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Economic Analysis in Securities Enforcement: The Next Frontier At the SEC

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ECONOMIC ANALYSIS IN SECURITIES ENFORCEMENT: THE NEXT FRONTIER AT THE SEC

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I. INTRODUCTION

The Securities and Exchange Commission (SEC) has undergone measured change in the last fifteen years in the way it executes its mission to protect investors. Since reforms adopted in 1996, the SEC has operated under a new mandate to consider the effect of new rules on efficiency, competition, and capital formation. That new guiding legal principle, accompanying pressure from courts, and oversight from Congress have spurred measured reforms at the SEC and have begun to change the structure and culture of the agency with respect to its rulemaking process.

That process reform effort has been supported by a preliminary investment in a small group of new economists at the SEC, housed in the new Division of Economic and Risk Analysis (DERA). This Article argues that these developments are incomplete unless the SEC's economic analysis capability is similarly used to apply robust scrutiny to the SEC's enforcement process as well. This Article draws on lessons from the FTC's successful application of economic analysis to its enforcement process in order to develop practical reforms for the SEC.

II. BACKGROUND ON ECONOMIC ANALYSIS AT THE SECURITIES EXCHANGE COMMISSION

A. Legal and Political Action to Enhance the Role of Economics at the SEC

Economic analysis at the Securities and Exchange Commission has recently become a hot topic, owing to a series of successful challenges to SEC rules on the basis of insufficient analysis culminating in a significant setback for the SEC in 2011. Challenges the SEC has faced in economic analysis of its rulemaking, and structural reforms adopted in response to those challenges, opens the door for a discussion on how the SEC can improve its enforcement process in the same way.

The proxy access rule, the first rule the SEC promulgated pursuant to the landmark Dodd–Frank Act, was struck down in 2011 by a

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unanimous panel of the D.C. Circuit, on the grounds that the SEC conducted insufficient economic analysis of the rule by failing to take into account the effect of the rule on efficiency, competition, and capital formation.

The D.C. Circuit opinion summarized that the SEC failed to conduct an adequate analysis because:

> [T]he Commission inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters.[1]

That defeat came on the heels of two similar defeats for the SEC on the same grounds in the prior fifteen year period since new rules requiring additional economic analysis were adopted.[2] In 1996, a provision contained in the National Securities Markets Improvement Act (NSMIA) amended the Securities Exchange Act to require that the SEC consider the impact of new rules on efficiency, competition, and capital formation in addition to its existing investor protection mission.[3]

That provision was introduced by Congressman Jack Fields, who understood it to introduce a form of cost–benefit analysis to SEC rulemaking, as he introduced the legislation by noting:

> This is an important provision of the bill because it will introduce an element of explicit cost benefit analysis into SEC rulemaking. We want to encourage the SEC to take efficiency, competition and capital formation into account in its rulemaking. We view these goals as complementary to the important goal of investor protection.[4]

Regulatory cost–benefit analysis began as a field considering the unanticipated effects of rate and competition regulation by scholars like Alfred Kahn[5] and developed into consideration of the wider tradeoffs posed in fields like safety regulation by scholars like Kip Viscusi and

1. Bus. Roundtable v. SEC, 647 F.3d 1144, 1148–49 (D.C. Cir. 2011).

2. *See* Chamber of Commerce v. SEC, 412 F.3d 133 (D.C. Cir. 2005). *See also* Am. Equity Inv. Life Ins. Co. v. SEC, 613 F.3d 166, 167–68 (D.C. Cir. 2010).

3. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, § 106, 110 Stat. 3416, 3424–25 (1996). The Investment Advisers Act and the Investment Company Act were later amended by the Gramm–Leach–Bliley Act to include the same provision. *See* Gramm–Leach–Bliley Financial Modernization Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999).

4. *Deregulating Capital Markets: Hearing Before the Subcomm. on Telecomm. and Fin. of the H. Comm. on Commerce*, 104th Cong. (1995), 1995 WL 706020 [hereinafter *Deregulating Capital Markets*] (statement of Jack Fields, Chairman, Subcomm. on Telecomm. and Fin.).

5. ALFRED E. KAHN, THE ECONOMICS OF REGULATION: PRINCIPLES AND INSTITUTIONS (7th prtg. 1988).

Richard Zeckhauser.[6] That field provides the tools the White House Office of Management and Budget (OMB) uses to review rules put forward by executive agencies of the federal government.

This movement toward enhanced cost–benefit analysis in regulation began within government principally by way of developments in the functioning of the Office of Information and Regulatory Affairs (OIRA) at the White House Budget Office, which was informed by developments in the law and economics of regulation. Cass Sunstein, President Obama's former Director of OIRA, described the initial germination of the agency as beginning in the Nixon and Carter White Houses and blossoming during the Reagan era into a full executive order requiring agencies to submit proposed regulations for review.[7] The White House OIRA has never sought regulatory review authority over independent agencies like the SEC however, and so the new three-part economic analysis standard created by NSMIA serves the same principal function as OIRA review but is accomplished through judicial review.[8]

Congress responded forcefully to the SEC's most recent economic analysis defeat with a series of congressional oversight hearings seeking explanation for the agency's repeated rebukes by the D.C. Circuit.[9] Partly in response to those hearings and to the *Business Roundtable* case, the SEC began to empower a new Division of the agency, now called the Division of Economic and Risk Analysis.

In a memorandum promulgated by that Division, the SEC describes DERA's mission in informing regulation and requiring the SEC to consider the following in adopting regulations: (1) a statement of the need for proposed action; (2) the definition of a baseline against which to measure the likely economic consequences of the proposed regulation; (3) the identification of alternative regulatory approaches; and (4) an evaluation of the benefits and costs—both quantitative and qualitative—of the proposed action and the main alternatives identified by the analysis.[10]

And yet if one accepts the basic logic of analysis of the costs and

6. *See* W. Kip Viscusi, *The Value of Risks to Life and Health*, 31 J. ECON. LITERATURE 1912 (1993). *See also* EDITH STOKEY & RICHARD ZECKHAUSER, A PRIMER FOR POLICY ANALYSIS (1978).

7. *See* Robert W. Hahn & Cass R. Sunstein, *A New Executive Order For Improving Federal Regulation? Deeper and Wider Cost-Benefit Analysis*, 150 U. PA. L. REV. 1489, 1506 (2002).

8. *See id.*

9. *See, e.g., The SEC's Aversion to Cost-Benefit Analysis: Hearing Before the Subcomm. on TARP, Fin. Servs. and Bailouts of Pub. and Private Programs of the H. Comm. on Oversight & Gov't Reform*, 112th Cong. (2012).

10. *See* Memoradum from RSFI and OGC to the Staff of the Rulewriting Divisions and Offices 1 (Mar. 16, 2012), *available at* http://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf.

benefits of new regulations, one must also accept the need to apply those principles to enforcement decisions. Former SEC Chairman Harvey Pitt described how regulation and enforcement often bleed together, as the SEC prefers to accomplish through enforcement what it may otherwise attempt by way of regulation:

> It is, understandably, far easier for SEC officials to defend and pursue individual enforcement actions, particularly if they are highly visible enforcement actions, than to attempt to develop and maintain comprehensive regulatory responses to difficult and technical industry and professional issues. To be sure, there are administrative benefits to such an approach—that is, to the approach of securities regulation by enforcement. Among other things . . . the agency is not required to chart out, explicate, maintain or perfect a comprehensive solution to identified issues, taking into account those circumstances where deviation from normative standards might be appropriate . . . critics and overseers of the agency's activities are less likely to be able to detect inconsistent approaches by the agency to comparable problems, or even to ascertain guiding principles or policies employed by the agency to respond to certain types of situations.[11]

B. Economics in Securities Enforcement

The new three-part economic analysis requirement added by NSMIA and Gramm–Leach–Bliley applied to new rulemaking, but a previous requirement that it also apply to SEC orders was withdrawn from the original legislation on the recommendation of Chairman Arthur Leavitt.[12] Former Chairman Leavitt did not provide any context for that argument, but merely asserted in a hearing about that provision that:

> At present, the Commission generally requires a cognitive analysis when it proposes or adopts its rules. The Commission is prepared to strengthen this requirement by requiring the staff to perform additional analysis of a rule's impact on competition, efficiency and capital formation. The Commission does not believe, however, that this analysis would be appropriate in the context of enforcement actions and adjudicated opinions. Thus, the Commission would oppose legislation that would mandate such an analysis in those contexts.[13]

This argument was particularly curious given that some of the rules the SEC enforces have uniquely economic questions attached to them.

11. *See* Harvey L. Pitt & Karen L. Shapiro, *Securities Regulation By Enforcement: A Look Ahead at the Next Decade*, 7 YALE J. ON REG. 149, 156–57 (1990).

12. *Securities Legislation: Hearing on H.R. 3005 Before the Subcomm. on Telecomm. and Fin. of the H. Comm. on Commerce*, 104th Cong. (1996) (statement of Thomas J. Bliley Jr., Chairman, Comm. on Commerce).

13. *Deregulating Capital Markets*, *supra* note 4 (statement of Arthur Levitt, Chairman, SEC).

The extent to which a potentially harmful disclosure has already been revealed to the market, and therefore, is not materially harmful to investors, is one example of a uniquely economic question which forms one of the key elements in a 10b-5 action, the SEC's principal tool in combating financial fraud.[14]

Dirks v. SEC is an instructive case study in the consequence of excess discretion for the SEC Enforcement Division. Dirks, an investment analyst, learned through investigation and conversation with a company insider that a company in which his clients were invested was engaged in a massive fraud.[15] Dirks told his clients of the fraud, and they sold their investments. Dirks did not bribe the source of the information, and he even attempted to inform the SEC, the Wall Street Journal, and state authorities of the fraud, but was ignored.

Dirks was bound by his obligation to his clients to inform them of the fraud, and did so. Dirks engaged in no inappropriate action to obtain the information. Dirks promptly informed all relevant enforcement authorities. And yet the SEC Enforcement Division targeted him anyway.

Though the opinion ultimately turned on legal questions about the doctrine of insider trading, Daniel Fischel notes that the SEC ignored the economic implications of this action, which if successful could have significantly hindered investment analysts, through which investors obtain information about the value of their investments, by reducing their incentive to conduct due diligence to root out corporate fraud.[16]

The SEC Enforcement Division currently uses DERA to effectively provide litigation support after a case has been brought, or utilizes DERA to provide expert guidance during an investigation, but DERA has no authority to participate in the decision to bring an investigation or action nor to set the ground rules for how the SEC Enforcement Division prioritizes its caseload or determines penalties and settlements. SEC Chair White explains DERA's current role in the SEC's enforcement actions:

> DERA also provides ongoing expert support to the Division of Enforcement, and its work directly contributed to a number of successful investigations. For example, last year, economists assisted in several market manipulation investigations, creating algorithms to analyze the order and transaction files of high-speed traders and quantify the extent of suspicious trading. Staff also provided expert testimony to assist with the freezing of assets in a $150 million fraud scheme, and also aided Federal

14. *See* Merck & Co., Inc. Sec. Litig., 432 F.3d 261 (3d Cir. 2005).

15. *See* Daniel R. Fischel, *Insider Trading and Investment Analysts: An Economic Analysis of* Dirks v. Securities and Exchange Commission, 13 HOFSTRA L. REV. 127, 127–30 (1984).

16. *See generally* Fischel, *supra* note 15.

prosecutors in charging insider trading by analyzing evidence of materiality.[17]

The next Part will draw from the Federal Trade Commission's experience in incorporating economic analysis into its enforcement process and empowering staff economists in that process to help shape useful reforms for the SEC as it faces this challenge.

III. LESSONS FROM THE DEVELOPMENT OF ECONOMIC ANALYSIS AT THE FEDERAL TRADE COMMISSION

A. Similarities Between the SEC and FTC

The Federal Trade Commission is an agency whose mission and history is similar enough to the SEC's that it offers a useful benchmark for gauging the potential for harnessing economics in informing legal enforcement policy. The SEC, like the FTC, is a consumer protection agency. The FTC was in fact the agency initially empowered to enforce the Securities Act of 1933.[18] James Landis, a drafter of the Securities Act, led the Securities Division of the FTC, the division initially empowered to enforce the law, and focused the agency's initial rules on disclosure mandates to help investors understand the value of their investments and antifraud rules to police violations of those rules using principles developed by the FTC for other consumer regulation.[19]

The SEC also functions as a market structure regulator, where its statutory mission appears similar to the FTC's within the context of securities exchange oversight. Its operative statute explicitly states that "competition" is one of its four primary statutory purposes. In *Credit Suisse Securities LLC v. Billing*[20] the Supreme Court interpreted the "competition" reference in the new standard as embodying a mission that replaces regulatory jurisdiction which would otherwise be enforced by the FTC.[21] Thus it exercises, much like the FTC, a form of competition authority over the securities exchanges and securities sales. It also administers a disclosure-based regulatory regime that oversees the public distribution of statements about the value of publicly traded

17. *See Testimony on "Oversight of the SEC's Agenda, Operations and FY 2015 Budget Request" Before the H. Comm. on Fin. Servs.*, 113th Cong. 16 (2014) (statement of Mary Jo White, Chair, Sec. & Exch. Comm.), *available at* http://financialservices.house.gov/uploadedfiles/hhrg-113-ba00-wstate-mwhite-20140429.pdf.

18. *See* Joel Seligman, *The SEC in a Time of Discontinuity*, 95 VA. L. REV. 667 (2009).

19. *431 Days: Joseph P. Kennedy and the Creation of the SEC (1934-35)*, SECHISTORICAL.ORG, http://www.sechistorical.org/museum/galleries/kennedy/politicians_b.php (last visited Jan. 4, 2014).

20. Credit Suisse Sec. LLC v. Billing, 551 U.S. 264 (2007).

21. *Id.* at 283.

securities and mutual funds, an analogous mission to the FTC's role in overseeing public statements about the value of consumer products.

The SEC's primary and most frequently utilized source of enforcement authority is Section 10b of the Securities Exchange Act and Rule 10b-5 promulgated thereunder. That section of the Exchange Act and the rule thereunder is somewhat ambiguously drafted, conferring a substantial amount of discretionary authority to the agency's enforcement function. The Sherman Act's prohibition of "every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade . . . is declared to be illegal"[22] is similar in character to the Securities Exchange Act's prohibition on "any manipulative or deceptive device or contrivance . . . ."[23] Both afford substantial discretion to their regulatory agencies and enforcement attorneys.

The SEC Enforcement Division has, at times, used the discretion it enjoys under 10b-5 to extend the boundaries of its jurisdiction, as in cases such as *Santa Fe Industries, Inc. v. Green*,[24] *SEC v. Texas Gulf Sulphur Co.*,[25] and *Dirks v. SEC*.[26] Those particular instances of overreach by the Commission to develop novel theories of liability under the auspices of 10b-5 were struck down by the courts or those doctrines were subsequently abandoned by the courts, but represented costly interventions by the SEC into market activity in the interim. This challenge calls for a solution, and the FTC's innovations in this area offer an informed comparison.

B. Lessons from Developments at the FTC

Bill Kovacic, former Chairman of the FTC, describes how selection of personnel by the President is not the only force that drives competition policy at the Department of Justice (DOJ) and the FTC, but argues that policy is more directly shaped by the doctrinal changes in the law and economics of antitrust, which shape enforcement as they are embodied in changes in legal doctrines developed by the courts and Congress, as well as internal dynamics within agencies that maintain momentum across changes in political regimes.[27]

Though Kovacic's claim is specific to competition policy, that same dynamic can clearly be viewed in the development of securities

22. 15 U.S.C. §§ 1, 3(a) (2012).

23. *Id.* § 78j(b).

24. Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977).

25. SEC v. Tex. Gulf Sulfur Co., 401 F.2d 833 (2d Cir. 1968).

26. Dirks v. SEC, 463 U.S. 646 (1983).

27. *See* William E. Kovacic, *The Modern Evolution of U.S. Competition Policy Enforcement Norms*, 71 ANTITRUST L.J. 377, 394 (2003).

regulation policy described in the last Part, as the SEC is influenced by courts and Congress, who themselves are influenced by changes in law and finance. He notes that "[s]tatutes and judicial decisions (formal legal rules) define the outer boundaries of the agencies' operations, but the agencies often develop policies or principles that lack the force of law (norms) to decide how to execute their prosecutorial discretion."[28] The analysis offered in this Article is the next step in the natural progression of the SEC, if the stages of evolution explored by Kovacic can be grafted across agencies.

Kovacic describes how the level of institutional capability in economic analysis directly affects the level of deference courts are willing to afford an agency that makes claims grounded in economic analysis.[29] That initial pattern is evident at the SEC as well, given the low level of institutional commitment the SEC has given to economic analysis in years since the added three-part standard and the low level of deference the court seemed to afford the SEC as a result.

Kovacic also argues that it is not enough for an agency to possess institutional capability in economic analysis, the agency must further empower that capability in the decision to bring enforcement cases. He points to how the increasing role of economists in the decision to bring cases at the FTC marked a key turning point for the agency in the 1970s.[30] Kovacic also describes a useful dynamic relationship between the agency and the external economics profession, as developments internal to the agency were more effectively translated into changes in industrial organization theory once enforcement cases began to develop within a more vigorous analytical economic framework.[31] Those developments in theory were more then effective at informing future evolution in enforcement practices in a feedback loop.[32]

Another benefit to the evolution of economics-grounded enforcement actions at the FTC that Kovacic describes is that it yields a more sophisticated assessment of the value of cases than an overly simplistic focus merely on simplistic metrics like the number of enforcement cases brought, the size of the target of the investigation, or the size of the recovery by the agency. Economics-grounded enforcement actions instead calculate how likely the case is to deter future wrongdoing and may consider the value of a particular case to test a novel legal theory.[33] As one example, Kovacic argues that the FTC's prioritization of cases

28. *Id.* at 395.
29. *See id.* at 389–99.
30. *See id.* at 400.
31. *See id.* at 401.
32. *See id.* at 402.
33. *See id.* at 405.

involving cartels in the construction of infrastructure assets and cases involving public procurement display a legitimate concern about the broader economic impact of underlying violations of law apart from their size or frequency.[34]

Kovacic also argues that one of the more important forms of economic analysis came with the DOJ's 1982 promulgation of broad-based guidelines that afford greater predictability of, and intellectual foundation for, enforcement actions.[35] Thus in addition to developing individual cases, a regulatory agency's economic analysis capability can also inform macro level decision making at the agency.

C. Molding an Economic Analysis Function for SEC Enforcement

The unique structure of the securities laws calls for a few observations about the application of economic analysis to SEC enforcement activity. Professors Stephen Choi and Adam Pritchard observe that behavioral economics, a branch of economics that considers the behavioral biases of consumers in weighing the costs of regulation, is not particularly advisable at the SEC given the countervailing institutional biases of the regulatory agency, combined with the monopoly regulatory power it enjoys.[36]

Behavioral economics is irrelevant for purposes of securities regulation under the Securities Exchange Act of 1934, which is the source of the SEC's frequently used authority under 10b-5, for an even more fundamental reason. The structure of the '34 Act is built around a presumption of efficient markets, which requires an assumption that the average investor is rational. The mandatory disclosure architecture of the '34 Act presumes rational investors able to process the information required. Likewise, the materiality element of 10b-5 and the truth on the market presumption also assume information shared with the market will be rationally processed by it.[37]

At times the SEC has used its enforcement function to regulate the structure of the securities exchanges and the fees they are allowed to charge, such as when the SRO affiliated with NASDAQ was developed as part of an enforcement settlement over the odd-eights pricing controversy.[38] Professor Bruce Johnsen has argued that in fulfilling its

34. *See id.* at 421.

35. *See id.* at 436.

36. *See* Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1 (2003).

37. *See* J.W. Verret, *The Securities Exchange Act is a Material Girl, Living in a Material World*, 3 HARV. BUS. L. REV. 453 (2013).

38. See J.W. Verret, *Dr. Jones and the Raiders of Lost Capital: Hedge Fund Regulation, Part II, A Self-Regulation Proposal*, 32 Del. J. Corp. L. 799, 818 (2007).

market structure function, the SEC must consider the extent to which pricing differentials or other market dynamics represent negotiated outcomes between market participants that represent efficient market solutions to agency cost problems.[39]

Bruce Johnsen demonstrates, for instance, how mutual fund fee structures alleged by the SEC to be inequitable or inefficient actually represent Klein–Leffler type performance bonds of future premium cash flows in lieu of direct monitoring.[40] Johnsen explores the impact of the SEC's ban on directed brokerage, noting that the future income streams associated with directed brokerage can serve as the type of quasi-rent described by Klein–Crawford–Alchian to bind actors to future performance.[41] Johnsen argues that brokerage is a good subject to determination of quality only after purchase, and as such, a broker can only be induced to assure high quality through the prospective future income streams of the revenues from directed brokerage.[42] He describes the link between the initial up-front agreement to market mutual fund portfolios by the broker and the subsequent agreement by mutual funds to direct brokerage to the broker as creating the type of quasi-rent income streams described by Klein–Leffler.[43]

Johnsen argues that merely looking at the first order apparent conflict of interest that might arise from directed brokerage arrangements is an incomplete view, and taking a transaction cost approach can help to resolve the apparent problem. This can be accomplished by showing that the arrangement actually benefits investors, much as a transaction cost framework, including along Kleinn–Leffler lines, has helped to demonstrate the flaws in early positions of the Federal Trade Commission on vertical marketing arrangements.[44]

In developing cases pursuant to its 10b-5 antifraud authority, the SEC should be required to perform stock price event studies that tease out the effect of the harm forming the basis of its case on stock price absent the effect of other market or firm specific events. The event study methodology is a primary mode of determining both materiality and loss causation in private securities litigation. In order to fulfill its statutory mission, the SEC should be held to using the same methods where

39. *See* D. Bruce Johnsen, *Transaction Cost Benefit Analysis, With Applications to Financial Regulation* (2013) (preliminary draft), *available at* http://works.bepress.com/d_bruce_johnsen/7.

40. Stephen M. Horan & D. Bruce Johnsen, *Does Soft Dollar Brokerage Benefit Portfolio Investors: Agency Problem or Solution?*, *available at* http://www.law.gmu.edu/assets/files/publications/working_papers/04-50.pdf.

41. *See generally* D. Bruce Johnsen, *The SEC's Mistaken Ban on Directed Brokerage: A Transaction Cost Analysis*, 40 ARIZ. ST. L.J. 1241 (2008).

42. *See id.* at 1244.

43. *See id.* at 1245.

44. *See id.*

appropriate.[45]

When making arguments about any deterrent value of cases it brings, the SEC should also be held at an absolute minimum to the rigor that the U.S. Sentencing Commission, and those who study the efficiency of its recommendations, have brought to bear on difficult questions of the relationship between criminal enforcement penalties and crime deterrence. This should apply in any instances where the SEC makes similar arguments about the deterrent effect of its penalties in particular cases or its penalty structure generally.[46]

IV. FIRST STEPS TO EMBED ECONOMIC ANALYSIS IN SEC ENFORCEMENT

A. Guidance

One useful role for the Division of Economic and Risk Analysis is to assist the Division of Enforcement with the prioritization of particular types of cases. Choi and Pritchard note that "[t]he SEC ranks potential violations based on whether the violations are in an area of enforcement priority for the SEC."[47] DERA can similarly help to prioritize the SEC's limited resources toward the most useful activity.

In order the fulfill its investor protection mission, the SEC would need to develop its prioritization schedule in a systematic way using estimates of the typical net harm caused to investors and to capital formation by different types of infractions. This is a job for which the DERA is uniquely qualified, and if DERA were to have a more direct role in overseeing setting of case prioritization it could also help limit the tendency of government bureaus to take actions principally to maximize their budgets and scope of authority.[48]

Zywicki and Stearns note that "Agency employees will prefer agency expansions, especially into novel areas, to enhance their prospects for internal promotion as part of a growing enterprise and their postgovernment career prospects in the private sector."[49] Though DERA employees may be subject to the same public choice dynamics as attorneys, the unique differences between the economics and legal

45. *See* Frank Torchio, *Proper Event Study Analysis in Securities Litigation*, 35 J. CORP. L. 159 (2009).

46. *See generally* A. Mitchell Polinsky & Steven Shavell, *On Offense History and the Theory of Deterrence*, 18 INT'L REV. L. & ECON. 305 (1998).

47. *See* STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS 750 (3d ed. 2012).

48. *See* MAXWELL L. STEARNS & TODD J. ZYWICKI, PUBLIC CHOICE CONCEPTS AND APPLICATIONS IN LAW 342 (2009) (citing WILLIAM A. NISKANEN JR., BUREAUCRACY AND REPRESENTATIVE GOVERNMENT (1971)).

49. *See* Stearns & Zywicki, *supra* note 48, at 343.

professions may disrupt those forces. For example, attorneys have a professional culture built on the adversary system, whereas professional economists tend to be more grounded in the scientific method.

The DERA can also serve an important function in promulgating guidance about how the Enforcement Division should calculate economic harm in other contexts which it purports to conduct. In an Enforcement Division Staff Report offering guidance on how cooperation will be used to decrease penalties in investigations, the Enforcement Division references a number of economic determinations, such as "[h]ow much harm has the misconduct inflicted upon investors and other corporate constituencies? Did the share price of the company's stock drop significantly upon its discovery and disclosure? . . . Did the company appropriately recompense those adversely affected by the conduct? . . . Did the company adopt and ensure enforcement of new and more effective internal controls and procedures designed to prevent a recurrence of the misconduct?"[50]

The variables referenced in that report touch on issues debated extensively in the finance and economics literature. Whether, and the extent to which, corporate governance reforms like independent directors, changes in board composition or size, and various other reforms actually enhance shareholder value across the board, or at particular subsets of companies, is widely debated.[51] Without the direction of DERA in setting appropriate general guidance and assistance in applying those concepts to particular enforcement cases, what has resulted are litigation releases from the SEC Enforcement Division that merely recite the concepts listed in the SEC's Enforcement Commission Statements, but do not analyze their relevance to facts in a specific case, or provide justification for how a particular penalty or fine is related to those objectives.

B. Structural and Process Reform

Structural and procedural reform at the SEC will be required in order to ensure a primary role for DERA in making economic determinations at the heart of the SEC's enforcement mission. This would require a role in both litigation as well as in administrative proceedings that

50. *See* Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 44,969, 76 SEC Docket 220, 2001 WL 1301408, at *3 (Oct. 23, 2001).

51. *See generally* ROBERTA ROMANO, FOUNDATIONS OF CORPORATE LAW 410–25 (2d ed. 2010).

require economic determinations.[52] For those determinations made by SEC Enforcement personnel in lieu of reporting up to the full Commission, this would require that DERA obtain co-equal authority to the Division. For those determinations made by the full Commission, it would require that DERA obtain authority to provide supplemental staff reports to the full Commission or sign off on the Enforcement Division's staff report.

DERA is currently the only Division of the SEC which does not have staff authority expressly delegated to it in the operating rules of the SEC. A simple way to provide delegated authority to DERA would be to amend the SEC's operating rules so that DERA could serve as a check on the authority delegated to the other Divisions. The SEC could adopt a resolution providing:

> The following language is hereby added to Section 200.23a of the Commission's internal operating rules: "The Office of Economic Analysis shall be led by the Director of Economic and Risk Analysis. The Office may suspend any authority delegated to any staff of the Commission with respect to a particular matter upon a finding that the Director cannot determine that the benefits of the action exceed its costs. In that instance, the Director shall submit an analysis of the decision to the Commission. In that instance, the delegated authority will remain suspended with respect to that particular matter until such time as it is renewed by an act of the Commission."

The SEC economic analysis division remains lightly staffed relative to total employees compared to the same ratio at other agencies, the Federal Trade Commission has roughly 10% of its staff designated as economists, relative to only 1% at the SEC. In addition to empowering those employees, the SEC must commit to allocating a more significant percentage of its budgetary resources to DERA. Once sufficiently equipped to inform the Enforcement Division's priorities and the legitimacy of its cases, DERA can also contribute to review of enforcement personnel by scoring the relative economic impact of enforcement cases they resolved that year, and compare against a standardized distribution of other employees at the agency, using metrics like the relative rate of growth in an ongoing fraud projected forward to determine fraudulent activity prevented by an enforcement action.

52. *E.g.*, 15 U.S.C. § 78u-3 (2012). Under Section 21(c) of the Exchange Act, the SEC has the authority to issue temporary cease and desist orders upon determining a violation is "likely to result in significant dissipation or conversion of assets, significant harm to investors, or substantial harm to the public interest . . . ." *Id.* § 78u-3(c)(1).

V. CONCLUSION

The SEC has a vital mission to protect investors and maintain sound markets. That mission cannot be effectively accomplished until the SEC places economic analysis at the vanguard of the full breathe of its regulatory function. Economic analysis will not stand in the way of an aggressive enforcement agenda, but merely ensure that agenda is directed toward preventing activity most harmful to investors and markets.