SUMMARY OF STATEMENT OF JOHN S.R. SHAD, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION, BEFORE THE HOUSE JUDICIARY SUBCOMMITTEE ON ADMINISTRATIVE LAW AND GOVERNMENTAL RELATIONS

July 27, 1983

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° Congress should consider carefully the cumulative costs and benefits of H.R. 2327 and the eight existing procedural statutes.

° Although the direct and indirect costs and prophylactic value of certain Commission rules, particularly in the antifraud area, are difficult to quantify, the Commission supports cost-benefit analysis in rulemaking, to the extent practicable.

° Although the Commission is not subject to the cost-benefit analysis requirements of Executive Order 12291, it has voluntarily incorporated cost-benefit analyses into its regulatory programs, to the extent practicable.

° Opponents of the Executive oversight provisions of H.R. 2327 believe that agencies are already subject to adequate Executive oversight. Proponents believe that the provisions are necessary to ensure a coordinated national regulatory policy.

° Opponents of the legislative veto provisions of H.R. 2327 believe that they would unnecessarily encumber and delay the regulatory process. Proponents believe they would reinforce the legislative authority of the elected representatives of the people.

° Opponents of the judicial review provisions of H.R. 2327 believe they could invite wasteful litigation and judges to substitute unduly their judgments for those of agencies. Proponents believe they would improve agency accountability.

° In order to avoid duplicative efforts, the H.R. 2327 periodic rule review proposal should take into consideration reviews already mandated by statute or voluntarily initiated by agencies.

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Chairman Hall and Members of the Subcommittee:

As requested by Chairman Rodino, the Securities and Exchange Commission appreciates this opportunity to testify on three topics:

- the impact of regulatory reform legislation on the Commission;
- the extent to which the Commission is currently complying with the requirements of Executive Order 12291 regarding regulatory impact analysis and OMB oversight; and
- H.R. 2327.

A. Regulatory Reform

Since the mid-sixties, there has been a rising bipartisan tide of public, Congressional and Executive demand for regulatory reform. Numerous articles, studies and surveys cite the heavy costs to the nation of mounting regulatory burdens. Some view independent regulatory agencies as unaccountable to elected Congressional representatives or the President. They have been characterized by some critics as exercising unbridled

power. Under broad statutory mandates, independent agencies, such as the SEC, exercise quasi-legislative and judicial authority as well as prosecutorial responsibilities.

B. Impact of Regulatory Reform Legislation on the SEC

Regulatory agencies are subject to judicial review of their decisions, Congressional oversight, and eight procedural statutes which limit or proscribe their activities. 1/ These statutes fall within three general categories. Those designed to:

- increase public access to government agencies;
- limit prosecutorial activities; and
- require agencies to assess the impact of their regulations.

1. Public Access

The SEC is subject to four statutes which increase public access to government agencies:

- The Federal Advisory Committee Act of 1972 prohibits private consultations by agencies with interested

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1/ Federal Advisory Committee Act, Freedom of Information Act, Privacy Act, Government in the Sunshine Act, Right to Financial Privacy Act, Equal Access to Justice Act, Regulatory Flexibility Act, and Paperwork Reduction Act. The agencies are also, of course, subject to the Administrative Procedure Act of 1948, which prescribes agencies' minimum procedural requirements in adopting rules and making adjudications. Most commentators view this 35-year-old statute as a flexible and modest approach to agency accountability.

parties before commencing formal rulemaking proceedings under the APA, unless certain exemptions apply.

- The Freedom of Information Act Amendments of 1974 and the Privacy Act of that year afford the public access to certain government information.
- The Government in the Sunshine Act of 1976 requires agencies to permit public attendance at certain meetings.

2. Prosecutorial Limitations

The following two statutes affect the SEC's authority to conduct law enforcement proceedings or inquiries concerning certain parties:

- The Right to Financial Privacy Act of 1978 prescribes an agency's notice and procedures in obtaining bank and other financial records.
- The Equal Access to Justice Act of 1980 provides for recovery of legal fees by certain parties who prevail in litigation against agencies which have not taken "substantially justified" legal positions.

3. Regulatory Impact

The SEC is subject to the following two regulatory impact statutes:

- The Regulatory Flexibility Act of 1980 requires agencies to review, and publish periodically, economic

analyses of rules which have a significant economic impact on a substantial number of small businesses.

- The Paperwork Reduction Act of 1980 is intended to reduce duplicative and unnecessary requests by requiring agencies to obtain OMB clearance before collecting information from the public.

4. Costs and Benefits of Regulating the SEC

Each of these eight statutes addresses recognized problems. Some also impose unintended burdens. For example:

- Contrary to the primary Congressional objectives of the FOIA, most FOIA requests (and attendant lawsuits) with respect to subjects of SEC investigations are from their business competitors and their adversaries in private litigation.
- Under the Sunshine Act, three or more SEC Commissioners may not privately discuss Commission matters, unless certain exemptions apply. This inhibits the candid exchange of views and the development of sound decisions.
- The Federal Advisory Committee Act inhibits the Commission's ability to obtain candid advice and assistance from the private sector.

An estimated 50 staff-years per annum are required to comply with these eight statutes. This effort has detracted from or delayed the Commission's ongoing regulatory activities, including the reduction and simplification of regulations, such as the Commission's 1982 integration of corporations' registration and reporting requirements, which is saving companies hundreds of millions of dollars per annum and reducing the SEC's paperwork, without compromising investor protections.

It is recommended that Congress carefully consider the cumulative costs and benefits of H.R. 2327 in conjunction with those of the eight existing statutes discussed above.

C. Executive Order 12291

Although the direct and indirect costs and prophylactic value of certain Commission rules, particularly in the antifraud area, are difficult to quantify, the Commission supports cost-benefit analysis in rulemaking, to the extent practicable. As an independent regulatory agency, the Commission has not been subject to the cost-benefit analysis requirements of Executive Order 12291. However, the Commission has voluntarily incorporated cost-benefit analyses into its regulatory programs. Its operating divisions attempt to ensure that new rules and proposals are cost-effective. The Directorate of Economic and Policy Analysis and the Office of the Chief Economist provide the Commission and its operating divisions with specialized technical assistance in performing cost-benefit analyses.

The economic staff reviews rule proposals when they are submitted to the Commission. They assist the Commission in assessing the effects of a proposed rule on competition and attempt to identify more cost-effective means of accomplishing regulatory objectives. When, in their view, costs are expected to exceed benefits, they recommend that the Commission modify or not adopt rules.

D. H.R. 2327

The following are the Commission's views concerning H.R. 2327.

1. Cost-Benefit Analysis
(H.R. 2327, proposed APA § 622(b)-(d))

H.R. 2327 would add to the Administrative Procedure Act new Sections 622(b)-(d), which are designed to assure that agencies subject all major rules to cost-benefit analysis. A "major rule" is defined as one that

> imposes economic costs which are likely to result in an annual impact on the economy of $100,000,000 or more; or * * * otherwise is designated a major rule by the agency proposing the rule * * * because the rule would have significant adverse effects on [certain enumerated factors, including] the environment, health or safety, [or] competition * * *.

In addition, even if the agency does not designate a rule as major, the President could do so under H.R. 2327.

In the view of the Commission's staff, in recent years it has proposed or adopted very few rules that would be classified as "major" under H.R. 2327. Based on this view, the cost-benefit analysis provisions of the bill would not have a significant impact on the Commission's rulemaking processes. However, if interpreted broadly, these provisions could have a significant impact on the Commission.

When the Commission proposes or adopts what might be considered "major" rules, it subjects them to a cost-benefit analysis. For instance, the Directorate of Economic and Policy Analysis is conducting an economic and statistical analysis of the likely effects of proposed Rule 415, the temporary "shelf registration" rule, which permits companies to register securities that they expect to offer from time to time during the next two years. This rule was adopted on a temporary basis, in part, to permit an analysis of its costs and benefits.

A possible concern is that "major" rules, including those that would reduce regulatory burdens, will be subject to protracted litigation on the grounds that the cost-benefit analysis was inadequate. H.R. 2327 provides that cost-benefit analyses shall not be subject to separate judicial review. Other pending bills contain qualified judicial review provisions applicable to the cost-benefit analysis. Therefore, the H.R. 2327 language is preferable, although the analysis would be part of the record and subject to judicial scrutiny as to whether it supports the adoption of the rule.

The bill requires an analysis of benefits and costs, but it is unclear whether benefits would be required to be quantified in justifying the choice of alternatives. In the case of SEC rules and regulations, enforcement and compliance costs can generally be approximated, but not the benefits and prophylactic values, particularly of fraud and other prohibitions. Under such circumstances, it remains to be seen what standards reviewing courts would apply in order to measure the adequacy of cost-benefit analyses in determining whether they adequately support the adoptions of rules.

2. Executive Oversight
(H.R. 2327, proposed APA § 624)

Several of the major regulatory reform proposals would increase Executive Branch control over rulemaking by administrative agencies. Those in favor of greater Executive Branch control argue that the President, as an elected official, should have the authority to coordinate a coherent national regulatory policy. Regulatory overlaps, conflicts and excesses are cited as evidence of the need for a centralized authority, as well as concern over the adequacy of independent agencies' accountability to the President or Congress.

Opponents of Executive oversight argue that the agencies which exercise quasi-legislative authority are already subject to adequate Executive oversight through the budget and appointment processes; and that Congress delegated to these agencies some of its technical legislative responsibilities, to be carried out by experts under policy mandates set forth in enabling statutes. To these ends, Congress required the composition of these agencies to be bipartisan and the terms of their members to be staggered.

The Commission recognizes that Congress did not intend independent agencies to be unaccountable to the Executive Branch. For example, the President appoints SEC commissioners for five-year terms, and can designate or remove chairmen at will. The Commission must submit its budget through the Executive Branch. The Executive Branch establishes the Commission's administrative and personnel regulations and regulates Commission activities under the Paperwork Reduction Act and the Regulatory Flexibility Act. Moreover, comments by Executive Branch agencies, Congressional committees and others on proposed Commission rules receive very careful consideration. The Commission and its activities are also subject to Congressional oversight through hearings, and the legislative and confirmation processes, and to the courts through judicial review of Commission rule-making, enforcement, and other actions.

Proposed APA Section 624 would direct the Director of the Office of Management and Budget to establish guidelines and monitor agency compliance with certain provisions of the APA "in order to comment on the adequacy of such compliance." The provisions for which the Director would monitor compliance include those relating to regulatory flexibility, cost-benefit analysis, regulatory agendas, and periodic review of rules. In order to carry out the intent that cost-benefit analyses shall not be subject to judicial review, should H.R. 2327 become law, a provision should be added to Section 624 to the effect that adverse OMB comments shall not be given special weight in litigation concerning the validity of rules.

3. Legislative Oversight and Veto
(H.R. 2327, proposed APA § 553(g)(3)-(10))

Rules published by the Commission currently are not subject to a formal legislative veto procedure. Moreover, to our knowledge, Congress has never expressly overturned a Commission rule by legislation.

H.R. 2327 would add a new Section 553(g) to the APA that would subject the Commission and most other administrative agencies to formal legislative oversight of rulemaking. It would prevent most major rules -- that is, those that impose economic costs with a $100 million annual impact -- from

becoming effective until 30 days after they have been transmitted to Congress. It would also provide for another 60-day delay if a committee of Congress orders favorably reported a resolution of disapproval. In order to overturn an agency rule, a resolution of disapproval would have to be passed by both houses of Congress and signed by the President or passed over his veto. Thus, in effect, H.R. 2327 would require Congress to enact legislation to overturn an agency rule -- just as it must today. It sets up a procedure with a fixed time for Congress to consider such legislation before the rule becomes effective.

Those in favor of H.R. 2327 argue that the legislative oversight procedure would:

- give Congress and the President an opportunity to consider regulatory rules before they are implemented;
- reinforce the legislative authority of the elected representatives of the people; and
- serve as an incentive for Congress to increase its oversight of administrative rulemaking.

Those opposed argue that it would:

- delay the administrative process;
- require Congress to function on complex issues requiring detailed expertise;
- increase the workload of Congress; and
- encourage circumvention of administrative proceedings by those who would take their cases directly to Congress.

4. Judicial Review
(H.R. 2327, proposed APA § 706(a), (c) and (d))

H.R. 2327 would effect three changes in the standards used by courts in reviewing agency action. First, it would insert the word "independently" into the introductory clause of Section 706(a) of the Administrative Procedure Act, thereby directing courts to "independently decide all relevant questions of law, interpret constitutional and statutory provisions, and determine the meaning or applicability of the terms of an agency action" (emphasis added).

Second, H.R. 2327 would insert a new Section 706(c) into the Administrative Procedure Act, which directs courts, when determining questions of law, to exercise their independent judgment, giving the agency's interpretation "such weight as it warrants."

Third, H.R. 2327 would add a new subsection (d) to Section 706 of the APA. This provision would effect a change in the standards of judicial review applicable to rule adoptions. It would direct courts to consider whether the facts on which the agency was required to rely in adopting a rule or the facts asserted by the agency as the basis for the rule have "substantial support" in the rulemaking file, viewed as a whole.

Proponents assert that the first two provisions are designed to emphasize the proper role of courts under the Constitution by reaffirming that courts, not administrative

agencies, are the final authorities on questions of law; that courts should not uncritically defer to agency determinations of law; and that these changes merely codify existing law.

Opponents assert that the proposed changes could discourage courts from entertaining the presumption that exists today in favor of an agency's interpretation of law. Currently, that presumption is subject to important limitations. A reviewing court must consider the thoroughness evident in the interpretation, the validity of the agency's reasoning, and the consistency of the interpretation with earlier and later interpretations. Also relevant is whether the agency participated in drafting the questioned provision, and the legislative history. Some also argue that the presumption in favor of an agency's interpretation under these conditions facilitates a workable relationship between agencies and courts.

Opponents of the H.R. 2327 amendments express serious concern that they might invite judges to substitute their judgment for that of agencies on matters of policy and could tilt judges to overturn agency decisions. They contend that this is at variance with the concept of increased accountability that the bill seeks to implement, since federal judges are constitutionally protected from political accountability by life tenure and other means. Opponents also contend that

because of difficulties in dealing with mixed questions of law, policy, and fact, and because judges are often not experts in the law they are interpreting, they should not be encouraged to substitute their policy judgments for those of the agencies to which Congress has entrusted policymaking functions.

Proponents of the amendment concerning factual support for agency rules (Section 706(d)) argue that its intent is to assure that courts are given statutory guidance in applying the arbitrary or capricious standard prescribed by existing law, and that, to the extent that agencies rely upon facts in adopting rules, those facts must be disclosed. Opponents argue that since rulemaking is a delegated legislative authority, the factual basis of legislative-type rules need not be separated from legal and policy judgments; and that Section 706(d), viewed in conjunction with the proposed cost-benefit requirements, could result in wasteful litigation.

The H.R. 2327 judicial review provisions are an improvement over prior proposals, but if H.R. 2327 becomes law it is recommended that the legislative history make it clear that these provisions are not intended to modify the ability of agencies to make reasonable policy determinations in rulemaking. When an agency promulgates rules of general applicability and future effect, a quasi-legislative function, it must draw upon its knowledge, expertise, and judgment. Such proceedings are not intended to identify primarily facts relating to the

conduct of individuals, but predictive, policy-oriented facts relating to problems and trends in the regulated community. 2/

5. Periodic Review of Rules
(H.R. 2327, proposed APA § 641)

H.R. 2327, like most of the major regulatory reform proposals of recent years, would establish a program requiring each agency to undertake a ten-year program of major rule reviews.

The Commission has instituted a periodic rule review program:

- It published in June 1981, pursuant to the Regulatory Flexibility Act ("RFA"), a plan for a ten-year program to review most Commission rules. While the RFA requires review only of rules that may have a significant economic impact on a substantial number of small entities, the Commission's plan provides for review

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2/ The report on H.R. 746 published by the House Judiciary Committee last year contained an explanation intended, in part, to preserve the distinction between the "substantial support" test proposed for judicial review of informal rulemaking and the "substantial evidence" test now applicable to review of formal rulemaking and adjudication. If the Committee decides to retain the "substantial support" test, a similar explanation could serve to clarify the distinction between "substantial support" and "substantial evidence."

of a much broader class of rules, primarily because the Commission staff had already targeted certain rules for review. The RFA requirement is, of course, the model for the program contemplated by H.R. 2327.

- The Commission recently completed a multi-year program of reviewing, integrating and simplifying its disclosure rules under the Securities Act and the Securities Exchange Act. This program is saving corporations in excess of $350 million per annum.
- The Commission is engaged in a major review of the proxy rules to provide more uniform and less duplicative disclosures in clear, concise language and to reduce compliance costs in a manner consistent with investor protection.
- The Commission is reexamining the Investment Company Act and the regulations issued under the Act, with a view to continuing the development of a regulatory system that relies more heavily on investment companies and their managers and less on the Commission.
- The Commission is engaged in a reexamination of the Williams Act of 1968, and the rules and regulations issued thereunder, in the light of the dramatic changes in the size and nature of tender offers over the past 15 years.

- The Commission's Directorate of Economic and Policy Analysis is monitoring the effects of significant new rules.
- The Commission is continuing an ongoing "sunset" review of its accounting-related rules to ensure that they remain cost-effective in today's environment and that they contribute to the usefulness of financial reporting without imposing unjustified regulatory burdens.

These periodic review programs of the Commission are in accord with the objectives of proposed APA Section 641. Therefore, the Commission questions the need to undertake another separate review program under H.R. 2327. Other agencies also have undertaken rule review programs required by the Regulatory Flexibility Act or on their own initiatives. It may be preferable, therefore, to address this issue in the context of Congressional oversight or reforms of individual agencies. In any event, the legislative history of H.R. 2327 should provide guidance as to the effects of its periodic rule review provisions on rule review programs already undertaken.

Conclusion

° The foregoing summarizes the SEC's experience with eight existing procedural statutes and Executive Order 12291, and pros and cons concerning the possible impact of H.R. 2327 on the Commission's activities.

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