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Economic Analysis in the Federal Rule-Making Process to Implement the Dodd-Frank Wall Street Reform and Consumer Protection Act



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Introduction

The recent passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) marks the completion of an arduous legislative process. But it also marks the beginning of an entirely new (and equally arduous) undertaking: the post-enactment process of creating the rules and regulations necessary to give effect to the Dodd-Frank Act. Although Dodd-Frank articulates the general intent of Congress with respect to the reformed regulatory structure, important decisions about crafting the specific rules and regulations have been delegated to financial regulatory agencies such as the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), the Board of Governors of the Federal Reserve System (BOG), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the newly created Federal Bureau of Consumer Financial Protection (BCFP). Dodd-Frank instructs or empowers regulatory agencies to propose and finalize well over 200 rules and regulations (nearly 100 at the SEC alone). Many of these rules and regulations will be crafted jointly across agencies.

These new rules and regulations will govern among other things:

- Over-the-counter derivatives
- Central counterparty clearing
- Capital and margin requirements
- Leverage
- Proxy access
- Executive compensation disclosure
- Hedge funds
- Credit rating agencies
- Consumer protection
- Systemic risk monitoring

The federal rule-making process has often been contentious and will likely be especially so for the Dodd-Frank rule-makings given their scope. The first round of battles for the Dodd-Frank rule-makings will take place at the regulatory agencies, where regulators are charged with drafting the specific rules reflecting the intent of Congress, voting on proposed rules and publishing them for public comment, revising the proposed rules based on public comments received, and then voting to adopt the rule in final form. A second round of battles may ensue if adopted rules are challenged in court.

For potentially affected businesses or other parties, engaging in the public comment process with respect to rules and regulations proposed by regulatory agencies now replaces the process of lobbying legislators as the means to influence the new regulatory regime. Because of the potential for litigation, parties commenting on proposed rules should direct their comments not only to the members of the regulatory commission involved in adopting rules, but also to the judges who may be involved in reviewing challenges to the rules. As the outcome of recent court challenges to federal rules have turned on the adequacy of the economic support considered by regulators when they adopted new rules, parties submitting comments should pay particular attention to the quality of their economic arguments.

The Federal Rulemaking Process and Economic Analysis

The federal rule-making process is governed by the Administrative Procedures Act (APA), which requires that federal regulatory agencies adequately justify their exercise of rulemaking authority. The APA also provides for public participation in the rulemaking process. In addition, the APA sets up a process of judicial review for rules and regulations promulgated by regulatory agencies. Although Dodd-Frank instructs financial regulatory agencies to move swiftly in adopting new rules and regulations, and sets deadlines for regulatory action, regulatory rule-making remains bound by the procedural requirements of the APA.

In recent years the courts have identified weaknesses in the application of economic analysis to regulatory decisions,¹ resulting in rules being sent back to regulators for further consideration. Because regulators have begun to take note of this increased judicial scrutiny, they will likely try to bolster their economic arguments to ensure that their rules promulgated under Dodd-Frank have a reasoned basis and are not found to be, in the words of the APA, “arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law.” In addition, economic analysis plays an important part in satisfying the cost-benefit requirements of the Paperwork Reduction Act (PRA), a component of the rule-making process. Individual statutes, such as the Securities Exchange Act of 1934, may also require regulators to consider other economic effects, such as whether a regulatory action will promote efficiency, competition, and capital formation. The message from the courts is that regulators’ economic arguments need to be adequately supported—that vigorous assertion is not a substitute for rigorous economic analysis.

Firms affected by regulation can help themselves by presenting meaningful economic analysis in their comments to the regulator and urging the regulator to weigh these economic considerations in its rule-making. An effective comment letter makes strong economic arguments, supported with empirical evidence that challenges the regulator to apply rigorous economic analysis to the proposed rule. Once a comment letter is placed on the public record, the regulator must consider the comment in its deliberations. In addition to comment letters, affected firms may be able to arrange meetings with individual commissioners. Firms should prepare for these meetings with substantive cost-benefit presentations. At a minimum the notice and comment rule-making process leads the regulator to provide a transparent appraisal of the trade-offs and related facts about the impact of a proposed rule by helping ensure adequate public documentation of the reasoning behind regulatory decisions. There is no requirement that regulators heed public comments, only that they consider these comments in a responsible way.

Within the regulatory process the role of economic analysis is often referred to as “cost-benefit analysis” or “regulatory impact analysis.” The meaning applied to these terms is not universally shared among regulators. A narrow interpretation would imply that economic analysis is limited to cases where regulatory impacts can be quantified in dollars. Under this interpretation, the analysis would involve toting up and comparing dollar costs and dollar benefits attributable to a proposed rule. However, a broader interpretation, shared by many regulators and judges, goes beyond what is readily quantifiable and includes qualitative factors associated with a proposed rule. Under a broader interpretation, economic analysis can enhance the regulator’s understanding of the trade-offs, potential effects, and side effects of their actions, including identifying potential changes in behavior by market participants. Economic analysis can also help clarify the problem the proposed rule is aimed at solving and show why a rule would, or would not, improve upon the status quo. Economic analysis can also look beyond the status quo and compare the effects of the proposed rule with alternative rule specifications, or market-based solutions, aimed at addressing the same problem. The value of economic analysis to the regulator derives from its capacity to provide a clear, credible, and coherent framework for articulating the reasoned basis for regulatory action. For the regulator, failure to adequately consider on-the-record economic arguments leaves the adopted rule vulnerable to a court challenge on the grounds that the agency’s action lacked a reasoned basis.

The Path Ahead

The Dodd-Frank Act contains 16 titles and hundreds of sections covering a diverse set of topics. The Act instructs financial regulatory agencies to promulgate a large number of rules on a designated timetable. In addition to the designated mandatory rulemaking, Dodd-Frank authorizes financial regulators to adopt an additional set of rules. A complete listing of the Dodd-Frank rule-makings, both mandatory and non-mandatory, can be found at the following link: <http://www.nera.com/6911.htm>.

Some of the new rules can be implemented by a single regulator, but many others will require coordination with other regulators, or in consultation with the newly formed Council of Regulators. For example, rule-making mandated by amendments to the Bank Holding Company Act of 1956 requires that federal banking agencies, the SEC, and the CFTC adopt rules imposing additional capital requirements and quantitative limitations with respect to positions taken in the market, to protect the safety and soundness of banking entities engaged in activities permitted under the Act. Joint rule-making is also required between the SEC and the CFTC, in consultation with the Board of Governors, on several matters related to the over-the-counter swap market and swap market participants.

One set of mandatory rule-makings—those regarding over-the-counter (OTC) derivatives—serve as a good example of rules that will likely involve a number of economic factors regulators will need to consider. Title VII of Dodd-Frank, the title covering OTC derivatives, requires rule-making to increase the transparency and efficiency of the OTC market and to mitigate counterparty and systemic risk. To achieve these goals, this title requires, among other things, that certain OTC transactions be executed on swap execution facilities (SEFs), be centrally cleared, and that trading and contract information be publicly reported to data repositories. However, the Act leaves it to rulemaking by the SEC and the CFTC to define the universe of swaps that must meet these requirements. Defining this universe requires that regulators determine the boundary point at which certain swaps, if included in the mandate, would exacerbate counterparty and systemic risk. The economic arguments about the benefits and costs of central clearing have been addressed in the academic finance literature and will be relevant considerations in rule-making deliberations. A complementary set of rule-makings is required for swaps that are not cleared.

Title VII also directs the SEC and CFTC, through joint rulemaking, to define the regulatory boundaries between swaps, which are regulated by the CFTC; security-based swaps regulated by the SEC; and mixed swaps, which contain both swap and security-based swap characteristics. The boundary will depend on the characteristics of the underlying financial instrument, asset, reference rate, or index from which the swap derives its principal source of value. Defining the boundary is more than a semantic issue, as ambiguity or imprecision in the definition is a real compliance and liability problem for firms that must operate in an uncertain regulatory environment.

Title VII also requires rulemaking by the SEC and CFTC on position limits for swaps and related markets. The statutory goal of position limits is to 1) diminish, eliminate, or prevent excessive speculation; 2) deter and prevent market manipulation, squeezes, and corners; 3) ensure sufficient market liquidity for bona fide hedgers; and 4) ensure that the price discovery function of the underlying market is not disrupted. This is another area in which the costs and benefits have been addressed in the economics and finance literature and where economic analysis can inform policymakers in their rule-making deliberations.

Other rule-makings required under Title VII will need to include analysis regarding potential costs and benefits. For example, the Title requires that swap dealers and major market participants be subject to capital requirements and to margin requirements. In addition, some of the mandated rules and regulations require regulators to adopt specific definitions or interpretations. Yet, some of these definitions and interpretations can have a potentially large economic impact and are important part of the process of implementing the statute. Although these definitions and interpretations may not be part of the rule-making process, they should not be overlooked if regulators seek public comment.

Title VII is just one title where mandated rule-making will require rigorous economic analysis. This is true also, to one extent or another, with the other 15 titles of the Act. The notice and comment rule-making process is an opportunity for affected firms to place on the public record factual information about likely compliance costs with proposed rules, suggested alternative means of meeting the objectives of regulators, and analysis that addresses the issues before regulators. Contributing to the public record by putting forth economic evidence on the impact of a proposed rule on efficiency, competitiveness and capital formation can lead to better rule making or lay the groundwork for challenges to rules that may have negative economic consequences.

Note

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

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