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The Evolving Role of Economic Analysis In SEC Rulemaking

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THE EVOLVING ROLE OF ECONOMIC ANALYSIS IN SEC RULEMAKING

*Joshua T. White**

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I don't understand why people in this country are so bent on doing the "perfect," when you have something that is good and makes sense from a cost-benefit point of view.

U.S. Senator George Voinovich¹

I. INTRODUCTION

In economics literature, public policies are often compared to the benchmark of a benevolent regulator—one that maximizes social welfare while balancing the interests of all affected parties.² The result is the socially optimal choice of regulations with full economic justification. Accordingly, a benevolent regulator takes actions that it perceives will accrue benefits that outweigh the costs.³

In reality, regulations are imperfect. They cannot be costlessly executed or enforced.⁴ Regulators also lack full information on the actual costs and benefits of proposed policies.⁵ For the Securities and Exchange Commission (SEC or Commission), scholars note that the costs and benefits of proposed actions are especially difficult to generate because their rules frequently involve disclosure⁶ or a probabilistic prediction of future risky events.⁷

¹ 151 CONG. REC. 20,016 (2005).

² See, e.g., Joel S. Demski & David E.M. Sappington, *Hierarchical Regulatory Control*, 18 RAND J. ECON. 369, 369–70 (1987) (describing the typical portrayal of the role and purpose of a regulator).

³ See, e.g., Alfred Wagenhofer, *Towards a Theory of Accounting Regulation: A Discussion of the Politics of Disclosure Regulation Along the Economic Cycle*, 52 J. ACCT. & ECON. 228, 229–30 (2011) (discussing the paradigm of a benevolent regulator in regulatory literature).

⁴ See generally Paul L. Joskow & Nancy L. Rose, *The Effects of Economic Regulation*, in 2 HANDBOOK OF INDUSTRIAL ORGANIZATION 1449 (Richard Schmalensee & Robert D. Willig eds., 1989) (examining alternative approaches to measuring the effects of economic regulation and reviewing empirical literature employing those approaches).

⁵ See, e.g., David P. Baron & David Besanko, *Regulation, Asymmetric Information, and Auditing*, 15 RAND J. ECON. 447, 447–48 (1984) (describing the information asymmetry between the regulator and the regulated firm).

⁶ See Cass R. Sunstein, *The Office of Information and Regulatory Affairs: Myths and Realities*, 126 HARV. L. REV. 1838, 1866 (2013) ("A disclosure requirement . . . may have benefits that cannot be quantified, but an agency is nonetheless entitled to conclude that, all things considered, they are likely to justify the costs.").

These challenges indicate that the SEC will sometimes misestimate quantified values of costs and benefits.

Consider Section 404 of the Sarbanes-Oxley Act of 2002 (SOX), which attempted to improve management's internal controls over financial reporting for public companies.⁸ A recent study found that the SEC greatly underestimated the cost of compliance with Section 404.⁹ Some critics argue that the SEC's cost-benefit analysis is often a "guesstimation" due to challenges such as data limitations and the inability to draw causal inferences.¹⁰ Regulations also create unintended or unforeseen consequences. For example, multiple academic studies associate the costs of complying with SOX with the decision of public companies to go private.¹¹ Given that seemingly well-intended policies sometimes lack *ex-post* economic justification upon review, this elevates the importance of *ex-ante* cost-benefit analysis.

Recently, the SEC has come under great scrutiny for how it conducts economic analysis around rulemakings, especially those associated with the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank or the Dodd-Frank Act).¹²

⁷ See, e.g., Thomas O. McGarity, *A Cost-Benefit State*, 50 ADMIN. L. REV. 7, 15–16 (1998) (noting that basing cost assessments on government agencies' determinations of risk makes it difficult to weigh the costs and benefits of proposed actions); Nadelle Grossman, *The Sixth Commissioner*, 49 GA. L. REV. 693, 747–48 (2015) (“[I]nformation about underlying risk ‘is never complete.’ As such, even with extensive resourced [sic] devoted to it, risk assessments are not accurate.”).

⁸ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 404, 116 Stat. 745, 789 (2002) (codified as amended at 15 U.S.C. § 7262 (2012)).

⁹ See Joseph A. Grundfest & Steven E. Bochner, *Fixing 404*, 105 MICH. L. REV. 1643, 1645–46 (2007) (citing CRA INT'L SARBANES-OXLEY SECTION 404 COSTS AND IMPLEMENTATION ISSUES: SURVEY UPDATE 5–6 (2006)) (noting that the costs of Section 404 compliance were as much as eighty times greater than the initial SEC estimate of \$91,000 per firm).

¹⁰ See John C. Coates, IV, *Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications*, 124 YALE L.J. 882, 895 (2015) (discussing issues in performing a cost-benefit analysis caused by the necessity of including estimates).

¹¹ See generally Ellen Engel, Rachel M. Hayes & Xue Wang, *The Sarbanes-Oxley Act and Firms' Going-Private Decisions*, 44 J. ACCT. & ECON. 116 (2007) (investigating the impact of the Sarbanes-Oxley Act of 2002 on firms' decisions to go private); Christian Leuz, Alexander Triantis & Tracy Yue Wang, *Why Do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations*, 45 J. ACCT. & ECON. 181 (2008) (analyzing how SOX affects a firm's decision to go private).

¹² Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as 12 U.S.C. § 5301 (2012)) [hereinafter Dodd-Frank Act].

Dodd-Frank tasked the SEC with more than 100 rulemaking provisions.¹³ Perhaps no criticism had a more profound effect than the D.C. Circuit's decision in *Business Roundtable v. SEC*, which struck down the SEC's proxy access rule due to inadequate economic analysis.¹⁴

Following *Business Roundtable* and an introspective review by the SEC's Office of Inspector General (OIG), the Commission greatly revamped how economic analysis is conducted. These changes were publicly disclosed in a memorandum (New Guidance) detailing how SEC cost-benefit analysis would be conducted moving forward.¹⁵ The New Guidance established that every SEC economic analysis should include a stated need for rulemaking, a well-defined economic baseline, the identification of reasonable alternative regulatory approaches, and a full analysis of the economic consequences of the proposed rulemaking compared to the reasonable alternatives and status quo.¹⁶

In this study, I examine the role of economic analysis, and economists, following the New Guidance. I provide descriptive and empirical evidence on the changes in the organizational structure of the SEC's economics division following the New Guidance. I then use the risk retention rulemaking from Dodd-Frank to illustrate how economic analysis at the SEC has evolved following the New Guidance. I also discuss what I believe are the most important elements of the enhanced economic analysis. The goal of economic analysis at the SEC is to provide an even-handed and objective assessment of the costs and benefits when analyzing the potential effects of a rulemaking action. In order to achieve this goal, prior literature asserts that the two most important roles of any cost-benefit analysis are to first identify and then quantify all

¹³ The SEC frequently updates its progress on Dodd-Frank rulemakings on its website. *Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act*, SEC, <https://www.sec.gov/spotlight/dodd-frank.shtml> (last modified Aug. 6, 2015).

¹⁴ *Bus. Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011).

¹⁵ Memorandum from the Division of Risk, Strategy, and Financial Innovation and the Office of the General Counsel of the SEC to the Staff of the Rulewriting Divisions and Offices of the SEC (Mar. 16, 2012), available at https://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf [hereinafter New Guidance].

¹⁶ *Id.*

relevant costs and benefits.¹⁷ I argue that this is a necessary but not sufficient condition for greater rigor and transparency in economic analysis around regulatory decisionmaking. My contention is that defining the economic baseline, which is the articulation of the current market conditions or the status quo, is at least as important as estimating costs and benefits in a sound economic analysis. The way problems are described and our understanding of the current economic landscape beg certain solutions.¹⁸ Because policy choices frequently vary as a result of how a problem is framed, it is imperative that cost-benefit analyses provide decision makers with the best possible understanding of the current economic landscape.¹⁹

One implication of this analysis is that focusing solely on the SEC's identification and estimation of costs and benefits overlooks one of the most essential elements of the New Guidance: the economic baseline. This point is illustrated through a discussion of the economic analysis surrounding the Dodd-Frank Act rules on risk retention in residential mortgage-backed securities (RMBS), which was proposed before the New Guidance and then re-proposed and adopted after the New Guidance.²⁰

¹⁷ See PETER G. SASSONE & WILLIAM A. SCHAFFER, COST-BENEFIT ANALYSIS: A HANDBOOK 43 (1978) ("It is fair to state that the most important aspect of a cost-benefit analysis is the *identification* of all the relevant costs and benefits. Second only to this in importance is the quantification of such benefits. The *raison d'être* of quantification is to facilitate the analyzing of trade-offs. Any CBA will involve considerations of both losses and gains to society. Obviously, the magnitudes of such losses and gains are crucial to the decision maker.").

¹⁸ See generally Amos Tversky & Daniel Kahneman, *The Framing of Decisions and the Psychology of Choice*, 211 SCIENCE 453 (1981) (examining how similar problems, if framed differently, may result in varying proposed solutions).

¹⁹ See generally Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851, 859 (1992) (discussing the risk that persons will make inaccurate decisions based on the most recent or news-worthy information and urging decision makers to examine the entire economic picture before chasing trends); Amos Tversky & Daniel Kahneman, *Rational Choice and the Framing of Decision*, 59 J. BUS., Oct. 1986, at S251 (noting the complexity of framing decision problems and arguing for a more nuanced approach to the theory of choice).

²⁰ See Credit Risk Retention, Exchange Act Release No. 34-64148, 76 Fed. Reg. 24,090 (proposed Mar. 30, 2011) [hereinafter Credit Risk Retention 2011]; Credit Risk Retention, Exchange Act Release No. 34-70277, 78 Fed. Reg. 57,928 (proposed Aug. 28, 2013) [hereinafter Credit Risk Retention 2013]; Credit Risk Retention, Exchange Act Release No.

The remainder of this Article is structured as follows. Part II provides a brief description of the evolution of economic analysis at the SEC. It also describes the New Guidance on economic analysis and provides descriptive and empirical evidence on the successive organizational changes in the SEC's economics division. Part III examines a case study using the Credit Risk Retention rulemaking under Dodd-Frank. This case illustrates the effect of enhanced economic analysis on the risk retention rulemaking, which encompasses the periods before and after the New Guidance. Part IV concludes this Article.

II. ECONOMIC ANALYSIS AT THE SEC

A. BASIS FOR COST-BENEFIT ANALYSIS

The voluminous literature on cost-benefit analysis identifies it as a fundamental tool in economically analyzing proposed financial regulations.²¹ Cost-benefit analysis helps the SEC make informed decisions and informs the public on whether rulemaking activities are in their interest. The goal of cost-benefit analysis is to identify and, to the extent possible, quantify all relevant costs and benefits so the Commission can make policy decisions with the best available information on the anticipated effects of the

34-73407, 79 Fed. Reg. 77,602 (Oct. 22, 2014) (effective Feb. 23, 2015) (to be codified at 24 C.F.R. pt. 267) [hereinafter Credit Risk Retention 2014].

²¹ This expanding literature is multi-disciplinary and spans legal, finance, and economics scholarship. See, e.g., J. Harold Mulherin, *Measuring the Costs and Benefits of Regulation: Conceptual Issues in Securities Markets*, 13 J. CORP. FIN. 421, 421 (2007) ("Measuring the costs and benefits of regulation is an important but challenging task for economic analysis."); Eric A. Posner & E. Glen Weyl, *Cost-Benefit Analysis of Financial Regulations: A Response to Criticisms*, 124 YALE L.J. FORUM 246, 262 (2015) ("CBA is at least as well suited to financial regulation as to other forms of regulation, and possibly better suited."); Bruce Kraus & Connor Raso, *Rational Boundaries for SEC Cost-Benefit Analysis*, 30 YALE J. ON REG. 289, 296–97 (2013) (tracing the history of the SEC's use of cost-benefit analysis); Eric Posner & E. Glen Weyl, *Benefit-Cost Analysis for Financial Regulation*, 103 AM. ECON. REV. (PAPERS & PROC.) 393, 393 (2013) ("When an agency proposes a regulation, it should compare the compliance costs and the benefits."); Eric A. Posner & E. Glen Weyl, *Benefit-Cost Paradigms in Financial Regulation*, 43 J. LEGAL STUD., June 2014, at S1, S1 (2014) ("Nearly all U.S. regulatory agencies use benefit-cost analysis (BCA) to evaluate proposed regulations."); cf. Coates, *supra* note 10, at 912–20 (critiquing judicial efforts to apply CBA to disclosure rules under SOX Section 404).

regulations.²² Yet cost-benefit analysis is not a panacea as it is often difficult to translate some policy actions into monetary terms so they may be quantitatively assessed.²³ Although cost-benefit analysis is often criticized, many agree that by forcing regulators to justify their reasoning through quantification or disclosure of assumptions, it serves as a useful tool for preventing inefficient regulations.²⁴

As early as the 1960s, academics began arguing that securities regulations should be criticized and challenged if the SEC fails to economically justify that a rulemaking will serve its goal of protecting investors.²⁵ The SEC began voluntarily including a cost-benefit section in rulemaking in the 1970s, although this was not required at the time by any executive order or statute.²⁶ The disclosures were ultimately codified by Congress and enforced judicially by the D.C. Circuit.²⁷ For example, the National Securities Market Improvement Act of 1996 (NSMIA) amended

²² Garrett F. Bishop & Michael A. Coffee, Note, *A Tale of Two Commissions: A Compendium of the Cost-Benefit Analysis Requirements Faced by the SEC & CFTC*, 32 REV. BANKING & FIN. L. 565, 571 (2013) (explaining the initial reasoning for the use of cost-benefit analysis in rulemaking).

²³ See, e.g., Frank Ackerman & Lisa Heinzerling, *Pricing the Priceless: Cost-Benefit Analysis of Environmental Protection*, 150 U. PA. L. REV. 1553, 1553 (2002) (explaining that cost-benefit analysis can create absurd results); Cass R. Sunstein, Commentary, *The Office of Information and Regulatory Affairs: Myths and Realities*, 126 HARV. L. REV. 1838, 1838–44 (2013) (describing the role of the Office of Information and Regulatory Affairs in regards to cost-benefit analysis); Cass R. Sunstein, *The Limits of Quantification*, 102 CALIF. L. REV. 1369, 1375–76 (2014) (noting the difficulty of quantifying the costs and benefits for cost-benefit analysis); Grossman, *supra* note 7, at 696–98 (criticizing judicial interference with the SEC's power to administer securities laws by requiring quantitative cost-benefit analysis for certain rules).

²⁴ See, e.g., Cass R. Sunstein, *Cognition and Cost-Benefit Analysis*, 29 J. LEGAL STUD. 1059, 1059 (2000) (“Cost-benefit analysis is often justified on conventional economic grounds, as a way of preventing inefficiency.”); Bishop & Coffee, *supra* note 22, at 571 (explaining that cost-benefit analysis is intended to “increase agency accountability” and produce “well-reasoned” regulations).

²⁵ See George J. Stigler, *Public Regulation of the Securities Markets*, 37 J. BUS. 117, 120 (1964) (“A proposal of public policy . . . is open to criticism if it omits a showing that the proposal will serve its announced goal.”).

²⁶ See, e.g., Bruce Kraus & Connor Raso, *Rational Boundaries for SEC Cost-Benefit Analysis*, 30 YALE J. ON REG. 289, 296–97 (2013) (noting that the voluntary inclusion of economic analysis was likely a strategic decision to thwart additional oversight).

²⁷ *Id.* at 296, 298.

securities laws to require the SEC to consider whether an action will promote “efficiency, competition, and capital formation” in addition to investor protection when considering if a rulemaking is in the public interest.²⁸

In the last decade, a number of judicial interventions faulted the SEC for some form of inadequate economic analysis.²⁹ Perhaps none had a more profound effect at the SEC than the D.C. Circuit overturning the proxy access rule in *Business Roundtable*.³⁰

B. THE PROXY ACCESS RULE

As Jill Fisch comments, the SEC had considered the notion of shareholder director nominations since the 1940s.³¹ It ultimately issued proposed proxy access rules in 2009.³² The following year, Congress authorized the SEC to promulgate proxy access rules in Section 971 of Dodd-Frank.³³ In September 2010, the SEC adopted rules allowing certain shareholders to include a limited

²⁸ National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, § 106, 110 Stat. 3416, 3424 (1996).

²⁹ See, e.g., *Am. Equity Inv. Life Ins. Co. v. SEC*, 613 F.3d 166, 177 (D.C. Cir. 2010) (“[T]he Commission’s consideration of the effect of Rule 151A on efficiency, competition, and capital formation was arbitrary and capricious.”); *Chamber of Commerce v. SEC*, 443 F.3d 890, 909 (D.C. Cir. 2006) (chastising the SEC for relying on extra-record materials and for its failure to reopen the public comment period in rulemaking under the Investment Company Act); *Chamber of Commerce v. SEC*, 412 F.3d 133, 144 (D.C. Cir. 2005) (“[T]he disclosure alternative was neither frivolous nor out of bounds and the Commission therefore had an obligation to consider it. . . . The Commission may ultimately decide the disclosure alternative will not sufficiently serve the interests of shareholders, but the Commission—not its counsel and not this Court—is charged by Congress with bringing its expertise and its best judgment to bear upon that issue.”).

³⁰ See Jill E. Fisch, *The Long Road Back: Business Roundtable and the Future of SEC Rulemaking*, 36 SEATTLE U. L. REV. 695, 696 (2013) (“The *Business Roundtable* decision is of particular importance.”).

³¹ See Jill E. Fisch, *The Destructive Ambiguity of Federal Proxy Access*, 61 EMORY L.J. 435, 473 (2012) (“As early as 1942, the SEC proposed a rule that would have required issuers to include shareholder-nominated candidates in their proxy statements.”).

³² *Facilitating Shareholder Director Nominations*, 74 Fed. Reg. 29,024 (proposed June 18, 2009) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249, 274).

³³ Dodd-Frank Act, Pub. L. No. 111-203, § 971, 124 Stat. 1376, 1915 (2010) (codified as amended at 15 U.S.C. § 78n(a)(2) (2012)).

number of director nominees in a public or investment company's proxy materials.³⁴

In the cost-benefit analysis of the adopting release, the SEC cited both empirical evidence and economic theory in noting that proxy access could potentially improve board and company performance.³⁵ One month later, the Business Roundtable and U.S. Chamber of Commerce filed a petition with the D.C. Circuit seeking judicial review.³⁶ The *Business Roundtable* petition argued that the SEC acted arbitrarily and capriciously in promulgating the proxy access rule because the SEC failed to fulfill its statutory obligations to adequately assess the rule's effect on efficiency, competition, and capital formation imposed by the Administrative Procedure Act³⁷ and § 2(b) of the Securities Act of 1933.³⁸ The D.C. Circuit agreed with the petitioners and vacated the rule, faulting the SEC's economic analysis for relying upon unpersuasive empirical studies in arguing that proxy access could improve board performance.³⁹

The *Business Roundtable* decision was a critical juncture in economic analysis around SEC rulemaking. By ruling that the SEC "inconsistently and opportunistically framed the costs and benefits of the rule," the D.C. Circuit cast doubt upon the ability of the SEC to adopt provisions of Dodd-Frank that could withstand judicial review of the cost-benefit calculus.⁴⁰ Prominent corporate law scholars noted that the setback was the culmination of a string

³⁴ Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668 (proposed Sept. 16, 2010) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249).

³⁵ *Id.* at 56,761 ("[I]t is our conclusion that the potential benefits of improved board and company performance and shareholder value justify the potential costs.").

³⁶ *Bus. Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011).

³⁷ Administrative Procedure Act, Pub. L. No. 79-404, 60 Stat. 237 (1946) (codified as amended in scattered sections of 5 U.S.C.).

³⁸ 15 U.S.C. § 77b(b) (2012).

³⁹ *See Bus. Roundtable*, 647 F.3d at 1148–49 ("[T]he Commission inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify 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.").

⁴⁰ *Id.*

of challenges in SEC rulemaking and predicted a long recovery to restore the SEC's reputation.⁴¹

C. NEW GUIDANCE ON SEC ECONOMIC ANALYSIS

Building on the criticisms of *Business Roundtable*, the SEC's economic analysis received additional scrutiny in a May 2011 letter from the minority members of the Senate Committee on Banking, Housing, and Urban Affairs.⁴² The Congressional Request asked the SEC's Office of Inspector General to review Dodd-Frank economic analyses for potential inconsistencies.⁴³

One month later, the SEC's OIG reported an initial assessment of the cost-benefit analyses conducted for six specific Dodd-Frank rulemakings.⁴⁴ The OIG report concluded that the SEC had

⁴¹ See, e.g., Robert B. Ahdieh, *Reanalyzing Cost-Benefit Analysis: Toward a Framework of Function(s) and Form(s)*, 88 N.Y.U. L. REV. 1983, 2057–58 (2013) (explaining the impact that Dodd-Frank has on SEC rulemaking); Fisch, *supra* note 30, at 695 (“[T]he *Business Roundtable* decision . . . [has] dealt lasting damage to the SEC's reputation.”).

⁴² See OFFICE OF AUDITS, OFFICE OF INSPECTOR GEN., SEC, REPORT NO. 499, FOLLOW-UP REVIEW OF COST-BENEFIT ANALYSES IN SELECTED SEC DODD-FRANK ACT RULEMAKINGS, at App. V (Jan. 27, 2012), available at http://www.sec.gov/about/offices/oig/reports/audits/2012/rpt499_followupreviewofd-f_costbenefitanalyses_508.pdf (expressing concern that the SEC and other regulatory agencies were inadequately considering the costs and benefits of Dodd-Frank rulemaking and requesting an assessment of how the SEC considers alternative approaches and incorporates public input). The Senators sent a similar letter asking for a review of the economic analyses for specific Dodd-Frank rulemakings to the Inspectors General from the Board of Governors of the Federal Reserve System, the Commodity Futures Trading Commission, the Department of the Treasury, and the Federal Deposit Insurance Corporation. *Id.*

⁴³ *Id.*

⁴⁴ OFFICE OF INSPECTOR GEN., SEC, REPORT OF REVIEW OF ECONOMIC ANALYSES PERFORMED BY THE SECURITIES AND EXCHANGE COMMISSION IN CONNECTION WITH DODD-FRANK ACT RULEMAKINGS (June 13, 2011), available at http://www.sec.gov/oig/reportspubs/report_6_13_11.pdf. The six regulatory initiatives were: Credit Risk Retention 2011, Exchange Act Release No. 34-64148, 76 Fed. Reg. 24,090 (proposed 2011); Clearing Agency Standards for Operation and Governance, 76 Fed. Reg. 14,472 (proposed Mar. 16, 2011) (to be codified at 17 C.F.R. pt. 240); Registration and Regulation of Security-Based Swap Execution Facilities, 76 Fed. Reg. 10,948 (proposed Feb. 28, 2011) (to be codified at 17 C.F.R. pts. 240, 242, 249); Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, 76 Fed. Reg. 8068 (proposed Feb. 11, 2011) (to be codified at 17 C.F.R. pts. 275, 279); Registration of Municipal Advisors, 76 Fed. Reg. 824 (proposed Jan. 6, 2011) (to be codified at 17 C.F.R. pts. 240, 249); and Conflict Minerals, 75 Fed. Reg. 80,948 (proposed Dec. 23, 2010) (to be codified at 17 C.F.R. pts. 229, 249).

conducted a systematic economic analysis for these rulemakings, but it found both a lack of macro-level and quantitative analysis on the impact of the rules and that the level of involvement of the SEC's economics division varied considerably across rulemakings.⁴⁵ In January 2012, the SEC's OIG published a follow-up report that provided recommendations to enhance SEC cost-benefit analyses.⁴⁶

Viewing these setbacks as an opportunity to improve economic analysis, the SEC responded to the repeal of proxy access and the OIG's review by publishing the New Guidance on how cost-benefit analysis would be conducted at the Commission.⁴⁷ This guidance was meant to improve the effectiveness of cost-benefit analysis by refining its rigor and structure so that it could withstand legal challenges.⁴⁸ The SEC noted that the guidance is general and "allow[s] for flexibility in the context of any particular rulemaking."⁴⁹

In the New Guidance, the SEC asserted that robust economic analysis should have at least four basic features:

- (1) a statement of the need for the 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.⁵⁰

Below, I briefly describe each of these features in greater detail.

⁴⁵ OFFICE OF INSPECTOR GEN., *supra* note 44, at 42–43.

⁴⁶ OFFICE OF AUDITS, *supra* note 42.

⁴⁷ New Guidance, *supra* note 15, at 2 (“[T]he Division of Risk, Strategy, and Financial Innovation (‘RSFI’) and the Office of the General Counsel (‘OGC’) are providing the following guidance on economic analysis for SEC rules. . . .”).

⁴⁸ *See id.* at 1–2 (showing the Commission’s intent to improve its economic analysis in its rulemaking).

⁴⁹ *Id.* at 2.

⁵⁰ *Id.* at 4.

1. *Stated Need for Rulemaking.* The first element of the economic analysis is to identify the problem or market failure leading to the proposed rulemaking and to describe how the action will correct it.⁵¹ It is an essential first step since clearly defining a problem creates a path for the remainder of the economic analysis.⁵² Moreover, the way a problem is framed will beg certain solutions.⁵³ By lucidly communicating the significance of the issue at hand, the decision makers and the public can determine if there is a compelling public need for action.⁵⁴ The New Guidance also clarifies that Congressional direction to adopt a rule is justification alone for a rule but that the SEC should describe its specific authority for the action.⁵⁵

2. *Defined Economic Baseline.* An economic baseline is the universal alternative regulatory approach—the status quo.⁵⁶ It is a detailed description of the economic facts concerning the current situation. In other words, it describes a “time stream of costs and benefits” if no action is taken.⁵⁷ This baseline scenario is the essential point of reference in comparing both the proposed rulemaking action and each of the alternatives.⁵⁸ Although defining the baseline may seem less daunting than quantifying the costs and benefits of a regulatory change, its importance cannot be overlooked in establishing the economic facts.

One of the key challenges of crafting the economic baseline is obtaining the necessary data before the analysis has been conducted. As Sherlock Holmes once told Dr. Watson: “I have no

⁵¹ *Id.* at 5.

⁵² See SASSONE & SCHAFFER, *supra* note 17, at 156 (“[D]efining the problem to be analyzed . . . gives direction to the remainder of the analysis.”).

⁵³ See generally Tversky & Kahneman, *supra* note 18, at 453 (demonstrating that the way an identical problem is framed can affect the outcome of rational agents).

⁵⁴ See New Guidance, *supra* note 15, at 1 (“The Commission has long recognized that a rule’s potential benefits and costs should be considered in making a reasoned determination that adopting a rule is in the public interest.”).

⁵⁵ *Id.* at 6.

⁵⁶ See SASSONE & SCHAFFER, *supra* note 17, at 158 (explaining the importance of the baseline in a cost-benefit analysis).

⁵⁷ *Id.*

⁵⁸ See *id.* (“[I]t is exactly this ‘do-nothing’ or baseline scenario with which each project is compared. The CBA focuses on how a project will change the baseline time stream of social well-being.”).

data yet. It is a capital mistake to theorize before one has data. Insensibly one begins to twist facts to suit theories, instead of theories to suit facts.”⁵⁹ In the absence of data availability, the SEC often encourages market participants to provide this data to the Commission. Yet some datasets necessary for analysis simply do not exist. In this respect, the New Guidance notes the importance of detailing all assumptions and unknown costs in the baseline.⁶⁰ Put differently, any of the current costs or benefits of the status quo that are either intangible or incommensurable should be clearly acknowledged in the baseline.

3. *Alternative Regulatory Approaches.* The New Guidance clarifies that the economic analysis should include a discussion of reasonable alternatives to the proposed regulation and the status quo.⁶¹ For the SEC, these alternatives must be limited to those where the SEC has the authority to implement them,⁶² although some scholars question if the SEC should take into consideration the resources and ability to enforce.⁶³ A common alternative is to take a similar but either more or less stringent approach than the proposed rulemaking. For example, the SEC has often imposed different requirements based on the size of the issuer⁶⁴ or the securities offering.⁶⁵ The SEC also solicits public comments on

⁵⁹ ARTHUR CONAN DOYLE, *A Scandal in Bohemia*, in ADVENTURES OF SHERLOCK HOLMES 7 (1892).

⁶⁰ See New Guidance, *supra* note 15, at 12 (“Where particular benefits or costs cannot be monetized, the release should present any available quantitative information Even without hard data, quantification may be possible by making and explaining certain assumptions.”).

⁶¹ *Id.* at 16.

⁶² See *id.* at 8 (“Reasonable alternatives include only those that are available to the SEC and not, for example, those that the SEC lacks the authority to implement.”).

⁶³ See, e.g., Jeff Schwartz, *The Conflict Minerals Experiment*, 6 HARV. BUS. L. REV. (forthcoming 2015) (manuscript at 55), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2548267 (noting that the SEC would likely not expend limited resources to enforce noncompliance with human-rights disclosures).

⁶⁴ See, e.g., Securities Offering Reform, 70 Fed. Reg. 44,722, 44,727–28 (effective Dec. 1, 2005) (noting creation of different rules for registering and offering securities based on an issuer’s market capitalization).

⁶⁵ See, e.g., Amendments for Small and Additional Issues Exemptions Under the Securities Act (Regulation A), 80 Fed. Reg. 21,806 (effective June 19, 2015) (noting the amendments to Regulation A generate different disclosure and registration requirements based on the size of the offering).

alternative solutions, especially from parties potentially affected by the action, to help assess and inform the Commission of feasible alternatives.⁶⁶ These comments are likely more beneficial to the economic analysis when parties, such as market participants, provide both feasible alternatives and the data necessary to evaluate these approaches.

4. *Analysis of Economic Consequences.* The final element of the economic analysis assesses the anticipated consequences of proposed rulemaking. Here, the SEC compares the economic costs and benefits of the proposal and alternative approaches to those of the baseline. In this section, the analysis needs to provide an economic argument that the proposed action will both address the market failure or need for rulemaking and is better than reasonable alternative actions or the status quo.

The New Guidance states that costs and benefits should be quantified to the extent possible but be framed in a neutral and consistent manner.⁶⁷ It also seeks transparency in the process by requiring full disclosure of data sources and the method of quantification accompanied by a discussion of the uncertainties underlying the estimates.⁶⁸ Since the SEC likely expects most analyses to undergo judicial review, it is a strategic decision to point out any shortcomings or inability to measure key costs or benefits in the analysis.

D. ORGANIZATIONAL CHANGES

From a divisional standpoint, the momentous effects of the *Business Roundtable* decision and the structured approach in the New Guidance are noteworthy. In the months that would follow, the SEC's economics division reorganized and expanded significantly under the leadership of a prominent finance scholar.⁶⁹

⁶⁶ New Guidance, *supra* note 15, at 9.

⁶⁷ *Id.* at 9, 14.

⁶⁸ *Id.* at 9–10.

⁶⁹ Craig M. Lewis, the Madison S. Wigginton Professor of Finance at Vanderbilt University's Owen Graduate School of Management, led the division as Chief Economist and Director of the Division of Economic and Risk Analysis from May 2011 to May 2014. After serving as Chief Economist for three SEC Chairs, Professor Lewis was praised by

Below, I briefly discuss key changes in the SEC's economics division regarding the structure, size, and proportional resources.

In 2013, the economic division's name was recast from the elaborate yet enigmatic Division of Risk, Strategy, and Financial Innovation, or RiskFin, to a more descriptive and explicit Division of Economic and Risk Analysis, or DERA.⁷⁰ The number of deputy directors (who also serve as deputy chief economists) doubled in size from one to two.⁷¹ The quantity of specialized offices within RiskFin/DERA also expanded from seven to ten in the three years following the New Guidance.⁷² The most substantial growth in the division was in the number of Ph.D. financial economists, growing from approximately thirty in 2011 to more than seventy in 2015.⁷³

In terms of resources, an analysis of the net costs as a percentage of total SEC program costs reveals that the economics

Chair Mary Jo White for his "extraordinary leadership, judgment and vision" during this period of expansion. *Chief Economist and Division of Economic and Risk Analysis Director Craig Lewis to Leave SEC*, SEC (May 2, 2014), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541719744>.

⁷⁰ See *SEC Renames Division Focusing On Economic and Risk Analysis*, SEC (June 6, 2013), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171575272> (noting that the name change would better reflect the group's "core responsibilities and focus").

⁷¹ Kathleen Weiss Hanley served as the sole Deputy Director of RiskFin/DERA from August 2011 through August 2013. *Deputy Chief Economist Kathleen Weiss Hanley to Leave SEC*, SEC (Aug. 1, 2013), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539745177>. Jennifer Marietta-Westberg and Scott Bauguess were named deputy chief economists and deputy directors during 2013. *SEC Names Jennifer Marietta-Westberg as Deputy Director of the Division of Risk, Strategy, and Financial Innovation*, SEC (Apr. 11, 2013), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171514626>; *SEC Announces Two Promotions to Senior Positions in Division of Economic and Risk Analysis*, SEC (Oct. 3, 2013), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539861827>.

⁷² The ten offices include the Offices of Asset Management, Chief Counsel, Corporate Finance, Financial Intermediaries, Markets, Litigation Economics, Managing Executive, Research and Data Services, Risk Assessment, and Structured Disclosure. *About the Division of Economic and Risk Analysis*, SEC, <http://www.sec.gov/dera/about> (last modified Sept. 17, 2015). The seven offices on the date of the New Guidance (March 16, 2012) were the Offices of Chief Counsel, Corporate Finance, Markets, Investments and Intermediaries, Litigation Support, Quantitative Research, and Risk Assessment and Interactive Data. *Division of Risk, Strategy, and Financial Innovation Overview*, SEC (Feb. 28, 2012), <https://web.archive.org/web/20120228201027/http://www.sec.gov/divisions/riskfin.shtml>.

⁷³ The SEC's website lists biographical data for seventy-three financial economists as of October 26, 2015. *Economists*, SEC, <http://www.sec.gov/divisions/riskfin/economistbios.shtml> (last updated Oct. 26, 2015).

division has experienced more growth in net costs than any other reported division or office in the SEC.⁷⁴ Figure 1 graphs the fiscal year (FY) growth in net costs, normalized by the value from FY 2011, which predates the New Guidance. DERA net costs grew from \$20 million to \$43 million over FY 2011 to FY 2014.⁷⁵ This represents a 72.1% growth in net costs as a percentage of the total program costs from the baseline value in FY 2011. By comparison, no other reported office or division has experienced growth in proportional net costs greater than 14%.⁷⁶ In the SEC's FY 2014 Congressional Budget Justification, it states that the majority of these expansions in resources were allocated to recruit and hire additional financial economists in support of economic analysis.⁷⁷

⁷⁴ SEC, FISCAL YEAR 2012 AGENCY FINANCIAL REPORT 65 (2012) [hereinafter FY 2012 REPORT], available at <http://www.sec.gov/about/secpar/secafr2012.pdf>; SEC, FISCAL YEAR 2013 AGENCY FINANCIAL REPORT 65 (2013) [hereinafter FY 2013 REPORT], available at <http://www.sec.gov/about/secpar/secafr2013.pdf>; SEC, FISCAL YEAR 2014 AGENCY FINANCIAL REPORT 75 (2014) [hereinafter FY 2014 REPORT], available at <http://www.sec.gov/about/secpar/secafr2014.pdf>. The SEC's fiscal year ends on September 30.

⁷⁵ The SEC reported total program costs of \$1.15 billion (FY 2011), \$1.20 billion (FY 2012), \$1.33 billion (FY 2013), and \$1.44 billion (FY 2014). The net program costs for the economics division were \$20.1 million (FY 2011), \$20.3 million (FY 2012), \$29.5 million (FY 2013), and \$43.4 million (FY 2014). Thus, the net program costs as a percentage of total program costs for the economics division were 1.75% (FY 2011), 1.69% (FY 2012), 2.21% (FY 2013), and 3.01% (FY 2014). FY 2012 REPORT, *supra* note 74, at 65; FY 2013 REPORT, *supra* note 74, at 65; FY 2014 REPORT, *supra* note 74, at 65; FY 2014 REPORT, *supra* note 74, at 75.

⁷⁶ FY 2012 REPORT, *supra* note 74, at 65; FY 2013 REPORT, *supra* note 74, at 65; FY 2014 REPORT, *supra* note 74, at 75.

⁷⁷ See SEC, FY 2015 CONGRESSIONAL BUDGET JUSTIFICATION, FY 2015 ANNUAL PERFORMANCE PLAN, AND FY 2012 ANNUAL PERFORMANCE REPORT (2014), available at <https://www.sec.gov/about/reports/secfy15congbudjust.pdf> ("For FY 2014 the SEC plans growth of 45 positions in the Division of Risk, Strategy and Financial Innovation (RSFI), primarily to hire financial economists to perform economic analyses and research in support of Commission rulemaking activity."). Similar language in the discussion of the FY 2015 budget shows DERA plans to hire additional economists. See SEC, FY 2015 CONGRESSIONAL BUDGET JUSTIFICATION, FY 2015 ANNUAL PERFORMANCE PLAN, AND FY 2013 ANNUAL PERFORMANCE REPORT (2014), available at <https://www.sec.gov/about/reports/secfy15congbudjust.pdf> (noting that DERA seeks to add fourteen positions in FY 2015, primarily financial economists). SEC budget reports are available at <https://www.sec.gov/about/budgetreports.shtml>.

SEC YEAR-OVER-YEAR GROWTH IN NET COSTS AS A PERCENTAGE OF THE TOTAL PROGRAM COSTS BY OFFICE OR DIVISION

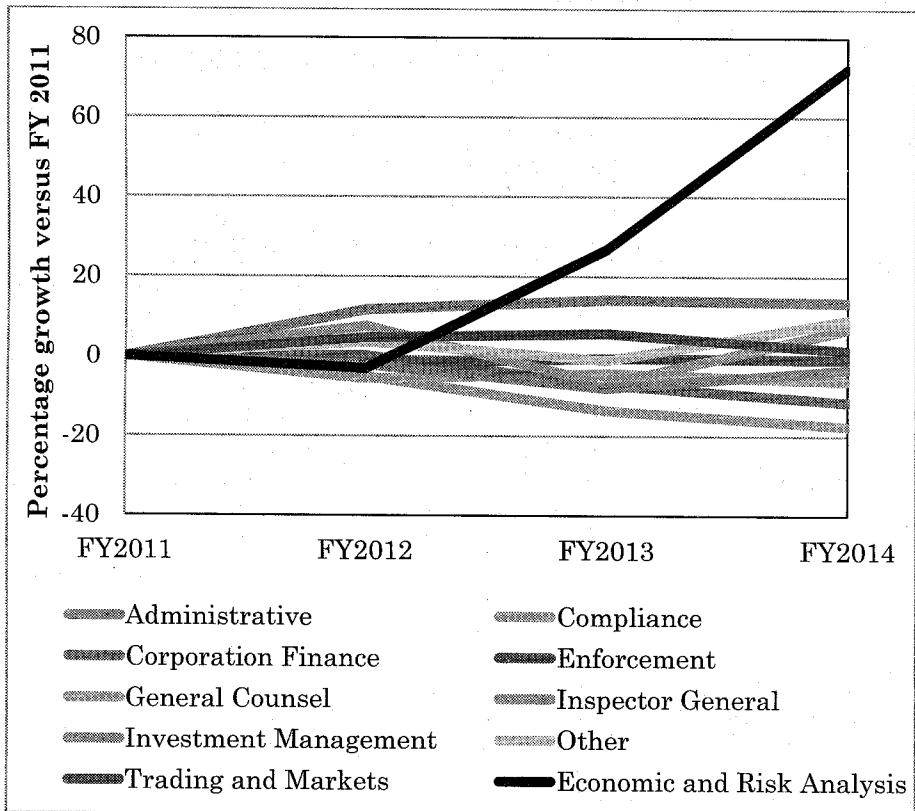


Figure 1⁷⁸

III. CASE STUDY: CREDIT RISK RETENTION

A. WHY STUDY THE RISK RETENTION RULE?

The previous section discussed the organizational changes following the New Guidance. In order to elucidate its effect on

⁷⁸ FY 2012 REPORT, *supra* note 74; FY 2013 REPORT, *supra* note 74; FY 2014 REPORT, *supra* note 74.

economic analysis, I provide a case study around the proposed and final rules of Credit Risk Retention.⁷⁹ Figure 2 provides a timeline of key dates surrounding its adoption.

TIMELINE OF CREDIT RISK RETENTION RULES

July 21, 2010	The Dodd–Frank Wall Street Reform and Consumer Protection Act is signed into law. ⁸⁰
March 30, 2011	Joint Regulators propose rules on Credit Risk Retention including a proposed definition of a qualified residential mortgage (QRM). ⁸¹
March 16, 2012	SEC publishes New Guidance. ⁸²
August 28, 2013	Joint Regulators re-propose rules on Credit Risk Retention including two alternative definitions of a QRM. The SEC includes a DERA White Paper analysis of historic default risk. ⁸³
January 3, 2014	The Consumer Financial Protection Bureau (CFPB) defines a qualified mortgage (QM). ⁸⁴
October 22, 2014	Joint Regulators adopt final rules on Credit Risk Retention and equate the definition of a QRM with that of a QM defined by the CFPB. ⁸⁵

Figure 2

⁷⁹ See generally Credit Risk Retention 2011, Exchange Act Release No. 34-64148, 76 Fed. Reg. 24,090 (proposed Mar. 30, 2011); Credit Risk Retention 2013, Exchange Act Release No. 34-70277, 78 Fed. Reg. 57,928 (proposed Aug. 28, 2013); Credit Risk Retention 2014, Exchange Act Release No. 34-73407, 79 Fed. Reg. 77,601 (Oct. 22, 2014) (effective Feb. 23, 2015) (to be codified at 24 C.F.R. pt. 267).

⁸⁰ Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as 12 U.S.C. § 5301 (2012)).

⁸¹ *SEC Proposed Rules: 2011*, SEC, <http://www.sec.gov/rules/proposed/proposedarchive/proposed2011.shtml> (last modified Sept. 3, 2015); Credit Risk Retention 2011, Exchange Act Release No. 34-64148, 76 Fed. Reg. 24,090 (proposed Mar. 30, 2011).

⁸² New Guidance, *supra* note 15.

⁸³ *SEC Proposed Rules, 2013*, SEC, <http://www.sec.gov/rules/proposed/proposedarchive/proposed2013.shtml> (last modified Sept. 3, 2015) (proposed rules for 2013); Credit Risk Retention 2013.

⁸⁴ *CFPB Regulations Establish a Broad Qualified Mortgage Definition*, CENTER FOR RESPONSIBLE LENDING (Jan. 3, 2014), <http://www.responsiblelending.org/mortgage-lending/research-analysis/2014-CRL-QM-Fact-Sheet-FINAL-Jan-03pdf.pdf>.

⁸⁵ *SEC Final Rules, 2014*, SEC, <http://www.sec.gov/rules/final/finalarchive/finalarchive2014.shtml> (last modified Oct. 2, 2015); Credit Risk Retention 2014, Exchange Act Release No. 34-73407, 79 Fed. Reg. 77,61 (Oct. 22, 2014) (effective Feb. 23, 2015) (to be codified at 24 C.F.R. pt. 267).

A study of the risk retention rule is beneficial for two reasons. First, the rules were proposed as part of Dodd-Frank prior to the New Guidance and then re-proposed due to, among other reasons, pushback from housing market participants,⁸⁶ some of which claimed the SEC and the other federal agencies tasked with designing the rule did not correctly analyze the data in the original proposal.⁸⁷ Second, the cost-benefit analysis of the risk retention rule is one of the six specific Dodd-Frank Act rulemakings named in the SEC's OIG Review in response to the Congressional Request discussed in Section II.⁸⁸

Although the particular details of the risk retention rule are not the primary concern of this study, they are relevant in exploring my principal topic—the manner in which the risk retention rule was influenced through evolving economic analysis. I begin with a general overview of the financial crisis that resulted in lawmakers including risk retention in the Dodd-Frank Act.

B. THE ROLE OF RESIDENTIAL MORTGAGE SECURITIZATION IN THE FINANCIAL CRISIS

Scholars point to the growth of private-label RMBS in the late 1990s and 2000s as one of the principal causes of the financial crisis.⁸⁹ Unlike conforming loans purchased and securitized by the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac, private-label RMBS included layers of risk through non-traditional mortgage products (e.g., negative amortization

⁸⁶ See Floyd Norris, *Mortgages Without Risk, at Least for the Banks*, N.Y. TIMES, Nov. 28, 2013, <http://www.nytimes.com/2013/11/29/business/mortgages-without-risk-at-least-for-the-banks.html> (discussing opposition towards the proposed rules from the banking industry, housing industry, and consumer advocates).

⁸⁷ See Letter from Kevin D. Schneider, President and Chief Exec. Officer, Genworth Mortgage Insurance, to Joint Regulators 11 (July 28, 2011), available at <https://www.sec.gov/comments/s7-14-11/s71411-180.pdf> (“The approach taken by the Agencies relies on analysis of loan data that is flawed. . .”).

⁸⁸ OFFICE OF INSPECTOR GEN., *supra* note 44, at 1.

⁸⁹ See, e.g., Benjamin J. Keys et al., *Mortgage Financing in the Housing Boom and Bust*, in HOUSING AND THE FINANCIAL CRISIS 143, 143 (Edward L. Glaeser & Todd Sinai eds., 2013), available at <http://www.nber.org/chapters/c12624.pdf> (“With ‘crisis-like’ events unfolding on a regular basis around the world, it is easy to forget that the financial crisis started with the US subprime mortgage market.”).

contracts), poor underwriting practices (e.g., lack of fully-documented income), and low-quality borrower characteristics (e.g., low credit scores).⁹⁰ The design of private-label RMBS also made them particularly sensitive to the market prices of the underlying asset, in this case residential houses.⁹¹ As house prices continued to climb during the early to mid-2000s, the multifaceted risk of private-label RMBS was partially concealed to investors as borrowers could take advantage of house-price appreciation and a liquid mortgage market by refinancing or selling their property, which kept default rates low.⁹² Once house prices began to fall, historically high instances of default and foreclosure, resulting in a banking panic, exposed the true risk of these products and their poor underwriting practices.⁹³

Securitization itself gives rise to the economic phenomenon of moral hazard. Unlike traditional mortgages, where the same bank originates and services the loan and is therefore concerned with its performance, securitized loans often involve numerous lending agents whose compensation may not depend on the performance of the loan.⁹⁴ This results in a potential misalignment of incentives. Academic studies find that borrower screening was reduced as a result of rapid securitization as loan originators had greater financial incentives to focus on “hard” information that may be communicated to RMBS investors and could simply ignore “soft” information regarding default risk.⁹⁵

⁹⁰ See *id.* at 144, 151 (discussing the change in mortgage finance practices).

⁹¹ See Gary Gorton, *Information, Liquidity, and the (Ongoing) Panic of 2007*, 99 AM. ECON. REV. (PAPER & PROC.) 567, 567 (2009) (discussing the price-sensitive design of subprime mortgages).

⁹² See *id.* (“As long as house prices appreciated, subprime mortgages could be refinanced, and the various structured securities linked to subprime mortgages were attractive investments.”).

⁹³ See *id.* at 567–68 (describing the events preceding the banking panic).

⁹⁴ See Cem Demiroglu & Christopher James, *How Important is Having Skin in the Game? Originator-Sponsor Affiliation and Losses on Mortgage-Backed Securities*, 25 REV. FIN. STUD. 3217, 3217 (2012) (“[S]ecuritization involves a number of different agents performing different services, often for fees that could be unrelated to the performance of the securitized pool of loans.”).

⁹⁵ See, e.g., Benjamin J. Keys, Amit Seru & Vikrant Vig, *Lender Screening and the Role of Securitization: Evidence from Prime and Subprime Mortgage Markets*, 25 REV. FIN. STUD. 2071, 2077 (2012) (“[A]lthough lenders are compensated for collecting the borrower’s hard

C. DODD-FRANK, RISK RETENTION, AND QUALIFIED RESIDENTIAL MORTGAGES

In Dodd-Frank, Congress attempted to address the moral hazard present in asset-backed securitizations by requiring the originator or sponsor of securitization issuances to maintain a loss exposure in the loan pools that they securitize. By requiring these agents to have “skin in the game,” it should result in higher quality loans by aligning the incentives of the bank with the performance of the securitized loans.⁹⁶

Section 941 of the Dodd-Frank Act tasked the SEC, along with the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Department of Housing and Urban Development, and the Federal Housing Finance Agency (Joint Regulators) with cooperatively prescribing regulations requiring at least 5% risk retention by securitization agents in the issuance of any asset-backed securities.⁹⁷ Importantly, Dodd-Frank instructs the Joint Regulators to provide a complete exemption from risk retention for certain securitizations.⁹⁸ One notable exemption is for RMBS loans meeting the definition of a yet-to-be defined qualified residential mortgage (QRM).⁹⁹ The economic analysis around this exemption is the focus of this case study.

The notion behind the QRM exemption was that loans that are extremely safe do not need costly risk retention. Dodd-Frank instructs the Joint Regulators to define a QRM based on analysis of historical mortgage performance and provides a list of loan and borrower characteristics to consider in the definition.¹⁰⁰ One

information, the incentive for lenders to process soft information critically depends on whether they have to bear the risk of loans they originate . . .”).

⁹⁶ Norris, *supra* note 86.

⁹⁷ Dodd-Frank Act, Pub. L. No. 111-203, § 941, 124 Stat. 1376, 1891–92 (2010).

⁹⁸ *Id.* at 1892.

⁹⁹ *Id.* at 1894–95.

¹⁰⁰ *See id.* at 1894 (“[The Joint Regulators] shall jointly define the term ‘qualified residential mortgage’ for purposes of this subsection, taking into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default . . .”). The list of proposed factors include: loan documentation, debt-to-income ratio, payment shocks associated with adjustable rate mortgages, underwriting standards,

important limitation was that the definition of a QRM could be no broader than the separately defined qualified mortgage (QM), which was to be defined by the newly created Consumer Financial Protection Bureau (CFPB).¹⁰¹ Former Congressman, and Dodd-Frank Act namesake, Barney Frank later testified that

The statutory intent was to create 3 categories of mortgages: those that fell below QM standards and were subject to various legal constraints; the QM mortgages which would meet minimum standards and be subject to risk retention; and a separate sub-set of mortgages that were virtually certain to be repaid and would therefore be given an exemption from risk retention.¹⁰²

D. EVOLUTION OF THE RULE

1. *Original Proposal.* In March 2011, the Joint Regulators first proposed the risk retention rules (Original Proposal).¹⁰³ As required by Dodd-Frank, the Original Proposal defined a QRM and exempted securitizations of QRMs from all risk retention.¹⁰⁴ The proposed QRM definition included many notable restrictions. Risky loan products, such as loan terms greater than thirty years and the so-called “toxic” loan payment structures, which include interest-only and balloon payments, were prohibited.¹⁰⁵ There were also restrictions on borrower characteristics through required

mortgage guaranty insurance, and the use of balloon payments, negative amortization, prepayment penalties, interest-only payments, and other features associated with a higher risk of default. *Id.* at 1895.

¹⁰¹ *Id.*

¹⁰² *Assessing the Impact of the Dodd-Frank Act Four Years Later: Hearing Before the H. Comm. on Fin. Servs.*, 113th Cong. 1 (2014) (statement of former Rep. Barney Frank), available at <http://financialservices.house.gov/uploadedfiles/hhrg-113-ba00-wstate-bfrank-20140723.pdf> [hereinafter Frank Testimony].

¹⁰³ All five SEC Commissioners voted for the issuance of the proposed rules. Sarah N. Lynch, *US SEC Votes 5-0 to Propose Risk Retention Rules*, REUTERS (Mar. 30, 2011), <http://www.reuters.com/article/2011/03/30/financial-regulation-secrisk-idUSWEN023420110330>.

¹⁰⁴ Credit Risk Retention 2011, Exchange Act Release No. 34-64148, 76 Fed. Reg. 24,090 (proposed Mar. 30, 2011).

¹⁰⁵ *Id.* at 24,122.

underwriting standards. A QRM required full documentation of income with varying debt-to-income ratio restrictions based on the purpose of the loan (i.e., purchase versus refinance).¹⁰⁶ A QRM also had credit history restrictions, which substituted for credit scoring as federal regulators moved towards a policy of relying less on private credit rating organizations.¹⁰⁷

In what would be the most controversial feature of the proposed definition, a QRM was to have a maximum 80% loan-to-value (LTV) ratio and a minimum 20% down payment for purchase loans.¹⁰⁸ This key threshold for a mortgage down payment and LTV ratio had long been the rule of thumb for a safe level of home equity since borrowers with less than 20% down were typically required to purchase mortgage insurance.¹⁰⁹ These down payment requirements were loosened during the height of the private-label securitizations in the mid-2000s as lenders frequently offered zero down payment “80/20” loans where borrowers would finance 80% of the purchase price with a first mortgage and the remaining 20% with a “piggyback” second mortgage.¹¹⁰

In terms of the expected costs and benefits of risk retention, the most salient costs were potentially reduced loan volume and access to capital, especially for low-income borrowers,¹¹¹ and increased mortgage costs as banks are expected to charge higher rates as

¹⁰⁶ *Id.* at 24,152.

¹⁰⁷ See, e.g., Lawrence J. White, *Credit-Rating Agencies and the Financial Crisis: Less Regulation of CRAs Is a Better Response*, 25 J. INT'L BANKING L. & REG. 170, 177 (2010) (“The SEC has withdrawn a few regulations that required SEC-regulated financial institutions to rely on NRSRO ratings and has proposed withdrawing a few more.”).

¹⁰⁸ Credit Risk Retention 2011, 76 Fed. Reg. 24,090, 24,096 (proposed Mar. 30, 2011).

¹⁰⁹ See Allan N. Krinsman, *Subprime Mortgage Meltdown: How Did It Happen and How Will It End?*, 11 J. STRUCTURED FIN. 13, 15 (2007) (“Until recently, most borrowers were expected to make at least a 20% down payment on the purchase price of their home, and to finance the remaining amount of the purchase price. For borrowers that didn’t have the financial means to make a 20% down payment, lenders required private mortgage insurance.”).

¹¹⁰ *Id.*

¹¹¹ See generally Roberto G. Quercia, Lei Ding & Carolina Reid, *Balancing Risk and Access: Underwriting Standards for Qualified Residential Mortgages*, Center for Responsible Lending 7 (Mar. 5, 2012), available at <http://www.responsiblelending.org/mortgage-lending/research-analysis/Underwriting-Standards-for-Qualified-Residential-Mortgages.pdf> (analyzing the negative impact of underwriting guidelines for ARMs on low-income, minority, and other households traditionally underserved by the mainstream mortgage market).

compensation for the cost of bearing risk retention.¹¹² The expected benefit was reduced mortgage default due to the higher quality loans, restoring faith and capital formation in the RMBS market, and avoiding a repeat of the subprime financial crisis.¹¹³

In the economic analysis of the Original Proposal, the Joint Regulators examined the application of the proposed definition on historical default rates¹¹⁴ using two sources but primarily relied upon FHFA “Enterprise” data on approximately 75 million loans purchased and securitized by Fannie Mae and Freddie Mac from 1997 to 2009.¹¹⁵ The analysis showed that historical default rates were significantly higher for loans that did not meet the proposed criteria of a QRM. For example, the Original Proposal finds the overall default rate of 5.3% is reduced to 1.0% for the sample of Enterprise purchase loans that would meet the definition of a QRM.¹¹⁶ The analysis also shows that borrower credit history and LTV ratios are among the most significant predictors of default risk in a univariate setting.¹¹⁷ It is important, however, to note that the Original Proposal exempts securitization transactions sponsored by Fannie Mae and Freddie Mac from risk retention since these GSEs maintain 100% risk retention through payment guarantees.¹¹⁸ Academic literature also finds significantly better

¹¹² See BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, *Report to the Congress on Risk Retention* 78 (2010), available at <http://www.federalreserve.gov/boarddocs/rptcongress/securitization/riskretention.pdf> (predicting that risk retention requirements will likely not increase the volume of FHA-insured lending despite the higher costs of funding conventional mortgages).

¹¹³ See, e.g., Ioannis Floros & Joshua T. White, *Qualified Residential Mortgages and Default Risk* 24 (Feb. 12, 2015) (unpublished manuscript) (on file with Iowa State University), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2480579 (“[T]he percentage decline in serious delinquency is viewed as a benefit . . .”).

¹¹⁴ The analysis estimated default rates using serious delinquency rather than actual instances of default. Serious delinquency is defined as a loan that has ever been ninety days delinquent or in the process of foreclosure. Credit Risk Retention 2011, Exchange Act Release No. 34-64148, 76 Fed. Reg. 24,090, 24,140 (proposed Mar. 30, 2011).

¹¹⁵ *Id.* at 24,117. The second data source was a sample of just under nine-million securitized loans spanning 2005 to 2008. *Id.*

¹¹⁶ *Id.* at 24,121–24, 24,141–43.

¹¹⁷ *Id.* at 24,121, 24,123.

¹¹⁸ *Id.* at 24,119. This exemption would only remain in effect for as long as Fannie Mae and Freddie Mac operated under the conservatorship or receivership of the FHFA with capital support from the U.S.

performance for loans purchased and securitized by Fannie Mae and Freddie Mac versus private-label RMBS.¹¹⁹ Market participants would eventually point to the Original Proposal's focus on Enterprise data to measure the effect of QRM on default risk as a potential flaw of the economic analysis.¹²⁰

2. *Industry Pushback.* After the proposal, there was considerable pushback by industry participants and consumer advocates.¹²¹ The Joint Regulators noted that they received more than 10,000 total and nearly 300 unique public comment letters prior to re-proposing the risk retention rules in August 2013.¹²² Most commenters argued that the 2011 proposed QRM definition was overly narrow, and they especially criticized the requirement of a 20% down payment.¹²³ Commenters also argued that banks would not want to originate non-QRM mortgages, which caused concerns that a narrow definition of QRM could disproportionately limit access to mortgages for low-income and minority borrowers.¹²⁴ Several commenters advocated for aligning the QRM definition with that of a QM implemented by the CFPB, which was the broadest definition allowed by Dodd-Frank.¹²⁵ The QM definition, established in January 2013, focuses on borrower "ability to repay" by requiring loans without large upfront fees, restricting loan terms to no greater than thirty years, requiring full documentation of borrower debt-to-income ratios limited to 43%, and disqualifying loans with interest-only payments,

¹¹⁹ See Floros & White, *supra* note 113, at 29–30 (finding that serious delinquency occurred at a rate of 44.6% in non-agency loans as opposed to 5.3% in agency loans).

¹²⁰ See Letter from Kevin D. Schneider, *supra* note 87, at 11 (asserting that the loan data is flawed because it excludes private label loans and compares above 80% LTV loans to LTVs less than 80%).

¹²¹ See Norris, *supra* note 86 ("The six regulators that are supposed to agree on rules for [QRM] put out a proposal in 2011 that gave in to banks on many issues, but not all. The banks reacted with anger . . .").

¹²² Credit Risk Retention 2013, Exchange Act Release No. 34-64148, 78 Fed. Reg. 57,928, 57,991 (proposed Aug. 28, 2013).

¹²³ *Id.*

¹²⁴ *Id.* at 57,991.

¹²⁵ See *generally* Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z) 78 Fed. Reg. 6,408 (Jan. 30, 2013) (to be codified as 12 C.F.R. pt. 1026), *amended by* 78 Fed. Reg. 35,430 (June 12, 2013) (to be codified at 12 C.F.R. pt. 1026), and 78 Fed. Reg. 44,686 (July 24, 2013) (to be codified at 12 C.F.R. pts. 1024, 1026).

negative amortization, or balloon payments.¹²⁶ However, the definition of QM has no minimum down payment or maximum LTV ratio and places no restrictions on credit history or credit scores.

Two market participants were particularly influential in generating additional analysis by the SEC: Genworth Mortgage Insurance and the Center for Responsible Lending (CRL). Genworth argued that the economic analysis supporting the Original Proposal was flawed because it focused on loans purchased by the GSEs, which are exempt from risk retention due to payment guarantees, and did not include a multivariate analysis.¹²⁷

Another criticism of a strict QRM definition is that it would disproportionately affect low-income and minority borrowers. The CRL submitted a letter¹²⁸ and later published a study¹²⁹ to that effect, both showing that an application of the QM criteria to historical loans reduced the default rates from greater than 25% to nearly 7%. Both argue that QM-eligible loans performed well enough and that a QM efficiently trades off access to capital with reduced mortgage defaults.¹³⁰ Thus, the CRL advocated for equating the definition of a QRM with a QM and met with members of the SEC's rulewriting and economic analysis team to discuss the study.¹³¹ However, the CRL study blended the default rates of prime, subprime, and Federal Housing Administration

¹²⁶ *Id.*

¹²⁷ Letter from Kevin D. Schneider, *supra* note 87, at 11.

¹²⁸ See Letter from Mike Calhoun, President, and Ellen Harnick, Senior Policy Counsel, Center for Responsible Lending, to Joint Regulators 7 (Aug. 1, 2011), available at <https://www.sec.gov/comments/s7-14-11/s71411-279.pdf> ("This result is striking because it demonstrates that acceptable default rates could be achieved without restrictions that disproportionately exclude lower wealth or lower income borrowers.")

¹²⁹ Quercia, Ding & Reid, *supra* note 111, at 23–33.

¹³⁰ See Letter from Mike Calhoun, *supra* note 128, at 7 ("[A]dding limitations on debt-to-income and/or credit history would reduce default rates further—but further reductions are not necessary for investor protection or systemic stability and would unnecessarily burden many credit-worthy borrowers and the nation's economic recovery.")

¹³¹ Memorandum from Steven Gendron, Analyst Fellow, Office of Structured Fin., Div. of Corp. Fin., SEC, to File No. S7-14-11 (June 5, 2013), available at <http://www.sec.gov/comments/57-14-11/S71411-362.pdf> (describing a meeting with representatives of the Center for Responsible Lending).

(FHA) mortgage market loans in their analysis.¹³² By combining separate sources of data and mixing private-label loans with prime and FHA loans, the CRL study potentially paints a better picture of default rates for loans meeting the QM definition than an analysis strictly limited to private-label RMBS.

Overall, the criticisms of the economic analysis in the Original Proposal highlight the important role of an economic baseline in establishing the facts surrounding a proposed rulemaking. Essentially, many commenters presented analyses that challenged the facts of the historic economic landscape in the private-label RMBS space. These challenges had the intent of broadening the QRM definition.¹³³ Yet many of these studies used different data sources, blended different GSE and non-GSE loans, and used different time periods of mortgage origination than the Original Proposal and, not surprisingly, reported different mortgage performance in their analyses.¹³⁴ These challenges are particularly concerning in establishing an objective and robust cost-benefit analysis because market participants (and regulators) have a vested interest in the outcome. Often times, “data will arrange themselves to fit preconceived conclusions.”¹³⁵

3. *DERA White Paper and Re-Proposal.* In response to this and other criticisms of the Original Proposal, and following the publication of the New Guidance, the SEC conducted an expanded multivariate analysis of historical default rates for loans securitized in private-label RMBS.¹³⁶ In this analysis (DERA White Paper), SEC economists found the default rates of a dataset focusing solely on private-label RMBS were substantially higher

¹³² Quercia, Ding & Reid, *supra* note 111, at 12.

¹³³ See generally *id.* (advocating a less restrictive QRM definition).

¹³⁴ See, e.g., *id.* (incorporating the default rates of multiple types of loans into the analysis, resulting in skewed results).

¹³⁵ GEORGE E. REEDY, LYNDON B. JOHNSON: A MEMOIR 148 (1982).

¹³⁶ Joshua White & Scott Bauguess, *Qualified Residential Mortgage: Background Data Analysis on Credit Risk Retention*, DIV. OF ECON. AND RISK ANALYSIS, SEC (Aug. 2013), available at <https://www.sec.gov/divisions/riskfin/whitepapers/qrm-analysis-08-2013.pdf>. In February 2015, the SEC published an updated version of the DERA White Paper that corrects errors in “a small number of records in the underlying data set” that do not change the conclusion of the paper. The updated version is available at <http://www.sec.gov/dera/staff-papers/white-papers/qrm-analysis-02-2015.pdf>.

than the Enterprise loans cited in the Original Proposal.¹³⁷ The DERA White Paper shows the overall default rates for private-label RMBS loans originated during 1997 to 2009 with full information on debt-to-income ratio was 44%, which is significantly greater than the 5% overall default rate cited in the Original Proposal.¹³⁸ The DERA White Paper also finds that 34% of historical loans that would meet the QM definition experienced serious delinquency, which is nearly five times larger than the default rate cited in the CRL study.¹³⁹ The DERA White Paper found the default rate reduced to 5% for private-label RMBS loans meeting the original QRM definition.¹⁴⁰ It also finds LTV ratios and credit history as among the most important predictors of default, even in a multivariate setting.¹⁴¹ The robustness of these findings was later confirmed in an expanded academic paper examining the multivariate relationship between loan and borrower characteristics and default risk.¹⁴² The implication of the DERA White Paper was that if regulators wished to reduce defaults, then even modest limitations on LTV ratios and credit history would have a much greater influence than most factors included in the definition of a QM.

In the re-proposal, the Joint Regulators cited the DERA White Paper as part of the economic analysis and significantly expanded the cost-benefit discussion to meet the standards of the New Guidance.¹⁴³ The economic analysis of the re-proposal also responded to criticisms that 5% risk retention is costly and noted that few commenters provided analysis on these costs.¹⁴⁴ The re-proposal estimated a retention cost between zero and thirty basis

¹³⁷ *Id.* at 8 n.11.

¹³⁸ *Id.* at 6.

¹³⁹ *Id.*

¹⁴⁰ *Id.*

¹⁴¹ *See id.* at 10 (“[T]he economic significance of DTI is about one-fifth of either FICO or CLTV.”).

¹⁴² *See* Floros & White, *supra* note 113, at 22–23 (explaining five particular variables with the greatest marginal effects).

¹⁴³ Credit Risk Retention 2013, Exchange Act Release No. 34-70277, 78 Fed. Reg. 57,928 (proposed Aug. 28, 2013).

¹⁴⁴ *Id.* at 57,994.

points depending on the method of funding risk retention.¹⁴⁵ By this estimate, 5% risk retention was estimated to increase mortgage costs by approximately one-quarter of 1%.

The re-proposal offered two options for the QRM definition: equate the definition of a QRM with the definition of a QM or, alternatively, a QRM would include additional underwriting standards (e.g., a 70% maximum LTV ratio) beyond even the Original Proposal, which was termed “QM-Plus.”¹⁴⁶

4. *Final Rule.* In October 2014, the Joint Regulators adopted the final risk retention rules, mostly following the provisions in the 2013 re-proposal. The final rule defines a QRM to mean a QM as defined by the CFPB and exempts sponsors from all risk retention for securitizations consisting solely of QRMs.¹⁴⁷ Thus, under the final rule, loans to borrowers with zero down and high loan-to-value ratios or poor credit history can be securitized with no risk retention as long as they meet the provisions of a QM. This concern was raised in the dissenting statement of SEC Commissioner Daniel Gallagher, who warned that loans that would have been considered “subprime” would now carry a government label of “qualified.”¹⁴⁸ Commissioner Gallagher cautioned that, “When every mortgage is labeled as ‘qualified,’ investors should assume none really will be.”¹⁴⁹ Barney Frank also

¹⁴⁵ *Id.* at 57,991, 58,021–23.

¹⁴⁶ *Id.* at 57,991–92.

¹⁴⁷ The final rule also exempts RMBS issuances by Fannie Mae and Freddie Mac from risk retention as long as they are operating under the conservatorship or receivership of the FHFA with U.S. capital support. Credit Risk Retention 2014, Exchange Act Release No. 34-73407, 79 Fed. Reg. 77,602, 77649 (Oct. 22, 2014) (effective Feb. 23, 2015) (to be codified at 24 C.F.R. pt. 267).

¹⁴⁸ See *Dissenting Statement of Commissioner Daniel M. Gallagher Concerning Adoption of Rules Implementing the Credit Risk Retention Provisions of the Dodd-Frank Act*, SEC (Oct. 22, 2014), available at <http://www.sec.gov/News/PublicStmnt/Detail/PublicStmnt/1370543240793> (“It was securitizations of what we called subprime RMBS carrying triple-A ratings from credit rating agencies implicitly endorsed by the government as ‘nationally recognized statistical rating organizations’ that played a major role in the last crisis. For the next, there won’t even be the ‘subprime’ moniker to dissuade investors from purchasing securitizations of low-quality loans. Instead, residential mortgages with zero percent down and weak loan-to-value ratios that in the past would have been called subprime will now carry the same ‘quality’ endorsement from the government as solid mortgages with significant down payments and strong LTV ratios.”).

¹⁴⁹ *Id.*

voiced disappointment in the decision to equate the definitions of QRM and QM, but claimed he was:

not surprised that the overwhelming majority of commenters who are interested in building, selling or promoting the sale of housing to lower income people, support effectively abolishing risk retention[.] I should note that if all of these people were correct in their collective judgment, we would not have had the crisis that we had.¹⁵⁰

SEC Commissioner Luis Aguilar also acknowledged concerns that the final QRM definition lacked restrictions on LTV ratios and credit history, which was highlighted through the DERA White Paper.¹⁵¹ However, Commissioner Aguilar noted that his decision to vote for adopting the risk retention rules and equating the definition of a QRM with a QM was comforted by the rule requiring a periodic review of the QRM definition beginning four years after its effective date and every five years thereafter.¹⁵² Under the final rule, any of the Joint Regulators can also request a review of the QRM definition at any time.¹⁵³ Commissioner Aguilar also disclosed that his decision was informed by the SEC's adoption of "Reg AB2" just two months prior, which added

¹⁵⁰ Frank Testimony, *supra* note 102.

¹⁵¹ See Comm'r Luis A. Aguilar, *Skin in the Game: Aligning the Interests of Sponsors and Investors*, SEC (Oct. 22, 2014), available at <http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370543250034> ("[T]here are concerns that by deferring to the CFPB's 'qualified mortgage' definition, the rule may exempt certain loans that could exhibit other high credit risk characteristics that are not taken into account by the CFPB definition—such as high loan-to-value ratios or loans to borrowers with weaker credit histories. In fact, these concerns are reflected in an analysis made public by the Commission's Division of Economic and Risk Analysis.").

¹⁵² *Id.*

¹⁵³ See Credit Risk Retention 2014, Exchange Act Release No. 34-73407, 79 Fed. Reg. 77,602, 77,689 (Oct. 22, 2014) (effective Feb. 23, 2015) (to be codified at 24 C.F.R. pt. 267) ("[T]he agencies will commence a review at any time upon the request of any one of the agencies.").

additional asset-level disclosure of RMBS and other specific asset-backed security issuances.¹⁵⁴

In the end, the decision by the Joint Regulators to align the QRM and QM definitions was made with robust information of the expected costs and benefits, and an economic baseline that accurately described the status quo. The expanded analysis of the SEC can be attributed directly to the New Guidance requiring rigorous and structured economic analysis in rulemaking efforts. Moreover, the publication of the DERA White Paper reflects the responsiveness of the SEC to concerns raised by the public that the cost-benefit analysis of the Original Proposal was potentially flawed. Only time will tell if the decision to loosen the QRM definition was wise.

IV. CONCLUSION

The role of economic analysis and economists at the SEC has evolved following a series of judicial setbacks, *Business Roundtable*, in particular. Throughout this study, two key transformations of economic analysis at the SEC are highlighted. First, there were substantial organizational changes resulting in significant growth in the amount of resources allocated to the division conducting economic analysis at the SEC. Much of these added resources were spent to recruit and hire additional Ph.D. financial economists to conduct economic analysis. Second, the SEC responded to the judicial setbacks and public criticism by establishing New Guidance on economic analysis following an introspective review. The New Guidance mandates that every economic analysis must include: (1) a stated need for rulemaking; (2) a well-defined economic baseline of the status quo; (3) identification of alternative regulatory approaches; and (4) an analysis of the economic consequences of the proposed action and each alternative as compared to the baseline. I argue that the economic baseline can be as important as the estimation of the costs and benefits of a proposed rule.

¹⁵⁴ See *Asset-Backed Securities Disclosure and Registration*, 79 Fed. Reg. 57,184 (adopted Sept. 24, 2014) (discussing meaningful revisions to regulations).

As an example of how an economic baseline is critical in SEC rulemaking, I present a case study of the Dodd-Frank risk retention rules and the definition of a QRM, which is exempt from risk retention. Market participants criticized the economic analysis accompanying the original QRM proposal in 2011, stating that the SEC and other Joint Regulators analyzed the wrong dataset and did not conduct a robust multivariate analysis. There was also significant pressure from housing market participants and consumer advocates to align the definition of a QRM with that of a QM as defined by the CFPB.

At the time of the risk retention re-proposal in 2013, and following the New Guidance, SEC economists provided an additional and expanded analysis in the DERA White Paper on QRMs. This analysis showed that QMs did not significantly reduce default risk because credit scores and LTV ratios are among the best predictors of default, yet both are absent from the QM definition.

Eventually, the Joint Regulators chose to adopt the broader definition of a QRM by equating it with that of a QM. Nevertheless, I argue that the SEC analysis provided important information about the economic landscape and the potential effect of the rule. Ultimately, the role of economic analysis is to aid the decision makers—in this case, the principals of the Joint Regulatory agencies. By providing the best possible information on the status quo and accrued costs and benefits of each rulemaking choice, the overall decision process should be improved through rigorous economic analysis. Regulations and regulators are not perfect. But, recall that the goals of a benevolent regulator are not perfection. They are well-designed public policies with sound economics that improve social welfare.

