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TOWARDS BETTER COST-BENEFIT ANALYSIS: 
AN ESSAY ON REGULATORY MANAGEMENT

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TOWARDS BETTER COST-BENEFIT ANALYSIS:
AN ESSAY ON REGULATORY MANAGEMENT

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Cost-benefit analysis of financial regulation (CBA/FR) has emerged as an important
topic in both policy and legal debates.1 The emergence of CBA/FR is due in part to the
once-in-a-lifetime number and importance of new regulations (more accurately, re-
regulations) called for by the Dodd-Frank Act.2 Interest groups seeking to delay and
shape those regulations have joined a set of policy entrepreneurs and academics whose
long-term project has been to spread the use of cost-benefit analysis generally, and with a
related but partially distinct group of political entrepreneurs with the long-term and
largely partisan project of embedding CBA/FR in judicial review of regulations under the
Administrative Procedures Act.3 A growing number of white papers calling for CBA/FR
have elicited academic symposia and multidisciplinary efforts to study and improve
CBA/FR, while an increasing number of bills have been introduced in Congress to
mandate or empower the President to mandate CBA/FR, some getting bi-partisan
support, even as some on the D.C. Circuit continues to use CBA as a tool for intervening
in regulatory contests.4

Yet, as I detail elsewhere,5 the movement to advance CBA/FR has several odd
features. First, debates over CBA/FR are marked by a significant degree of basic
terminological confusion, with some speaking of CBA/FR purely as a mode of policy
analysis, and others speaking of it as a set of laws and legal practices that affect
regulatory processes; with some speaking of it as a conceptual framework and others
assuming that CBA/FR it does or should consist not simply of the identification and

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1 See, e.g., Symposium, Developing Regulatory Policy in the Context of Deep Uncertainty: Legal, Economic, and
Natural Science Perspectives, J. Legal Stud. (forthcoming 2014) (including several articles on the topic of cost-benefit
analysis of financial regulation); Conference, Critiquing Cost-Benefit Analysis of Financial Regulation (May 19-20,

2 The full title of this statute is the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No.

3 Administrative Procedure Act (APA), 5 U.S.C. § 101 et seq.

4 See John C. Coates IV, Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications, Working

5 Id.
analysis of costs and benefits but the quantification (or, more accurately in practice, guesstimation) of costs and benefits; and still more confusion arising over the goals and likely effects of CBA generally, with some assuming it can only produce benefits, such as transparency and discipline, but others pointing to a darker mix of effects, including camouflage and rent-seeking. These distinctions should be kept in mind when evaluating claims about CBA/FR.  

Second, none of the advocates for CBA/FR law – particularly on the D.C. Circuit, but also those in think tanks, trade groups and academic institutions – have engaged in quantified CBA/FR themselves, or been able accurately to identify good examples of reliable, precise quantified CBA/FR. Nor have they engaged in anything approaching a robust and scientific cost-benefit analysis of cost-benefit analysis law – that is, the study of whether in fact regulation has improved (or could be expected to improve) when CBA (particularly quantified CBA) is mandated. It is as if they are advocating a faith-based method for regulation – something like “if we mandate it, it will be done, and it will be good.” Since the beginning of recorded history, thousands of financial regulations have been enacted across hundreds of polities. Many have been subjected to long and searching academic scrutiny, much of it relevant to CBA/FR. It would be an understatement, however, to say that reliable, precise quantified CBA of a significant financial regulation has emerged only rarely from that research – in fact, I am still searching for a single example. In other research, I speculate that the reason CBA/FR is so hard include that finance is central to the economy, that finance is social and political, and that finance is non-stationary. (Even if my suggested reasons are inadequate to explain why CBA/FR estimates remain imprecise and unreliable, even if estimates in CBA/FR are no less reliable or imprecise than estimates adduced by CBA in other contexts, the estimates nevertheless remain imprecise and unreliable.) Whatever the reason, CBA/FR is an order of magnitude more difficult than its advocates seem to believe.

To be clear, I am not a skeptic of CBA altogether. To the contrary, I believe that quantified CBA/FR is a worthy if distant goal, and conceptual CBA is currently a valuable if limited element of the regulatory toolkit. But until quantified CBA/FR can produce more reliable and precise estimates, it is in fact not a true alternative to expert judgment. This straightforward implication renders empty the standard critique of non-CBA decision-making offered by quantified CBA supporters (viz., “what’s the alternative to quantified CBA?”) because in fact it is CBA supporters themselves who need to show that CBA is anything different than judgment in drag.

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7 Posner and Weyl, Benefit-Cost Paradigms in Financial Regulation, in Symposium, supra note 1, offer none, nor does Bubb, infra this volume. Claims that quantified CBA/FR is feasible would be stronger with one example. The fact that financial regulatory agencies have not been legally required to produce such analyses is not an answer to this weakness, as nothing has prevented academics from producing CBA/FR, in the past or currently. The fact that CBA has been challenged as difficult outside of the financial regulatory area, in such as areas as climate change, is also no answer, particularly since most close observers of the use of CBA to assess climate change regulation as just as skeptical as Coates, supra note 4, about financial regulation. E.g., Robert S. Pindyck, Climate Change Policy: What Do the Models Tell Us?, 51 J. Econ. Lit. 860 (2013).

8 Coates, supra note 4, at 89-94.

9 For an interesting exposition of judgment, see Bent Flyvbjerg, Making Social Science Matter (Cambridge U. Press 2001); see also Coates, supra note 4, at 17-18.
That brings me to the fourth oddity about current CBA/FR debates. Neither advocates nor skeptics have engaged in sustained attention to what sorts of institutional and legal changes might actually move us towards a set of CBA/FR practices that would have positive net benefits for society. Instead, CBA/FR advocates have been largely content to argue for the blind mimicry of laws and institutions that have been used (but never seriously evaluated10) outside the financial regulatory context.

This essay is intended to begin the project of analyzing and developing recommendations on how regulatory agencies might be managed to produce better CBA/FR. Specifically, this paper will (1) briefly summarize why CBA/FR might be a good social project, but one best advanced outside the courts; (2) briefly summarize what good CBA/FR would look like, drawing on analysis and case studies developed elsewhere, and (3) sketch a program of institutional and legal reform that would be more likely to produce good CBA/FR, at least over time and for a subset of financial rules. The reforms would include changes to the funding, governance, rule-design and cultures of relevant agencies. The primary high-level point of the paper is that the task of generating good CBA/FR is managerial, not methodological, much less legal, at least as “law” is routinely understood by CBA/FR advocates, as simple legal mandates. Good CBA/FR is not susceptible of command, any more than dispersed shareholders can command managers to use good business judgment in the private sector. Disciplines often derided as “soft” – such as management science, organizational behavior, and psychology – are likely to be crucial to any serious effort to elicit good CBA/FR.

1. Why CBA/FR Might Be a Good Idea

Elsewhere, I develop six detail detailed case studies of actual or potential CBA/FR for six major, representative types of financial regulations: (1) disclosure rules under Sarbanes-Oxley (SOX) Section 404,11 (2) the mutual fund governance reforms adopted in 2004 by the Securities and Exchange Commission (SEC),12 (3) Basel III’s heightened capital requirements for banks,13 (4) the Volcker Rule,14 (5) the SEC’s cross-border swap proposals,15 and (6) the mortgage reforms adopted by the Financial Services Authority (FSA).16 The main take-away from the case studies is that precise, reliable, quantified CBA remains unfeasible.17 These case studies show that quantified CBA of such rules can be no more than “guesstimated,” as it entails (a) causal inferences that are unreliable under standard regulatory conditions; (b) using problematic data, and/or (c) the same

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10 Coates, supra note 4, at note 30.
13 See www.bis.org/bcbs/ (last visited Dec. 23, 2013). Formally, standards set under the auspices of the Bank for International Settlements are not “law” but multilateral agreements among central banks of different countries that must then be transposed into law by participating countries. Id.
16 The FSA was subsequently broken up into two different agencies. See Financial Services Act 2012, amending inter alia sections 138I (Financial Conduct Authority) and 138J (Prudential Regulation Authority) of the Financial Services and Markets Act 2000.
17 Coates, supra note 4, at 87-89.
contestable, assumption-sensitive macroeconomic and/or political modeling used to make monetary policy, which even CBA advocates would exempt from CBA law. Expert judgment remains an inevitable part even of what advocates label “gold-standard” quantified CBA.

A naïve response to the case studies would be to jettison CBA/FR altogether. This response would be a mistake, for four reasons. First, it is possible that some financial regulations are susceptible of quantified CBA/FR. This possibility seems strongest for certain types of consumer protections, particularly where the regulation in question is designed to intervene in a modest, constrained way to constrain the terms of simple financial products. Of the case studies of the six rules sketched above, the most developed and convincing CBA was that of such rules – the FSA’s mortgage market reforms – although even that CBA/FR was, on close inspection, highly imprecise and sensitive to numerous assumptions, both conceptual and as applied to available data.

Nevertheless, it is possible that – with some of the methods of designing and studying regulations discussed in Part 3 below – a precise, reliable quantified CBA may be feasible for some limited aspects of consumer finance. This seems most likely to be true in settings where financial product is relatively simple. Simple settings may permit a rule’s direct effects to be modeled with sufficient detail to allow for causal inferences about the effect of regulation to be drawn from observational data, rather than requiring random or quasi-random treatment to do so. To use observational methods convincingly, data must be plausibly gathered about the full range of the product’s direct effects, and the external or indirect systemic effects of the use (or misuse) of the financial product must be limited. Limited external effects are likely not true of home mortgages, the subject of the FSA’s reforms. The last financial crisis made clear how important the housing market is to the economy, and how important residential mortgages are to that market. Other consumer financial products, however, may be less systemically important. I have in mind a cap on fraud losses for credit cards, as has been mandatory in the US since 1968, or the recent reforms imposed by the Credit CARD Act of 2009.

A second reason not to jettison CBA/FR altogether is that CBA/FR remains the best available overarching conceptual framework for organizing and communicating the pros and cons of a proposed regulation. It is hard to imagine a regulator not engaging in conceptual (as opposed to quantified or guesstimated) CBA for any regulation if the merits of the regulation are not strongly determined by a statute or constitutional legal requirement. (If they are, the regulator in question may not need or be expected to reasonably expend more than modest resources in real welfare analysis of the regulation, since the regulator will derive no direct benefit from doing so.) Even if relevant costs and benefits cannot be reliably quantified, it is useful for a regulator (and potentially the public and other actors) to identify and analyze, as a theoretical matter, why a rule could be good or bad, and for whom, and how.

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20 By conceptual CBA, I have in mind the following basic components: identifying a potential problem to be addressed, setting forth reasonably feasible alternative regulatory means to address the problem, identifying a baseline for assessing costs and benefits (i.e., the world without addressing the problem), and then identifying in qualitative terms the major categories of costs and benefits each plausible alternative would generate. For examples, see Coates, supra note 4.
In financial regulation generally, a standard set of justifications for regulatory intervention, derived largely from welfare economics, can provide the basis for conceptual CBA of this kind. Asymmetric information, particularly caused by fraud or misrepresentation, can defeat welfare-enhancing transactions. Externalities can induce suboptimal results, particularly when choices by major financial services or institutions have systemic effects, as through the payment system, through investments, loans or other direct exposures to and from other financial institutions, or the public more generally. Moral hazard (when the threat of external effects is likely to induce a taxpayer-funded bailout or subsidy) can erode market discipline and result in socially wasteful dislocations and rent seeking. Inefficient levels of competition can exist in unregulated settings when natural monopolies exist, as arguably was or is true for certain functions, such as payment, clearing, credit ratings, and exchange, or when regulations (that may be justified on their own narrow terms) have the unintended consequence of imposing high barriers to entry.

A standard set of anti-regulatory considerations is also familiar from research on financial regulation. As just noted, even well-intentioned and narrowly justifiable regulations can create barriers to entry and reduce competition, which may create the need for more regulation (in the form of anti-trust regulation or subsidies designed to induce entry) but which may also lead a neutral analyst to conclude that the regulation is not worth the costs it imposes. Regulations can impose unjustifiable direct and indirect costs by imposing standards that would not emerge in a fully competitive market with full information – the socially optimal level of fraud is not zero. Regulations can deter innovation, particularly if they require government agents with low-powered incentives or inadequate resources to screen or approve new investments, financial products or institutions. Regulations can generate pure transfers among equally wealthy firms, without welfare-based justifications, and so induce socially wasteful rent seeking. In the presence of inevitably imperfect enforcement, regulations can impose excessive liability risk on legitimate activities, and so chill socially beneficial risk-taking.

These standard lists of benefits and costs can readily be adapted, if imperfectly applied, to any particular financial regulation. Conceptual CBA at the most basic level is relatively low cost. Its development in particular regulatory settings is likely to generate benefits, in the form of improving both regulators’ self-understanding of what they are doing, and public understanding of why what they are doing is worthwhile.

A third potential benefit of conceptual CBA/FR is that it can facilitate improvements in quantified CBA/FR. Quantified CBA/FR would be highly valuable if it could generate precise and reliable estimates of the social costs and benefits of a regulatory change. Having such estimates would considerably advance the ability of financial regulators to increase welfare, and of the public (and its politically appointed agents) to detect and push back against regulations that fail to do so. But without considerably more conceptual CBA/FR, quantified CBA/FR will never be achievable, even for a subset of

21 See, e.g., John C. Coates, Reforming the Taxation and Regulation of Mutual Funds: A Comparative Legal and Economic Analysis, 1 J. Legal Anal. 591 (Summer 2009) (arguing that resource-constrained officials within the SEC are unable to respond adequately to requests for regulatory exemptions to permit innovation under the Investment Company Act).
23 Steven Shavell, Do Excessive Legal Standards Discourage Desirable Activity?, 95 Econ. Ltrs. 394 (2007).
financial regulations. This is in part because, as Jim Cox has noted to me, conceptual CBA helps identify ways that the regulation under consideration will affect the world — by shaping private behavior, by stimulating or constraining activities of various kinds, and by producing (or eliminating) events or transactions that have effects that are at least in principle quantifiable.

A final reason not to abandon CBA/FR altogether, even if it is not capable of generating precise, reliable estimates in the near future, is that it may serve a brainstorming function. That is, efforts to engage in conceptual CBA/FR, which may extend to attempts to engage in quantified CBA/FR,24 may prompt analysts to be more creative in regulatory design and evaluation. This point is developed more in Part 3 below.

2. What Good CBA/FR Would (and Would Not) Look Like

For conceptual CBA to be useful in this way, however, careful attention must be paid to institutional details, where the devil always lurks. Conceptual CBA/FR will not be useful in stimulating thought or guiding research if it consists of a simple, abstract list of the benefits and costs of a category of regulations. For example, it is correct in most instances for the SEC to include in the category of qualitative benefits of its rules “investor protection” and “investor confidence,” but it would be useless to leave things at that. How, precisely, does a rule improve confidence — through what channels? How does improved confidence constitute a social benefit — how does it affect the cost of capital? Nor will conceptual CBA/FR be useful if it consists of lengthy and opaque boilerplate circumlocutions designed to deflect or confuse judicial review rather than actually communicate to researchers or those who fund, evaluate or publicize research. Conceptual CBA/FR needs to be primarily a body of applied economic analysis, informed by law, psychology, sociology, and other scientific disciplines, and not primarily a body of legal briefs, political tracts, or media missives.

A review of CBA conducted by the financial regulatory agencies demonstrates that fleshing out even the conceptual benefits of financial regulation is a largely incomplete conceptual task.25 For example, the SEC has yet to identify reduction in the externalities or non-pecuniary costs of fraud as significant potential benefits of rules designed to reduce fraud, such as rules adopted under SOX 404.26 Before quantified CBA/FR will be feasible, the more basic task of conceptualizing and modeling in a theoretically sound and complete way the important forces determining the objects of financial regulation: fraud and asymmetric information more generally; externalities; moral hazard; and competitive conditions.

Other conceptual tasks confronting financial regulation aimed at asymmetric information and fraud include the following unresolved if surprisingly basic, questions.

24 Ryan Bubb made this point to me in commenting on this paper, and Larry Tribe also made this point forty years ago when discussing CBA of environmental regulation. Laurence H. Tribe, Ways Not to Think about Plastic Trees: New Foundations for Environmental Law, 83 Yale L.J. 1315, 1322 (1974) (“even before anyone is very good at the task of attaching shadow prices to varying levels of constraints as elusive as ecological diversity, the attempt to attach them rather than simply incorporating such constraints in an all-of-nothing fashion should lead better decision processes even if not better outcomes”). I thank Duncan Kennedy for the reference.

25 One goal of Coates, supra note 4, is to advance that task on several fronts.

26 Cf. SEC rule, supra note 9, with Coates, supra note 4.
What institutions and rules affect the incidence of fraud? How can financial market participants be induced to obtain, understand and rely on socially optimal levels of information about financial activity? What produces and destroys trust? How do retail investors draw inferences about the integrity of one investment based on fraud revelations affecting other investments? What explains the slow drift towards more intermediation of retail investment over the last seventy years, and how should that drift be reflected in anti-fraud regulation? How might we model the distribution of financial fragility across households that participate in the financial sector – an exercise that might allow us to more precisely predict how one instance of fraud may propagate financial distress across other households? Even more basically but importantly, how important is household finance to the economy?

These topics remain significantly underdeveloped in academic research, much less in rulemaking analyses – with deep uncertainty not only about the quantities in the relationships, but even relevant first-order factors. For example, “finance” in its most basic form – that is, as understood and studied by financial economists and legal scholars and regulators who focus on finance – is not part of the basic “Ferbus” model of the economy used by the U.S. Treasury and the Federal Reserve Board, except in the simple exogenous identity of the “equity premium.” The only way that such macroeconomic models can reflect the effect of changes in fraud is via a crude and necessarily imprecise change in that equity premium. The model does not contain any representation of basic factors affecting household finance, such as liquidity, intermediation, or propensity to hoard. If a large-scale spike in corporate frauds (as with Enron, etc.) were to have effects on liquidity, propensity to hoard, or the degree to which funds are invested through intermediaries rather than directly, rather than simply an effect on how much investors would on average charge to invest in equity securities, then such a model will misestimate the effects of frauds, and of regulations designed to reduce fraud.

To make progress on these questions, regulators will need to be open to using tools other than those of conventional economics. Rational-actor models of consumer (investor) choice and stylized life-cycle models of household savings will no doubt be part of the conceptual work. But it is also likely that studies of belief formation, cognitive biases, and social norms will also be important.

On the conceptual tasks confronting financial regulation aimed at externalities and systemic risk, consider the following equally basic questions: What are the channels connecting important financial intermediaries? Stress tests and living wills can be thought of as early-stage qualitative efforts to model (some) systemic risks for the very large institutions subject to those requirements. But the results of those tests and wills need to be better studied and analyzed before they can be assessed for reliability or generality. What forces gave rise to shadow banking? How valuable to users are the repos, swaps, asset-backed commercial paper markets, prime funds, contingent notes, collateralized debt obligations, and securities lending pools that went largely unregulated and unsupervised prior to the last crisis? Put differently, what if any net benefit do such activities generate for society, and how might we model and then quantify that benefit?27

27 It surely is too simplistic to assume as some CBA/FR advocates want to do that the net profits of firms active in those markets provide a reliable estimate of those benefits, since a significant portion of those profits were more than reversed once the popping of the bubble produce something more closely approximating full information relevant to the participants in the markets. That is, even if we think that institutions on average are better able to protect themselves
Why did banks in Canada and Australia do so comparatively well in the crisis, despite being active participants in the same overall financial markets as banks in the US and the European Union? If the answer to that question is simply “more capital,” what political model explains the greater capital requirements in those polities, which at least at a first approximation are similar in kind to the United Kingdom? Did depositors and other consumers of financial services suffer any costs that offset the apparent benefits of not having to bail out banks in those countries?

Similarly, a framework attempting to identify and model the most important indirect or systemic costs of regulation remains undeveloped. CBA/FR proponents have a strong point when they mock past CBA/FR efforts as exercises in “paperclip counting.” Those who are unhappy with the financial agencies are striving to promote quantified CBA through law in part because they rightly worry that regulatory practices that focus only on easily quantified subsets of costs in isolation will achieve little good. But it is only fair for such critics to acknowledge that academic researchers have yet to agree upon even a well-specified list of more important costs, much less on methods to generate reliable inferences about the size of the effects of regulations on such costs. Opponents of financial regulation have generally relied upon anecdote and politics to mobilize deregulatory efforts, as in the lead up to the JOBS Act, when no serious effort was made to estimate the supposed costs of burdensome disclosure regulations on the capital-formation process by new companies.

Without significantly more progress in answering these and other questions relevant to conceptual CBA, quantified CBA/FR will remain over the horizon. Any guestimates that emerge from superficial CBA/FR will only reflect crude assumptions based on the prior judgmental beliefs (i.e., theoretical guesses, informed by experience and ideology) of researchers about the value of regulation. In other words, without significantly more conceptual CBA/FR, guesstimated CBA/FR will decorate and illustrate but not inform much less discipline regulatory decisions.

3. How Might Law and Legal Institutions Encourage Good CBA/FR?

The question, then, is how to encourage financial regulators to engage in meaningful, detailed conceptual CBA so as to stimulate research on quantitative CBA. How can lawmakers or law affirmatively encourage the use of conceptual CBA to stimulate thought and innovation? This challenge is primarily managerial, not methodological, a challenge not susceptible to simple legal commands or conventional judicial review (as from fraud than ordinary retail investors, the difficulties of asymmetric information and fraud reviewed above also afflict modeling and quantification of purely institutional markets.


discussed more below). The challenge is not going to be met by specifying in meta-regulations methods to be used to conduct CBA/FR, but about using law and the lawmaking process to encourage expert agencies to better manage their resources and rulemaking processes in the short run to improve conceptual CBA/FR, with goal in the long run of facilitating reliable, precise quantified CBA/FR. The focus needs to be on funding, governance, disclosure, rule-design, and culture (as amorphous as “culture” may seem to those inclined to the hard edges and sharp corners of economic reasoning). This section presents a number of possible means to improve the management of the agencies so as to improve their ability and propensity to conduct good CBA/FR.

a. Restrict “Hard Look” Review by Courts

Rather than rely on CBA/FR to discipline agencies across the board, skeptics of regulation, and of the supposed empire-building tendencies of federal bureaucrats, would do well to take a lead from the private sector in how large corporations are disciplined. There, investors focus their agency-cost control efforts on the selection and screening of agents, on governance, and on focused rather than broadly sweeping judicial second-guessing of particular decisions.30 Administrative law doctrines should be modified (by statute if necessary) to require courts to give agencies deference in their CBA-related choices similar to the deference accorded “business judgment” in corporate law. This review should be substantially more deferential than the “searching and careful inquiry” required by “hard look” review, as the “arbitrary and capricious” test under the APA was articulated in Overton Park31 and State Farm.32 Rather, the deference should be more akin to what is due to statutory interpretations by regulatory agencies under Chevron,33 closer in spirit to the approach in Baltimore Gas.34 That degree of deference has increasingly not been afforded by the primary court overseeing the agencies, the D.C. Circuit,35 which has tended not to cite cases like Baltimore Gas in its recent aggressive reviews of the SEC’s rules. Generalist courts should recognize that they are unlikely to do better than specialist agencies in conducting CBA of CBA, or in conducting CBA itself, and should defer to the agencies’ choices in these matters, even if regulators may sometimes be influenced by particular “interests” or “politics” which reviewing judges

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30 See Robert C. Clark, Corporate Law (1986) 93-140 (discussing shareholder voting rights as primary tool for governance, as well as business judgment rule, duty of care, and limited role of courts in reviewing merits of decisions by corporate boards).
34 Baltimore Gas & Elec. Co. v. NRDC, 462 U.S. 87, 103 (1983) (“a reviewing court must generally be at its most deferential” when examining scientific determinations).
They should create a “safe harbor” for agencies to conduct CBA when and how they believe best.

If courts are to play a more aggressive role, they should reserve that role to cases where the review is most likely to generate benefits greater than its costs. Rather than focusing on “major” or “economically significant” regulations, which need not imply any agency-level conflict of interest, heightened review should be reserved for categories of rule changes most likely to generate or represent large agency costs. That is, courts should be deferential save only when a rule change enlarges an agencies’ jurisdiction analogous to “self-dealing” review in corporate law.

An example of a jurisdiction-enlarging rule may be the SEC’s rule to cover fixed indexed annuities, which sought to bring within the SEC’s regulatory domain a type of financial product that had been offered by insurance companies. How to characterize the rule is not straightforward – good faith arguments can be made about whether in fact it was designed to expand SEC jurisdiction. On the one hand, the rule may fairly be seen as attempting to prevent the insurance industry from expanding an exemption to the SEC’s rules, by offering products that were closer in kind to mutual funds or variable annuities (which had long been governed by the SEC) than to conventional insurance products. On the other hand, the insurance industry certainly perceived the rule as an effort by the SEC to expand its jurisdiction, and the direct result of the rule would have been to impose SEC requirements on products that previously had been subjected only to state insurance regulation. Similarly, the SEC’s proxy access rule may be an example. Although formally the rule only mandated disclosure of shareholder nominations in public company proxy statements, the SEC arguably was intruding into substantive corporate governance, traditionally governed by state corporate law (albeit pursuant to explicit Congressional authorization in the Dodd-Frank Act).

As this example illustrates, the classification exercise – jurisdiction-expansion vs. jurisdiction-preservation – will generate disputes, and itself require adjudication. It is in part for this reason that the U.S. Supreme Court in City of Arlington recently rejected such an approach in deciding when Chevron deference should be afforded to agency decisions. Instead, the Court used a simpler approach, mandating sweeping deference by courts to agencies in the substance of their rules, even when they arguably expand an agency’s jurisdiction. If the logic of City of Arlington is followed, courts should simply

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36 For a similar approach to the relationship between courts and regulators in an earlier era, see Vermont Yankee Nuclear Power Corp. v. NRDC, 435 US 519 (1978). The relevance of this case to contemporary efforts by courts to heighten and enforce CBA requirements on agencies is discussed in Sunstein and Vermeule, supra note 29.  
37 SEC Rel. 33-8996 (Jan. 8, 2009), struck down as “arbitrary and capricious” in American Equity Investment Life Ins. Co. v. SEC, 613 F.3d 166 (2009, reissued 2010). The merits of the D.C. Circuit’s analysis in American Equity are contestable. The Court critiqued the SEC for claiming its rule would enhance efficiency and competition by clarifying the legal status of the annuities, implying that the baseline prior to the rule was an “unregulated market,” but in fact the status of the annuities was unclear under the Securities Act of 1933 itself, because they might well have been found ex post to have been “securities” by a court. The Court was also dismissive of the SEC’s claim that more disclosure would enhance competition because the SEC did not evaluate the pre-rule state law regulatory regime – but anyone even slightly familiar with that regime would know that the information produced by insurance company sellers of annuities is vastly less useful and clear than produced under the federal securities laws.  
38 City of Arlington, Texas v. Federal Communications Commission, 133 S.Ct. 1863 (2013). Justice Scalia in that case argued that there is no difference between jurisdiction-expanding and other regulatory decisions, using a canned example of a pair statutes where regulatory implementation in fact would not differ. But the application of the distinction will be real in some settings, at least in the financial context. For example, a decision to apply an existing fraud statute to a new financial product or firm, not previously regulated, would be jurisdiction expanding, while a decision to alter an existing fraud statute to raise the penalty for violations would not. Blurry lines are still lines.
defer to CBA-related decisions altogether. If not, if the courts do have a plausible role in reviewing CBA-related decisions in a cost-effective manner, it should be limited to those rules in which an agency’s regulatory jurisdiction is being contested. In those settings, an agency may be most likely to use CBA to “camouflage” rather than discipline its decision-making – as technocratic cover for expanding its power and authority. In other settings, when the agency is simply modifying rules that are clearly within its jurisdiction, CBA-related or –based decisions – even if they are essentially judgmental guesses – are less likely to reflect empire building or turf grabbing, and more likely than judicial second-guesses to reflect the public interest. While an agency still may be making a mistake in such settings – in whether or how to conduct CBA, or whether or how the CBA should affect the rule – such second-guessing by the courts is likely to only make matters worse, on average, by adding a lottery-like component to the end of what is already likely to be a lengthy and burdensome regulatory process under the APA.

b. Eliminate Legal Impediments to CBA/FR

Even more straightforwardly, the agencies should identify, and Congress should eliminate, any existing legal impediments to the effective design of financial regulations that interfere with the agencies’ ability to gather data relevant to quantified CBA/FR policy analysis, whether direct or indirect. Together, the APA and the Paperwork Reduction Act (PRA), for example, indirectly impose a burden on agencies, because they must go through a lengthy process to obtain information that can be used to conduct CBA/FR.

One-time efforts to collect information, however, should be distinguished from ongoing regulatory burdens. One-time efforts to collect information directly relevant to agency self-evaluation of potentially burdensome regulations is straightforwardly net beneficial. Concerns about privacy can be addressed as they have been in the medical arena (with anonymization), as opposed to CBA/FR-inhibiting bans, exemptions or special process requirements.39 The costs associated with the generation of such data should be more than offset by the elimination of litigation expenses the current CBA/FR legal framework is generating.

c. Improve Funding of CBA/FR

Better CBA/FR and better alignment of agencies with public-regarding goals of financial regulation could be achieved by improving the agencies’ funding. At least two ways exist to improve CBA/FR through the funding process. First, Congress should give all of the financial agencies – and not just a subset – self-funding authority, at least for purposes of conducting CBA/FR. Doing so would remove funding disputes over CBA/FR from the annual, increasingly polarized and partisan budget battles in Congress. Most federal financial regulatory agencies already enjoy self-funding authority, including the Federal Reserve Board, the Consumer Financial Protection Bureau, the Federal

39 Cf. S. 2242, 113th Cong. (2013-2014) (bill introduced by Senator Dan Coats that would give “prudential regulators” a veto over information requests from Consumer Financial Protection Bureau).
Deposit Insurance Corporation, and the Public Company Accounting Oversight Board.\footnote{United States General Accounting Office, SEC Operations: Implications of Alternative Funding Structures (2002), GAO-02-864, available at \url{http://www.gao.gov/new.items/d02864.pdf} (last visited July 1, 2014).} No good reason exists for not extending it to the SEC and the CFTC for purposes of CBA/FR – not even politics, since the amounts likely to be spent by the agencies will leave large portions of their budgets subject to Congressional oversight.

Congress should take off budget any amounts of fees collected by financial agencies that the agencies believe can be cost-effectively spent on research and study designed to enhance CBA/FR. Even if Congress is not willing to let go of the purse-strings altogether, they should give the agencies an incentive to use their revenues to further agency knowledge and expertise relevant to CBA/FR. Such funds could be spent on staff, data, systems, studies, pilots, research grants, and other methods to build CBA/FR capacity. By moving such funding off-budget, Congress will allow the agencies to invest in multi-year projects safely, without fear that investments made in one year will be wasted if funding is cut in the next year’s budget fight.

Second, Congress can focus its control of agency budgets to insure that CBA/FR is being promoted adequately within the agency, by (for example) requiring a set percentage or dollar amount of agency funds be devoted to CBA/FR units. While this will leave CBA/FR spending subject to political fights, and is less desirable on its own than the prior suggested reform, it will be better than the status quo, and could be combined with the prior suggestion. That is, Congress could specify a minimum amount to be spent on CBA/FR, but allow the agencies to earmark higher amounts without needing to make further budget requests or defend them in the annual budget fights.

d. Better Align Governance of Agencies with CBA/FR

Congress could reinforce the above funding suggestions by altering the governance of the financial agencies. For example, the standing and role of CBA/FR within the agencies could be enhanced if the President were to include a specific number of CBA/FR-qualified members in the multi-member commissions that have been dominated by lawyers (the SEC and the CFTC). When regulatory staff consider how their proposals will be reviewed, they will never be as willing to work as hard on even statutorily mandated CBA/FR if they know that the ultimate decision-makers do not have the background or taste for CBA/FR. This is particularly important if (as I advocate above) courts have less of a role in reviewing CBA/FR. For other agencies, Congress could consider ways to increase the expert diversity of the agencies that have been governed by economically literate appointees to better challenge existing conventional wisdom on what CBA/FR is possible and how regulation should be changed. Specifically, Congress could consider adding more individuals to the Federal Reserve Board who have skillsets other than macroeconomics – such as those with knowledge of financial economics (such as my colleague Jeremy Stein), financial regulation (such as former Georgetown law professor Dan Tarullo), financial markets, financial institutions, and financial decision-making (including relevant psychology). If the crisis of 2007-08 taught us anything, it is that the job of preserving financial stability is as least as important as balancing inflation against full employment.
Another governance reform would be to give all members of multi-member commissions or boards of financial agencies direct lines of communication to their agencies’ CBA/FR staff. While this change would slightly dilute the standard “single line of command” model of governance that was transferred to regulatory agencies from the military, it will not represent a genuine break from good governance elsewhere. Corporations have long embraced “matrix” reporting to accommodate the need for multidimensional communications and information flows. Corporate audit committees have direct access to internal and external audit staffs, which has been thought to improve and not compromise the effectiveness of the audit process. A change in the internal reporting of financial agencies would help reduce two risks. One risk it would address is that a hostile chair might try to ignore the output of CRA/FR staffs, even if they were given more resources. The other risk is that without access to CBA/FR staff, minority commission members would be unable to assess the feasibility of alternatives, might resort to ad hoc and baseless critiques in dissents, and might resist regulatory changes that CBA/FR might suggest were compatible with the public interest.

A more controversial but potentially useful change would be to give CBA/FR staff autonomy to (or even mandate that they) release analyses without political appointee approval. This would make them more similar to the “inspectors general” within the agencies, who have similar authority. Particularly if combined with restrictions on judicial review of CBA/FR, such autonomy (or mandate) would open up CBA/FR discourse in two ways, relative to the status quo. CBA/FR analyses could be written in ways that did not have to respond to political appointees’ concerns about how the write-ups might affect the reception of the regulations the political appointees’ approve, and the analyses could be more candid about the limitations and sensitivities of the analyses without fear that courts turn such candor against the agencies.

e. Enhance Transparency and Communication about CBA/FR

To improve public understanding of CBA/FR, and make it more likely that a program of CBA/FR will have positive effects on welfare, more should be done to explain the limits of current CBA/FR techniques and the unreliability of their outputs. To that end, Congress should require any quantified CBA/FR estimate to include not only conventional confidence intervals around point estimates, but also clear statements designed to emphasize the current imprecision and unreliability of CBA/FR guesstimates. Agencies should be required to clearly explain the limits of any causal inferences implicit in the analysis, given the difficulties of causal inference about the effects of regulation. They should also be required to provide a summary of the major sources and extent of the sensitivity of quantitative outputs of the CBA/FR, preferably presented in simple-to-understand charts or tables. A reader should be able to quickly identify both the conceptual assumptions implicit in the analysis, and the alternative reasonably believable

assumptions (ARBAs) that could have been made, and the effects that the assumptions actually made had on the results relative to the ARBAs. Any inclusion of quantified estimates of costs or benefits in the presence of non-estimable costs or benefits should be clearly identified as “partial gross estimates.” If OIRA or any other secondary agency is given a role in reviewing CBA/FR, that agency should be required to evaluate the analyses for these de-biasing disclaimers and clarifications as much as for the use of appropriate discount rates or specified baselines.

f. Reflect Uncertainty in Regulatory Design

Given the limits and sensitivities of currently available techniques for CBA/FR, a broader and more general set of recommendations concern the nature of regulation itself. Any financial regulation remains uncertain, a work in the realm of judgment, not science. Regulations should reflect this fact. New regulations and deregulatory reforms (such as new exemptions) alike should be accompanied by sunsets, and should expire unless affirmatively re-enacted. This will allow for post-adopter assessments – which will still remain tentatively, given the general inability to adequately control for contemporaneous changes in the financial environment, but which will nevertheless generate information about potential costs and benefits that will be materially more reliable and precise than will be possible in advance of the regulatory change. The uncertainty of CBA/FR also suggests that disclosure should be preferred over conduct rules, although the effects of disclosure can often have action-forcing effects that approach those of direct mandates.

g. Create a Culture of Regulatory Innovation and Creativity

The most important task for improving future CBA/FR is for the President, Congress and the agencies to work together to inculcate a culture of innovation and creativity in financial regulation. This task follows from the points just made – that uncertainty over costs and benefits of financial regulation is likely to endure, making it all the more important that agencies (and courts and political representatives) remain open-minded about the potential vices about inherited modes of regulation, and the potential virtues of novel modes. This general point applies both to the content of the rules and methods and approaches for conducting CBA/FR – for conceptualizing, modeling, gathering data for, and then estimating the magnitudes of the costs and benefits of different regulations.

1. The Permanent Role of Regulation in Finance

For some, the idea that regulators should be encouraged to be “creative” may seem odd. Particularly for those skeptical of regulation, such a suggestion may imply that more regulation will follow. But such a take-away is too simple. Deregulation is just a difficult a task as regulation. In truth, given the nature of finance, financial markets, and

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43 Those who advocate regulatory sunsets on the ground of regulatory uncertainty rarely call for similar treatment of deregulatory reforms or new regulatory exemptions. E.g., Larry Ribstein, SarbOx: The Road to Nirvana, 2004 Mich. St. L. Rev. 279. Asymmetric treatment of regulation and deregulation can only be justified on ideological grounds.

44 This is one of the few clear lessons of the Sarbanes-Oxley Act. See John C. Coates IV and Suraj Srinivasan, SOX After Ten Years: A Multidisciplinary Review, Accounting Horizons (forthcoming 2014) (available in working paper form at ssrn.com/abstract=2343108).
financial institutions, no full-scale deregulation is ever likely to occur. Fluid financial markets present multiple opportunities for theft. Financial investments typically generate a common need for trust in and dependence on agents. The information-sensitivity of financial investments makes common metrics and comparable accounting systems too socially valuable to leave entirely to private ordering. Anarchy and finance are incompatible.

As a result, all regulatory reforms are best characterized as “re-regulation” rather than either new regulation or deregulation. Consider, for example, the Sarbanes-Oxley Act. While it added the controversial disclosure requirements in Section 404, it also created the Public Company Accounting Oversight Board (PCAOB), and gave it authority to implement Section 404(b)’s requirements. The PCAOB exercised that authority in 2007 to reduce the burden of its initial requirements. That reform is fairly understood as reducing regulation – a deregulatory change – rather than increasing it. Creativity in the design and CBA-based assessed of de- and re-regulation will be just as if not more important to burden-reducing reforms as it will be to reforms designed to regulate new activities or products for the first time.

This general point can be made more concrete. The existing executive order on CBA by independent agencies emphasizes the need for retrospective analyses – consistent with this general point – but more could be done along these lines. Agencies could be required to identify each economically significant regulation it has adopted in the past and to prepare an estimated budget and data needs for conducting a retrospective assessment of each such rule. If the agencies will not do this themselves, Congress could task the GAO with doing so.

2. Randomization and Quasi-Randomization

More ambitiously, statutes and regulations could be jointly designed and implemented in pilot programs that build in randomization. Doing so would create the possibility of generating genuinely reliable information about the effects of the rules, a substantial improvement over the current need to rely on expert judgment and intuition. Random controlled treatments allow for more certain causal inference because they more efficiently control for differences in treated subjects than with observational studies, and by design can forestall selection effects, at least in some settings. Random controlled trials in regulation are not easy to implement. The variation they require will commonly clash with deep rule-of-law value of equal treatment. By definition, an experiment requires some randomly selected private actors to be regulated, while a control group remains uncontrolled. If the regulations provide benefits to regulated entities (for example, if they permit activity subject to set conditions that would otherwise be banned), those who are regulated will enjoy a competitive advantage over

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45 See Executive Order 13579 (July 11, 2011) at Section 2.
46 Financial regulation is not the only area in which random controlled experiments are challenging. E.g., Gina Kolata, Method of Study is Criticized in Group’s Health Policy Tests, N.Y. Times (Feb. 2, 2014), available at http://nyti.ms/MRygf4 (last visited Feb. 2, 2014) (describing $10 billion fund for research in public health established by the Affordable Care Act and debates over when and how extensively such funds should be used for random controlled trials, rather than observational studies and uncontrolled pilot studies).
the control group in the product, labor and/or capital markets. That control group would certainly complain that they were being disadvantaged by the regulation. Conversely, if regulations impose costs on the regulated, to generate benefits for third parties (e.g., consumers), then the reverse would be true, and regulated persons would complain that they were being disadvantaged. As a result, only regulations that have no clear and strong implications for competition among firms are likely to be legally or politically viable for true random control treatments.

Nonetheless, there are types of regulations that could be treated in this fashion. CBA/FR advocates rightly point to the SEC’s pilot program on short sale rules, which randomly exempted a stratified sample from new rules for purposes of evaluating the rules’ effects in a statistically reliable way. Even more recently, the SEC announced a similar pilot program for tick sizes on the stock exchanges. A range of consumer financial regulations could be randomized within each producer firm, so that no one firm was advantaged over others. In such settings, any benefit or harm to subject consumers would have small if any competitive effects in labor market or other settings where consumers are effectively competing with each other. Retail financial products and services are typically simpler and easier to model than institutional or wholesale products and services. Simpler models should make it more feasible to estimate and quantify the effects of regulation. However, one difficulty with consumer regulation is precisely that it involves individuals. Individuals are more likely to place unobservable, varying utility on activities or products than for-profit firms, where the goal is to generate wealth, which is commensurable and less likely to be affected by latent psychic valuations.

Another way that the fairness-in-application challenges of randomization can be addressed is not to exempt the control group, but merely to delay modestly the implementation of the regulation in question. Although not designed for this purpose, the staggered and phased-in application of rules under Section 404 of the Sarbanes-Oxley Act for different subsets of US and foreign companies provides another template for how better causal inferences can be (at least in theory) drawn through the process regulatory implementation. One could imagine a law like SOX 404 applying at date X to all firms with a past (and so non-manipulable) market capitalization of between $75 million and $100 million, between $125 million and $150 million, and between $175 million and $200 million, and so on the way through the full distribution of market capitalizations, but only start to apply at date Y for all firms between $100 million and $125 million, $150 million and $175 million, etc. This would only work, of course, if the effects of the regulation could be inferred from changes occurring between date X and date Y, and to that extent, political resistance could still be expected from one or both the treatment and control group. It would also require enough political stability that the phase-in period would not be used by the temporarily exempt group to lobby for a permanent exemption – it would thus be useful to not phase-in rules from large to small, as under SOX, because that will only reinforce political vulnerabilities of the experiment, but instead to use layered phase-ins, with some large firms covered, some exempt, some medium-size firms

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50 For discussion of such studies of SOX, see Coates and Srinivasan, supra note 40.
covered, some exempt, etc. With these caveats, at least for modest regulations and reforms, such an approach may be feasible even in the non-consumer financial context.

A third approach that may allow for better causal inferences is to allow regulatory opt-outs in return for agreements to collect information relevant to the evaluation of the effects of the opt-out.\textsuperscript{51} While the opt-out may generate selection effects, these can be overcome with statistical techniques in some regulatory settings, as where (for example) the subject populations are large. Again, consumer or retail financial regulation may be easier to assess for this reason than will be true of wholesale, institutional or structural regulations, where the subjects of regulation are fewer in number.

Yet another source of potentially useful causal inferences can be derived from exogenous “natural experiments” – “shocks” to components of financial markets or institutions, or to behaviors meant to be the subject or target of regulation (such as fraud)\textsuperscript{52} – and a team of researchers – call it the Office of Shock Identification – might be usefully tasked with periodically reviewing changes in the regulatory and financial environments to identify plausible candidates for such shocks. Of course, inferences from any of these regulatory designs will not be available ex ante, in a CBA/FR in advance of the rule, and so are best combined with sunsets, as suggested above, with re-authorization contingent on the results of the ex post study.

2. Statutory Flexibility as Prerequisite

Implicit in this sketch is the need for coordination not just at the regulatory agency level, but also between Congress and the agencies. Legislators should consult with the CBA/FR staffs of the regulatory agencies before adopting legislation such as the Dodd-Frank Act or the Sarbanes-Oxley Act, and ask whether it would be useful to include discontinuities in regulatory deadlines and phase-ins. Agencies should be expressly permitted to implement randomized regulations (which will be formally “unequal” in application) so as to improve causal inferences about the effects of regulations. While causal inference is only one challenge facing CBA/FR of financial regulation, it is an important one, and such reforms would go a long way to allowing advances toward the long-term goal of serious quantified CBA/FR policy analysis.

3. Encouraging Creativity and Innovation at the Agency Level

Creativity and innovation can also be encouraged within agencies. Regulators already enjoy some degree of political shelter due to civil service protections, but explicit “tenure” equivalent to that enjoyed by academics might be considered for those staff members whose tasks are meant to be primarily evaluative, to encourage such staff members both to experiment in their research techniques and to give them greater ability to disclose the results of their research even when it does not fit current political or policy agendas. Agencies might host more frequent interagency conferences and research symposia, in combination with private researchers, particularly if funding for CBA/FR is

\textsuperscript{51} See, for example, J. Manzi, Uncontrolled: The Surprising Payoff Of Trial-And-Error For Business, Politics, And Society (2012).

\textsuperscript{52} E.g., A. Dyck, A. Morse, and L. Zingales, How Pervasive Is Corporate Fraud?, Working Paper (Feb. 2013) (exploiting “shock” of the collapse of Arther Andersen following Enron to estimate the prevalence of certain types of corporate fraud).
increased as suggested above, or working sabbatical programs where staff members swap jobs for a year across agencies. Agencies might develop awards for the best and/or most innovative techniques for conducting internal CBA/FR. Agencies could self-consciously create multi-disciplinary teams to draw on the multiple disciplines that are going to be required to conduct reliable quantified CBA/FR – ranging from economics and law to accounting and finance to psychology and sociology. Agencies should also face up squarely to the seemingly inevitable novelty-aversion that all humans experience, particularly in bureaucratic settings, and try to develop managerial techniques for encouraging innovation, similar to techniques used in the private sector by large companies faced with similar tendencies towards bureaucratic sclerosis.

h. Rely More on Supervision Rather Than Regulation

A final suggestion builds on the above points about how best to respond to the likely fact of enduring uncertainty about the costs and benefits of financial regulation, and that is to rely less on regulation per se, and more on supervision. Supervision – conceived loosely as close monitoring the conduct of relevant financial actors and directing those actors to take or refrain from taking specific actions – can be distinguished from regulation – the adoption of rules (or standards) intended to specify in advance constraints on or mandated actions by private actors. Supervision is often targeted, may not generalize to other private actors, even ones that are apparently similar situated (based on observable and verifiable criteria), while regulation does. Supervision is largely exempt from judicial review, while regulation must generally comply with the APA. “Safety and soundness” have been the traditional goals of supervision, a task that has required assessments of management, operations, capital, relevant markets, and (for lending organizations) credit risk. All financial sectors are subject to a combination of supervision and regulation in the US, but the balance varies significantly: supervision is a more significant component of bank regulation in the US, while for securities firms and investment companies, regulation has been a more important component, even if those entities are also subject to some types of supervision.

Supervision has two advantages over regulation. First, supervision can adapt more readily – both to changed circumstances and to new information about existing circumstances. By falling outside the APA, supervision can be more tentative and experimental, and be modified more rapidly and frequently, at lower cost, than

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53 For a description of the use of household “well-being” surveys in the FSA’s CBA of its mortgage market reforms, see Coates, supra note 4. Similar surveys could be developed through interagency task forces to allow for better estimation of the benefits of financial regulation. But doing so will likely require researchers trained in psychometrics and longitudinal survey design, not simply in econometrics or finance.

54 In contrast to regulation, about which oceans of ink have been spilled, supervision in the US financial regulatory context is relatively understudied by legal scholars, and it has remained the province of banking specialists. For examples of studies focusing on supervision, see, e.g., James E. Kelley, Transparency and Bank Supervision, 73 Alb. L. Rev. 421 (2010) (noting tension between movement for more transparency stimulated by the financial crisis and bailouts and the traditional expectations of supervisory confidentiality reflected in, among other things, the bank examiners’ privilege); Mark B. Greenlee, Historical Review of “Umbrella Supervision” by the Board of Governors of the Federal Reserve System, 27 Rev. Bank. & Fin. L. 407, 453 (2008) (reviewing Fed’s role as “umbrella supervisor” for financial holding companies, after the Gramm-Leach-Bliley Act’s repeal of the Glass-Steagall Act, and the fact that the Fed had already acquired sufficient powers to supervise bank holding companies and their affiliates by 1983); and Thomas H. Stanton, Federal Supervision of Safety and Soundness of Government-Sponsored Enterprises, 5 Admin. L.J. 395 (1991) (describing supervisory needs of government-sponsored financial institutions).
regulation. Second, supervision can be more incremental, and tailored, and so impose fewer unnecessary costs across different subject entities, who face different regulatory cost functions—supervision, for example, can take into account firm size or scale in a more continuous fashion than can regulation, which generally takes on clear values above or below a small number of size thresholds.

Supervision is no panacea. Concerns arise from two directions. First, supervision requires the regulatory agents to get “close” to the supervised entity in order to have the ability to get the information necessary to supervise effectively—raising concerns about regulatory capture. Second, from the other perspective, supervisors may fail to get “close enough” to their supervised entities, and may effectively impose harmful regulations through the guise of supervision, all outside the purview of the public or the courts, making political reform more difficult. Despite these costs, however, supervision in combination with regulation holds out the promise of allowing for better governance of financial institutions over time in the face of deep uncertainty about costs and benefits of different legal constraints than is possible with pure regulation. The risks of capture can be mitigated with strong rules about independence, strong supervisory cultures, elite status, high pay, long-term careers on-staff, and upward mobility within a (large) organization. The risks of opaque sclerosis can be mitigated by including in the supervisory culture a healthy appreciation for the importance of innovation and adaptability, by carefully regulating supervisory practices (for example, by directing agencies to rely on existing reports or disclosures where possible, rather than requiring duplicative reports), by continuously benchmarking supervisory practices against those in other countries, by holding up supervisory practices to periodic (not continuous!) examination and review, and by ensuring periodic political accountability at the top of the regulatory organization.

Some might argue that the last crisis demonstrates the failure of supervision. However, both regulation and supervision were in operation prior to and during the crisis, leaving it difficult to draw any clear lessons from the crisis about the optimal balance between the two. While much can be criticized in how the banking agencies performed in the US, particularly the now-defunct Office of Thrift Supervision, the worst excesses leading up to the crisis occurred at entities subject to the very weak supervision of the SEC (Lehman, Bear Stearns), the fragmented and ineffective supervision of insurance and re-insurance companies (AIG), and in the “shadow banking” markets, which were exempted through a combination of Congressional and SEC action and so went unsupervised altogether. As between regulation and supervision, the persistent uncertainty in the costs and benefits of legal limits on financial markets and institutions makes it likely that some strong component of supervision will increasingly be seen as a mechanism to test and adjust those limits over time, in response to new information and market needs.

55 Bank examination reports are for good reason exempt from the Freedom of Information Act. 5 U.S.C. § 552 (exempting materials “contained in or related to examination, operating or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions”). But that does not mean that such reports could not be reviewed in camera in periodic meta-reviews by a watchdog arm of the supervisory agency, or even by a third-party agency such as the GAO, and the results of such meta-reviews made public. Efforts to “audit the Fed” range from the unworkably intrusive to the sensible and valuable—the question is not whether but how, as well as by whom, and how frequently, under what circumstances, and with what output.
Conclusion

Cost-benefit of financial regulation is a topic du jour among political entrepreneurs and legal academics. Unfortunately, its time is not yet ripe. Much more work is required, at both a technical level (the conduct of CBA/FR itself) and institutional design (the settings in which CBA/FR is to be conducted), before CBA/FR will be capable of doing more than edifying, rather than generating regulatory judgments. In the long term, quantified CBA/FR has the potential to improve regulatory outcomes substantially. But until the work is done that is necessary to permit CBA/FR to produce reliable, precise estimates, CBA/FR can be expected instead to generate more smoke than light, obscuring what will remain essentially intuitive judgments under a cloak of pseudo-scientific guesswork. Until that work is done, courts should have little or no role in reviewing CBA/FR-related decisions by agencies, and both the public and regulatory agencies should treat CBA/FR as helpful but limited exercises in structured reasoning, not as methods to produce optimal regulatory changes. This article has attempted to sketch ways to improve the institutional setting for and content of CBA/FR, including improvements in funding, governance, disclosure, regulatory implementation, and agency design and culture – tools of management, not law.