raise an urgent policy question for the SEC: whether the agency, in engaging in rulemaking, should consider the costs and benefits of its rules from the perspective of society as a whole, or instead consider the costs and benefits from the perspective of investor welfare only. It should be noted in particular that regulatory measures of investor protection justifiable under Circular A-4’s cost-benefit analysis basis may not necessarily improve investor welfare, and vice versa. What, then, should be the proper criterion by which to evaluate the efficiency of a securities regulation? By examining a handful of SEC’s major rulemakings, I argue that before there can be any meaningful discussions regarding whether to require the SEC to conduct a more stringent cost-benefit analysis, there must first be a consensus regarding the efficiency criterion of SEC rules. I also suggest certain benefits of having the SEC subscribe to the total surplus approach.

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INTRODUCTION

What is the proper criterion for evaluating the efficiency of a government regulation? In instances where a regulation purports to address a market failure, the dominant framework is the Kaldor-Hicks criterion. According to it, a regulation is “efficient” if its overall economic benefits to society exceed the overall economic costs, even as some market participants may bear costs (on net) and others reap benefits (on net). Because the Kaldor-Hicks criterion is agnostic about distributional issues, some might consider it only as setting forth a minimum standard of desirability for a regulation. In addition, this criterion might be altogether unsuitable in instances where a regulation is intended to achieve some compelling social interests apart from efficiency objectives. But as long as the Kaldor-Hicks criterion remains relevant, the regulator should}

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3 FRIEDRICH NIETZSCHE, ON THE GENEALOGY OF MORALS in BASIC WRITINGS OF NIETZSCHE 5 (MODERN LIBRARY ED., 2000).
engage in some meaningful comparison of benefits and costs of the regulation.\footnote{See Richard A. Posner, \textit{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.”’’); Anthony E. Boardman et al., \textit{COST-BENEFIT ANALYSIS: CONCEPTS AND PRACTICE} 31 (3d ed. 2006).} If a regulatory agency can clearly show that a rule’s economic benefits will exceed its economic costs, then the agency can be said to have established a rebuttable presumption of going forward with the regulation.

Where a regulation is intended to address a market failure, the general idea that a robust cost-benefit analysis--or at least a good faith to conduct it despite uncertainty and complexity--should inform agency rulemaking seems at least plausible. True, one can also argue that for certain types of regulation, the sheer complexity of conducting a cost-benefit analysis would negate any value whatsoever of undertaking it.\footnote{For arguments against mandating cost-benefit analysis for financial regulation, see John C. Coates, IV, “Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications” (January 6, 2014), \textit{available at http://ssrn.com/abstract=2375396.}} Nevertheless, as a threshold matter, there is something unsettling about justifying a government intervention on the basis of an existing market failure (which is causing an economic loss for society) on the one hand, but not considering, at the same time, whether the intervention measure might not cause an even greater loss on net.

This Article focuses on one particular government agency whose economic analyses in rulemaking have been in the spotlight of late: the Securities and Exchange Commission (“SEC”). The SEC is tasked with regulating the federal market for securities. But what is the proper criterion for evaluating the efficiency, or desirability, of a securities regulation? In one sense, I have already answered this question in more general terms. To begin with, one might view securities regulation as a necessary federal intervention to correct failures in the market for capital.\footnote{See, e.g., Stephen J. Choi & A.C. Pritchard, \textit{SEcurities Regulation: CASES AND ANALYSIS} 26-30 (3d ed. 2012).} These include asymmetric information, adverse selection, moral hazard, agency problems, collective action problems, and others. Under this latter view, unless there is good reason to believe securities regulation is in a class of its own, the same Kaldor-Hicks criterion should apply to evaluate the overall desirability of a securities regulation. There is thus an argument that the SEC should seek to justify its rules on the basis of cost-benefit analysis--that its rules’ overall benefits would exceed the overall costs.\footnote{Note, however, that this does not necessarily imply that such cost-benefit analyses should be subject to judicial review. Some would argue, forcefully, that “[l]itigation is a terrible way to do economic analysis.” Bruce Kraus & Connor Raso, \textit{Rational Boundaries for SEC Cost-Benefit Analysis}, 30 Yale J. on Reg. 289, 341 (2013).} Currently, however, the SEC is not subject to any explicit statutory requirement to consider costs and benefits of its regulation. Nor, as an independent agency, is it (yet) subject to the various Executive Orders requiring \textit{executive} agencies to conduct cost-benefit analysis and
submit them for approval to the White House Office of Management and Budget ("OMB").

Therefore, the SEC’s economic analyses of its rules need not, and indeed do not, conform to the guidance provided by the OMB under Circular A-4. The SEC instead conducts economic analyses pursuant to a somewhat ambiguous statutory mandate requiring it to “consider” the effect of its actions on “efficiency, competition, and capital formation.” Although the SEC does purport to consider “costs” and “benefits” of its rules, as I explain in this Article, the SEC’s framework takes a rather narrow--and at times ad hoc--perspective of costs and benefits: the comparison is largely between benefits that would accrue to investors and compliance costs to be incurred by regulated entities. While a permissible manner of complying with the statutory mandate (more on this later), the SEC’s framework cannot be considered as analyzing the regulation’s overall benefits and overall costs to society. Hence, the framework cannot be considered as being consistent with Circular A-4’s framework, or as evaluating the regulation under the usual Kaldor-Hicks criterion.

Should the SEC be encouraged to conduct its economic analysis under the Kaldor-Hicks criterion? Or should it instead be encouraged to continue on with its current framework but simply do a better job at it (such as exerting a greater effort to quantify the effects of the rules)? Importantly, under which framework, should the agency be permitted to consider its rule “justified under the cost-benefit analysis” and hence “efficient”? The obvious underlying premise behind these inquiries is that a rule’s “efficiency” under the cost-benefit analysis should have some probative--though not necessarily determinative--value in policymaking.

This Article seeks to address these questions. My first point is to raise a Chestertonian critique of the debate: that various arguments put forward to impose additional burdens of cost-benefit analysis on securities regulation cannot be meaningful unless parties can first agree upon the suitable efficiency criterion for securities regulation. Otherwise, two parties may argue about a rule’s efficiency on completely different terms, and calls to have the SEC justify its rules on a cost-benefit basis may mean different things to different people. Indeed, if parties cannot agree on the criterion of efficiency for securities regulation, much (though admittedly not all) of the discussions regarding progress in securities regulation can quickly become non-sensical. This is especially troublesome given that politicians and legislators often rely on the rhetoric of cost-benefit analysis merely as a strategic political tool. It seems therefore that musing over the criterion of efficiency cannot be an entirely futile exercise. Of this point, I am confident. In addition, although I limit my analysis to the SEC’s rules, one can easily imagine similar policy debates for other regulatory agencies tasked with protecting certain constituents (e.g., consumers, borrowers, depositors).

My second point is that despite the SEC’s long history of employing the investor welfare framework, there is a case for the SEC to consider costs and benefits under the Kaldor-Hicks criterion--much like Circular A-4’s approach. Of my second point, however, I am far more tentative. I acknowledge that there are clear advantages to the SEC’s framework and the SEC

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10 Section 3(f) of the Exchange Act and Section 2(c) of the Investment Company Act of 1940, codified at 15 U.S.C. §§ 78c(f) and 80a-2(c).
may have institutional reasons for employing it. Nevertheless, I argue that there are legitimate reasons to prefer Circular A-4’s framework.

The rest of the Article is organized as follows. Part I formalizes the inquiry by considering the relevant statutory provisions and placing it in the context of recent legislative developments. I also distinguish the inquiry from other tangentially related policy questions, which often distract the audience away from the main inquiry. Part II contrasts the approaches of economic analysis taken by Circular A-4 and by the SEC. The SEC’s approach, which largely compares the benefits to investors against regulatory compliance costs, is best understood roughly as the “investor welfare” approach (though not without certain important caveats). Circular A-4’s approach, which I call the “total surplus” approach, is more consistent with the conventional partial equilibrium analysis under applied microeconomic theory. At the risk of oversimplifying, I will henceforth be considering as equivalent Circular A-4’s approach, the total surplus approach, “cost-benefit analysis,” and the Kaldor-Hick criterion. Part III qualitatively examines a handful of specific SEC rules, most of them controversial regulations. I discuss how the balancing of benefits and costs would significantly differ under the two approaches. It is not necessary, for my purposes, to develop more detailed economic analyses of these rules than the ones provided by the SEC itself. The SEC’s economic analyses often fail to quantify costs and benefits because the agency seldom has access to data to ascertain the effect of its rules. Indeed, most of the agency’s economic analyses in rulemaking remain largely conceptual, more than anything else. The aim of my exercise is to highlight the tensions that would arise in case the agency had to adopt Circular A-4’s approach but not necessarily with any greater access to data or resources. My first point will be established as long as there is a colorable claim that, for a number of SEC rules, the choice of the perspective taken in conducting the cost-benefit analysis can lead to different efficiency determinations. In Part IV, I advance several policy arguments to prefer the total surplus approach. Part V concludes.

I. STATUTORY CONSIDERATIONS AND POLICY QUESTIONS

When the federal securities laws were first enacted in 1933 and 1934, there were no statutory provisions requiring the SEC to conduct economic analyses before adopting rules. Congress has since amended the laws twice to mandate economic analysis in rulemaking. In 1975, Congress added Section 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.”11 The main provision, however, did not come until 1996 when Congress amended the federal securities laws to require the SEC to consider “whether the action will promote efficiency, competition, and capital formation” (hereinafter, “ECCF”) in addition to “the protection of investors,” whenever the relevant statute provides that the Commission is “required to consider or determine whether an action is necessary or appropriate in the public interest.”12

The ECCF directive, however, is ambiguous at best. For instance, none of the organic statutes define the term “efficiency.” Neither the SEC nor the courts have ever interpreted this

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term. In economic jargons, “efficiency” can have multiple meanings. Still more plausibly, the term might also refer to the efficiency of the stock market. However, there are reasons to believe Congress intended something like a cost-benefit analysis under its ECCF directive. At the time of the amendment, the SEC noted that the ECCF requirement “largely codifies an existing practice of the agency.” Likely, the SEC was referring to the fact that the agency had, by then, already been routinely including discussions of “costs” and “benefits” in final rule releases. The legislative history of the 1996 amendments also supports 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 cost and benefits.” Legal scholars have also consistently interpreted the ECCF directive as requiring some type of analysis of costs and benefits.

With all that said, for much of the SEC’s history, the SEC’s economic analyses in rulemaking flew under the radar for the most part. Unlike agencies such as the Environmental Protection Agency or the Occupational Safety and Health Administration, the SEC has managed to escape much of the public scrutiny as regards its economic analyses. All this changed, however, by 2011. Beginning in 2005, the SEC lost a series of court challenges--on rules of varying levels of significance--and in 2011 came the most serious blow. The SEC’s proxy access rule, a controversial rule supplemented by the agency’s most heavily invested economic analysis to date, was vacated by the D.C. Circuit in Business Roundtable v. SEC on the ground that its ECCF analysis was “arbitrary and capricious.” Ever since the SEC’s embarrassing loss in Business Roundtable in 2011, there have been greater calls for the SEC to conduct more robust cost-benefit analyses. Critics of the SEC likely feel vindicated in their position that the SEC, under the loose and ambiguous ECCF mandate, has never undertaken a serious effort to

16 Id. at 39. 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 of 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.

18 See generally Am. Equity Inv. Life Ins. Co. v. SEC, 613 F.3d 166 (D.C. Cir. 2010); Chamber of Commerce v. SEC (Chamber II), 443 F.3d 890 (D.C. Cir. 2006); Chamber of Commerce v. SEC (Chamber I), 412 F.3d 133 (D.C. Cir. 2005).
consider the costs and benefits of its rules as many executive agencies have been doing for decades.

Members on the Hill wasted little time to respond to Business Roundtable. Two independent legislative efforts--neither of them yet successful nor completely dead--sought to impose a more stringent cost-benefit analysis requirement on the part of the SEC (along with other independent agencies). First, the Financial Regulatory Responsibility Act of 2011 sought to require enhanced economic analysis and justification of regulations proposed by federal banking, housing, securities, and commodity regulators. The bill would have prevented each agency from proposing rules unless the agency engages in a serious quantitative and qualitative assessment of all relevant benefits and costs (and a special justification in case the quantified benefits do not outweigh the quantified costs). Second, the Independent Agency Regulatory Analysis Act of 2012 sought to affirm the authority of the President to require independent regulatory agencies to comply with regulatory agency requirements applicable to executive agencies, which would include the requirement to conduct cost-benefit analysis that conforms to Circular A-4’s guidance. Former administrators of the Office of Information and Regulatory Affair—the Office within the OMB in charge of overseeing executive agencies’ cost-benefit analyses--supported the Act on the ground it would enhance accountability and analytical rigor in the rulemaking process.

As of this writing, the future of the SEC’s economic analysis requirement in rulemakings remains uncertain. The SEC may indeed be compelled to conduct a quantitative cost-benefit analysis similar to those currently conducted by executive agencies. Whether subjecting the SEC’s rules to OMB oversight will in fact be beneficial or not is not clear. There are policy considerations as well as institutional considerations. At a minimum, however, one point need be highlighted before this debate can proceed any further: there is no reason to believe that regulatory measures of investor protection justified or justifiable on a cost-benefit basis will necessarily increase, much less maximize, investor welfare. This point follows from the simple fact that what is net beneficial to society on the whole is not necessarily net beneficial to individuals in society qua investors—that is, in their capacity only as investors—and vice versa.

This is more than just a theoretical nicety. As I illustrate in this Article, many of the SEC’s rules involve significant transfers between investors and other stakeholders, including managers, gatekeepers, vendors, employees, consumers, and others. Under the total surplus approach, transfers are offsets of costs and benefits among different market participants, which do not increase or decrease the total surplus of the economy taken as a whole. Transfers are in fact ubiquitous and inevitable because of the uniquely complex structure of the market for securities. It is indeed difficult to imagine a major SEC rule that would not entail significant transfers. The current legislative debates therefore trigger an important policy question to consider:

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21 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.
23 See id.
Policy Question I: In the absence of further statutory specification, should the SEC consider a rule efficient if the rule’s benefits outweigh its costs from the perspective of society as a whole (i.e., if it increases the total surplus on net), or if the rule’s benefits outweigh its costs from the perspective of investors at large (i.e., if it increases investor welfare on net)?

To the best of my knowledge, this question has not been raised by anyone. To be clear, Congress has the authority to specify the desired economic analysis requirement for administrative agencies. Administrative agencies are after all “creatures of statutes.” There are indeed cases where an agency’s organic statute specifies the constituents whose interests are to be considered in the agency’s economic analysis. In such cases, courts might even rule that it would be “arbitrary and capricious” for the agency’s consider any other costs or benefits. This is not the case presently with the SEC, however. No further direction is provided by the relevant statutes other than the ECCF mandate. At the same time, when proponents of cost-benefit analysis demand more stringent requirements, I am quite sure that they do not mean that the SEC should take whichever ad hoc perspective it deems most advantageous to get its rules out each time.

Policy Question I is related to, but is not identical to, another important question:

Policy Question II: In the absence of statutory specification, should securities regulation generally seek to maximize the total surplus (by means of regulating transactions of securities), or should it instead seek to maximize investor welfare?

Although legal scholars have debated over the purpose of securities regulation, I am also not aware of anyone who has raised the question in this particular manner. It is important to not conflate Policy Question I with Policy Question II. They are not quite identical because the

25 Technically, the answer need not be binary. It is possible for the agency to choose different perspectives for different rules. In this case, however, unless the agency has a clear mechanism dictating the choice of perspective for each rule, there is a danger that the agency will simply choose in a somewhat arbitrary manner whichever framework that helps its rule adoption.

26 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 Act section 1022(b)(2)(A).

27 See Motor Vehicle Manufacturers’ Association v. State Farm, 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. American Trucking, 121 S.Ct. 903 (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).

28 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 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). Professor Donald Langevoort specifically raises a question regarding the role of corporate disclosure regulation as to stakeholders interests. However, he raises the question in a much narrower fashion than I do here: as to what type of mandatory disclosure duty should attach to firms that go to stakeholder values. See Donald C. Langevoort, Commentary: Stakeholder Values, Disclosure, and Materiality, 48 CATH. U. L. REV. 93 (1998). This question is distinct from Policy Question II in that Policy Question II may remain germane even if we were to restrict the scope of disclosure regulation to those seeking to protect shareholders’ interest only.
first goes to the criterion for efficient regulation, while the second goes to the aim or objective of regulation (or what an economist would call an “objective function”). As such, hybrid responses are technically possible: one may reasonably believe that the purpose of securities regulation is to maximize investor welfare subject to the condition that the total surplus not decrease; alternatively, though much less likely, one may argue its purpose is to maximize the total surplus subject to making sure investors do not come out any worse off. In other words, a response to one policy question does not necessitate a particular response to the other.

Policy Question II is, of course, reminiscent of two other policy debates that are in fact perennially raised and about which much is written: first, whether corporate law should seek to maximize shareholder welfare or total stakeholder welfare; and second, whether antitrust law should seek to maximize total surplus or consumer surplus. As far as I can tell, however, these two age-old debates, however resolved either may be, do not offer much in the way of answering Policy Question II, much less Policy Question I.

Take the corporate law debate, for instance. The question is most often couched in terms of what kind of duty should be imposed upon corporate directors—whether they should owe due to shareholders only or to all stakeholders. But what the federal government should seek to maximize through regulation of securities transactions is a entirely different question from what corporate directors should be expected to accomplish through their individual management and operational decisions. Each state’s corporate law can have its own answer, but the regulation of the market for capital would be a layer within the purview of the federal government.

Consider now the antitrust law debate. Both antitrust law and securities regulation deal with statute-based federal laws. There is, however, an important distinction between antitrust law and securities regulation that should not be disregarded. Antitrust laws are intended to apply broadly to product markets for all industries. As such, the antitrust law debate, as generally framed, cannot take into consideration variations exhibited across various product markets. Securities regulation, by contrast, is intended to apply to largely one market: the market for capital. Although there are a large number of issuers, the market as a whole exhibits far more unity than the set of all product markets. As such, the structure of the general capital market can and should play a much more central role in responding to Policy Question II. The antitrust law debate is still less relevant when it comes to Policy Question I: neither the Justice Department nor the Federal Trade Commission has any statutory requirement to conduct a cost–benefit analysis (or something like it) in enforcing antitrust laws. For these and other reasons, I believe Policy Questions I and II deserve fresh considerations.

There is always the simple and familiar rhetoric that the primary purpose of securities regulation is to protect investors. For my part, however, I do not find this saying particularly helpful in answering either Policy Question. It is hardly a statement of economic precision.

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29 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 Adolf A. Berle, Corporate Powers as Powers in Trust, 44 HARV. L. REV. 1049 (1931); E. Merrick Dodd, 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 SO. CAL. L. REV. 1189 (2002).

Investor protection is not 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. Critically, this simple rhetoric makes provides no indication as to whether investor protection is an ends in and of itself or a means for promoting a greater ends (e.g., the total surplus). Certain measures of investor protection may indeed be necessary for enhancing the total surplus; and thus, undertaking such measures is consistent with either the investor welfare framework or the total surplus framework. Prevention of fraud, for example, protects investors but can also increase the total surplus by reducing transaction costs in the market for capital. Meanwhile, certain other measures may seek to benefit investors at the expense of other stakeholders. Undertaking these measures could thus mean a reduction of the total surplus, while increasing the economic welfare of investors. Still other measures may take on a narrow notion of investor protection as a means to address social problems, rather than enhancing economic welfare. These include mandated disclosure of information which only a particular subgroup of investors may care about (investors qua social activists). 31 Much like words “gentleman”32 or “liberalism”33 of the old, the term “investor protection” has lost much of its original meaning (if there ever was one). It thus seems a stretch to try to answer either Policy Questions I or II by appealing to such an amorphous and ambiguous concept. For the remainder of this Article, my exclusive focus is on Policy Question I, not Policy Question II. Policy Question I, however, will be of little important if there is little difference, either in theory or in application, between the investor welfare approach and the total surplus approach. Therefore, I will begin by comparing these two approaches.

II. COST-BENEFIT ANALYSIS: PERSPECTIVES MATTER

It is often very difficult to capture the aggregate economic effect of a government action in a given economy with just two categorical concepts, benefits and costs. Uncertainties aside, there are usually too many moving parts in the equation. But this is precisely what a cost-benefit analysis seeks to do. It seeks to compare, often quantitatively, two different states of the economy: the status quo and the post-implementation equilibrium. It is a daunting task. In fact, some believe, in the context of financial regulation, quantifying true costs and benefits is either not meaningful or just altogether impossible. 34 I am myself sympathetic to this view. 35 The point I am raising in this Article, however, remains somewhat orthogonal, if somewhat prior, to the ability of a regulator to accurately predict and assess the economic effects. In other words, the unresolved debate over whether a cost-benefit analysis can be meaningfully conducted in the context of financial regulation does not quite address what kinds of benefits and costs such a cost-benefit analysis should entail. For this reason, I will assume for the purpose of this Article

32 See, e.g., C.S. LEWIS, MERE CHRISTIANITY xiii (HarperOne 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).
35 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).
that some consideration of costs and benefits--as via quantification or some other manner of comparison--is theoretically possible for SEC regulations.

Here is the first thing about cost-benefit analysis: in practice, all cost-benefit analyses used in policymaking are perspectivistic. Nietzsche’s perspectivism takes on a life of its own in the realm of cost-benefit analysis. Each cost-benefit analysis takes on a certain perspective in identifying costs and benefits to the economy and compare only those costs and benefits. Factors lying outside the chosen perspective are ignored. Some perspectives are more inclusive than others, but I know of none that are holistic.

There are at least three reasons why it is difficult to take a complete, holistic view of the economy. First, the government never has enough data to characterize the effect of its action across all industries. Second, even if it had sufficient data, a holistic analysis would require predicting the equilibrium under the new conditions, which would entail solving an applied general equilibrium model. But to date, all attempts to solve applied general equilibrium theory models on a general level have failed. Third, even if one could solve for the new equilibrium, there is currently not a well-defined metric to compare the welfare of the two economies. For these reasons, in most cases, a cost-benefit analysis employs a partial equilibrium perspective, which is by definition perspectivistic. This means, for instance, that the analysis ignores intersectoral transfers of resources and secondary price effects.

This Part compares and contrasts the two approaches to identifying costs and benefits: the SEC’s investor welfare approach and Circular A-4’s total surplus approach. The most important difference between the two is their way of accounting for transfers among various market participants. My point, for the time being, is not that one approach is superior to the other, only that they are different. This, of course, means that a policy may be justified as efficient under one criterion but not under the other. In short, the two frameworks can lead to different conclusions regarding the “efficiency” of a given securities regulation.

A. SEC’s ECCF Analysis: The Investor Welfare Approach

When the SEC analyzes costs and benefits, the agency’s typical approach is to consider the benefits that would accrue to investors of the regulation and consider whether these benefits justify the out-of-pocket compliance costs the regulation imposes on the regulated entities. But there are significant caveats to this characterization. First, it need be recognized that, historically, the SEC’s approach has not been entirely consistent. The inconsistency was due to the fact that cost-benefit analyses were mainly drafted by staff attorneys rather than economists, and the agency had never issued a guidance document to advise its staff in conducting economic analyses. Finally, in 2012, after the SEC lost Business Roundtable, it issued its first-ever guidance document. Second, although the 2012 guidance document does purport to streamline

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38 See id.
the agency’s economic analyses and to provide guidance much like Circular A-4, in regard to which benefits and costs to consider, it is written in highly ambiguous terms. “Benefits” are described simply in terms of correcting market failures. 40 And while document appear to leave room for consideration of “transfers,” the discussion is essentially buried in one footnote,41 and does not otherwise elaborate upon how to account for such transfers or instances in which transfers are likely. There is nothing particular in the new guidance document that is dramatically inconsistent with the total surplus approach; but neither does it openly embrace the total surplus approach. All in all, it remains to be seen how substantially the guidance changes or redefines the typical way in which the SEC approaches cost-benefit analysis 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.42 Therefore, my discussion of the SEC’s economic analysis relates to the approach that was taken prior to issuance of the guidance document and the approach that will likely persist for the time being.

That said, the SEC’s typical approach of comparing benefits accruing to investors against compliance costs is is at first blush eminently sensible. The SEC, as an advocate for investors, is taking measures to benefit the investors while being mindful of what it might cost to provide such benefits. If the regulated entities are issuers, this approach lives up to the label of “investor welfare approach.” Compliance costs are initially borne by the firm. But because investors, so to speak, “own” the firm, especially in cases where they are residual claimants (e.g., holders of common equity), compliance costs would eventually pass through to investors in many cases.43 Therefore, all benefits and costs can be seen as ultimately accruing to the investors, without any double counting.

In this case, one might say costs and benefits are being calculated from the perspective of the “representative investor.” A representative investor is an investor who own shares of a firm, who has a long-term interest in the economic well-being of the firm, and who has no economic interest in any other capacity (e.g., employee/consumer) except as an investor of that firm. Because the economic welfare of the representative investor is closely tied to the market value of the firm, empirical analysis of a regulation often examines changes following the regulation of affected firms’ stock prices. If the SEC cared only about investor welfare (more precisely, the economic welfare of all citizens but only in their capacity as investors) and nothing else, this approach would make sense.

How might this approach work in practice? Take a common mode of regulation by the SEC: mandated information disclosure. In its cost-benefit analysis, the SEC would begin by considering as benefits of regulation the benefits flowing to the investors of having this type of information available. These are usually in some vague terms as transparency, price efficiency, better informed investment decisions, and more effective governance benefits. The SEC would then provide estimates of compliance costs, as submitted by various issuers. If a previous event provides a useful analogy, the SEC may also rely on published studies documenting the effects

40 See id. at 8-9.
41 See id. at n.32.
43 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. This idea is illustrated more concretely in Section II.D when we consider how consumers may end up bearing some of the compliance costs as pass-ons.
of relevant events. The SEC, however, very rarely considers private benefits or costs flowing to managers, gatekeepers, vendors, employees, consumers, or other stakeholders. Therefore, to the extent that benefits to investors may not be social benefits and private compliance costs may not be social costs, the SEC’s analysis would diverge from the consideration of costs and benefits from the perspective of society on the whole.

One advantage of the investor welfare approach is that stock prices (hence, firm values) are easily observable. Therefore, to the extent the stock market is fundamentally efficient, analyzing the firm value potentially allows for a quantifiable ex ante approach. This can be done by measuring stock market reactions to announcements regarding regulation.

Meanwhile, if regulated entities are not issuers but other market participants, such as broker-dealers or investment advisors, the story becomes a bit 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 non-issuer entities can pass on the compliance costs back to investors. If the market for such regulated entities’ services is perfectly competitive, then these entities would have been making zero economic profits prior to compliance. Therefore, all additional compliance costs would have to be passed on to others; otherwise, the industry cannot continue to exist at a negative economic profit. In many cases, compliance costs can pass on right back to investors as residual claimants, and the analysis would again amount to the investor welfare perspective. If these compliance costs are passed on to some others, investors come out even better off at the expense of others. On the other hand, if the market for such services is characterized by market power, then these participants would have been earning rent for their services. In such cases, likely, some of the compliance costs will be borne by these non-issuers and some of them will be passed on to investors (or still others). Standard applied microeconomic theory informs us that the extent to which these compliance costs will be eventually passed on will depend on the relevant price demand elasticities. At any rate, here again, if not all costs are passed onto investors, then investors would come out even better off. Therefore, if the SEC’s framework (of comparing benefits accruing to investors against compliance costs incurred by regulated entities) leads to a positive net benefit, then one might say this is sufficient to ensure that investor welfare would come out net positive.

There are several downsides to the SEC’s approach, however. First, the concept of representative investor appears 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. Second, this mode of analysis ignores the economic effects to all other parties in the economy. For example, this approach might treat as economically equivalent the following two states of the world: In State A, the regulation would

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45 I say “potentially” because the SEC never considered the stock market reaction study prior to adopting its regulation. But where either Congress or the SEC has made a significant announcement relating to the rule prior to adoption, a “likely” firm value cost-benefit analysis can be undertaken in theory prior to rule adoption. Given that the SEC and other financial regulatory agencies have been criticized for not quantifying benefits, the stock market approach might indeed provide the most immediately available tool for quantifying certain effects of regulation.

46 An example of such a rule is the registration of municipal advisors, discussed infra in Section III.D.

47 Although the fact that there may not be any representative investor in practice does not wholly 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.
increase firm values by 1% and have virtually no effect all other parties; in State B, the
regulation would increase firm values by 1% but would use up $2 million of government
revenues in enforcement, reduce each manager’s salary by $50,000, and reduce the rent collected
by monopoly service providers by half. Third and relatedly, this mode of analysis is somewhat
ad hoc in its choice of investors whose welfare is to be considered. Shareholders of brokerage
companies, or listing companies, or proxy service companies are all just as much “investors” as
those individuals purchasing shares through such brokerage or listing services or shareholders
making use of such proxy services. Yet, the SEC’s analysis would normally consider only the
economic welfare of the investors in their capacity as consumers of these services. Whether
such a distinction is warranted is, of course, not obvious.

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

Circular A-4’s cost-benefit analysis is best understood as a partial equilibrium, total
surplus approach (the “total surplus” analysis). The framework takes into consideration costs,
benefits, and transfers among immediately relevant sectors of the economy. At a minimum, the
language of Circular A-4 is far more consistent with conventional applied microeconomics
which relies on money metric to measure surpluses. Under its approach, given a regulation, the
agency is to consider, to the extent feasible and permitted under the law, costs and benefits
accruing to all parties immediately identifiable—rather than those accruing only to a specified
group of constituents.

For example, in its Introduction, the Circular states that “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).” Circular A-
4’s framework for understanding costs and benefits thus remains neutral with respect to
distributional issues. Although the Circular does advise each agency to consider the effect on
distributions, such considerations are not directly incorporated into the analysis of costs and
benefits, which focuses on the total surplus.

In a section entitled “Other Benefits and Cost Considerations,” the Circular 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.

This is a fairly comprehensive list of costs and benefits. Three things should be noted. First, the
fact that the Circular directs each agency to consider “private-sector compliance costs and
savings” should not be interpreted to mean that the Circular would consider those as necessarily
social costs or savings. Even when there is a divergence between social costs and private-sector
compliance costs (“private compliance costs”), there are always good reasons to consider private
compliance costs in an analysis that seeks to capture the total surplus. This is because firms’

49 See id.
50 See id.
private compliance costs can affect the behavior of the firms, including exiting the market and rendering the industry more concentrated. Second, the framework appears to put consumers’ surplus and producers’ surplus on the same footing. Therefore, a loss in consumers’ surplus would not be considered a social loss if it is compensated by the same or greater increase producers’ surplus. This is to be contrasted with, for example, the consumer-surplus focused position taken by the Federal Trade Commission and the Justice Department in antitrust merger reviews. Third, the framework even suggests taking the government’s administrative costs and savings into consideration. This, too, is a stark contrast from the SEC’s approach, which has for long largely ignored the costs and benefits accruing to the SEC of its rules.51

Elsewhere, Circular A-4 is even more explicit in its commitment to consider the total surplus. It goes on to distinguish specifically between “costs” and “transfer payments.” In its relevant part, the document reads:52

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.

Therefore, Circular A-4 specifically acknowledges monopoly profits and scarcity rents as transfers, rather than costs of a regulation. The consideration of costs and benefits will thus need to acknowledge such transfers as not affecting total resources available to society. Arguably, the total surplus approach takes a more comprehensive view of the economy than the investor welfare approach. This is not to say the total surplus approach provides a holistic view of the economy, however. In the next Section, I provide a simple example to illustrate both (i) how the two frameworks would come out differently in theory, and (ii) how each one comes short of capturing a holistic view of the economy.

C. A Simple Illustration

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Consider a 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. Suppose the SEC were to devise a rule that seeks to make the industry fully competitive at cost $K$. For simplicity, I do not discuss the source of $K$.

In 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 and $F$ is the monopoly price and $BCD$ is the familiar measure of deadweight loss.

In this example, investors are the consumers of monopoly services. A government regulation that seeks to render this industry perfectly competitive would shift the equilibrium from $(G, F)$ to $(H, E)$. Investors certainly gain by going from the welfare of $ABF$ to $ACE$. Under the investor welfare approach, the regulation would be efficient as the area of $FBCE$, the overall increase in investors’ welfare, is greater than the compliance cost $K$. The total surplus approach, however, would account for the loss of monopoly profit, $FBDE$. Therefore, under the latter 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 $K$ happen 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 is not complete for the following reason. When the equilibrium shifts from $(G, F)$ to $(H, E)$, at least three other things are happening. First, in order to increase the output level from $G$ to $H$, society ultimately needs to expend a greater amount of capital and labor. These factor inputs need to come from another industry, which would then experience a contraction of the supply curve. This will in turn affect the consumer surplus of that other industry. Second, when the price level drops from $F$ to $E$, this frees up more money for investors to spend. In other words, investors who were previously paying $F$ -- investors who are on the $AB$ segment of the demand curve -- now find themselves with an additional amount of money ($F - E$), and they will now spend this money elsewhere. Hence, in some other industry, there may be an expansion of the demand curve. Finally, those investors who previously could not afford the service -- investors who are on 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 spending -- most likely, some inferior substitutes they were purchasing. Therefore, the demand curve of that substitute industry will be contracted. There is no reason to believe these effects are of secondary order, and yet all three effects are completely ignored in a partial framework analysis. To solve for the new equilibrium requires solving multiple systems of equations simultaneously. But there is no guarantee from a theoretical perspective\(^{53}\) that a suitable solution is solvable, or is unique, or is stable -- that is, even as our

\(^{53}\) See generally Frank Ackerman, “Still Dead After All These Years: Interpreting the Failure of General
The economy might in reality find ways to stabilize to a unique solution.

The fact that even the total surplus approach is incomplete and that the only possible way to account for all costs and benefits would rely on a discipline of economics that has essentially died highlights the overall fragility of any cost-benefit analysis. That said, if any discrepancy or inconsistency among these different approaches were only marginal and purely theoretical, there would be no reason to quibble over these difference. The real question is whether in practice one would actually reach different efficiency conclusions. In the next Part, I argue that there is reason to believe this is indeed the case.

III. SEC RULES, STAKEHOLDER INTERESTS, AND COST-BENEFIT ANALYSIS

In this Part, I re-examine some major SEC rules under the two different approaches. As mentioned, the main difference lies in the accounting of transfers. There are at least five types of transfers that can be expected to arise under SEC rules: (i) direct transfers, (ii) transfers resulting from market power, (iii) transfers resulting from bargaining power, and (iv) transfers resulting from demand elasticity.

A. Managers

An important function of securities regulation is to reduce agency problems between managers and investors. For now, I limit my discussion to the potential problem of managerial expropriations. Managerial expropriations, if they exist, are in a sense direct transfers of wealth from investors to managers. Justifying the reduction of managerial expropriation under the investor welfare approach would be relatively easy. Such a rule would undoubtedly “protect” investor welfare. The SEC simply needs to ensure that the compliance cost with regulation does not exceed the amount of expropriation (minus any deadweight loss that may arise in complying with the rule).

But what would happen if one were to demand a justification under the total surplus approach? The cost-benefit analysis would consider not only investor welfare but also managerial surplus. This is not to say managerial expropriation can be justified on any ethical basis or even that it is consistent with managers’ fiduciary duty. Neither is the case. But doctrinal or ethical concerns do not inform a total surplus analysis. An economist tasked with conducting a cost-benefit analysis is not being asked to act as a judge or a moral philosopher. Rather, he finds himself in an awkward position much like that of Nobel laureate Gary Becker, who once confessed that it was difficult to see the social harm of theft because thieves merely facilitated wealth-preserving transfers. He later concluded, however, that although theft by


54 Another type of agency problem would be managerial shirking, referring to instances where managers, despite their fiduciary duty, may slack off and not exert their best efforts to improve the welfare of shareholders.

55 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 pointing out 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.
itself may only facilitate a transfer, criminals must ultimately spend time and resources to facilitate such transfer, and thus will end up expending society’s resources. Although Becker did not explicitly mention, it is equally wasteful for society that rightful owners of property must spend time and resources to protect their property from theft.

Becker’s initial insight of theft as a mere transfer applies to managerial expropriation, but his argument regarding private measures taken to facilitate theft (or private measures taken to protect one’s own property from theft) is somewhat less apposite in the context of managerial expropriation. To understand the social harm from the perspective of wasted resources, one must ask whether, in the absence of regulation prohibiting managerial expropriations, managers would try to spend a great deal of resources to facilitate such transfers and investors would try to spend a great deal of resources to ensure these transfers would not happen. This is unlikely the case for two reasons: first, investors’ cost of monitoring and controlling managers may be prohibitive as it is; and second, in the absence of transparency, managers’ cost of facilitating such a transfer may be essentially zero. If these costs are small, then on what grounds might one say a regulatory measure to reduce managerial expropriation is “efficient”?

Consider, for example, the SEC’s executive compensation disclosure regulation. In 1992, the SEC adopted new executive compensation disclosure rules in response to complaints that corporate executive compensations had become “excessive,” and in the hope that the new rules would make executives more accountable to shareholders. The unanticipated ex post outcome of executive compensation disclosure regulation is now well-known. Rather than a decline in salaries, the disclosure correlated with an upward spiral in compensation as compensation consultants have pushed boards to hire above average executives at above average salaries. Whether the current market for executives is efficient and competitive is a subject of much debate. One could argue that the greater transparency has brought about a more efficient market for executive labor, and that the increased compensation level more properly reflects the value added of the executive’s effort.

For the purpose of this Article, however, what actually happened with executive compensation ex post matters far less than the underlying ex ante justification for regulating compensation disclosure from the outset (however faulty it may have been). Because my focus is largely limited to the ex ante perspective of cost-benefit analysis as a basis for justifying regulation, the relevant inquiry is instead the following: if the SEC, prior to initiating executive

58 See id.
59 At least one heavily cited study has shown that the level of executive compensation depends almost entirely on the size of the firm—a finding that may be consistent with the hypothesis that executives are getting paid for the value they bring to their firms. See Xavier Gabaix & Augustin Landier, Why Has CEO Pay Increased So Much?, 123 Q.J. ECON. 49 (2008); see also http://www.yourarticlelibrary.com/business/7-important-theories-that-can-explain-executive-compensation/2595/.
60 In the final example when I consider the municipal advisor registration rule, however, my focus shifts to ex post evaluations. See infra Section III.D.

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http://law.bepress.com/usclwps-lewps/174
compensation disclosure regulation and without the benefit of hindsight that it now has, had to justify the disclosure on a cost-benefit basis under the total surplus approach, what would it have looked like?

Given that as of 1992, the SEC was largely responding to the public perception that executive compensations levels were “excessive,” the SEC almost certainly did not expect an across-the-board rise in executive compensation. Likely, the SEC, as well as the general public, thought the market for executives would function just as well with an overall reduction in executive pays. Viewed from this ex ante perspective, however, executive compensation regulation would have been intended primarily to effect a transfer (or perhaps, a reverse transfer) from managers to investors, rather than to increase the total surplus.

Consider the following example. Suppose Company A’s executive, Edward, was previously receiving $10 million a year in the form of salary and stock options. Suppose that the SEC (and perhaps the general public) believes Edward would perform his job equally well even if he were paid only $8 million. If the executive compensation disclosure were intended to reduce this pay by $2 million, this difference would be either paid to shareholders in the form of dividends, or further invested in Company A’s operations. If shareholders were to receive as dividends, that is simply a difference between $2 million in Edward’s pocket or $2 million in shareholders’ pockets. No social surplus is generated from the transfer (likely) intended by the rule, although some may be lost due to compliance effort.

A possible efficiency argument might be that if $2 million were to be further invested in Company A’s operation rather than paid out to investors, it could potentially produce a greater return than $2 million. On the other hand, the extra $2 million in Edward’s pocket likely be invested somewhere as well--perhaps other companies or mutual funds--and generate returns. Still, one critical difference in this case, however, is that if $2 million were invested in Company A, this is $2 million already in the primary market for capital; by contrast, $2 million invested elsewhere, coming out of Edward’s pocket, is more likely to be in the secondary market for capital, hence not directly contributing to productivity unless further transaction costs are incurred. That is arguably an efficiency justification, but it hardly seems to be the ex ante basis for enacting executive compensation disclosure.

One might advance an indirect efficiency justification: that the prospect for greater dividend payment may increase investors’ ex ante incentive to invest in the capital markets. Although this appears a more promising argument, there are several hurdles before one can raise this justification. To begin with, there is no evidence (I know of) that suggests that “excessive” executive compensation levels were actually discouraging investors from investing in the capital markets. Investors largely saw it as an inevitable consequence of incentivizing managers by

61 There are two difficulties in trying to divine what the SEC was anticipating in adopting executive compensation disclosure regulation. As of 1992, the SEC had no statutory requirement to conduct an ECCF analysis; as mentioned already, the ECCF provision was introduced only in 1996. Instead, its duty to consider the economic effect of its rule was governed mostly by the Administrative Procedure Act’s Section 706 -- that its action be not “arbitrary or capricious.” Therefore, even if the SEC had considered the economic effect, it may not have felt compelled to include any detailed analysis in its release. Second and more significantly, it is difficult to imagine the SEC openly taking a position on this executive compensation debate and making a judgment call that corporate executives were indeed being overpaid. In fact, even in its 2006 effort to mandate more comprehensive executive compensation disclosure, the SEC made no mention of reducing any compensation level, but noted only that its new rules “will provide investors with a fuller and more useful picture of executive compensation” and “will benefit investors in terms of the transparency, completeness and accessibility of executive compensation disclosure.” See Executive Compensation Disclosure, 71 Fed. Reg. 78,338 (Dec. 29, 2006).
tying their compensations to the firms’ performance. Second, even if there is some empirical validity to this argument, there still remains a hurdle before one can consider this additional flow of capital as necessarily being beneficial overall. One must assume that prior to disclosure regulation the capital market was suffering from underinvestment, rather than overinvestment. This may be a plausible assumption but not an obvious fact. This is partly because the amount of capital investment is determined by a host of other factors, such as investors’ exuberance, the Fed’s interest rate, and other factors.

The story becomes still more complicated if one takes a general equilibrium perspective. The additional investment will have to be diverted from some other market, most likely another market for investment instruments. Likely, this would affect the market for deposits, which in turn can adversely affect the market for credit, the final effect of which may adversely affect borrowing firms. For better or for worse, a typical partial equilibrium analysis would not take these intersectoral resource transfers into consideration.

Overall, what I surmise as the ex ante vision of executive compensation disclosure regulation -- that of reducing managerial expropriation in the form of “excess” pay through disclosure regulation -- is difficult to justify under the total surplus approach. In other words, executive compensation regulation is an example of a rule, the ex ante perspective of which is easily “efficient” under the investor welfare approach but not at all clear under the total surplus approach. Regulation to address managerial expropriation seems better justified on a distributional ground rather than on an efficiency ground. In addition, abstract goals such as transparency or fairness cannot be captured under the cost-benefit analysis. If this is the case, insisting that the SEC carry out a cost-benefit analysis, especially under the framework posited by the Circular A-4, may lead to the agency having to rely on a somewhat roundabout basis to justify its regulation.

B. Gatekeepers and Vendors

The market for securities cannot function without gatekeepers or certain essential vendors. What role, if any, should surpluses or profits by gatekeepers and vendors play in SEC regulation? Under the total surplus approach, any regulation that requires the industry to make significant uses of gatekeepers’ and vendors’ services should keep track of rent accruing to them. This is not to say all payments given to gatekeepers and vendors are social benefits. If the market for a certain type of services is highly competitive, conventional economic theory tells us that price will be close to marginal cost, and gatekeepers or vendors will make zero economic profits. If this were the case, then regardless of how expensive a service may seem, price may indeed reflect the marginal cost to society of supplying that service. Gatekeepers or vendors in these instances would not be earning positive economic profits. Nevertheless, not all markets for gatekeeping/vendor services are competitive in practice. If anything, among gatekeepers and vendors, a competitive market structure appears to be the exception, rather than the norm.

Consider, for example, credit rating agencies. The market for credit rating services is a pure oligopoly. The industry has historically been dominated by just two agencies, Moody’s and S&P, until Fitch came along and became a major player about a decade ago. Meanwhile, even as the industry is ostensibly an oligopoly, many economists seem to believe there are compelling reasons to model the industry more as a monopoly rather than an oligopoly.62 This is partly

because issuers often seek multiple ratings. Therefore, where the SEC’s rule directly curtail the demand of these services, reduction in economic profits would be part of the analysis under the total surplus analysis.

Or consider how issuers deliver proxy materials to investors. As it so happens, issuers do not internally handle their own delivery requirements. The industry has one firm that services every issuer in delivering proxy material to shareholders: Broadridge. This is an instance of pure monopoly. One can therefore expect much of the costs paid to Broadridge to consist of monopoly profit, rather than the marginal cost of servicing. Under the total surplus approach, if an SEC’s rule significantly curtails the demand for these services, then the analysis should include a significant reduction Broadridge’s monopoly profits. In these two cases, however, as long as there are good substitutes for these services available at lower costs, there will ultimately be no difference in the efficiency conclusions (although the value (e.g., net benefit) of each rule may be much smaller under the total surplus approach).

For the remainder of this section, I will focus on one particular group of gatekeepers: outside auditors. Consider the SEC’s rules implementing Section 404(b) of the Sarbanes-Oxley Act: the auditor attestation requirement under Section 404(b). In the aftermath of the Enron scandal, Congress enacted the Sarbanes-Oxley Act (SOX) in 2002 to reform public company accounting. The most controversial provision of SOX is Section 404, which requires management to assess and disclose the adequacy of internal control over financial reporting (Section 404(a)) and independent auditors to attest to the effectiveness of those controls (Section 404(b)).

SEC’s Section 404 rules are controversial because nearly everyone agreed that, at least as of the early stage of implementation, compliance costs outweighed benefits. Scores of articles and reports were published on the economic effect of Section 404, many of them focusing on

64 For a description of the industry structure, see Chris Kentouris, A Proxy Statement: broadridge Holds a Monopoly. Should It?, SECTORIES TECH. MONITOR (Sept. 8, 2009), at http://www.securitiesandtechnologymonitor.com/issues/19_/103/23917.html.
65 In 2007, the SEC sought to ease the burden on the firms’ delivery requirement 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. This was an instance of regulation taking a mandated demand regime under monopoly to a voluntary demand regime. See Final Rule: Shareholder Choice Regarding Proxy Materials, available at http://www.sec.gov/rules/final/2007/34-56135fr.pdf (Aug. 1, 2007).
unprecedented increase in the audit costs and the abnormal negative stock market returns of affected companies (at least among smaller companies). The fact that independent auditor attestation was required by statute rather than by a discretionary SEC rule is significant. Even without Section 404(b), the SEC would have had general statutory authority under the Exchange Act to require independent auditor attestation of management assessment. But the SEC would have had an extremely difficult time justifying the efficiency of such requirement under the investor welfare approach. The rule likely would have been challenged by strong interest groups, and the SEC likely would not have been able to defend it. But with Section 404(b) mandated by Congress, the SEC’s hands were tied and it needed only worry about properly implementing the statutory provision (and later implementing more cost-effective measures). Therefore, in responding to the criticisms regarding high compliance costs, the SEC granted repeated extensions of the compliance deadlines for smaller companies and also promulgated certain reforms to streamline compliance efforts. Eventually Congress enacted Section 404(c), formally granting relief to smaller companies.

Most of the debate surrounding Section 404 had to do with whether the added level of investor protection -- in the form of transparency and greater likelihood of detecting error or fraud in financial statements -- is worth the increase in compliance costs. As mentioned already, being mindful of compliance costs is important in understanding the viability of public firms. There was indeed evidence that some of the fringe firms may have gone private as a result of Section 404 requirements. On the other hand, this comparison ignores an important economic factor. Section 404(b) was undoubtedly a nontrivial business-generating opportunity for auditors. To this extent, accounting firms “benefited” enormously from the enactment of Section 404(b)’s independent auditor attestation requirement. What is one to make of this effect?

This question is best understood by asking how much rent auditors may be earning from their services. The extent to which auditors earn rent on their services is a complicated topic. The industry structure is marked by three factors: (i) demand is mandated (in that all Exchange Act reporting issuers are required to have an outside auditor), (ii) the market for audit services is a tight oligopoly, dominated by the Big Four accounting firms, but (iii) not a pure oligopoly. Therefore, even though the audit itself is mandated, not all firms are required to go to a Big Four

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accounting firm, but they can choose to go with lesser accounting firms. This leaves room for Cournot-styled competition among Big Four. More than 90%, however, choose to work with Big Four. Given any particular industry, the picture is still more disconcerting: due to industry specialization among the Big Four auditors, most large firms have realistically only one or two attractive options when it comes to their choice of outside auditors. In Appendix, I consider some documented evidence pertaining to competition and overall profitability of the audit market. The short of it is that although auditors may not be charging monopoly prices, there is little evidence that they are charging marginal costs of service. It is small wonder indeed that when Congress finally sought to exempt smaller companies from Section 404(b) requirements, auditors vigorously lobbied against such exemption.\footnote{See, e.g., Lora Bentley, Audit Groups Lobby Against Sarbox 404(b) Exemption, ITBUSINESS EDGE (June 16, 2010), http://www.itbusinessedge.com/cm/blogs/bentley/audit-groups-lobby-against-sarbox-404b-exemption-for-smbs/?cs=41781.}

Consider now the following scenario, illustrating how Section 404(b) compliance may play out for a representative company. A firm must spend $1 million to comply with Section 404(b). The marginal cost of supplying Section 404(b) to the auditor, however, is $800,000. In other words, if the market were teeming with high quality auditors, the price at which compliance audit would be offered would be reduced to $800,000. The auditor thus makes an economic profit, in the amount of $200,000. Suppose the benefit to the firm of complying with Section 404(b)--such as the value of the marginal reduction in the likelihood of fraud or accounting errors--is $850,000. In this case, under the investor welfare approach, Section 404(b) may be inefficient: year after year, they are forced to spend $1 million to earn a benefit of $850,000 only. Furthermore, if the stock market is efficient, the SEC’s announcement of Section 404(b) rule would coincide with a negative abnormal returns, whereby the stock price of the firm would be reduced by a percent that represents $150,000 as a fraction of annual cashflow. For example, if we assume a 5% discount rate, then the net present value of paying $150,000 each year forever will be $150,000/0.05 = $3 million. If the firm’s original market capitalization is $200 million and if the stock market were efficient, it would react by reducing the stock value by 1.5%. This seems to be consistent with what studies have documented.\footnote{See, e.g., Peter Iliev, The Effect of SOX Section 404: Costs, Earnings Quality, and Stock Prices, 65 J. Fin. 1163 (2010).}

Under the total surplus approach, however, Section 404(b) will be efficient. This is because the marginal cost of supplying compliance is only $800,000, which is lower than the gross benefit of $850,000 accruing to investors.\footnote{In addition, there is almost certainly positive externalities to other firms of each firm’s compliance. But even if one discounts such externalities for now, there is a socially beneficial regulation producing a net gain of $50,000.} It so happens that there is a transfer of $200,000 from investors of the firm to its auditor, and therefore, from the perspective of such investors and from the perspective of the value of the firm, there is an overall loss. Should we then consider Section 404(b) to be justified on the cost-benefit basis?

There is something tantalizing and perverse about this example. Section 404(b) was primarily aimed, one would think, at protecting investors. In addition, under the contemplated scenario, the overall effect was that regulation was net beneficial to society--it is an instance of “efficient” regulation under the total surplus approach. But investors themselves, the intended beneficiary, came out net negative, and the primary beneficiary turned out to be auditors. Notice also that there is no question of whether Section 404(b) promotes investor protection. It clearly does. But this particular mode of promoting investor protection, though efficient, turned out to
be more costly than beneficial to investors.

It is not my intention to oversell this back-of-the-envelope calculation. The sign of the net benefit of Section 404(b) compliance is sensitive to the parameter assumptions, although I do not think the assumptions behind this example are indefensible. At a minimum, one point should be made clear: the economic cost of the Sarbanes-Oxley Act will be overstated to the extent that it does not take into consideration the audit firms’ economic profits. Likewise, to the extent that the industry has come to acknowledge a decreasing trend in the net cost (to the firm) of complying with Section 404--approaching the break even point—-the overall efficiency of Section 404 rules under the total surplus approach may have already been established at an earlier time.

This example also illustrates the difference between out-of-pocket compliance cost and social cost. Therefore, measures of investor protection can be justified under one framework, without actually benefitting investor welfare. This raises questions for those who advocate use of cost-benefit analysis to justify investor protection. For instance, will the proponents of cost-benefit analysis--especially those who are attempting to subject the SEC to the OMB’s oversight--perfectly content when measures intended to promote investor protection is net beneficial to society, while actually harmful to investors? Or will they insist on changing the cost-benefit analysis framework to take only the perspective of investors’ economic welfare, and completely ignore the economic effects of other members of society? Would the SEC feel comfortable explaining in its analysis that though compliance costs may be high, the actual resources being used up may not be as high? Will the court consider it arbitrary and capricious for the SEC to justify regulation based on the transfers accruing to auditors? None of these questions can be answered presently.

C. Employees

For publicly-traded companies, employees and investors can be in a complicated relationship. Employees affect the firm’s productivity, and thus its value. At the same time, employees themselves, as a group, are often a very large investor of the firm. This is because their compensations can consist of a large number of company shares.

This takes me to the subject rule of Business Roundtable. In 2011, the SEC adopted a rule requiring a company’s proxy ballots to include director candidates nominated by a shareholder, or a group of shareholders, with significant ownership. The SEC, as well as several corporate law scholars, believed such a rule can help promote better disciplining of corporate managers. The rule would then have a salutary effect on the overall firm value. Others were concerned with union and pension fund shareholders hijacking the mechanism for their own benefit.

Business Roundtable’s argument against the rule was that, given access to proxy ballots, management may be forced to spend millions of dollars year after year to campaign against candidates nominated by shareholders with narrow interests. Or alternatively, union shareholders would use their bargaining power to extract some concessions from management for their own enjoyment. One focal point of debate on this issue was whether managers can legitimately campaign against director-candidates nominated by shareholders as part of their

74 See, e.g., Cindy R. Alexander et al., The Economic Effect of SOX Section 404: A Corporate Insider Perspective, 56 J. ACCOUNTING & ECON. 267, 274 (2013) (discussing the decreasing trend in net costs of compliance reported by survey participants).
The SEC ultimately believed that such costs would “be limited to the extent that the directors’ fiduciary duties prevent them from using corporate funds to resist shareholder director nominations for no good-faith corporate purpose.” The SEC relied on an old Delaware case which held that corporate expenditures made in directors’ campaign for proxies are not proper. It was perhaps not the most unassailable legal argument ever constructed. But the point is, the SEC therefore never fully engaged in the economic consequence that would arise in the event union shareholders end up exercising their bargaining power through proxy access.

There was indeed some evidence that public and union pension funds would have been the institutional investors “most likely to make use of proxy access.” In the decision vacating the SEC’s rule, the Court faulted the SEC for “fail[ing] to respond to comments arguing that investors with a special interest, such as unions and state and local governments whose interests in jobs may well be greater than their interest in share value, can be expected to pursue self-interested objectives rather than the goal of maximizing shareholder value, and will likely cause companies to incur costs even when their nominee is unlikely to be elected.”

To be clear, the Court’s concern was not that the SEC neglected to consider as a benefit of the rule the actions taken by self-interested shareholders and the surplus that would therefore accrue to them. Rather, the Court seems to have considered this opportunistic movement only as an economic cost to investors. In a sense, the Court might be seen as signing on to the “investor welfare” approach that the SEC had adopted. I do not read the Court’s opinion as giving its general blessing of the SEC’s investor welfare approach. Rather, in vacating the proxy access rule, the Court needed to have considered only whether the SEC’s analysis was adequate within its own articulated framework, which it concluded was not.

The concern with union shareholders is that they are not just shareholders but they also represent employees; therefore, they might seek to elect a director who would promote employee value rather than shareholder value. On the other hand, they are also not just employees but are also collectively significant shareholders. Conventional economic theory would suggest that union shareholders would exercise their power in a way to maximize the sum of their surpluses, which includes employees’ surplus as well as investors’ surplus. It should not be entirely surprising if the firm value might also increase en route to the union shareholder’s own utility maximization. At the same time, maximization of a sum of surpluses is different from maximization of a single surplus. To this extent, there is a misalignment of incentives, and there will be a deadweight loss typical of agency problems.

What does all this mean from the perspective of the representative investor? Without proxy access, there is likely some deadweight loss being generated from one type of agency problem: imperfect monitoring of directors who are largely shielded from discipline. With proxy access, there may be better accountability, but there may be a different type of agency problem: union shareholders, maximizing the sum of their profit function, may take active measures to

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76 See Hall v. Trans-Lux Daylight Picture Screen Corp., 171 A. 226, 228 (Del. Ch. 1934) (“where reasonable expenditures are in the interest of an intelligent exercise of judgment on the part of the stockholders upon policies to be pursued, the expenditures are proper; but where the expenditures are solely in the personal interest of the directors to maintain themselves in office, expenditures made in their campaign for proxies are not proper.”).
77 Business Roundtable, 647 F.3d at 1158.
78 Business Roundtable, 647 F.3d at 1158.
79 Under SEC v. Chenery Corp., An agency action can be upheld only if the grounds upon which the agency acted in exercising its powers were those upon which its action can be sustained SEC v. Chenery Corp., 323 U.S. 194 (1943).
dictate firm policies. As theoretically framed, it is ambiguous which of the two regimes would be more beneficial to the representative shareholder. It would seem to come down to a comparison of two different deadweight losses.

Empirically, however, there was some documentation that even under the proxy access rule as proposed by the SEC -- that is, even with the possibility of union shareholders voting opportunistically -- shareholders on net would have come out ahead. At least one carefully designed event study, introduced after the case was filed, lends support for the proposition that the market expected the SEC’s proxy access rule to be net beneficial to shareholders. In other words, the market appears to have expected the rule to increase the overall firm value, despite the evidence that certain shareholders may seek to misuse the mechanism.

At the same time, a cost-benefit analysis under the total surplus approach would remain value neutral regards to private benefits. It would treat as either a benefit or a transfer (if offset by a cost to other investors) the concessions union shareholders would gain. More precisely, even if the SEC’s proxy access rule may have proved to be costly to the representative shareholder, this does not necessarily mean that the proxy access rule is net costly to society. Instead, it would be facilitating a transfer from representative shareholders to employees (or a special category of shareholders) -- a transfer arising from bargaining power. Therefore, under the total surplus approach, the efficiency of the proxy access rule should not exclusively be determined by whether it promoted the overall share value, but whether any possible loss on the representative shareholder’s part is sufficiently compensated by the gains accruing to these employees.

Here again, the situation is somewhat regrettable. A mechanism is designed to benefit shareholders at large. But it might get “hijacked” by shareholders with narrow and special interests. The mechanism may still promote protection of certain investors, but not necessarily in the intended manner. I noted that there is reason to think the proxy access rule, even with active union shareholders, may benefit the representative shareholders. But even if that were not the case, can the SEC still consider the rule “efficient” as long as the total benefits (including the surplus accruing to union shareholders) exceed the total costs (possibly borne by the rest of the shareholders)? More specifically, should the SEC consider the proxy access rule desirable if it increases the total surplus even as it may decrease firm values? If not, must a rule which has the potential to increase the total surplus for society be vacated simply because it is costly to the representative shareholder? Is the SEC permitted to conclude that either the proxy access rule will be beneficial to the representative shareholder, or in the alternative, it may be costly to the representative shareholder but will still be increasing the total economic surplus? It is unclear, and at any rate, this was certainly not the argument the SEC ever advanced. Hence, it was not the ground upon which the rule was vacated.

D. Consumers

Securities do not exist in a vacuum; rather, they exist to facilitate capital raising to develop product markets. Securities regulation can also facilitate transfers between investors and consumers. In some cases, there may be indirect transfers between consumers and investors arising from mandatory disclosure regulation. For example, disclosure regulation, intended to protect investors, can influence managers’ business decisions and firms’ production levels,

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which can in turn affect the surplus of consumers in the product market. There are also cases—though not frequent—in which compliance costs of securities regulation can be passed on to consumers, rather than to investors. In other words, investors may indeed benefit from the rule but only at the expense of consumers. In this case, the discrepancy between the total surplus framework and the investor welfare framework may or may not be significant ex ante. Nevertheless, evaluating the effect of the rule ex post by measuring net benefits accruing to investors may overstate the rule’s efficiency under the total surplus framework.

One example of a rule facilitating this latter type of transfer (or cross-subsidization) is the SEC’s 2012 rule requiring registration of municipal advisors, as mandated by the Dodd-Frank Act. This is an example of the second group of rules from Section II.A: a rule in which regulated entities are not issuers but intermediaries. Municipal bonds are tax-free bonds issued by state, municipalities, or counties to help them finance their various projects, such as in building infrastructures for common enjoyment (e.g., highways, parks, or schools). Municipal advisors are intermediaries—usually, financial advisors or agents—who “provide[] advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities, including advice with respect to the structure, timing, terms, and other similar matters concerning such financial products or issues; or [] undertake[] a solicitation of a municipal entity.” Importantly, the market for municipal bonds remains largely opaque and little information is available. There is a common saying that municipal bonds “are not bought, they are sold.”

The SEC’s registration requirements were “intended to mitigate some of the problems observed with the conduct of some municipal advisors, including ‘pay to play’ practices, undisclosed conflicts of interest, advice rendered by financial advisors without adequate training or qualifications, and failure to place the duty of loyalty to their clients ahead of their own interests.” As the SEC noted, on the benefit side, the rule can potentially promote a greater level of transparency in the market for municipal advisory services, and can in turn “lead to reduced issuance costs and better financing terms for municipal entity clients” and “better borrowing terms, lower reoffering yields, and narrower underwriter gross spreads.”

Prior to Dodd-Frank, the activities of municipal advisors were largely unregulated. When

81 Brisley et al. (2008) model a competitive industry where managers choose quantities and costs to maximize a combination of firm profits and private benefits from expropriation. Neil Brisley et al., A Theory of Optimal Expropriation, Mergers and Industry Competition, 35 J. BANKING & FIN. 955 (2011). In their model, managers are able to expropriate because corporate governance ‘slack’ is permitted to some extent by the government. Managers reap private benefits from curryng favor with stakeholders. For example, if suppliers can provide benefits to managers for generating large business opportunities, managers may commit to produce levels of output and costs that are higher than would otherwise be optimal for shareholders. On the other hand, this higher level of output indicates reduced prices at the product market and higher consumer surplus. Therefore, managerial slack has allowed consumers to benefit at the expense of investors. A tight disclosure regulation aligning managers’ incentives to shareholders incentives will increase shareholder wealth but sacrifice consumer surplus.


the Dodd-Frank Act required the SEC to issue a rule requiring registration of municipal advisors, the SEC essentially had to engage in a rulemaking in the dark. There is virtually no compiled data regarding municipal advisors’ profitability and how the compliance cost for registration can affect municipal advisors. The SEC tried to estimate compliance costs on the part of municipal advisors.

But in this rulemaking, in the final rule release, the SEC departed from its usual practice of considering only investors welfare but engaged, albeit briefly, in consideration of the rule’s the effect on consumers. The reason why the SEC took this step, as far as I can tell, was not because the agency suddenly took a keen interest in a total surplus approach. Rather, this step was taken because the agency received several strong comment letters that asserted the costs of the regulatory regime 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. One bank submitted a letter predicting that the rule will have economic costs, which “will either come out of the bottom lines of firms or be passed along to municipal clients in the form of fee increases.”86 Even if its typical framework of economic analysis would not have incorporated such effects, the SEC now had a separate duty to consider these comments once they are submitted through the official notice-and-comment channel.87

Whether or not these costs will be passed onto municipal entities and obligated persons should depend on two factors: (i) current profitability of municipal advisors, and (ii) the comparative sensitivity (i.e., price-demand elasticity) between investors and municipal entities. As regards (i), if the market for municipal bond advice were very competitive to begin with so that municipal advisors were earning essentially zero profits—as commenters vigorously indicated88—then nearly all of the new costs municipal advisors would have to bear would eventually have to pass on to either investors or municipal entities. This would be the only way most of the advisors would be able to stay in the market. As regards (ii), it also seems reasonable, as the bank commented, that a substantial portion of the compliance costs among municipal bond advisors should pass on to municipal entities, rather than back to investors. Municipal entities are likely less sensitive to fees than investors who are always shopping for better return rates. After all, municipal entities, by contrast, must raise money in some form, and municipal bonds are the most significant channel of raising money outside tax revenues. Ultimately, this amounts to issuers bearing the compliance costs of registration by municipal advisors.

At this point, however, the representative investor framework breaks down because of the special nature of municipal bond issuers. Municipal entities do not exist to generate profits; they are not dollar-maximizers. More importantly, there are no equity holders—no investors who are residual claimants of municipal entities’ economic interests. Therefore, in the end it will be the consumers of municipal entities’ services and utilities (and the taxpayers, to some extent) who will bear the economic cost of compliance, rather than investors. The rule can thus be seen as effecting a transfer between consumers (and taxpayers) and investors. Of course, to the extent

87 This is based on the “hard look” doctrine. The Supreme Court held that “an agency rule would be arbitrary and capricious if the agency had . . . entirely failed to consider an important aspect of the problem . . . .” Motor Veh. Manufacturer’s Ass’n v. State Farm Mut. Auto. Ins., 463 U.S. 29, 43 (1983).
that most investors of municipal bonds are likely residents and consumers of the issuing municipalities (since they would qualify for the most tax benefits), the overall effect may simply be a trade-off between one’s surplus as a consumer (or a taxpayer) versus one’s surplus as an investor. All of sudden, the rule does not appear to be as protectionist as it once did when couched only as regulating intermediaries.

When the effects of pass-ons are considered, the economic cost of compliance will likely be greater than out-of-pocket compliance costs--it would be the total loss in consumers’ surplus resulting from these pass-ons. This would be at least as large as compliance costs incurred by municipal advisors, but likely larger. Each stage of pass-on may create a deadweight loss (unless the pass-ons happen in a lump-sum manner). Whether the magnitudes of these deadweight losses will be significant or not cannot be determined without further data.

This is not an instance of rulemaking in which the two different ex ante cost-benefit analysis approaches will necessarily lead to a different efficiency conclusions. If these deadweight losses are not large, there will not be a great discrepancy between the two frameworks in terms of the efficiency outcome; the rule’s efficiency under one standard likely implies its efficiency under the other. Nevertheless, it is worth pointing out the implication of considering these pass-ons for ex post policy evaluation purposes. Because compliance costs are not being passed on back to investors, the total surplus approach would compare the benefit of enhanced transparency for investors against the resulting reduction in consumer surplus. In the bond market, the benefit of transparency translates to a reduction in the bid-ask spread, which is the equivalent of the transaction cost of purchasing or selling bonds.\(^89\) It may thus be misleading, for example, if the SEC were to look to an ex post reduction in the bid-ask spread as evidence that the regulation is efficient under the total surplus standard. In the case of Section 404 of the Sarbanes-Oxley Act, there was a danger that stock market reactions could understate the net benefit of regulation. Here, by contrast, there is a danger that ex post measurable reductions in bid-ask spreads would overstate the net benefit of regulation.

IV. A CASE FOR THE TOTAL SURPLUS APPROACH

In this Part, I will try to put forth a few reasons why it may make sense to have the SEC analyze costs and benefits of its rules under the total surplus approach, rather than under the investor welfare approach. I am advancing these reasons despite fully recognizing the fact that several cards are stacked against this position (many of them my own). First, the total surplus approach can at times lead to somewhat unintuitive efficiency outcomes, as illustrated in Part III. Second, the investor welfare approach, while less comprehensive, is much easier to execute in practice, especially in the presence of an efficient stock market. Third, to the extent all cost-benefit analyses are perspectivistic, it is difficult to make a case for one approach over the other under some absolute standard.

That said, let me begin with a number of sobering caveats. First, the fact that I consider the total surplus approach comparatively more beneficial for the SEC does not necessarily mean that I believe the the SEC should be subject to oversight by the OMB. An agency may subscribe to the guidance of Circular A-4 without being subject to OMB’s oversight. Second, consistent with recent scholarship,\(^90\) I fully affirm the SEC’s authority to interpret its current ECCF

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90 See Bruce Kraus & Connor Raso, Rational Boundaries for SEC Cost-Benefit Analysis, 30 Yale J. on Reg. 289,
mandate to conduct a cost-benefit analysis it deems most suitable for its rules. Third, because the SEC’s current guidance document on economic analysis does not intrinsically conflict with Circular A-4’s framework, I believe the total surplus approach, while marking a change from the agency’s prior practice, can be implemented without issuance of a new guidance document.

Before I consider the comparative merits of the total surplus approach, it makes sense to inquire why the SEC has traditionally employed the investor welfare approach. I can only speculate at this point, but I can hazard several possible reasons. First, this practice may have stemmed from a confusion regarding the agency’s overall mission and the ECCF statutory requirement. The SEC staff may be simply unsure whether it can legitimately 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’ welfare, without giving regard to any other constituents. There is, however, no basis for such an interpretation, at least when it comes to the ECCF mandate. If anything, the statutory language would caution against confusing “efficiency” and “investor protection.” The ECCF mandate requires the agency to consider the effect of its action on “efficiency . . . in addition to the protection of investors,” implying that these are two distinct concepts. Second, the SEC may be conflating Policy Question I with the prevailing views on the corporate law debate and the antitrust law debate. But as I explained, if anything, these two debates should not inform Policy Question I (and likely, not even Policy Question II in my opinion). In either corporate law or antitrust law, there is no statutory requirement for an administrative agency to consider costs and benefits of its actions. Third, there may also 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. Cost-benefit analysis frameworks belong to welfare economics, whereas understanding the intricacy of competition and industry structure belong to the field of industrial organization. Financial and accounting economists, by contrast, are trained to analyze firm values rather than social welfare. Indeed, there are very few studies within finance or accounting which consider the costs and benefits of regulation from the perspective of society on the whole. This of course means that the SEC, at the moment, may be better equipped to conduct its analyses under the investor welfare approach; however, it does not address whether the SEC as an institution should not ultimately invest in more welfare economists and industrial organization economists. Finally, there may be political reasons. The SEC may not want to acknowledge rent transfers to gatekeepers or vendors out of the concern that it may risk appearing to be catering to interests other than those of investors. Taken collectively, these reasons may explain why the SEC has historically employed the investor welfare approach. But they come short of offering strong reasons that it should continue to do so.

On what grounds, then might it be preferable for the SEC to employ the total surplus approach? In addition to some of the downsides I indicated in Section II.A, I think at least four


91 Although the agency may bear some burden of explaining why it has decided to change its approach, the agency’s justification need only be reasonable—it need not be “more substantial” than the prior reason as to why it had previously employed the investor welfare approach. See FCC v. Fox Television Stations, Inc., 129 S.Ct. 1800 (2009).

92 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).
policy reasons merit serious consideration. First, the total surplus approach is more consistent with the traditional rationale for regulation. From the standpoint of neoclassical economics, the main justification for regulation is market failure. Today, regulation is justified on two grounds: market failures or compelling public interests. For compelling public interests, regulation might be warranted even if it may not enhance efficiency. Meanwhile, the problem with a market failure, however, is that there are mutually beneficial transactions that do not take place. The woe of a market failure, as originally envisioned by classical economics, is not that some people may come out harmed; rather, there are surplus-increasing, resource-preserving opportunities that are not being materialized. Therefore, to the extent that cost-benefit analysis is primarily used for efficiency justification, it seems more consistent to take the total surplus approach.

Second, the total surplus approach potentially provides for greater transparency of government actions. At least two different types of transparency that would improve under total surplus approach, as compared to the investor welfare approach. The first kind is the clarity as to whether the government is seeking to preserve resources or is engaging in a distribution of existing resources. The investor welfare approach partly obscures this distinction. In some cases, a rule that is efficient under the investor welfare approach may indeed be increasing total surplus; in other cases, such as executive compensation, a rule may be efficient under the investor welfare approach may mean only that there is a transfer from other stakeholders to investors. But efficiency and distribution are already well-recognized concepts in general policy terms. The investor welfare approach introduces another concept of efficiency that conflicts with accepted terms of efficiency in this realm.

The second kind is the transparency that could expose the potential for legislative or agency capture. For example, the fact that audit firms may be earning significant economic profits through Section 404(b) audit may reveal to the public the possibility that certain provisions of the Sarbanes-Oxley Act may be a result of extensive lobbying by audit firms—a possibility one cannot easily discount given audit firms’ reaction to Section 404(c). Also, the fact that union shareholders may be able to seek concessions and private benefits through proxy access may also hint that proxy access rules may have been a result of heavy lobbying by union shareholders, rather than a result of a dire please from representative investors. If so, it is all the more understandable why the SEC might not want to come across as catering to these interest groups. On the other hand, this is the type of transparency from which the general public may benefit.

Third and relatedly, for the SEC, the total surplus approach may be more permissive and inclusive than the investor welfare approach in the following sense. It should be noted that the total surplus approach of considering costs and benefits need not necessarily bar any of the SEC’s policy choices it could justify under the investor welfare approach. The SEC need simply be clear about whether it is justifying its rules under efficiency or under a distributive policy. There may indeed be good reasons or even compelling public interests 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 broadly labeling its redistributive policies under the general rubric of “investor protection,” and in fact, the general public may expect as much from the SEC. On the other hand, where a regulation increases total surplus and thus saves resources for society—albeit in a roundabout manner, as might have been the case with Section 404 of the Sarbanes-Oxley Act or with the SEC’s proxy access rules—it seems the agency should be able to appeal to efficiency proper as a legitimate ground for regulation. In this sense, if
applied properly, the total surplus approach would not limit, but as expand, the SEC’s policy choice set.

Fourth and arguably least important, there may be a benefit of having the SEC take the more predominant approach to considering costs and benefits. It would facilitate comparability across all agencies. Executive agencies are already conducting their cost-benefit analyses under the total surplus approach. The Executive branch also compiles an annual report of overall costs and benefits of all regulations executive agencies have adopted. In terms of providing a broader picture of regulation by all government agencies, there may be of value—for example, for planning and budgeting purposes—to have costs and benefits under the same “reporting” standard.

V. CONCLUSION

In this Article, I highlighted the difference between the OMB’s Circular A-4 framework for considering costs and benefits of a regulation and the SEC’s ECCF analysis framework. I explained the difference first in theoretical terms, and also explained how this difference would play out in several of the SEC’s actual rules. In the first example, the ex ante vision of the rule could easily be justified under the investor welfare approach, but not necessarily under the total surplus approach. In the second example, the rule was widely perceived as net costly (at least as of early days of implementation) under the investor welfare approach, but may very well be efficient under the total surplus approach. In the third example, the rule was likely a close call under the investor welfare approach, but far more likely to be efficient under the total surplus approach. In the fourth example, the difference between the two approaches may or may not be significant ex ante, but the rule nonetheless presented an instance where focusing on the net benefits to investors ex post would have been misleading because in the end investors would not themselves bear the compliance costs but consumers and taxpayers.

Here is one way of summarizing my perspective. Either cost-benefit analysis will have probative value in policymaking or it will not. If it will not, it is a complete waste of time and resources to either require or expect government agencies to conduct them, unless they serve only political purposes of getting a rule out. Indeed, cynics will always say none of these frameworks will ultimately matter, and each cost-benefit analysis framework merely provides a different way for each agency to pay lip service of justifying its rules post hoc. But there are still those of us who think that cost-benefit analysis has a legitimate place in government agencies and that it should properly be given probative value in decisionmaking. If this is the case, unless the agency seeks to promulgate a rule for “compelling social reason,” the result of the cost-benefit analysis should significantly inform the way rules are structured and implemented. In this case, the cost-benefit analysis must be properly aligned with the economic mission of the agency. The agency must have a clear view of its economic mission and its own definition of progress in testable and measurable terms.

Insisting on a rigorous cost-benefit analysis requirement will do little to contribute to the progress of the administrative state if at every opportunity the agency takes a flawed perspective or, worse still, an ad hoc perspective as commenters dictate. True, there will always be rules which would be “efficient” under either criterion; conversely, there will also be rules which would be “inefficient” under either criterion. But this is hardly reassuring. It is not even clear that a majority of the SEC’s existing rules or contemplated rules would in fact fall under these categories.

No doubt my casual, back-of-the-envelope-styled cost-benefit analyses leave much to be desired. There are likely elements I have neglected to consider. But I still think my general
point goes through. In what sense can we say a given securities regulation is an efficient regulation? In what sense shall we say a particular securities regulation marks a *progress* for our markets? Do people who cry for a more robust cost-benefit analysis from the SEC sincerely desire cost-benefit analysis justified rules from society’s perspectives? If, previously, these questions were only of abstract and pedantic value, certainly the recent legislative initiatives have rendered these questions more urgent and relevant for policymakers. Even if there is no immediate consensus, it may still be sensible to focus on a particular framework and discuss whether it would be suitable for the types of rules that the SEC would implement.

I have also tried to build a tentative case as to why the SEC, despite its agency mission of “investor protection,” should consider subscribing to the total surplus approach. At the end of the day, there may still be good reasons for sticking with the investor welfare approach. But as long as there is a justification for having the SEC conduct a cost-benefit analysis -- as long as the role of cost-benefit analysis is something more than a *post hoc* justification for a pre-determined agency policy choice -- it seems worth our while to have an impassioned discussion on these inquiries.
VI. APPENDIX. COMPETITION IN THE AUDIT MARKET

In this Appendix, I consider some documented evidence pertaining to competition and overall profitability of the audit market. To the best of my knowledge, no federal government agency has directly engaged in the inquiry of the profitability of the audit industry. There is a 2008 report by the U.S. Government Accountability Office (“GAO”), which touches upon a tangential inquiry. The GAO report’s finding must be interpreted narrowly and with extreme caution, however. The report concluded that the then-recent increase in the market concentration due to Arthur Andersen’s exit following the Enron scandal did not lead to significant increase in audit fees. It is significant that GAO’s study was undertaken with the specific intent of examining whether the government should intervene to decrease the audit market concentration (e.g., by breaking up the existing audit firms) rather than examining the overall profitability of the audit industry. The report’s econometric model reviewed a panel data of audit fees from 2000 to 2006, and included (i) yearly fixed effect, (ii) post-SOX fixed effect, and (iii) industry fixed effect. The main finding was based on the coefficient of Herfindahl-Hirschman Index (“HHI”) after controlling for all these factors: meaning, after controlling for factors including (i) whether the audit occurred pre- or post-SOX and (ii) whether the audit occurred in 2000, 2001, … or 2006, any further increase in the HHI would not cause a significant increase in audit fees beyond whatever increases already captured by the control variables. Consequently, this study cannot account for: (i) any economic profit the industry may have been accruing during the Big Five era, (ii) any unjustified upward shift in audit fees happening contemporaneously across all firms in a given year, and importantly, (iii) any new level of economic profit introduced as a direct result of Section 404(b) compliance.

Elsewhere in the report, there is an acknowledgement that the Big Four audit firms enjoy a “brand label premium”; in other words, client firms are willing to pay above marginal cost because they find services from reputable auditors valuable to their operations. Indeed, whether customers find the auditors’ services worth the prices they pay is an entirely different question from whether the auditors are making economic profits. Back in the 90s, PC users might have found Microsoft’s Windows Operating System very much worth the price they paid for; and yet, Microsoft was making an enormous monopoly profit from sales.

Other studies, by contrast, have depicted a far rosier picture for profits in the audit industry. In Accounting and the Global Economy After Sarbanes-Oxley, authors present a panoramic view of the accounting industry post-Sarbanes-Oxley and depict a favorable outcome for the audit market. Writing as of 2008, the authors write:

The increasing demands for accounting services and accountants [due to the Sarbanes-Oxley Act] have caused salaries to rise. Over the past three years, the salary for a Big Four firm accountant with five years’ experience increased by 30 percent. Pricewaterhouse Coopers was reported to have paid $85,000 to $90,000 annually for accountants with five years’ experience, when three years before the salary paid was $65,000. Salary.com, a Web site for tracking employment trends, indicated that

94 See id. at n.38.
recruiters offered 35 percent increases in annual salaries for both accounting graduates and experienced practitioners. New hires with three years’ experience at other than Big Four firms were being offered around $75,000 annual salaries compared to two years ago, when $55,000 was the level.\footnote{Id. at 197.}

In the face of such stiff increases in salaries for new hires, it is difficult to imagine that audit firms would not be earning a significant rent on their services.

A more systematic effort to understand the market’s profitability would have to take an industrial organizational perspective and examine the demand elasticity in the market for audit services. This would be useful because one can then make some suggestive inferences about industry margins from the demand elasticities. A recent study by accounting economists Joseph Gerakos and Chad Syverson does take this approach.\footnote{Joseph Gerakos & Chad Syverson, “The Competition in the Audit Industry: Policy Implications” (on file with author). The author thanks Joseph Gerakos and Chad Syverson for providing insights for this helpful analysis.} The authors calculated the demand elasticity of audit firms to about -1.6. According to applied microeconomic theory, if firms are profit-maximizing (and are doing so efficiently), they would be setting the price, as a multiple of marginal cost \( P/MC \) to \( e/(e - 1) \), where \( e \) is the absolute value of the demand elasticity. This would imply an optimal markup of \( P/MC = 2.67 \), way above 1. The authors also found that client firms appear to exhibit even less elastic demand for an auditor that they had already hired in the prior year—more on the order of -0.1.

Admittedly, the magnitude of this demand elasticity may be understated in the short-run, and the elasticity of -1.6 represents a short-run elasticity, rather than a long-run elasticity. But even a considerably higher long-run elasticity of, say, -2.5 would still imply \( P/MC = 1.67 \), which would imply \textit{a margin of nearly 40\%}. This is not to say that auditors are necessarily charging profit-maximizing prices and capturing such margins. On the other hand, this is certainly an indication that there is plenty of room for auditors to make economic profits out of their audit services, and factors such as repeated games dynamics can allow audit firms to sustain a supra-competitive price level without being found to be anticompetitive violations.