Written Statement for

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Thank you for the opportunity to participate in this symposium. I come at this topic from four primary vantage points: (1) as former practicing Wall Street lawyer, who routinely advised banks and other firms on financial regulation, (2) as a law professor who researches on and teaches financial regulation, particularly on what if any practical and useful role courts and legal mandates can play in mandating cost-benefit analysis, (3) as a user and teacher of finance and financial analysis, in both business school and law school settings, focusing particularly on ways in which financial analysis can be framed and manipulated, and (4) as someone who just ended a four-year stint on the Investor Advisory Committee of the Securities and Exchange Commission (**SEC**), in which role I studied closely the way in which the SEC's staff produced cost-benefit analysis and the political appointees of the SEC seemed to influence and be influenced by that analysis in their rule-making. My focus will be on data, models, and distributional impacts. I am mindful that my views are shaped by the areas I know well; unlike areas covered by the SEC, for example, in part because of market structures and dynamics, the CFPB may more routinely consider topics and possible regulations for which within-firm random treatments are more feasible and useful in generating more reliable data and estimates of causal impact.

At the outset, as I have written at length elsewhere,[1] it may be worth noting that cost-benefit analysis (**CBA**) is a broad topic covering a variety of techniques that might be usefully distinguished on two dimensions. One distinction is between conceptual CBA and quantified CBA. With *conceptual CBA*, analysts qualitatively specify the goals of a proposed regulation and try to identify the costs and benefits of some private activity or product and the corresponding costs and benefits of regulating that activity or product, as well as of reasonable alternatives to a given regulation. Conceptual CBA sometimes involves formal models to clarify or explain non-intuitive implications. As applied to many examples of financial regulation, formal models can be misleading if they, among other things, require heroic and counterfactual assumptions, about human capacity for reason, or about political, systemic or macroeconomic effects of the activity, the regulation, and reasonable alternatives to the regulation. Such assumptions may play a useful role in academic theory, where they can have the virtue of simplification in the scaling of foundational explanations, but in an applied setting, such as CBA, they can also have the potential to confuse or mislead non-expert readers, who may routinely not comprehend the importance of concededly counterfactual assumptions in assessing the outcome of a model.

Quantified CBA involves attempting to quantify the costs and benefits of regulation, which typically has to lag conceptual CBA and is at least an order of magnitude more difficult in practice. Difficulties arise in the

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[1] John C. Coates IV, Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications, 124 YALE L.J. 882 (2015). An online version is available at https://tinyurl.com/y5o98fjx.

need to use problematic or unavailable data and the need to make causal inferences in problematic settings or with weak models. A simple example is the common use of static discount rates in CBA, with the same rates being used in all moments of the business and interest rate cycles,[2] as compared to discounting by private actors, who routinely adjust discount rates to reflect then-current financial market conditions. When done by a regulator in practice, quantification is generally done in advance of observing the actual impact of the regulation being considered, making the difficulties all the more severe. When quantified CBA is reviewed by a court or another agency, comparative lack of expertise makes the review itself problematic for the same reasons.

Another distinction is between CBA as a mode of *policy analysis*, on the one hand, and CBA as set of *laws and legally mandated practices* that affect regulatory processes, on the other hand. CBA can be done by academics or the public, in principle, without having any direct implications for regulation. CBA can also be required by law, with various degrees of specificity, enforced (or not) by a variety of institutions, including courts, units within agencies, or other agencies. One can be – as I am -- a strong supporter of CBA as policy analysis, including attempts to develop fully quantified CBA, as being a useful analytical technique, one that can illuminate models and clarify assumptions, while also being a strong skeptic of CBA law or legal mandates, and particularly of the role that simple prescriptions can usefully play in how CBA is conducted or used in developing or assessing regulation.[3]

With that overview, I turn to a few points about data related to points about models and the purposes of CBA – which include, presumably, the goal of informing (and not simply confusing) rule-makers and the public about proposed or adopted regulations:

It is a commonplace that theory precedes data. As Einstein put it, perhaps a bit too strongly, "it is the theory that decides what we can observe." Without a good, clear effort at conceptual CBA, specifying the goal of a regulation, it will be impossible to reliably identify the kinds of data that would in principle inform a fully quantified CBA of the regulation. This basic point is often forgotten when data is discussed – instead, people rush on to identify particular types of known data that are in fairness usually relevant but also usually only a subset of the needed data, and sometimes not the most important data that would be useful to an effort at quantification.

To illustrate, consider fraud. What, conceptually, are the social costs of fraud? That remains a surprisingly contested and difficult theoretical question. Is fraud a "mere" transfer, in which case it has no social cost, "merely" transferring wealth from victim to fraudster? Few accept that idea. But what are its social costs, if the transfer itself is not to count as a cost? Private anti-fraud precautions? Fear-of-fraud induced unwillingness to engage in socially useful financial risk-taking? Externalities (e.g., to family members) from uninsured and expected shocks to victim wealth, which may exceed the size of the transfer itself? Without at least attempting to map out an informal model of why fraud is socially harmful, regulators cannot even begin the process of quantifying the anti-fraud goals of a regulation.

Another basic point about data is that a given agency will typically have in hand some data relevant to the CBA of a given regulation, while lacking other data. The agency will then be presented with the question of whether and to what extent to present the available data, and the implications for a partly quantified CBA of a given rule, in the absence of complete data. Methods such as bounding and scenario analysis may be used to relate partial data to the analysis, but those methods may not reliable if important data is absent from both

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[2] The same 3%/7% discount rates have been used in federal agency CBA since 1992. During that time, long-term risk-free rates have varied significantly, generally declining. These changes have been reflected in OMB guidance for cost effectiveness analysis. E.g., https://www.whitehouse.gov/wp-content/uploads/2019/12/M-20-07.pdf.

[3] See John C. Coates IV, Towards Better Cost-Benefit Analysis: An Essay on Regulatory Management, 78 Law and Contemporary Problems 1 (2015). An online version is available at https://tinyurl.com/y5mhb9vh.

sides of the cost/benefit ledger. If the goal of CBA is to inform political appointees – who may lack training in applying economic analysis – or the public, some of whom can be counted to misread all but the most carefully written economic analysis – it is, I think, not an easy question to know how to present data when it is known to be relevant but significantly incomplete. A few cautionary statements about the lack of data or its potential unreliability will often not be enough to prevent it from being misunderstood or even intentionally misused.

As an example, consider the effort by the SEC to include a quantification of "errors" by proxy advisory firms in its proposed rulemaking from last fall.[4] In its rule release, the SEC presented a table showing the results of a staff analysis of supplemental proxy statements filed by companies over the period 2016-2018.[5] From that analysis, the rule release stated that 54 factual errors had been made by proxy advisory firms. The SEC stated: "We divide registrant concerns into five categories: 1) factual errors, 2) analytical errors, 3) general or policy disputes, 4) amended or modified proposal, and 5) other. We classify a concern as 'factual errors' when the registrant identifies what it considers to be incorrect data or inaccurate facts that the proxy voting advice business uses in some part as a basis for its negative recommendation."[6] Similar "error" data supplied by corporate lobbying organizations was pointed to by the SEC in its discussion of the need for the proposed regulation,[7] the SEC cited no other data of its own in support of the idea that errors exist in proxy advisory firm recommendations, and yet the SEC stated that the proposed regulation had "the potential to improve the accuracy … and completeness of the information available to those making voting determinations."[8]

However, as the SEC's Investor Advisory Committee pointed out, the SEC rule release included no information on a baseline for what is possible for how error-free any complex analysis could realistically be, or any information sufficient to evaluate the importance of the errors, or the appropriateness of the staff's classification of errors as factual.[9] As a result of this and other critical public comments, the SEC in its final rule release retreated from relying on its "error" data, stating that the data were intended "solely" to present how companies currently respond to proxy voting advice and the frequency and timing of those responses, that the SEC made no judgment as to whether the concerns raised by companies in their supplemental filings were valid, and the data were not intended to provide an "error rate" or even proof that errors exist.[10] The SEC then went on to assert that the rule it adopted (which was significantly modified from the originally proposed rule) was still useful to improve the way in which investors were informed about issues addressed by proxy advisory firms. In neither proposing nor final release did the SEC present any other evidence to show that that aspect of the corporate voting system is not working well already.

This example illustrates some of the regulatory dilemmas concerning data. The SEC had in its possession a type of data, with uncertain meaning, but relevant to its rulemaking. Instead of presenting the data with all of its limitations in a clear way, and also discussing in a clear fashion the more relevant data that it did not have, the SEC presented the data it had in a misleading and incomplete fashion, attracting public criticism. In the end, its rule adoption was concededly based on its judgment, not on quantified CBA. The SEC's ability to defend the rule, should it be attacked in court as arbitrary, has if anything been weakened by its inclusion of "error" data in its rule release. Other elements of its CBA were similarly problematic, such as the inclusion the blanket statement that it had no other data relevant to a quantification of the costs and benefits of the

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[4] Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice, Rel. No. 34-87457 (Nov. 5, 2019).
[5] Rel. No. 34-87457 at 96 (Table 2).
[6] Id. at 239.
[7] Id. at 39-40.
[8] Id. at 43.
[9] https://www.sec.gov/spotlight/investor-advisory-committee-2012/sec-guidance-and-rule-proposals-on-proxy-advisors-and-shareholder-proposals.pdf.
[10] Exemptions from the Proxy Rules for Proxy Voting Advice, Rel. No. 34-89372 (July 22, 2020), at 165-66.

proposed rule, even as it included various inconsistent compliance cost estimates in its Paperwork Reduction Act analysis. In the final rule release, the SEC continued to include flatly inconsistent statements about its ability to quantify costs of the rule. In one place, it stated "We are unable to provide quantitative estimates of these direct costs on proxy voting advice businesses because the facts and circumstances unique to each proxy voting advice business…"[11] Later in the same release, however, it includes a dollar quantification of the compliance burden of the rule.[12]

It is easy to take away the basic point to avoid inconsistent statements about data and its availability in conducting CBA. However, the challenging aspect of using partial data remains. Similarly, as the dissenting SEC Commissioner Allison Lee noted about the final rule, "The Paperwork Reduction Act analysis provides that the increased burden on proxy advisors could be anywhere 'from 50 hours to 5,690 hours per year per proxy voting advice business,' a startlingly wide range."[13] What is the public (or a Commissioner) to make of such a wide range? Is it better to present a range such as that, or to simply state that no reliably precise quantified data is available at all?

Finally, I offer a few thoughts about varied regulatory mandates and distributional impacts. As well known, traditional economic analysis – and CBA – takes as its bottom line "social welfare" or "efficiency." In the calculus, everyone's benefits and costs are supposed to weighted equally. The analysis does not presume that some benefits should be ignored, or that that some benefits or costs are more important than others. Indeed, the idealized goal is to be able to take into account all effects of a rule using a single metric that would allow it to be compared to the status quo and to reasonable regulatory alternatives.

But most regulation occurs not in a political or legal vacuum, and agencies exist in part because they bring to bear specialized expertise beyond that required for general disciplines such as economics. Agency expertise in specialized domains corresponds to the fact that, legally, agencies are directed to pursue particular ends in the organic statutes that create them and define their purposes. Put differently, we do not have an overarching "Efficiency Agency" charged with enacting all and only rules that maximum social welfare. Rather, we have varied agencies with particular domains who can be expected to focus on aspects of CBA that are closest to their core regulatory missions.

The SEC, for example, is directed by Congress in the securities laws to adopt rules for the protection of investors. It is also directed to consider the "public interest," which can be more easily related to the economic bottom-line of social welfare or efficiency. However, it is clear that for many decades many if not most SEC rules were aimed primarily at, and oriented towards, the protection of investors as such, even when it was not clear that protecting investors was an all-in bottom line means to enhance social welfare. Complicating matters, further, an agency's mandates can change over time, often broadening to encompass more goals. In 1996, the SEC's goals were broadened to include a consideration of "whether the action will promote efficiency, competition, and capital formation."[14] These goals are sometimes aligned, sometimes in conflict. Collectively, they still do not fairly capture all aspects of social welfare, however. As a result, the economic analysis of a given rule may in practice only partly map onto an overall economic analysis.

A related point is that an agency may lack deep expertise or staff to evaluate some aspects of its mandates. The SEC is not primarily charge with competition policy, for example – that is given in the first instance to the Department of Justice (DOJ) and the Federal Trade Commission. Reflecting this fact, the SEC recently entered into a first-ever memorandum of understanding with the DOJ's Antitrust Division to address issues

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[11] Id. at 180.
[12] Id. at 232 (PRA Table 2).
[13] https://corpgov.law.harvard.edu/2020/07/24/statement-by-commissioner-lee-at-open-meeting-to-adopt-amendments-to-the-proxy-solicitation-rules/.
[14] https://www.congress.gov/104/plaws/publ290/PLAW-104publ290.pdf.

of competition in the SEC's overall sphere of focus.[15] The fact that such a formal joint venture is so recent – nearly 25 years after the SEC was tasked with considering competition – illustrates the way that its regulatory capacities, including in its CBA, have not necessarily aligned evenly with its actual legal mandate. Better economic understanding of natural monopoly or oligopoly, and how regulated entities with monopoly power respond to regulation, would I think have informed the proxy advisory rule proposal discussed above, including in the SEC's economic analysis.

To some extent, the particular mandate and expertise of an agency can also be expected to show up in the potential for CBA to include a distributional component. That is, the analysis is not simply of bottom line aggregate changes in welfare, but in an analysis of who benefits, and who loses, from a proposed regulation of a given activity or product. Some members of the public may gain if a product is banned, because for them it is primarily harmful, while others, perhaps more sophisticated or informed, may lose from the ban, because they were able to use the product more wisely. Alternatively, producers may lose if an activity is regulated, while some but not all consumers may gain.

Some may view distributional effects as second-order or subsidiary to CBA. But often distributional impacts are easier to anticipate at least in rough terms than all-in efficiency effects. Direct distributional impacts show up more obviously in lobbying efforts, and in public comments. Even if the impact is minor for individual members of the polity, agents working at consumer groups or trade associations may correctly (or self-interestedly) identify the impact as collectively important for some constituency, and successfully raise funds to fight for or against the proposed regulation. For political appointees that oversee agencies, for the same reason, those distributional impacts may be as or more important than all-in welfare effects. Components of a CBA, and how the CBA is presented, even if not understood initially as distributional in nature, may be rightly or wrongly seen as responding to political pressure, from interested constituents or agents of dispersed subsets of the public. Put differently, nearly every input to a complex CBA can be perceived or portrayed as both responding to and potentially in service of a distributional impact.

Nor are the distributional effects unimportant for traditional welfare analysis. A regulation may have a set of direct welfare-neutral distributional consequences, but those consequences may have indirect all-in incentive effects, which may even be more significant in principle for welfare than the direct effects. To return to fraud, for example, it seems clear that the most immediate effects of a ban on a fraudulent product or activity is to prevent transfers from victims to fraudsters. As noted above, that may be viewed as neutral for social welfare. But if the overall population confronts an overall ban on fraud, reinforced by new anti-fraud rules addressing specific types of fraud as they emerge, they may not invest in researching or developing or innovating new ways to commit fraud, knowing that at the end of the day those investments will face constrained returns, and possibly produce prison terms. From a social perspective, the indirect opportunity benefits of the ban on a particular kind of fraud – fewer people spending less time thinking about and pursuing careers in crime or near-crime – may plausibly exceed other kinds of direct effects of that ban.

The possibility of such indirect, systemic effects takes us back to the need for comprehensive models, which account for economy- and society-wide, dynamic relationships among incentives, activity, and outcomes. But that need also reinforces how difficult – and ultimately, contestable and judgmental – serious CBA will remain. Truly complete, reliable, consensus dynamic stochastic general equilibrium (DSGE) models of any complex human activity remain over the horizon. Even in their most basic form, DSGE models of the macro-economy remain uncertain in application. To my knowledge, they are not routinely used in analyzing financial regulation. Yet, save in settings where the activity or financial product is marginal to long-term

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[15] https://www.jdsupra.com/legalnews/sec-and-doj-s-antitrust-division-51405/.

incentive effects for the population overall, they are potentially as important as the partial equilibrium models that can in principle more routinely inform regulation.

As a coherent, defensible institutional response to these complex possibilities, and noting my own skepticism about the value of simple rules for CBA, I offer a basic set of suggestions as regards CBA generally and distributional considerations in particular:

- **Modesty**. Those creating CBA should be modest in their goals and descriptions. Above all, in most settings, quantified CBA should not attempt to pretend to be more than a set of initial rough guesstimates, likely speculative, not yet subject to normal scientific replication, and no more (even if no less) reliable than experience-based judgment of political appointees. If CBA is to inform, it should first do no harm, including by informing about what it can and can't inform.
- **Clarity**. CBA descriptions should be clear about what they are trying to do, and what they are not trying to do. Less may often be more, in the absence of relatively hard-to-achieve regulatory designs, particularly when randomization is impossible or infeasible. When confidence intervals get beyond a certain degree of width, it may be better to dispense with the included quantities and simply note the degree of unreliability in available data estimates.
- **Careful candor**. CBA components should be transparently and candidly identified as being motivated by legal mandates or distributional considerations when that is the case. Such motivations should not be treated as off-limits,[16] but they should be only carefully included, in response to an explicit legal mandate or policy goal, plausible indirect welfare implication or because they correspond to other data or evidence otherwise being included. CBA authors should be particularly cautious about their use when they consist of partial and potentially misleading data.

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[16] Indeed, distributional analysis has long been not only consistent with but arguably required by guidance from the Office of Information and Regulatory Affairs. See Circular A-4 at 14 ("Your regulatory analysis should provide a separate description of distributional effects (i.e., how both benefits and costs are distributed among sub-populations of particular concern) so that decision makers can properly consider them along with the effects on economic efficiency.").