

Testimony of James A. Overdahl
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Subcommittee on General Farm Commodities and Risk Management
United States House of Representatives
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Chairman Conaway, Ranking Member Boswell, and other members of the Subcommittee. I appear before you today in my current role as a Vice President of National Economic Research Associates, or NERA, and as a former Chief Economist of the Commodity Futures Trading Commission (CFTC). I thank you for allowing me a chance to share my observations about the role of economic analysis in the rulemaking process at the CFTC.

In my testimony today I will address three topics. First, I will describe the current role and importance of economic analysis in the rulemaking process at the CFTC. Second, I will describe some of the obstacles limiting the effective application of economic analysis to the process. Lastly, I will offer suggestions on how economic analysis can be better utilized to help craft cost-effective regulations, help enhance the accountability of regulatory agencies to the public, and help improve the overall transparency of the rulemaking process.

I. The Current Role of Economic Analysis in the Rulemaking Process at the CFTC

The economics program at the CFTC is administered in the Office of the Chief Economist and staffed by approximately a dozen economists. Economists within this office perform the bulk of the Commission's analytical work with respect to policy and regulatory initiatives. Although these economists play a role in the Commission's rulemaking process, they perform other roles too such as providing litigation support in enforcement proceedings, gathering data and conducting analysis about emerging market issues, and responding to abnormal market events, such as the 2008 financial crisis, or last year's "flash crash." Outside of the Office of the Chief Economist, another four dozen or so industry economists are employed within the CFTC's operating divisions, primarily in the Division of Market Oversight, performing the day-to-day tasks of market surveillance.

Determining priorities and allocating the resources of the economics program at the CFTC is the job of the Chief Economist, who must consider the Chairman's priorities, the complexity of analysis required, the urgency of the rulemaking calendar, litigation risks, and the staff-to-staff working relationship with the drafters of the rule. These considerations have contributed to the inconsistent application of economic analysis across the rulemaking agenda at the CFTC.

The CFTC does not have a formal requirement for including economic analysis in the rulemaking process, aside from the requirements of the Regulatory Flexibility Act and the cost-benefit requirements of the Paperwork Reduction Act (PRA). However, the analysis required in

the PRA applies only a rule's paperwork burden, and does not include an analysis of broader economic effects of a rule. The CFTC's authorizing statute, the Commodity Exchange Act, contains a provision in Section 15(a) requiring that the Commission "consider" costs and benefits in the rulemaking process. Section 15(a) requires that "[b]efore promulgating a regulation...or issuing an order...the Commission shall consider the costs and benefits of the action of the Commission." In addition Section 15(a) requires that:

The costs and benefits of the proposed Commission action shall be evaluated in light of (A) considerations of protection of market participants and the public; (B) considerations of the efficiency, competitiveness, and financial integrity of futures markets; (C) considerations of price discovery; (D) considerations of sound risk management practices; and (E) other public interest considerations.

The CFTC, like other federal regulatory agencies, is subject to the Administrative Procedure Act (APA) which requires the Commission to justify their exercise of rulemaking authority and avoid actions that are "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law." Although this language falls short of a formal requirement for the application of economic analysis to the rulemaking process, recent court decisions have turned on the adequacy of economic support considered by regulators before exercising rulemaking authority under the APA. The prospect of scrutiny by the courts has caused regulatory agencies like the CFTC to pay more attention to the quality of their economic arguments when proposing new rules—at least for those rules likely to be challenged in court.¹

Aside from requirements posed by statutes and the courts for consideration of costs and benefits when proposing new rules, the CFTC has its own internal policies. Within the CFTC, Commission policy requires operating divisions to "consult" with the Office of the Chief Economist before proposing a new rule to the Commission. However, operating divisions are not required to obtain formal sign-off from the Office before proposing a rule.

In sum, the requirements for conducting economic analysis in the rulemaking process are fairly minimal and easily satisfied. In this respect, the CFTC is not unlike other independent regulatory commissions (IRCs). A recent study of the economic analysis used by IRCs finds that "the analysis conducted ... is generally the minimum required by statute." The study also finds that:

In many instances the IRCs appear to be issuing major regulation without reporting any quantitative information on benefits and costs—apart from the paperwork burden—that would routinely be expected for executive branch agencies covered by E.O. 12866. Instead, there is only a qualitative discussion of the benefits and costs. The IRCs present this discussion without any formal review of alternatives. Their analyses generally do not consider behavioral change. They also do not estimate possible unintended effects. And perhaps most importantly, with the exception of

¹ See *Chamber of Commerce of U.S. v. S.E.C.*, 412 F.3d 133 (D.C. Cir. 2005), and 443 F.3d 890 (D.C. Cir. 2006); *Am. Equity Investment Life Ins. Co. v. S.E.C.*, 572 F.3d 923 (D.C. Cir. 2009), and 2010 WL 2813600 (D.C. Cir. July 12, 2010); and *NetCoalition v. S.E.C.*, 2010 WL 3063632 (D.C. Cir. August 6, 2010).

the estimates of paperwork burden...their analyses of economic effects are not prepared to comply with any identifiable standards for such analysis.²

Although the study does not directly address the CFTC (it is one of several IRCs reviewed in the study) the results ring true based on my experience at the CFTC. The CFTC has good economists and good capability to formally analyze proposed rules, but the economics staff is typically used in the rulemaking process only in a behind-the-scenes consulting role.

Aside from the contribution economic analysis can have to satisfying procedural and statutory requirements, its broader contribution is to improving regulatory decision making. I found that commissioners at the CFTC welcomed independent, data-driven economic analysis provided by the Commission economics staff. One reason for this welcoming attitude, I believe, is because interested parties constantly bombard commissioners with iron-clad arguments on all sides of all issues. Transparent analysis, combined with high-quality data and rigorous analysis clearly enhanced the ability of commissioners to ask better questions, better understand the trade-offs and consequences associated with a proposed rule, and make informed decisions. At times, commissioners made decisions that more heavily weighed considerations outside the realm of economic analysis. Even in these cases, the accountability and transparency of the process was improved by having on-the-record economic analysis because it led commissioners to publicly consider the economic evidence and then provide a reasoned basis for their decision.

Economic analysis can be useful at all stages of the rulemaking process, including the very earliest stage of identifying, clarifying, and framing the economic issues that can possibly be addressed by a regulatory action. Once an issue is identified, economic analysis can be helpful in evaluating alternative regulatory responses and in determining whether these responses improve upon the existing situation or dominate market-based solutions.

Within the regulatory process the role of what I am calling “economic analysis” is often referred to as “cost-benefit analysis” or “regulatory impact analysis.” As Professor Chester Spatt, has observed, the meaning applied to these terms is not universally shared among regulators.³ On the one hand, a narrow interpretation would imply that economic analysis is limited to cases where regulatory impacts can be quantified in dollars, such as out-of-pocket compliance costs. Under this interpretation, the analysis would involve toting up and comparing dollar costs and dollar benefits attributable to a proposed rule. On the other hand, a broader interpretation goes beyond what is readily quantifiable and includes qualitative factors associated with a proposed rule. Under a broader interpretation, economic analysis can enhance the regulator’s understanding of the trade-offs, potential effects and unintended consequences of their actions, including identifying potential changes in behavior by market participants. The value of economic analysis to the regulator derives from its capacity to provide a clear, credible, and coherent framework for articulating the reasoned basis for regulatory action.

² Arthur Fraas and Randall Lutter “On the Economic Analysis of Regulations at Independent Regulatory Commissions,” Discussion Paper, Resources for the Future, April, 2011.

³ See Chester S. Spatt, “Economic Analysis and Cost-Benefit Analysis: Substitutes or Complements?” March 15, 2007. Available at <http://www.sec.gov/news/speech/2007/spch031507css.htm>.

For the regulator, failure to adequately consider relevant economic evidence leaves an adopted rule vulnerable to a court challenge on the grounds that the agency's action lacked a reasoned basis under the requirements of the APA. In recent years, the courts have identified weaknesses in the application of economic analysis to SEC regulatory decisions, resulting in rules being sent back for further consideration. The message from the courts has been that regulators' economic arguments need to be adequately supported—that vigorous assertion is not a substitute for rigorous economic analysis. The SEC experience is relevant to the CFTC since its rulemaking process is also governed by the APA.

II. Obstacles Limiting the Effective Application of Economic Analysis to the Rulemaking Process

Although there currently are no formal requirements for including economic analysis in the rulemaking process at the CFTC, this has not always been the case.⁴ At one time the CFTC had a Division of Economic Analysis with full sign-off authority on proposed rules. However, as part of the CFTC's restructuring following the enactment of the Commodity Futures Modernization Act of 2000, the market surveillance portion of the Division was placed in a new Division of Market Oversight and the economic analysis function was spun-off into an independent Office of the Chief Economist. Although full sign-off authority for proposed rules resided with the new Division of Market Oversight, this authority was not retained for the new Office of the Chief Economist.

Across time, individual CFTC Chairmen have created requirements for the use of economic analysis in rulemaking, but these requirements were not institutionalized. Since the requirements simply reflected the preferences of individual chairmen, when these chairmen left, the requirements were discontinued or simply forgotten. The absence of an institutionalized role for economic analysis in the rulemaking process has been one obstacle limiting its effective application at the CFTC.

Another obstacle to applying rigorous economic analysis to the rulemaking process is that the rulemaking divisions of the CFTC have never fully bought into the idea. In some cases, particularly in cases where good working relationships existed between the economics staff and the staff of the operating divisions, the process worked well. Economists were routinely included at an early stage and their analyses were welcomed and integrated into the process. In other cases, those in the operating divisions who "held the pen" in drafting rules would take a proprietary view and regard the rules as their turf. In other instances the drafters of a rule would regard their product as an unassailable good work that could only be diminished by economic analysis. In these cases, intruders were not welcome until the process was sufficiently far along so that the rule would be recommended to the Commission with only superficial (and last minute) input from the economics staff.

Another obstacle to effectively applying economic analysis to the rulemaking process has been a lack of relevant data. In my view, this problem is related to the fact that economists are often not

⁴ At one point, in the early 1990s, three of the CFTC's five commissioners were PhD economists, who presumably conducted their own economic analysis of rules they proposed.

consulted in the rulemaking process with sufficient lead time to locate or generate useful data. Without useful data, the power of economic analysis is severely degraded.

Often, the CFTC has relied on public comments to supply data and analysis. Although public comments can be extremely valuable to providing some types of information, they rarely include the type of data and analysis that can truly inform the process and serve as a substitute for the Commission conducting its own analysis. Often, the most useful information from public comments is that which addresses compliance costs associated with proposed rules. To draw out this type of data, the CFTC will often pose specific questions on these topics in proposed rules. As with Commission staff, members of the public also require sufficient lead time to locate useful data and conduct meaningful analysis of proposed rules. The time constraints of the public comment process often limit the ability of the public to provide useful analysis for the record before the comment period expires.

Another problem in obtaining useful data and analysis from the public are constraints imposed under the Paperwork Reduction Act (PRA) that limit the ability of regulators to survey members of the public who may possess useful data and information relevant to a proposed rule. The PRA requires OMB approval of surveys involving more than nine entities. The time required to gain OMB approval of a survey design that would include a larger group of respondents can take nearly as long as the Commission's rulemaking process itself. As a result, the CFTC rarely uses surveys of more than nine people in forming cost estimates for proposed rules. This limitation necessarily reduces the quality of cost estimates. The CFTC will rely on the public comment process to challenge the cost estimates published as part of the proposed rule. A related problem involves the confidentiality of cost data supplied to the regulator to inform the rulemaking process. Businesses in a position to supply useful data and analysis often do not do so because they do not want to publicly disclose information that could deprive them of a competitive advantage.

I will note that there is evidence that the quality of information supplied through the public comment process has started to improve in response to recent court decisions. I have found that parties potentially affected by proposed rules now regard the notice and comment rulemaking process as if it was part of a legal proceeding. Affected parties are increasingly viewing the comment process as an opportunity to place on the public record factual information about likely compliance costs and suggested alternative means of meeting the objectives of regulators. Because of the potential for litigation, parties commenting on proposed rules are directing their comments not only to the members of the regulatory commission involved in adopting rules, but also to the judges who may be reviewing the public record for rules that are challenged through the courts. Because the outcome of recent court challenges to federal rules have turned on the adequacy of the economic support considered by regulators when they adopted new rules, parties submitting comments to the public record are paying particular attention to the quality of their economic arguments.

III. Suggestions on How Economic Analysis Can Be Better Utilized to Craft Regulations

In closing, I would like to offer a few suggestions on how economic analysis can be better utilized to help craft cost-effective regulations, help enhance the accountability of regulatory agencies to the public, and help improve the overall transparency of the rulemaking process.

First, economic analysis needs to be included in the rulemaking process at an early stage. It is at the early stages where a rule's "term sheet" is developed by the rulemaking division. The term sheet is a high level overview describing the proposed rule and identifying the market problem the rule is designed to address. I believe it would be useful at this stage to also include a high level economic review of both the rule and the problem. This review would be performed before the term sheet advances outside of the division proposing the rule. This review should include some analysis indicating whether the rule is likely to be a major or minor rule in terms of its economic impact. Determining at an early stage whether a rule is likely to be major or minor can help devote sufficient resources to those rules likely to have a major economic impact. An early review would provide lead time for the economics team to assess the complexity of the analysis required and to begin gathering data that could be applied to analyzing the proposed rule.

In my view, an early "term sheet review" will likely require a formal policy adopted by the Commission to guide the rulemaking process. A formal policy would add consistency to the process. Crafting such a formal policy holds the potential for making an already cumbersome process even more cumbersome. However, without sufficient lead times, regulators cannot effectively use economic analysis to help them identify and frame problems, evaluate alternatives, and have data-driven analyses available to inform their deliberations.

Another way to improve the quality of economic analysis is to improve the data collection process. One way to do this would be to streamline the process by which regulators can survey firms for information about potential compliance costs. Another way to do this is to allow a process where firms could confidentially disclose to the regulator cost information that would be useful in evaluating the potential impact of a rule. Another way to gather data is for the regulator, whenever possible, to run pilot programs that can generate useful data for analysis. In the past, such pilot programs have proven useful to the deliberations of regulators. One advantage of pilot programs is that data generated from the program can be made available to the academic community for analysis in addition to being available for the regulator's own staff. Finally, those providing public comments on proposed rules can improve the process by paying particular attention to the quality of their economic arguments and by providing data and analysis when appropriate.

Experience has shown that the discipline, rigor, and overall quality of economic analysis considered by regulators as part of their rulemaking process improves when the regulator knows that their analysis will be reviewed by others.⁵ We see some evidence of this as a result of recent court cases. Congressional oversight can also play an important role. For executive branch agencies, OMB review serves this role. But for independent regulatory agencies like the CFTC there is no hard-wired, ongoing review of their analyses. It is not clear how such a review could

⁵ See, for example, Richard D. Morgenstern, "Reflections on the Conduct and Use of Regulatory Impact Analysis at the U.S. Environmental Protection Agency," Discussion Paper, Resources for the Future, April, 2011.

be implemented for independent agencies or if a formal review structure is even desirable. One solution would be for independent regulatory agencies like the CFTC to make their analyses publicly available so that they can be reviewed and evaluated by professional peers.

Even in a rulemaking process that includes rigorous economic analysis, there will always be considerable uncertainty about a rule's economic impact. Therefore, it may be helpful to have an ongoing post-adoption review of rules to determine the actual economic impact of a rule's implementation.

I believe it would be helpful for the CFTC to develop a guide for the use of economic analysis in its rulemaking procedures. Britain's Financial Services Authority (FSA) has produced such a guide that could serve as a useful starting point for developing a similar guide for the United States.⁶ I understand that the SEC has been working on developing such a guide for its internal use. I believe that such a guide would be more helpful than current OMB guidance or the guidance offered in current or past executive orders that are difficult to apply directly to financial market regulation. I believe that such guidance can enhance consistency in the process both across the rulemaking agenda and across time. Such guidance would need to be adopted in the CFTC's internal policies and procedures.

In the end, economic analysis is more than about satisfying procedural requirements for regulatory rulemaking. Improving the power and consistency of economic analysis at the CFTC is important because it will enhance the ability of regulators to make informed decisions. An added benefit is that it will also help enhance the overall transparency and accountability of the rulemaking process.

I look forward to your questions.

⁶ See Financial Services Authority Central Policy, "Practical Cost-Benefit Analysis for Financial Regulators" June, 2000, available online at: <http://www.fsa.gov.uk/pubs/foi/cba.pdf>

Committee on Agriculture
U.S. House of Representatives
Required Witness Disclosure Form

House Rules* require nongovernmental witnesses to disclose the amount and source of Federal grants received since October 1, 2008.

Name: James A. Overdahl

Organization you represent (if any): NERA Economic Consulting

1. Please list any federal grants or contracts (including subgrants and subcontracts) you have received since October 1, 2008, as well as the source and the amount of each grant or contract. House Rules do **NOT** require disclosure of federal payments to individuals, such as Social Security or Medicare benefits, farm program payments, or assistance to agricultural producers:

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VICE PRESIDENT

Jim Overdahl is a Vice President in NERA's Securities and Finance Practice in Washington, DC. Prior to joining NERA, he was Chief Economist and Director of the Office of Economic Analysis for the US Securities and Exchange Commission (SEC). He served as principal economic advisor on policy, rulemaking, and litigation support and supervised the SEC's economics program. From 2002 to 2007, Dr. Overdahl served as Chief Economist and Director of the Office of the Chief Economist for the US Commodity Futures Trading Commission (CFTC). He has testified before Congress on behalf of the SEC and CFTC, and provided staff support and briefings for members of the President's Working Group on Financial Markets. He has published extensively in leading economics and finance journals and has co-edited and co-authored, with Robert Kolb, four books in multiple editions including *Financial Derivatives: Pricing and Risk Management* and *Futures, Options, and Swaps*. He graduated from St. Olaf College in 1980 and received his PhD from Iowa State University in 1984.