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SEC Rules, Stakeholder Interests, and
Cost-Benefit Analysis

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Abstract

Rules designed to regulate capital markets and protect investors often have spillover effects, either negative or positive, on stakeholders other than investors. These stakeholders can include managers, employees, consumers, taxpayers, gatekeepers, vendors, and others. This raises a question as to whether cost-benefit analyses of such investor protection rules – to the extent that the regulator is expected to conduct them – should take account of these spillover effects. One dilemma is that a rule may potentially be net beneficial to investors while net costly to society at large, or alternatively, it may be net beneficial to society at large but net costly to investors. An examination of several SEC rules indeed suggests that this type of discrepancy can indeed arise routinely. Therefore, current calls in the U.S. to have the SEC conduct more rigorous cost-benefit analyses of its rules should be preceded by a more candid discussion as to the appropriate criterion for determining the efficiency of SEC rules.

SEC Rules, Stakeholder Interests, and Cost-Benefit Analysis

Yoon-Ho Alex Lee¹

Key points

- Rules designed to regulate capital markets and protect investors often have spillover effects, either negative or positive, on stakeholders other than investors. These stakeholders can include managers, employees, consumers, taxpayers, gatekeepers, vendors, and others.
- This raises a question as to whether cost-benefit analyses of such investor protection rules--to the extent that the regulator is expected to conduct them--should take account of these spillover effects. One dilemma is that a rule may potentially be net beneficial to investors while net costly to society at large, or alternatively, it may be net beneficial to society at large but net costly to investors. An examination of several SEC rules indeed suggests that this type of discrepancy can indeed arise routinely.
- Therefore, current calls in the U.S. to have the SEC conduct more rigorous cost-benefit analyses of its rules should be preceded by a more candid discussion as to the appropriate criterion for determining the efficiency of SEC rules.

The purpose of this article is to raise a question regarding how the government ought to think about the efficiency or desirability of rules designed to regulate the market for capital. Although my immediate interest lies with the efficiency criterion for the U.S. Securities and Exchange Commission's (SEC's) rules for the U.S. capital market, this question will be of interest to those concerned with global capital markets generally for at least two reasons. First, because the U.S. capital market is a dominant market, the SEC's ability to successfully adopt rules and defend them from legal challenges (or failure to do so) will have consequences for not only U.S. firms but also major international firms. Second, the specific policy dilemma presented in this article, lying at the intersection of welfare economics and the political economy of regulation, will almost surely be an important concern for regulators of other capital markets as well.

We begin with the threshold inquiry: why do countries have securities regulation? It is commonly accepted that some level of central regulation is necessary in the securities market due to market failures that plague both the primary and the secondary markets. These include asymmetric information, adverse selection, moral hazard, agency problems, collective-action problems, externalities, and others.

But why do market failures justify regulation? According to neoclassical economics, market failures are thought to justify government intervention, not because any particular party may come out losing money, but rather because society is incurring economic losses as a result of failing to achieve Pareto optimality.² In other words, society is leaving money on the table. If

¹ Assistant Professor of Law, USC Gould School of Law. I would like to thank Scott Altman, Sam Erman, Jeffrey Gordon, Jonathan Greenstein, Bruce Kraus, Kim Krawiec, Jennifer Nou, Barak Orbach, Eric Posner, Connor Raso, Sid Shapiro, Carolyn Sissoko, Andrew Verstein, and Abby Wood for their helpful comments. I also thank Nandini Dasarathy for her research assistance and for the generous support from the Linnie and Michael Katz Endowed Research Fellowship. All errors are mine.

² See, e.g., AP Lerner, 'The Concept of Monopoly and the Measurement of Monopoly Power' (1937) 1 *Review of Economic Studies* 157 (1937) at 157 ("[I]ncreasing the price of the monopolized commodity [causes] buyers to divert their expenditure to other, less satisfactory, purchases. This constitutes a loss to the consumer which is not balanced by any gain reaped by the monopolist, so that there is a net social loss."); RA Posner, *Antitrust Law* (2001,

we take this market-failure view of securities regulation, then rules regulating the market for capital and protecting investors are in essence rules designed to mitigate economic losses. Under this view, the SEC's rules should be justified on an efficiency ground, according to the Kaldor-Hicks criterion. This criterion says that a regulation is "efficient" if and only if the aggregate economic benefits exceed the aggregate economic costs. Otherwise, one might question why the government should seek to correct an existing market failure unless the corrective measure can reduce the economic loss by more than it will cost the economy.

On the other hand, if the purpose of securities regulation is to promote distribution, the Kaldor-Hicks criterion is largely irrelevant. Indeed, if the SEC were to view its central mission as protecting the economic interests of investors only (for instance, at the expense of other market participants), then the applicability of the Kaldor-Hicks criterion is not at all obvious. It is unclear what considerations or weights should be given to a rule's social benefits or costs that lie outside investors' economic interests. Therefore, ascertaining the proper economic objective of its rule will be critical for the SEC as it considers what types of economic analysis should govern, or otherwise inform, its policy choices.

As it so happens, currently in the U.S., there is a contentious debate as to whether the SEC should conduct rigorous cost-benefit analyses of its rules, and more importantly, whether such analyses should be subject to judicial scrutiny.³ Some background might be helpful. In the U.S., most *executive* agencies conduct cost-benefit analyses of their regulations and submit them to the Office of Management and Budget (OMB) pursuant to the President's Executive Orders. Within the OMB, the Office of Information and Regulatory Affairs (OIRA) publishes a guidance document, called "Circular A-4," for conducting these analyses. Circular A-4's recommended approach is generally consistent with the Kaldor-Hicks criterion. In particular, it advises that distributional effects should be given consideration but should not be incorporated into the analysis of costs and benefits.

Major U.S. financial regulators, however, are independent agencies, which are not subject to the Executive Orders. Their requirements would come from their organic statutes, which usually instruct these agencies--often, only in vague language--to consider the overall impact of their regulations. For example, the SEC conducts its economic analysis pursuant to its statutory mandate to consider the effects of its rules on "efficiency, competition, and capital formation." Although these regulatory analyses are not submitted to the OMB for approval, they are subject to judicial review if an interested party were to bring litigation. Courts can vacate agency rules if they find the agencies' analyses to be "arbitrary or capricious." As a result, an open question for the U.S. financial regulators is the extent to which they should be expected to conduct rigorous cost-benefit analyses of their rules and the extent to which they should compare aggregate benefits against aggregate costs. Over the past few years, there have been several unsuccessful legislative attempts to require these independent agencies to conduct quantitative cost-benefit analyses and also to direct them to comply with the requirements applicable to executive agencies.

But here is a dilemma for the SEC in conducting a cost-benefit analysis: in theory, a rule intended to protect investors may increase investors' economic welfare or financial interests

The University of Chicago Press) at 12-13.

³ See generally JN Gordon, 'The Empty Call for Benefit-Cost Analysis in Financial Regulation' (2015) *Journal of Legal Studies* (forthcoming) <<http://ssrn.com/abstract=2378562>>; JC Coates, IV, 'Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications' (2015) *Yale Law Journal* (forthcoming) <<http://ssrn.com/abstract=2375396>>.

(hereinafter “investor welfare”), while decreasing the total surplus of society (hereinafter “total surplus”); conversely, it may increase the latter, while decreasing the former. Perhaps this is an obvious point. Cost-benefit analysis and investor protection are independent concepts. The market for capital is only one of many markets in society. Likewise, “being investors” is only one of many different capacities or identities in which ordinary citizens regularly act and function in society. Most of us wear many hats on a daily basis: we are at once investors, consumers, employees, taxpayers, as well as many others. Even if we as investors would care about our investor welfare, we as consumers will also care about our consumer welfare, and so forth. From this perspective, it might seem odd if the government, in seeking to regulate the capital market, should single out only one aspect of our ordinary activities and to seek to benefit its citizens only insofar as they are behaving as investors.⁴ On the other hand, it would also seem odd if a government regulation designed to protect investors should be considered efficient, or otherwise desirable, even as it may potentially be costly for investor welfare.

This dilemma thus presents a policy question for the regulator: in cases where there is a discrepancy between a rule’s potential efficiency outcome with respect to investor welfare and its potential efficiency outcome with respect to total surplus, how should the regulator ought to decide whether a given rule is efficient? Although this policy question bears some resemblance to the longstanding debate in corporate law, as to whether corporate managers should owe duty to shareholders only or whether they should seek to maximize stakeholders’ welfare, it is in fact a fundamentally different question. The central inquiry here is of the criterion for determining the efficiency of government regulation, rather than of the nature of the fiduciary duty that should govern corporate managers’ business operations.

In a separate piece,⁵ I have explored this policy question from the perspective of U.S. administrative law and provided an in-depth analysis of its statutory context and policy relevance for the SEC. In this article, I hope to demonstrate that this policy dilemma should be viewed as a real concern and one that is likely to be relevant for other countries as well. The problem is that in any jurisdiction the market for capital is heavily intertwined with other markets. As a result, a rule seeking to protect investors will often have an impact on the welfare of many other constituents in society.

I examine various stakeholder interests and consider how a cost-benefit analysis of certain SEC rules would look different depending on whether their interests are included in the calculus. These stakeholders can include managers, gatekeepers, vendors, employees, consumers, and taxpayers, as well as others. Although my analyses are at best speculative and sensitive to assumptions, I believe they will provide sufficient ground to sustain the policy debate for all intents and purposes. After all, all cost-benefit analyses conducted prior to rule adoption are necessarily speculative. Empirical data will not be available until after rule adoption. Unless regulators adopt rules on an experimental basis and extensively engage in *ex post* analyses to justify the stay of such rules,⁶ only speculative *ex ante* analyses can form the basis for the agency’s justification for adopting rules. In addition, the economic analyses conducted by the SEC’s staff are often not much more extensive than the exercises included in this article.

⁴ To be clear, however, a total surplus analysis may also include interests of certain job positions which may never apply to a majority of citizens.

⁵ YA Lee, ‘The Efficiency Criterion for Securities Regulation: Investor Welfare or Total Surplus?’ (2015) 57 *Arizona Law Review* (forthcoming) <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2406032>.

⁶ See YA Lee, ‘An Options Approach to Agency Rulemaking’ (2013) 65 *Administrative Law Review* 881.

The upshot of these analyses is that for many of the rules examined, the efficiency outcome would depend on whether we consider costs and benefits from the perspective of investor welfare only or whether we do so from the perspective of all stakeholders.⁷ One implication is that, for those who believe the SEC should focus its attention on protecting the financial interests of investors only, it may not be in their interest to demand that the SEC justify its rules under the type of cost-benefit analysis that executive agencies perform.

1. Managers

We begin by considering the interests of corporate managers. Corporate managers are often seen as *the* insiders from whom investors need be protected. Managers have informational advantage as well as control over corporate operations that can affect both long-term and short-term stock values. History has also shown us that not all of them can be trusted to act in the best interests of investors at large.

But the fact that investors need protection does not imply that a cost-benefit analysis of such rules must exclude considerations of the rules' potential effects on the welfare of corporate managers. In general, a cost-benefit analysis based on total surplus would employ money metric to aggregate surpluses to be captured by all parties (without, for instance, making any value judgment as to who is more deserving of the surpluses).⁸ Consequently, under this approach, any SEC rule that seeks to reduce managerial surplus for the purpose of increasing investor welfare, even if *effective*, would not be considered efficient unless the rule separately has the effect of increasing the size of the overall pie.

Take, for example, the SEC's executive compensation regulation. In the U.S., executive compensations are regulated by disclosure, rather than by prescribed bounds or limits. For decades the SEC has been trying to address the concern that CEO pay has become "excessive." The agency adopted its first set of executive compensation disclosure rules in 1992 and a more comprehensive set of rules in 2006. As of this writing, the SEC is in the process of adopting a "pay ratio" disclosure rule per Dodd-Frank Act. There are compliance costs associated with each of these initiatives. The "pay ratio" rule, in particular, is thought to require significant time and compliance costs.⁹

The unanticipated *ex post* outcome (thus far) of the executive compensation disclosure regulation in the U.S. is well-known. Rather than a decline in salaries, the disclosure correlated with a dramatic increase. The resulting transparency had the unintended effect of pushing up the level of executive compensation. Whether the current executive labor market is efficient and competitive is a subject of much debate. At least one heavily cited study argues that the increase in CEO pay can be justified on the ground of marginal product of labor.¹⁰ In addition, according to the Efficient Capital Market Hypothesis, investors will trade on the basis of the disclosure and the company's stock price will accurately reflect the value of its particular executive

⁷ For the most part, my analysis considers only the most prominent stakeholder interest to illustrate the potential discrepancy in the efficiency outcomes. Consideration of additional stakeholders' interests will, of course, further complicate the calculus and can raise further discrepancies.

⁸ A total surplus analysis still remains a partial equilibrium analysis. A general equilibrium analysis would consider the effects on all relevant sectors simultaneously, but is not often used in government policymaking.

⁹ See Center for Capital Markets Competitiveness, 'The Egregious Cost of the SEC's Pay-Ratio Disclosure Regulation,' (2014). <https://www.uschamber.com/sites/default/files/documents/files/Egregious-Cost-of-Pay-Ratio-5.14.pdf>.

¹⁰ X Gabaix & A Landier, 'Why Has CEO Pay Increased So Much?' (2008) 123 Quarterly Journal of Economics 49.

compensation policy to investors. Thus, one might expect the efficiency of the capital market to promote the efficiency of the executive labor market post-disclosure regulation.

For my purposes, however, what actually happened *ex post* is less relevant than the SEC's or Congress's underlying *ex ante* justification. Because the focus is on the *ex ante* perspective of cost-benefit analysis as a basis for justifying regulation, the relevant inquiry is the following: if the SEC, prior to initiating executive compensation disclosure regulation and without the benefit of hindsight, had to justify its disclosure regulation on a cost-benefit basis under the total surplus approach, what would it have looked like? A similar question can be raised of the SEC's "pay ratio" rule.

Although it is difficult to determine the SEC's own calculus for the 1992 rule, given that the agency was responding to the public perception that executive compensation levels were "excessive," it is fair to say that the SEC, as well as the general public, likely believed the executive labor market would function just as well with an overall reduction in executive pays. Viewed from this perspective, however, executive compensation regulation is intended primarily to effect a transfer (or perhaps, a reverse transfer) from managers to investors,¹¹ rather than to increase total surplus.

Now suppose a company's CEO was previously receiving \$10 million a year in the form of salary and stock options. Suppose that the SEC (and the general public) believes the CEO would perform his job equally well even if he were paid only \$8 million. If the disclosure regulation were intended to reduce the CEO's pay by \$2 million, then post-disclosure regulation, this difference would be either paid out to shareholders, further invested in the company's operations, or some combination of the two. Let x be the cost to the firm of complying with the disclosure regulation.

If shareholders were to receive the excess CEO pay as dividend payments post-disclosure regulation, this is simply a difference between \$2 million in the CEO's pocket or \$2 million (minus x) in shareholders' pockets. This policy is easy to justify as efficient under the investor welfare approach. All that is required is x is less than \$2 million, and shareholders will come out ahead with higher dividend payments on net. But justifying this policy under the total surplus approach is more difficult. No obvious surplus is generated from the transfer itself, although x is spent.

A possible efficiency argument might be that if \$2 million (minus x) were to be further invested in the company's operation rather than paid out to investors, it could potentially produce a greater return than \$2 million (minus x). On the other hand, the extra \$2 million in the CEO's pocket will likely be invested somewhere as well--perhaps other companies or mutual funds--and generate returns. Still, one difference in this case is that if \$2 million (minus x) were invested in the company's operation, this is \$2 million (minus x) already in the primary market for capital; by contrast, \$2 million invested elsewhere, coming out of the CEO's pocket, is more likely to be in the secondary market and does not directly contribute to any firm's productivity unless further transaction costs are incurred (e.g., the cost of capital). This is arguably an efficiency justification, but it seems a bit of stretch to take this transaction-cost saving as the primary basis for the compensation disclosure rules. Furthermore, efficiency under the total surplus approach would still require that the cost of capital relating to the portion of the CEO pay that would be

¹¹ An alternate view argues that excessive executive compensation occurs at the expense of not only shareholders but also employees. See DI Walker, 'Who Bears the Cost of Excessive Executive Compensation (and Other Corporate Agency Costs)?' (2012) 57 Villanova Law Review 653. This would not significantly change the nature of the analysis, however.

invested in the company's operation must exceed x .

The regulator might appeal to an indirect efficiency justification: the prospect for greater dividend payment may increase investors' *ex ante* incentive to invest in the capital markets, thereby reducing the cost of raising capital. Although this might be a more promising argument, there are still some challenges to raising it. First, there is no evidence (I am aware of) that suggests that "excessive" executive compensation levels were actually discouraging investors from investing in the stock market. Investors may have viewed it as an inevitable--though ethically questionable--consequence of incentivizing managers by tying their compensations to the firms' performances. Second, even if there were empirical validity to this argument, it must separately be established that this additional flow of capital is necessarily beneficial to the overall economy. 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. The amount of capital investment is determined by a host of other factors, including, for example, the interest rate set by the Federal Reserve and investors' exuberance in the stock market. The story becomes still more complicated if we consider countervailing risks. The additional investment will have to be diverted from some other market, most likely the market for deposits. This may in turn affect the supply of bank loans, and the overall effect may be adverse for borrowing firms.

To summarize, if the current level of executive compensation can be reduced without altering the firm's overall productivity, then a carefully crafted rule that can reduce this agency cost can indeed be seen as promoting investor protection. Nonetheless, justifying such executive compensation regulation under the Kaldor-Hicks criterion still presents a formidable challenge. If the SEC were required to conduct a cost-benefit analysis consistent with Circular A-4, it may have to conclude instead that such regulation is justified mostly on distributional grounds, rather than on efficiency grounds. In this case, the agency's burden would not be to show that the benefits of executive compensation regulation exceed the costs, but to show that its regulatory objective furthers a compelling public need and that it has structured its rule to reduce unnecessary compliance costs. Thus, a total surplus cost-benefit analysis does not appear to be a suitable tool for assessing the merits of executive compensation regulation.

2. Gatekeepers and Vendors

Consider now the interests of those who help the functioning of capital markets. The market for securities cannot function properly without gatekeepers or certain essential vendors (hereinafter, I refer to gatekeepers and vendors, collectively, as simply "vendors").

SEC rules often seek to protect investors by requiring issuers to use certain vendor services. These can include, for example, credit rating services, proxy delivery services, independent audit services, and others. The SEC in this case creates a *mandated* demand for such services. If certain services did not previously exist, the SEC's rule would effectively create a new market. If they were already being consumed by select (but not all) issuers voluntarily, and the market were already at an equilibrium under the natural demand curve, the SEC's rule would increase the output level to a point beyond the natural equilibrium. Therefore, some issuers might not consider their private benefits of purchasing such services as justifying their compliance costs. Of course, such rules can still be justified if there are sufficient positive externalities.¹²

¹² Alternatively, it may be that agency problems prevent firms from subscribing to those services even though they

What does this mean from the perspective of investor welfare? Equity shareholders are often seen as having the economic ownership of the firm. Although the SEC's regulation may benefit shareholders by protecting them from fraud or misinformation, the cost of complying with regulation also affects the firm's profit. Thus, a cost-benefit analysis from the perspective of investor welfare would ask whether the aggregate value provided to the investors of consuming such services (including positive externalities flowing from other firms' compliance) is worth the aggregate prices charged by the vendors. A total surplus approach, on the other hand, would also examine the economic effect of the mandated demand on the service industry. These can include, among other factors, economic profits or increased producer surplus or additional jobs created in the service industry, at the expense of investors.¹³

Suppose a particular service market is characterised by market power. In that case, a total surplus analysis of any new regulation mandating issuers to use such services would consider not only the compliance benefits and costs accruing to the investors but also the rents accruing to the vendors. These rents are merely wealth transfers from the investors to the vendors. Circular A-4's position is unambiguous on this point: "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. . . ."¹⁴ On the other hand, if the service industry were competitive, vendors would earn zero economic profits. But even so, there may be an overall increase in vendor surplus as a result of the outward shift in the demand curve. Additionally, in both cases, more jobs will be created in the service industry as the result of the newly mandated demand.

Two conclusions follow if the SEC were to justify its rules under the cost-benefit analysis based on the total surplus measure. First, the economic cost of complying with regulation mandating use of certain vendors' services should be recognized as the firms' compliance expenses *less* economic profits or producer surplus gained by such vendors, and the economic benefit should include additional jobs created in the service industry. Second, any SEC rule that seeks to save resources for firms and investors by relaxing previously mandated compliance should consider, in addition to the firms' increased profits, the resulting loss of economic profits or reduction in producer surplus as well as the possible loss of jobs in that service industry.¹⁵

Take credit rating agencies, for example. The market for credit rating services is a pure oligopoly. The industry is dominated by just three agencies, Moody's, S&P, and Fitch. Meanwhile, even as the industry is ostensibly an oligopoly, economists often model the industry as a monopoly rather than an oligopoly. This is partly because the goods are not perfect

are valuable to shareholders.

¹³ For consideration of deadweight loss, see note 15.

¹⁴ Office of Management and Budget, 'Circular A-4' (2003) <http://www.whitehouse.gov/omb/circulars_a004_a-4>.

¹⁵ There is a separate question as to whether deadweight loss might be reduced as the result of relaxing the mandate. But to the extent that compliance was previously mandated of all firms, as long as the sample of firms does not change, there would not have been any traditional deadweight loss arising due to market power, but only transfers. The economic loss would come instead from the fact that certain firms whose compliance would not have been socially desirable (i.e., the overall benefit of their compliance is below the marginal cost of providing the service) may have been mandated to purchase the service. By contrast, there may be some traditional deadweight loss due to market power when the mandate is lifted and the market reaches its natural equilibrium. The total surplus welfare comparison will thus involve comparing the deadweight loss against the socially inefficient mandate, which will depend on the marginal cost. What is clear, however, is that there are transfers between investors and service providers in both scenarios.

substitutes; issuers often seek multiple ratings. Therefore, where the SEC's rule directly curtail the demand of these services,¹⁶ the resulting reduction in the rating agencies' economic profits would be part of the economic cost of regulation.

Consider also how issuers deliver proxy materials to investors. In the U.S., most issuing firms do not handle their delivery requirements internally, but instead outsource it to one company: Broadridge. Because this is pure monopoly, one would expect at least some of the costs paid to Broadridge to consist of economic profits. Under the total surplus approach, if the SEC's rule significantly curtails the demand for these services,¹⁷ then the total surplus analysis would likewise include Broadridge's resulting loss of economic profits.

The fact that a total surplus approach would consider such reductions in economic profits does not necessarily imply that these rules will therefore be inefficient. If there are good substitutes for these services, there may be no difference in the efficiency outcomes between the investor welfare approach and the total surplus approach. The difference will be in the value (e.g., net benefit) of each rule: it will be smaller under the total surplus approach. But in some cases, the efficiency outcome may actually be different.

Consider now the SEC's rules implementing Section 404(b) of the Sarbanes-Oxley Act: the independent auditor attestation requirement. Section 404(b) rules were highly controversial because, at least during the early stage of implementation and for smaller companies, many believed compliance expenses outweighed the benefits.¹⁸ Although the general opinion regarding Section 404 seems to have taken a turn for the better, scores of articles and reports documented the unprecedented increase in the audit costs and the abnormal negative stock market returns of affected companies.¹⁹ The SEC granted repeated extensions of the compliance deadlines for smaller companies and also promulgated management guidance to streamline compliance efforts. Congress eventually stepped in through Dodd-Frank and enacted Section 404(c) to formally grant relief to smaller companies.

Most of the early debates surrounding Section 404(b) focused on whether the added level of investor protection was worth the increase in audit fees. This was important because there was some evidence that certain smaller firms may have gone private as a result of Section 404 requirements.²⁰ The exclusive focus on the capital market, however, ignores an important economic factor. Section 404(b) was a significant business-generating opportunity for auditors. Indeed, the accounting industry benefited enormously from it.

At least three different types of economic benefits merit consideration. First, audit firms may have earned economic profits from the increased audit services. The industry is a tight

¹⁶ See Securities and Exchange Commission, 'Security Ratings' (2011) Securities Act Release No. 9245, Exchange Act Release No. 64,975, 76 Fed. Reg. 46,603 <<http://www.sec.gov/rules/final/2011/33-9245fr.pdf>>.

¹⁷ See Securities and Exchange Commission, 'Shareholder Choice Regarding Proxy Materials' (2007), Exchange Act Release No. 56,135, 72 Fed. Reg. 42,222 <<http://www.sec.gov/rules/final/2007/34-56135fr.pdf>>.

¹⁸ See Securities and Exchange Commission, Office of Economic Analysis, 'Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements' (2009) <http://www.sec.gov/news/studies/2009/sox-404_study.pdf>. The SEC study also cites countless surveys conducted by professional associations detailing the cost of Section 404 compliance. See *ibid.* at n.35.

¹⁹ See, e.g., V Chhaochharia and Y Grinstein, 'Corporate Governance and Company Value: The Impact of the 2002 Governance Rules' (2007) 62 *Journal of Finance* 1759; Peter Iliev, 'The Effect of SOX Section 404: Costs, Earnings Quality, and Stock Prices' (2010) 65 *Journal of Finance* 1163.

²⁰ See, e.g., C Leuz and others, 'Why do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations' (2008) 45 *Journal of Accounting and Economics* 181.

oligopoly with the Big Four dominating the market.²¹ There is also a significant barrier to entry due to reputation. Issuers also face costs in switching from one auditor to another.²²

That said, the extent to which auditors earn rent on audit services is a complicated topic. Some argue that audit firms compete aggressively for audit services as a “loss leader” to earn non-audit consulting services.²³ But others question the “loss leader” hypothesis.²⁴ There is also evidence suggesting that at least the Big Four audit firms appear to charge above marginal cost on audit services. For instance, it is well-known that the Big Four audit firms enjoy a brand-name reputation premium, which cannot be competed away.²⁵ A recent study by the U.K. Competition Commission stated that the Big Four audit firms “do not monitor the actual costs of delivering engagements,”²⁶ a finding the Commission interprets as suggesting that “profit levels are sufficiently above cost to make close monitoring unnecessary.”²⁷ The market is also highly inelastic as measured by issuers’ revealed preferences, potentially allowing the Big Four audit firms to charge above marginal cost.²⁸

Second, even without earning rent on audit services, the increased audit services would have generated additional non-audit consulting services. It has been observed that “[t]he profit margins and growth opportunities were much greater with consulting than with auditing” and that “profits could better be obtained through expanding their consulting operations than to expend efforts to rest audit clients from their competitors.”²⁹ Consequently, various services provided by audit firms should be viewed as a bundle, and the increased audit engagement opportunities due to Sarbanes-Oxley Act can be seen as leading to economic profits for the bundles of services.

Third, even apart from firm-level profits for the auditors, the demand effect alone generated a lot of jobs in the accounting industry. The shift in the demand led to aggressive hiring by the incumbent audit firms and to enormous increases in accountant salaries:

The increasing demands for accounting services and accountants [due to the Sarbanes-Oxley Act] have caused salaries to rise. [Between 2005-2008,] 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

²¹ The market for audit services is a tight oligopoly, but not a pure oligopoly. Even though the audit itself is mandated, not all firms are required to go to a Big Four audit firm. This leaves room for Cournot-styled competition among the Big Four.

²² See generally JD Cox, ‘The Oligopolistic Gatekeeper: The U.S. Accounting Profession’ in J Armour and JA McCahery (eds), *After Enron: Improving Corporate Law and Modernising Securities Regulation in Europe and the U.S.* (Hart Publishing, 2006) 269. See also U.S. Government Accountability Office, ‘Reports to Congress Audit Market for Large Public Companies Does Not Call for Immediate Action’ (2008) <<http://www.gao.gov/new.items/d08163.pdf>>.

²³ See, e.g., Cox (2006) at 277.

²⁴ Competition Commission, ‘Statutory Audit Services for Large Companies Market Investigation: A Report on the Provision of Statutory Audit Services to Large Companies in the UK’ (2013) <https://assets.digital.cabinet-office.gov.uk/media/5329db35ed915d0e5d00001f/131016_final_report.pdf> at 63..

²⁵ See U.S. Government Accountability Office (2008), at n.38.

²⁶ Competition Commission (2013) at 67.

²⁷ *Ibid.*

²⁸ See J Gerakos & C Syverson, “The Competition in the Audit Industry: Policy Implications,” (working paper), available at <http://home.uchicago.edu/syverson/auditcompetition.pdf>. The authors calculated the demand elasticity of audit firms to about -1.6.

²⁹ Cox (2006) at 282.

before the salary paid was \$65,000. Salary.com, a Web site for tracking employment trends, indicated that 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.³⁰

It should be hardly surprising that when Congress finally sought to exempt smaller companies from Section 404(b) requirements, audit groups lobbied against such exemption.

Consider now how the SEC's Section 404(b) rule might have played out for some small firms. For simplicity, I will consider only the firm-level profits. Suppose an issuing firm must spend \$1 million to comply with Section 404(b). Suppose the marginal cost of supplying Section 404(b) to the auditor (net of any ancillary benefits) is only \$800,000. In other words, if the market were teeming with high quality auditors and was not characterised by switching costs, the price at which compliance audit would be offered could be reduced to \$800,000. The auditor then 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, as reflected in the company value--is about \$850,000. In this case, from the perspective of investor welfare, Section 404(b) would be considered inefficient: year after year, small firms are forced to spend \$1 million to reap a benefit of \$850,000 only. The SEC's announcement of Section 404(b) rule should coincide with a negative abnormal returns, whereby the firm's stock price would be reduced by a percent that represents \$150,000 as a fraction of its annual cashflow. Nevertheless, under the total surplus approach, Section 404(b) could well be efficient: the cost of \$800,000 is lower than than the gross benefit of \$850,000. It so happens that there is a transfer of \$200,000 from investors to audit firms.

There is something tantalizing about this example. Section 404(b) sought to provide investors with an added layer of protection. Under the contemplated scenarios, it *would* provide such benefits and at the same time also increase total surplus. And yet, investors, the intended beneficiary, would come out net negative. Therefore, a measure of investor protection may be justified as efficient under the total surplus framework, while potentially decreasing investor welfare. To be sure, the sign of the net benefit is sensitive to parameter assumptions. But one point is clear: if the SEC were to comply with Circular A-4, it would have to conclude that the net benefit of the Sarbanes-Oxley Act will be understated to the extent that it does not take into consideration the benefits accruing to the accounting industry. To the extent that the industry has come to acknowledge a decreasing trend in the net cost (to the issuers) of complying with Section 404--approaching the break-even point³¹--the overall efficiency for Section 404 rules even for relatively smaller firms may have already been reached at an earlier time.

3. Employees

Consider now a particular group of investors: investors who are also employees of the issuer. For publicly-traded companies, employees and investors are in a complicated relationship. Employees get paid wages from the firm's revenues, while investors receive dividend payments from the firm's profits. Therefore, at some point, employees' economic interests will be at odds with shareholders' economic interests. For example, there is evidence

³⁰ DE Garnet and others, *Accounting in the Global Economy After Sarbanes-Oxley* (2007, M.E. Sharpe) at 197.

³¹ See, e.g., CR Alexander and others, 'The Economic Effect of SOX Section 404: A Corporate Insider Perspective' (2013) 56 *Journal of Accounting and Economics* 267.

that weak corporate governance can result in higher wages for employees because managers may not feel compelled to bargain hard with employees on behalf of shareholders.³² On the other hand, employees can clearly affect the firm's productivity, and thus its profits. Thus, enhancing employees' stakeholder rights, such as employment protection, can also lead to greater sector-specific, human capital investments, which is consistent with enhancing shareholder values.³³ This implies that the division of economic interests between employees and investors is not necessarily a zero-sum game. Finally, employees as a group are often a significant investor in the firm's shares. This is because employees' compensations and benefits take the form of receiving their firm's shares.

Consider now the SEC's failed attempt to implement its proxy access rule. In the U.S., state law confers shareholders with a right to nominate directors, but management otherwise has no obligation to include the names of such shareholder-nominated director-candidates in the proxy ballots that can sent to shareholders for vote. If a shareholder wants to campaign for his nominee, he must run a proxy contest, which can cost him several hundred thousand dollars. In 2010, 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.³⁴ The SEC's rationale was that such a rule would allow corporate managers to become more accountable to shareholders' interests. But there was a concern among some commenters that union and pension fund shareholders, who are often significant long-term investors, might benefit from the rule by misusing the process to further their own private interests.

Taking a somewhat extreme position, Business Roundtable, a group of over 100 Fortune 500 CEOs, challenged the rule and argued that management may be forced to spend millions of dollars year after year to campaign against candidates nominated by union shareholders, or alternatively (and more likely), union shareholders would use their bargaining power to extract some concessions from management for their own enjoyment--such as higher wages or better benefits. A focal point of the debate between the SEC and Business Roundtable was *whether* managers can in fact legitimately campaign against director-candidates nominated by shareholders, as part of their fiduciary duty. The SEC dismissed this possibility and stated 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."³⁵ The agency did not seriously engage in the economic consequence that could arise in the event union shareholders do end up exercising their bargaining power through proxy access.

Let us assume *arguendo* that there is some merit to Business Roundtable's argument. There was at least some evidence that public and union pension funds would have been the institutional investors "most likely to make use of proxy access."³⁶ Whether or not they would misuse it, such shareholders would have gained the most bargaining power from the rule.

³² See H Cronqvist and others, 'Do Entrenched managers Pay Their Workers More?' (2009) 64 Journal of Finance 309.

³³ See, e.g., S Claessens & K Ueda, "Banks and Labor as Stakeholders: Impact on Economic Performance," IMF Working paper 08/229, Washington D.C. (Sept. 1, 2008), <<https://www.imf.org/external/pubs/ft/wp/2008/wp08229.pdf>>.

³⁴ See Securities and Exchange Commission, 'Facilitating Shareholder Director Nominations' (2010), Securities Act Release 9136, Exchange Act Release No. 62,764, 75 FR 56,668 <<http://www.sec.gov/rules/final/2010/33-9136fr.pdf>>.

³⁵ See *ibid.* at 56,770.

³⁶ Business Roundtable v. S.E.C., 647 F.3d 1144, 1158 (D.C. Cir. 2011).

Importantly, in vacating the 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.”³⁷

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. Rather, the court considered this opportunistic movement only as a potential *cost* to investors. It would be too hasty, however, to read the court’s opinion as requiring the SEC’s to consider only investor welfare. Because an agency rule must be justified under the agency’s own articulated reasons, the most one can conclude from the opinion is that the court did not view the SEC’s analysis as succeeding within the agency’s own articulated framework--that of looking at the economic impact of its rule on investor welfare.

But let us take a step back. What is the underlying logic behind Business Roundtable’s argument against the rule? The concern with union shareholders is that they are not just shareholders but they are shareholders who represent employees’ interests; therefore, it is argued, they would seek to elect a director who would promote employee value rather than shareholder value. Although this is a reasonable concern, as a challenge against the efficiency of the SEC’s proxy access rule, this argument can succeed only if it is established *a priori* that investors who are employees are inherently less deserving of the surpluses than representative long-term investors. For if Business Roundtable’s argument is correct, it must be true *ipso facto* that such employees’ economic interests will improve as a result of the rule.³⁸

At the same time, union shareholders are not just employees but also economically significant shareholders, collectively. In fact, at oral argument, the SEC pointed out that union shareholders, or shareholders otherwise qualifying under its rules, would collectively have roughly \$700 million at stake, and that it is difficult to imagine that they would do anything dramatic to jeopardize their wealth. Conventional economic theory would suggest that union shareholders would exercise their power in a way to maximize the *sum* of their surpluses, which includes their surplus as employees as well as their surplus as investors. It should not be entirely surprising, then, if the firm value might also *increase* as a result of the union shareholders’ own effort to maximize their joint utility. At the same time, maximizing of the sum of surpluses is not the same as maximizing of a single surplus. To this extent, there is a partial misalignment of incentives.

What does all this mean from the perspective of the representative long-term investor? Without the SEC rule, there is one type of agency cost: shareholders’ limited ability to monitor directors, who are largely shielded from discipline because of the high cost of running a proxy contest. With the SEC rule, there may be better accountability for directors, but also a different type of agency cost: union shareholders may seek to take measures or affect corporate policies that are not consistent with share value maximization. As theoretically framed, it is ambiguous which of the two regimes would be more costly to the representative shareholder. It would seem to come down to a comparison of the two agency costs. As long as the second cost is smaller, even the representative investor will come out better off under the SEC rule.

At least one carefully designed event study lends support for the proposition that the market expected the SEC’s proxy access rule to be net beneficial to shareholders, despite all the

³⁷ *Ibid* (emphasis added).

³⁸ Similar arguments would apply to other groups of special-interest shareholders.

rhetoric that was openly exchanged between Business Roundtable and the SEC during the rulemaking stage. The study examined the stock market reaction to the SEC's impromptu decision to stay the rule after the case was filed. Documenting negative stock market reactions among firms that are considered to be "most vulnerable" to proxy access, the authors concluded that evidence is consistent with the finding that "financial markets placed a positive value on shareholder access, as implemented in the SEC's 2010 Rule."³⁹ This finding might also be seen as consistent with the idea that enhancing employees' stakeholder rights, to an extent, can be consistent with enhancing shareholder values.

Meanwhile, a cost-benefit analysis under the total surplus approach would treat as either a benefit or a transfer (if offset by a cost to other investors) whatever concessions union shareholders would gain. This means that even if the SEC's proxy access rule may have proved to be costly to the representative shareholders (itself likely an untenable proposition), this would not necessarily mean that the proxy access rule would be net costly from the perspective of total surplus. Instead, it can be seen as facilitating a transfer from representative shareholders to employees (or a special category of shareholders)--a transfer arising from bargaining power. Therefore, the efficiency of the proxy access rule would not be determined exclusively by whether it increased share value, but whether any possible loss on the representative shareholder's part is sufficiently compensated by the gains accruing to these employees.⁴⁰

Here again, the situation is somewhat regrettable. The rule may still promote protection of certain investors, but not necessarily in the intended manner. Even so, a question remains as to whether the regulator should be able to defend the rule as "efficient" as long as the aggregate benefits (including the surplus accruing to union shareholders) exceed the aggregate costs (possibly borne by the rest of the shareholders).

4. **Consumers and Taxpayers**

Securities do not exist in a vacuum. Rather, they exist to facilitate issuers' capital-raising activities, which lead to product market development. In some cases, securities regulation can facilitate transfers between investors and consumers. For example, disclosure regulation, intended to protect investors, can influence the firms' production decisions, which can in turn affect the surplus of consumers in the product market.⁴¹ It is also possible that compliance costs of securities regulation can be passed on to consumers, rather than to investors. In this case, investors may benefit from regulation but only at the expense of consumers.

One example of a rule facilitating this latter type of tradeoff is the SEC's 2012 rule requiring registration of municipal advisors, as mandated by the Dodd-Frank Act. In the U.S., municipal bonds are tax-free bonds issued by state, municipalities, or counties to help them finance their various projects, such as building highways, parks, or schools. Municipal advisors are financial advisors who provide advice to municipal entities with respect to the issuance and sales of municipal bonds.

³⁹ B Becker and others, 'Does Shareholder Proxy Access Improve Firm Value? Evidence from the Business Roundtable Challenge' (2013) 56 *Journal of Law and Economics* 127.

⁴⁰ To simplify the analysis and highlight the transfers between investors and employees, I omit considerations of directors and managers. A more complete analysis would also take such factors into consideration. Proxy access may result in a loss for directors and managers in terms of their ability to shirk, but their compensations most likely would not have been affected.

⁴¹ See, e.g., N Brisley and others, 'A Theory of Optimal Expropriation, Mergers and Industry Competition' (2011) 35 *Journal of Banking and Finance* 955.

The market for municipal bonds in the U.S. is highly opaque and fragmented. Prior to Dodd-Frank, municipal advisors were largely unregulated. When 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 no compiled data regarding municipal advisors' profitability. There were no studies looking at how the compliance cost for registration can affect municipal advisors. The SEC faced a very difficult task of trying to estimate municipal advisors' registration costs and to predict the consequence of its rule.

The SEC's rationale for the registration requirements was "to mitigate . . . 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."⁴² The SEC noted that 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."⁴³

During the rulemaking stage, commenters expressed a concern that 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. In theory, whether or not these costs will be passed onto municipal entities will depend on at least two factors: (i) the profitability of municipal advisors, and (ii) the comparative sensitivity (i.e., price-demand elasticity) between investors seeking high returns and municipal entities seeking to find revenue sources. As regards (i), if the market for municipal bond advice were indeed not profitable to begin with, then nearly all of the new costs would eventually have to pass on to either investors or municipal entities as long as these advisors stayed in the market. As regards (ii), it also seems reasonable, that a substantial portion of the compliance expenses 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 returns. After all, municipal entities must raise money in some form, and municipal bonds are a significant revenue source outside tax revenues. In short, as commenters asserted, this would lead to issuers having to bear a large part of the compliance cost of registration by municipal advisors.

But as issuers, municipal entities are different from corporations. They 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 cross-subsidization between consumers (and taxpayers) and investors. To the extent that most investors of municipal bonds are likely residents and consumers of the issuing municipalities, 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.

When these effects are considered, the aggregate economic cost of the regulation will likely be greater than municipal advisors' (private) compliance costs. The aggregate economic cost would include the loss in consumers' surplus resulting from the effect of passing on these costs to them. This would be at least as large as the compliance costs incurred by municipal

⁴² See Securities and Exchange Commission, 'Registration of Municipal Advisors' (2013), Exchange Act Release No. 70,462 <<http://www.sec.gov/rules/final/2013/34-70462.pdf>> at 6.

⁴³ See *ibid.* at 536.

advisors, but likely larger. Each stage of passing on the costs can create a deadweight loss unless it is done in a lump-sum manner. Whether the magnitudes of these deadweight losses will be significant cannot be determined without data. Nevertheless, it is worth pointing out the implication of considering these costs for *ex post* policy evaluation purposes. Because compliance expenses are not being passed on 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. It might be misleading, for example, if the SEC were to look only 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 compliance with Section 404 of the Sarbanes-Oxley Act, there was a concern that stock market reactions, as an *ex ante* measure, could understate the net benefit of regulation. Here, by contrast, there is a concern that *ex post* measurable reductions in bid-ask spreads may overstate the net benefit of regulation. If the loss of consumer surplus outweighs the benefit to investors, the SEC and Congress should reconsider whether the regulation should still be considered efficient.

5. Conclusions

Cost-benefit analysis is a source of political inconvenience for regulators and policymakers. It effectively forces them to provide a normative value interpretation of a policy outcome. But regulators cannot conclude whether benefits of regulation exceed its costs without committing to a particular framework of analysis. Because capital markets exist only in relation to product markets and factor markets, it is not obvious that an analysis of costs and benefits of securities regulation should be limited to the costs and benefits accruing to investors only. This article has argued that depending on the framework selected, the efficiency outcome may be different. In other words, a policy may be justified as efficient under one framework but not the other. This suggests that various arguments and passionate rhetorics in the U.S. to have the SEC conduct more rigorous cost-benefit analyses cannot be constructive unless the parties can first agree upon the efficiency criterion for SEC rules. Ascertaining the economic objective of its rule is therefore an important first step for the SEC as it considers what types of economic analysis should be used to justify its policy choices. Finally, although not all jurisdictions may expect their financial regulators to conduct cost-benefit analyses, the ultimate policy question raised in this article may very well be pertinent to all jurisdictions having a concern for the overall efficiency of financial regulation.