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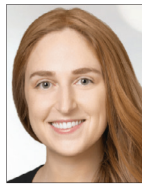
The SEC's Rulemaking Process: Long-Haul or Short-Cut?



By **Jonathan S. Sack**

And **Penina Moisa**

SEC Chair Gary Gensler has set out an ambitious regulatory agenda. In testimony, speeches, and interviews, he has put forward a substantial set of rulemaking priorities for the staff and Commission to consider. Among these priorities are (1) disclosure regarding environmental, social, and governance (ESG) policies, including the impact of business on climate change; (2) disclosure and liability obligations for special purpose acquisition companies (SPACs); (3) regulatory oversight of crypto currency; and (4) equities trading and market structure, including payment for order flow (PFOF).

This agenda raises important questions of both substance and process, including the technical, but very important, matter of SEC rulemaking: What is required for the Commission to create new rules, or change well-established rules? The answers to these questions, in turn, may determine what can realistically be accomplished given timing and political constraints.

A recent essay by law school professor J. W. Verret puts forward a provocative argument that the rulemaking process may not be as time-consuming, and may not require as much detailed study, as past experience and case law suggest, at least in one area of concern to Chair Gensler: market structure and PFOF. J.W. Verret, *Robinhood's Threat To Sue the SEC Over Broker-Inducement Regulation Unlikely To Succeed*, George Mason Law & Economics Research Paper Series 21-38 (Nov. 30, 2021).

Under well-established precedent, the SEC is required to perform substantial analysis of the economic consequences of proposed regulations, as the D.C. Circuit Court of Appeals has explained in *Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011) and other cases. In his essay, Professor Verret expressed the novel idea that the SEC could skip its usual economic analysis and promulgate rules based on considerations of "fairness" alone. If adopted by the Commission, this approach might obviate the usual quantitative analysis and short-cut the rulemaking process.

In this article, we begin by describing the Commission's authority to issue rules under the Securities Exchange Act of 1934 (the Exchange Act) and the additional requirements for rulemaking under the Administrative Procedure Act (the APA). Next, we consider Professor Verret's proposal of a "fairness" short-cut around the traditional "economic" or quantitative component of the SEC rulemaking process. In our view, his proposal is not justified under a fair reading of the Exchange Act or precedent in the D.C. Circuit. Lastly, we describe the exacting analytical process that has been required by courts to date in cases of SEC rulemaking.

SEC Rulemaking

The SEC's authority to issue rules derives from particular statutes,

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such as the Exchange Act and the Investment Company Act of 1940 (the Investment Company Act). These laws generally do not grant the SEC blanket authority to promulgate rules. Instead, specific statutory provisions, such as §10(b) of the Exchange Act, authorize the Commission to issue rules implementing a particular provision. Each authorizing provision typically directs the Commission to consider factors, such as the "public interest," the "protection of investors," or "fair and orderly markets," when exercising its rulemaking authority under that statute.

Requirements of the APA

An agency's rulemaking must also follow the steps set forth in the APA. First, the agency must publish a notice of the proposed rule in the Federal Register. 5 U.S.C. §553(b). The notice must include "the terms or substance of the proposed rule or a description of the subjects and issues involved." Id. Second, publication of that notice begins a comment period, during which interested parties may provide data, analysis, or arguments regarding the proposed rule. Id. at §553(c). The agency must respond to significant comments it receives, and if the agency makes substantial changes in the final rule, it may need to provide notice of the changed rule and begin the comment period again. Third, the agency must incorporate "a concise general statement of [its] basis and purpose" into its final rule. Id.

Once a rule is final, it is subject to judicial review. Under the APA, a court may set aside an agency rule that is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." 5 U.S.C. §706(2)(A). A rule may be deemed "arbitrary and capricious" on several grounds, including if the rule was formulated without considering the factors articulated in the statute authorizing agency action. See *Pub. Citizen v. Fed. Motor Carrier Safety Admin.*, 374 F.3d 1209, 1216 (D.C. Cir. 2004).

Economic Factors in the Exchange Act

Section 3 of the Exchange Act instructs the SEC to consider "in addition to the protection of investors, whether [a rule issued pursuant to the Act] will promote *efficiency, competition, and capital formation*." 15 U.S.C. §78c(f) (emphasis added). This requirement applies whenever "the Commission is … required to consider or determine whether an action is necessary or appropriate in *the public interest*." Id. (emphasis added). See also 15 U.S.C. §80a-2(c) (providing the same direction regarding rules promulgated under the Investment Company Act). Similarly, §23 of the Exchange Act instructs the SEC to consider "the impact any [proposed] rule or regulation would have on competition." 15 U.S.C. §78w(a)(2).

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In a series of cases, the D.C. Circuit has made clear that these provisions require the SEC to consider the "economic consequences of a proposed regulation." *Business Roundtable*, 647 F.3d at 1148 (quoting *Chamber of Commerce v. SEC*, 412 F.3d 133, 144 (D.C. Cir. 2005)). This requirement is a "unique obligation" pursuant to which the SEC must engage in a rigorous quantitative analysis of the economic costs and benefits of a new rule. Id.

A Fairness Exception?

In his recent essay, Professor Verret proposes a short-cut around that quantitative analysis. His essay focuses on SEC rulemaking in the context of PFOF—i.e., payments to retail brokers for directing customer order flow for execution—which has been the subject of SEC regulation for decades. *See generally* Jonathan S. Sack & Bronwyn C. Roantree, *Payment for Order Flow & Market Implications*, Bloomberg Law (Oct. 2021), available at https://aboutblaw.com/ZTz. His essay claims that the SEC may regulate PFOF without conducting its usual economic analysis as long as it supports its rulemaking with a qualitative "fairness" analysis.

In support of this argument, Professor Verret cites §3 of the Exchange Act, which, as noted above, directs the Commission to consider "efficiency, competition, and capital formation" when it is "engaged in rulemaking" and "is *required to consider … the public interest*." 15 U.S.C. §78c(f) (emphasis added). Professor Verret contends that this provision directs the SEC to consider "efficiency, competition, and capital formation" only if the rulemaking is pursuant to statu-

tory provisions that require consideration of the "public interest." He distinguishes provisions that direct the SEC to consider the public interest from other provisions that purportedly direct the SEC to consider objectives relating to "fairness," such as "the maintenance of fair and orderly markets" or "fair competition." Based on that sharp distinction, he argues that when the SEC adopts rules that further these "fairness objectives" instead of the "public interest," the agency is authorized to avoid considering the rule's economic consequences. Verret, *supra* at 8-10. Professor Verret observes that §11A, for instance, mentions the word "fair" 14 times, which he takes to support the SEC's authority to regulate PFOF under that section without engaging in an economic analysis.

This argument is flawed on several grounds. First and foremost, Professor Verret ignores other Exchange Act provisions and the structure of the Exchange Act as a whole. It is a "fundamental canon of statutory construction that the words of a statute must be read in their context," and interpreted to "fit, if possible, all parts [of a statute] into an harmonious whole." *Food & Drug Admin. v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 133 (2000).

Yet Professor Verret's analysis ignores §23 of the Exchange Act, which requires the SEC to consider "the impact any [proposed] rule or regulation would have on competition." 15 U.S.C. §78w(a)(2). As noted above, *Business Roundtable* cites §23 as requiring the Commission to consider the economic impact of a proposed rule. 647 F.3d at 1148. In fact, in *New York Stock Exch. v. SEC*, the D.C. Circuit criticized the SEC for attempting to institute a pilot program regulating PFOF without considering the burden that the rule would have on competition, as required under §23. 962 F.3d 541, 555 (D.C. Cir. 2020). Accordingly, at the very least, §23 requires the SEC to consider the impact that rules regulating PFOF will have on the market.

Professor Verret's analysis also ignores the fact that key provisions referencing "fairness" also reference the "public interest" and therefore require the economic analysis set forth in §3 of the Exchange Act. Section 11A of the Exchange Act, which Verret focuses on, and which would likely be a key provision relied on by the SEC in regulating PFOF, instructs the Commission to consider the "*public interest*, the protection of investors, and the maintenance of fair and orderly markets," when adopting rules to "facilitate the establishment of a national market system." 15 U.S.C. §78k-1(a)(2) (emphasis added). Thus, in rulemaking under §11A, the Commission must consider the "public interest" along with "fair" markets, and therefore (by virtue of §3 of the Exchange Act) must also consider whether a proposed rule will promote "efficiency, competition, and capital formation."

> Though time-consuming, a quantitative approach, which carefully considers costs and benefits, is necessary to support new or changed rules that have substantial impact on market practices.

Against this background, Professor Verret's idea—that fairness can be divorced from the public interest—makes little sense. References to "fairness" may not be taken out of context to override the clear directives in Sections 3 and 23 of the Exchange Act.

Finally, even a narrow focus on the relevant references to "fairness" in §11A—such as directions that the SEC also consider "fair and orderly markets" or "fair competition"—demonstrate that the Exchange Act regards "fairness" as closely linked to economic, market-based considerations—i.e., "orderly markets" and "competition." That is no coincidence: The word "fair" is not defined by the Exchange Act, and "vague or vacuous terms—such as 'fair and equitable,'" are an unsuitable basis to evaluate agency action. Cf., *Cath. Health Initiatives v. Sebelius*, 617 F.3d 490, 495 (D.C. Cir. 2010). Accordingly, §11A may not be read to authorize SEC rulemaking based solely on an amorphous fairness analysis.

Professor Verret cites additional sections of the Exchange Act in support of his argument, but a close reading of those provisions raises similar problems to those discussed with respect to §11A. While analysis of each provision is beyond the scope of this article, we note that these additional references to fairness must also be read in context. As with §11A, that context strongly suggests that the SEC cannot adopt rules without engaging in a rigorous economic analysis.

The Economic Analysis Requirements

Contrary to the notions of Professor Verret, the D.C. Circuit has made very clear what sort of economic analysis must be undertaken by the SEC under §§3 and 23 of the Exchange Act. The decision in *Business Roundtable* is particularly instructive. In that case, the court set aside Exchange Rule 14a-11 under the Exchange Act, which required public companies to disseminate information regarding shareholder-nominated candidates for boards of directors. The holding was based on the SEC's failure to sufficiently consider the rule's economic costs and benefits. Although the SEC claimed that the benefits of Rule 14a-11 were supported by two studies, the court, in a detailed critique of the SEC's methodology and findings, faulted the Commission for failing to address the studies' limitations and inconclusive results. The court further explained that the SEC had not adequately considered contrary studies and data submitted by commenters. *Business Roundtable*, 647 F.3d at 1148, 1150-51.

In a revealing passage, the court admonished the SEC for having "inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters." Id. at 1148-49. The SEC must at the very least "estimate and quantify the costs it expect[s] companies to incur" as a result of a proposed rule, support its conclusions with "empirical data," and engage with contrary data and studies. Id. at 1150-51. See also *Am. Equity Inv. Life Ins. Co. v. S.E.C.*, 613 F.3d 166, 178-79 (D.C. Cir. 2010) (striking down an SEC rule based on its failure to conduct a sufficient analysis of the rule's impact on the economy and competition); *New York Stock Exch.*, 962 F.3d at 555 (striking down an SEC rule creating a pilot program regulating access fees, rebates and PFOF, in part, because the SEC failed to consider the rule's impact on the market).

Though time-consuming, a quantitative approach, which carefully considers costs and benefits, is necessary to support new or changed rules that have substantial impact on market practices.

Following *Business Roundtable*, the SEC published a memorandum of "Current Guidance on Economic Analysis in SEC Rulemakings," which calls for empirical and quantitative analyses to be conducted by Commission staff in support of new rules (the "Guidance Memorandum"). U.S. Sec. & Exch. Comm'n, *Current Guidance on Economic Analysis in SEC Rulemakings* (March 16, 2012). The Guidance Memorandum instructs drafters of rules to develop and articulate "(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."

As the Guidance Memorandum acknowledges, it is "frequently difficult to reliably quantify the benefits and costs of financial regulations." Id. at 12 n. 33. However, while "uncertainty may limit what the Commission can do … it does not excuse the Commission from its statutory obligation" to do all it can to consider "economic consequences" before it adopts new regulations. *Chamber of Com.*, 412 F.3d at 144.

Conclusion

Under established authority, SEC rulemaking requires rigorous economic analysis, as described in the Commission's own Guidance Memorandum. Yet the Commission has not always conducted such analysis, as detailed in *Business Roundtable* and other D.C. Circuit decisions. Though time-consuming, a quantitative approach, which carefully considers costs and benefits, is necessary to support new or changed rules that have substantial impact on market practices. Market participants and their counsel will be watching closely to see how the Commission seeks to implement its ambitious agenda and, at the same time, meet the exacting requirements of the law.

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