COMMENTARY

Agencies Tied Their Own Hands in Failing to Get Market Data

Nela Richardson, Bloomberg Government senior economic analyst, says the CFTC and SEC should do pilot projects to test new rules' effect on the market in the absence of adequate data.

Photo: Bloomberg

Washington's financial regulators are under fire for not adequately analyzing the costs and benefits of Dodd-Frank derivatives rules. There's a problem with the criticism: Regulators don't have sufficient market data to do a proper analysis, and it's a situation they could have avoided.

The latest volley comes from the U.S. Government Accountability Office, which concluded in a Nov. 10 report that additional regulatory analysis would improve final rules.

GAO recommended that agencies incorporate guidelines from the Office of Management and Budget into their regulatory analysis process. OMB's guidance, known as Circular A-4, suggests three basic elements for economic analysis of rules: a statement of the need for the proposed action; an examination of alternative approaches; and a quantitative and qualitative assessment of the costs and benefits of the proposed action relative to alternatives.

This third area has been the most challenging for the Commodity Futures Trading Commission and the Securities and Exchange Commission. Three CFTC commissioners have criticized the agency's cost-benefit analysis. The SEC exposed its vulnerability to litigation over Dodd-Frank rulemaking when the agency lost a court ruling in July to the U.S. Chamber of Commerce based on insufficient economic analysis.

Data Gaps

A key obstacle to rigorous economic analysis of derivative rules is the lack of data. The OTC market has operated without regulatory intervention. There is no market data on transactions, collateral or contract terms.

The information asymmetry between regulators and market participants is staggering. Broker-dealers, derivatives industry associations and other market participants have years of transaction-level data on their own trades and the trades of their counterparties. The SEC and CFTC are significantly weakened by the fact that they understand much less about the market than the market participants they regulate.

This situation could have been avoided had CFTC and the SEC handled public disclosures differently.

Shortly after enactment of Dodd-Frank, many financial regulators – including the CFTC and the SEC – chose to publish on agency web sites the dates and participants in all external meetings. The CFTC and the SEC went one step further and declared they would also publish all written materials, including data, received from the public. There was an unintended cost to this disclosure, one debated during at least one private meeting I attended while employed as a CFTC economist. Companies said they wouldn't turn over proprietary data if it were to be made public, and they didn't.

As a result, regulators have limited the type of data and information they receive from market participants. Swap dealers have an interest in providing regulators with the data necessary for rulemaking that doesn't harm markets. However, much of their information that would be helpful to regulators would also give competitors an advantage if posted on the Web.

Though the GAO report provides recommendations for improving the coordination and coverage of the cost-benefit analysis in the promulgation of final rules, it has not provided a remedy for the fundamental flaw of regulatory analysis for the derivatives rules – the lack of market data to analyze.

Solutions

By continuing to promulgate rules while lacking market data, the SEC and CFTC expose themselves to litigation challenging the credibility of their analysis justifying the rule. Beyond the proposed recommendations in the GAO report, there are four things regulators could do to increase the rigor of cost-benefit analysis for derivatives rules:

- The CFTC and the SEC could implement pilot programs that test the effect of the rule on trading without potentially disrupting the entire market
- Regulations could be implemented in stages and adjusted to reflect ongoing analysis based on new data
- The Office of Financial Research, which was established under Dodd-Frank in the U.S. Treasury Department, could use its data collection authority to assist the SEC and CFTC in analyzing regulations
- The agencies may want to consider reducing transparency to improve data gathering from derivative participants.

Regulatory analysis using market data may be more illuminating than names of people who attend meetings and what documents they turn over.

REFERENCES

Government Accounting Office: Dodd-Frank Act Regulations Implementation Could Benefit from Additional Analyses and Coordination
http://www.gao.gov/new.items/d12151.pdf

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