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Regulating in the dark

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Abstract
Foundational financial legislation is typically adopted in the midst or aftermath of financial crises, when an informed understanding of the causes of the crisis is not yet available. Moreover, financial institutions operate in a dynamic environment of considerable uncertainty, such that legislation enacted even under the best of circumstances can have perverse unintended consequences, and regulatory requirements correct for an initial set of conditions can become inappropriate as economic and technological circumstances change. Furthermore, the stickiness of the status quo in the U.S. political system renders it difficult to revise legislation, even though there may be a consensus to do so.

This essay contends that the best means of responding to this dismal state of affairs is to include, as a matter of course, in crisis-driven financial legislation and its implementing regulation, two key procedural mechanisms: (1) a requirement of automatic subsequent review and reconsideration of the legislative and regulatory decisions at some future point in time; and (2) regulatory exemptive or waiver powers that encourage, where feasible, small scale experimentation, as well as flexibility in implementation. Both procedural devices will better inform and calibrate the regulatory apparatus, and could thereby mitigate, at least on the margin, the unintended errors which will invariably accompany financial legislation and rulemaking originating in a crisis.

Given the centrality of financial institutions and markets to economic growth and societal well-being, it is exceedingly important for legislators acting in a financial crisis with the best of intentions, to not make matters worse.

1 This article is an abridged version of a paper that is part of the book, *Regulatory breakdown: the crisis of confidence in U.S. regulation* (Cary Coglianese editor) published in 2012 by the University of Pennsylvania Press. The paper appears here with the Press's permission. I would like to thank Alain Pietrancosta for suggesting what became the title of this paper; Cary Coglianese, Jill Fisch, Jonathan Macey, Andrew Verstein and participants at the Penn Program on Regulation conference, the Quinnipiac University School of Law Federalist Society Student Chapter Lunch Lecture, and the Yale Law School Graduate Student Seminar for helpful comments; and Aaron Ferner for suggesting the abridged form.

Introduction

How should one regulate in the midst of a financial crisis? This is a fundamental question for financial regulation, and it is not readily answerable, as the issues implicated are truly complex, if not intractable. Yet foundational financial legislation tends to be enacted in a crisis setting [Romano (2005)], and over the past decade, when confronted with this question, the U.S. Congress has answered it reflexively by enacting legislation massively increasing the scope and scale of the regulation of business firms, and especially financial institutions and instruments, in a manner seemingly oblivious to the cost and consequences of its actions. By tending to enact comprehensive financial legislation only in reaction to an immediate financial crisis, Congress acts most swiftly precisely when greater deliberateness is called for, given the paucity of information available to produce a high-quality decision.

In order to understand financial regulation undertaken in a crisis, we need to take account, as Frank Knight (1965) put it, of "human nature as we know it." Human nature in this context is that legislators will find it impossible to not respond to a financial crisis by "doing something," that is, by ratcheting up regulation, instead of waiting until a consensus understanding of what has occurred can be secured and a targeted solution then crafted, despite the considerable informational advantage from such an approach, which would, no doubt, improve the quality of decision-making. Compounding the problem, Congress tends not to move nimbly to rework financial legislation when it becomes widely acknowledged as flawed or seriously deficient. For instance, it took decades to repeal the Glass-Steagall Act's separation of commercial and investment banking; eleven years to make relatively small revisions to accounting and bribery provisions of the Foreign Corrupt Practices Act; and eight years to amend the Sarbanes-Oxley Act to exempt only the smallest firms from the auditor attestation of internal controls' effectiveness requirement, despite substantial consensus regarding the statutes' problems.

In addition, financial firms operate in a dynamic environment in which there are many unknowns and unknowables and where state-of-the-art knowledge quickly obsolesces [Diebald et al. (2010)]. In such a context, even the most informed regulatory response — which Congress's reaction in the recent crises was not — will be prone to error, and is likely to produce backward-looking regulation that takes aim at yesterday's perceived problem, rather than tomorrow's, for regulators necessarily operate under considerable uncertainty and at a lag behind private actors. Further, institutions and individuals adapt their behavior in response to regulation, and their reactions change over time, interacting with the regulatory environment in nonlinear, often unpredictable, ways, greatly complicating analysis. Accordingly, the unintended consequences of crisis-driven financial legislation are legion.

This essay contends that the best means of responding to the typical pattern of financial regulation — legislating in a crisis atmosphere under conditions of substantial uncertainty followed by status quo stickiness — is for Congress and regulators to include as a matter of course in financial legislation and regulation enacted in the midst or aftermath of a financial crisis, procedural mechanisms that require automatic subsequent review and reconsideration of those decisions, along with regulatory exemptive or waiver powers that create flexibility in implementation and encourage, where possible, small-scale, discrete experimentation to better inform and calibrate the regulatory apparatus. Such an approach, in my judgment, could mitigate, at least at the margin, errors which invariably accompany financial legislation and rulemaking originating in a crisis atmosphere. Given the fragility of financial institutions and markets, and their centrality to economic growth and societal well-being, this is an area in which it is exceedingly important for legislators acting in a crisis with the best of intentions, to not make matters worse.

Improving the quality of crisis-based financial regulation

There are two key components that should be included in financial regulation to mitigate the adverse effects of crisis-based financial legislation: (1) a sunset requirement that the legislation and implementing regulation be reviewed and reconsidered within a fixed period after enactment (e.g., five to six years) to stay on the books; and (2) a structure that is hospitable to regulatory experimentation wherever possible. By permitting legislators and regulators to incorporate new information into the decision-making process, and simultaneously increasing the likelihood that new information will be generated from the regulatory variety, generated by experimentation, the quality of decision-making has a better chance of being improved.

Sunsetting financial regulation

Sunsetting — providing that a statute expires on a specified date unless re-enacted — is a time-honored legislative tool.[2] It has been used by Congress and state legislatures since the nation's founding, although its use as a lawmaking strategy has ebbed and flowed over time. For instance, in the late 1970s, sunset legislation rapidly coursed through the states, with 35 legislatures enacting sunset laws to review administrative agencies widely perceived to be ineffective and wasteful [Davis (1981); Price (1978)]. At the same time, Congress considered, but did not enact, a broad sunset statute, yet it still followed the trend in sunsetting the newly created Commodity Futures Trading Commission (CFTC) in the Commodity Futures Trading Commission Act of 1974.

By 1990, enthusiasm for administrative agency sunsetting waned, given the time and cost of reviews, but over twenty states still have some form of active sunset review, and in recent years, as states' fiscal situations have deteriorated, they have once again adopted or reinvigorated the process [Kearney (1990); Weaver (2011)]. Articles discussing the effectiveness of state sunset reviews in their heyday in the 1970s indicate that they were, on balance, successful, resulting in the termination of agencies (although no major entities were terminated) and improvements in agency operations, even in states that discontinued sunset reviews [Kearney (1990); Price (1978)].

Sunsetting is particularly well-suited for crisis-driven financial legislation. Of the rationales for adopting a sunsetting strategy, the key justification in the financial regulatory domain is that it mitigates the predicament of legislating with minimal information, and therefore running the risk of getting things seriously and, for all practical purposes, permanently wrong. Congress can, of course, in principle modify crisis-legislation that turns out to be misplaced. But the U.S. political system's organizing principles of separation of powers and checks and balances create numerous veto points throughout the legislative process (i.e., approval of both chambers, then presidential approval, or approval by a supermajority of both chambers) that make repealing a statute extremely arduous. Sunsetting loosens the institutional stickiness of the status quo, by putting a statute in play, with a need for affirmative legislative action at a specific date to remain in effect.

But more important, in the financial regulation context, sunsetting sets in motion a process by which post-enactment information can be incorporated into the regulatory regime. For instance, by the time of a statute's sunset review, several years after enactment, there should be a better understanding of the causes of the crisis that the legislation sought to address, along with knowledge of the enacted legislation's consequences — information indispensable for getting regulation right but unavailable when a crisis necessitates a response. In addition to permitting a more clear-eyed assessment, with the benefit of hindsight, of the crisis-enacted regulation, economic and technological conditions may have dramatically changed in the interim, with financial innovation occurring apace, and that information can also be taken advantage of in the legislative "second look," for the most appropriate regulatory responses will undoubtedly have shifted as well.

To be effective, it is important that the sunsetting process be crafted in light of the states' experiences with what works. To guide the collection and analysis of information in a sunset review, and hence the reassessment of whether legislation should be retained or revised, evaluative criteria for the sunset review, and not simply an expiration date, need to be specified in the statute responding to the crisis. Otherwise, a review will lack focus and may become a pro forma process, as legislators will often have more immediate concerns that they wish to pursue rather than undertake a serious reassessment, especially if, as is probable, constituent concerns in a crisis that motivated the statute in the first place have drifted to new matters [Davis (1981)]. The evaluative criteria will, of course vary, depending on the specific legislation.

The availability of new information at the time a second vote on a statute is required for it to remain in force does not, of course, guarantee that legislators will engage in a serious reassessment, rather than a pro forma review [Breyer (1982)]. To increase the likelihood that new information will be conscientiously acted upon, there is another component that should be included in a sunset provision. In addition to an expiration date and evaluative

2 For an overview of the use of temporary legislation, of which sunset statutes are one variety, see Gerson (2007). The U.S. income tax code is, in fact, rife with time-delimited provisions, often referred to as "extenders" (because they are typically automatically rolled over), rather than "sunsets." For a critical appraisal of the political dynamics of tax sunsets, which, being related to evasion of restrictive budgetary rules, is orthogonal to the issues concerning the use of sunsets in this paper's context of crisis-driven legislation, see Kysar (2005).

criteria, establishment of a sunset review panel to perform the review, along with a timetable for action, is also necessary [Breyer (1982)]. A sunset review panel should be tasked to recommend what action — repeal, re-enactment, revision — Congress should take, and a timetable should set out the interval in which a panel recommendation would be considered by the House and Senate committees with jurisdiction over the legislation, after which the panel's recommendation would be automatically discharged as a bill for a floor vote if the committees do not themselves bring it, or an amended version, to the floor.[3]

The sunset review panel should consist of independent experts, who are neither government employees nor officials, and be empowered to obtain information from relevant regulatory agencies and firms to undertake its review. The advantage of independent experts is that they tend to self-identify more strongly with professional norms and are more concerned about reputational damage if peers perceive them to be doing the bidding of interest groups or party politics, than government employees who are in a hierarchical chain of command. For the review panel to be both politically accountable and independent, it should be appointed by Congress and the President, paralleling the practice used for creating blue ribbon government panels. Although Congress could establish a standing blue ribbon review panel, which would reduce the cost to future Congresses of forming a panel, reviews would be more effective if undertaken by panels created specifically for the legislation to be evaluated, as the relevant expertise is likely to vary with a statute's focus. For example, expertise in macroeconomics would be pertinent for reviewing much of the Dodd-Frank Act, but not Sarbanes-Oxley.

To ensure that the sunset process is meaningful, the authorizing legislation would need to include adequate funding for a review. Budgets of prior congressionally appointed blue ribbon investigatory panels could be used to provide guidance. Given budgetary concerns, Congress could impose a fee on the relevant sector affected by the legislation to cover a review panel's operating cost. It could also mandate that governmental research organizations, such as the Congressional Research Service or General Accounting Office, and the relevant regulatory agencies, provide evaluations of the sunsetting regulations to the panel for use in its review. But that would probably not substantially reduce the expense of a sunset review, as the panel would likely want to seek to conduct its own evaluation de novo.

The rationale for this review mechanism, an expert panel and a timetable, is that the threat of a required floor vote on a recommendation made by outside experts would compel a higher-quality reassessment of a statute by all concerned and, in particular, by congressional committee members who know they cannot prevent a vote on a recommendation they might otherwise be able to oppose merely by inaction. It should also better incentivize review panel members, as they would know that a floor vote on their work product is assured. The use of a review panel has a further benefit, of reducing the time required by legislators and their staff to engage in a sunset review, for the panel would collect data and perform the analyses necessary for the legislature's reassessment. It would thereby mitigate a key operational problem experienced by states in their 1970s' sunset reviews and that led several states to abandon the procedure. Legislators, particularly in states where they were part-time, did not have the time or resources to engage in the demanding process of reviewing numerous state agencies [Kearney (1990)].

A variant of legislative sunset, which would further reduce demands placed on Congress of a required review, would be to impose the sunset review on agencies implementing the regulation. In this alternative, crisis-driven financial legislation would mandate agency reassessment of regulations implemented under the statute, with an automatic expiration in five years unless they are found to be cost-effective. With the technical analysis undertaken by independent experts, rather than agency staff, the potential bias that the agency might be too closely involved in the rules it administers to evaluate them objectively would be minimized [Coglianese (2011); Romano (2005)]. Further, to guard against an agency's inherent bias in interpreting the independent experts' analysis in support of the regulatory status quo or its agenda, a congressional vote on the agency's determination should be required in an administrative sunset review regime.

3 I am advocating a modified version of a proposal of Justice (then professor) Breyer (1982), for review of federal regulatory programs for waste and inefficiency. Breyer rejected a sunset approach because he was concerned that a congressional minority could "destroy" an existing program by preventing a bill from coming out of a committee or by filibustering or otherwise blocking a floor vote to reapprove a majority-supported program. His proposal would, therefore, continue a program were Congress not to adopt a recommendation. Breyer's proposed automatic discharge eliminates the issue of committee blocking, but not, of course, minority blocking on the floor. But sunset could be retained and the latter issue eliminated with a rule for sunset review analogous to the reconciliation process applicable to budget legislation, which limits debate and bypasses filibusters.

Opening financial legislation up to experimentation

An additional means of increasing the available information, and hence improving the quality of crisis-based legislative decision-making, is to incorporate experimentation into financial legislation. It is the genius of the federal organization of the U.S. government that makes it quite amenable to such an approach [Romano (1993)]. Moreover, structuring financial regulation to be more hospitable to experimentation is consistent with a contemporary trend in economics to introduce experimentation into policymaking, as the gold standard for policy evaluation [Greenstone (2009)]. Greenstone advocates implementing regulatory initiatives through a process that either starts with small-scale randomized experiments or permits states to implement different regulatory approaches. The expectation is that coverage would be expanded nationwide were these initial experiments successful, essentially on a cost-benefit metric. Although this approach, as he notes, is most feasible for environmental, health, labor market, and safety regulations, where discrete programs can be implemented using randomized trial experiments or "quasi" experiments, on the model of Food and Drug Administration testing requirements for new drugs, there is, I think, an analogue in the financial setting. That could be done by providing agencies with expanded exemptive and waiver powers and an accompanying directive to use the authority to permit individual institutions, or classes of institutions, to operate under different regulatory arrangements.[4]

Congress has, in fact, used such an approach in crisis-driven financial legislation, but it has been limited in scope. For example, Sarbanes-Oxley's mandate of independent audit committees (by requiring the SEC to direct stock exchanges to prohibit the listing of any firm without an independent committee), states that the SEC can establish exemptions to the statutory criteria of director independence (Sarbanes-Oxley Act § 301). Such an approach could be more broadly applied, and agencies instructed to implement rules along the lines of a small scale experiment, with incremental expansion only after a cost-benefit analysis undertaken by independent experts.

One means by which experimentation could be implemented within a waiver setting is by permitting a firm or class of firms to request a regulatory waiver, and by not leaving the matter solely up to an agency's initiative. The standard for approval of an exemption could be an assessment of minimal adverse impact on the statutory objective (i.e., on systemic risk or financial statement fraud, objectives, respectively, of Dodd-Frank and Sarbanes-Oxley). Because an agency could be expected to be predisposed to believe that whatever regulation exists is good and hence to oppose exemptions, it could be required to accept, or at least to have to rebut in a meaningful way, an analysis of the proposed waiver provided by independent experts. Maintenance of the statutory purpose would be safeguarded by having the agency engage in ongoing monitoring and review of approved waivers, to make sure no adverse impact developed. And paralleling Greenstone's (2009) contemplated regulatory reform process, were the waivers deemed successful, the agency would be expected to extend them to more, or all, firms or sectors. Where the proposed waiver is a private sector initiative, the firms could be required to cover the agency's cost of evaluating and administering the experiment.

The interaction between statutory experimentation through waivers and required sunset reviews can, however, be complicated. When exempted firms are nonrandom, one cannot evaluate properly either the impact of the waiver with an eye to generalization or the efficacy of the regulation under sunset review, for the analysis would be subject to selection bias, as covered, and excluded firms would not be comparable. For instance, firms that request a waiver would most likely be those that would be most adversely affected by a rule. This difficulty could be addressed if regulatory waivers were constructed as natural experiments, in which firms receiving a waiver were selected by lot.[5] But such an approach would, in my judgment, in many instances be politically infeasible and inappropriate, as it could seriously interfere with market competition, where the exempted firms' operating cost would be less than the regulated firms'. In addition, if the exemption was for a limited time frame – for instance, until the "experiment" would be evaluated by

4 This essay advocates congressional directives to agencies to use existing exemptive authority in implementing emergency regulation. I consider explicit instruction necessary because history teaches us that the SEC will not voluntarily use its exemptive powers to remedy flawed rules that it has adopted in implementing emergency legislation. The well-known cognitive bias to favor the status quo [Samuelson and Zeckhauser (1988)] aids in explaining why agency exemptive power alone is not an effective means of revising flawed legislation and that sunsetting is critical.

5 The Securities and Exchange Commission (SEC) undertook a random experiment to investigate the effect of relaxing restrictions on short selling in 2004 [SEC Office of Economic Analysis (2007)]. The experimental results led the agency to repeal the uptick rule restricting short sales [SEC (2007)]. Despite the change in policy's grounding in a "gold standard" natural experiment, in the wake of the financial crisis, pressed by opponents of the rule change, the SEC reinstated a limited version of the rule [SEC (2010)].

the agency for its effectiveness — then firms' behavior may not represent how they would respond to a permanent rule, as they strategize to affect the outcome. In short, there is an inherent tension between sunset reviews and experimentation. But I do not believe that the potential conflict is sufficient to reject the proposed dual-pronged regulatory approach.[6] Given the sunset review panel's expertise, it should be well attuned to the selection issue and able to recalibrate the analysis when undertaking its regulatory evaluation in the context of experimental data.

Conclusion

Congress typically legislates on financial matters in a crisis environment, which is not conducive to high-quality decision-making. Although Congress is not about to restrain itself from acting in a crisis and increasing financial regulation, there are procedural mechanisms that can be systematically employed to mitigate the unintended consequences likely to accompany those legislative decisions.

First, sunsetting is a useful legislative tool that could mitigate legislative failure in the field of financial regulation. Second, one could also make headway in improving the quality of decision-making by incorporating experimentation and regulatory diversity into the legislative process by having Congress direct agencies to use regulatory exemptive and waiver powers to foster such objectives. In tandem with sunsetting, the greater flexibility arising from the use of such tools would facilitate timely updating of the legislative and regulatory architecture, offsetting the woefully inadequate information environment in which crisis-based legislation is enacted.

6 Greenstone (2009), it should be noted, recommends automatic sunsets along with experimentation in his regulatory reform agenda and does not view them to be in tension. This is most likely because he envisions experiments undertaken on a randomized, small-scale basis, which would not be likely to interfere but rather would assist in the cost-benefit evaluation of the sunset review he contemplates. In addition, he advocates automatic sunset for all regulations, many of which would not have been subjected to experimentation.

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