

## Framework Regarding FINRA’s Approach to Economic Impact Assessment for Proposed Rulemaking

The Financial Industry Regulatory Authority, Inc. (FINRA) is an independent, non-governmental regulator for all securities firms doing business with the public in the United States. Our core mission is to pursue investor protection and market integrity, and we carry it out by overseeing virtually every aspect of the securities brokerage industry. We oversee nearly 4,300 brokerage firms, approximately 161,000 branch offices and almost 630,000 registered securities representatives.

We pursue our mission by writing and enforcing the rules that govern the activities of securities firms and brokers, and by examining brokerage firms for compliance with FINRA and Securities and Exchange Commission (SEC) rules—as well as the federal securities laws and the rules of the Municipal Securities Rulemaking Board. FINRA works to protect investors and maintain market integrity in a public-private partnership with the SEC, while also benefiting from the SEC’s oversight. In addition to our own enforcement actions, each year we refer hundreds of fraud and insider trading cases to the SEC and other agencies.

Key to conducting FINRA’s work is a careful understanding of how our rulemaking impacts markets and market participants. Indeed, the Office of Management and Budget (OMB) notes that economic analyses of rules provide “a formal way of organizing the evidence on the key effects, good and bad, of the various alternatives that should be considered in developing regulations.”<sup>1</sup> Accordingly, this document provides FINRA’s framework for conducting economic impact assessments as part of how we develop rule proposals, focusing first on the background and legal requirements leading to its creation and then discussing the philosophy, principles and guidance that influence FINRA’s evaluation of economic impacts.

## I. Background

This framework is informed by guidance published by the SEC, OMB, international financial regulators and academic literature.<sup>2</sup> It reflects general best practices and is designed to help guide the judgments necessary to best align rulemaking with the public interest. It is intended to better inform policy making, increase stakeholder participation in the rule development process and increase transparency into FINRA's rulemaking.

In developing this framework, we draw on the advantages FINRA has as an independent regulatory organization. A key advantage of an independent regulator such as FINRA is that we can actively and broadly seek the input and perspective of market participants and the investing public as part of our rulemaking. This consultative process is important to help us better understand if a rule is well designed to meet its objective and how the rule, as proposed, may likely impact investors as well as the firms and individuals FINRA regulates.

FINRA believes that clarity with regard to the potential economic impact of proposed rulemaking increases both transparency and accountability. By adhering to the principles outlined here, FINRA's rulemaking will clearly present our analysis, including assumptions and risks, as to why the proposal is necessary and how it best achieves its stated goal(s). This analysis, in turn, will be valuable to the public and other stakeholders as they assess and comment on the rule proposal.

The framework described here applies specifically to the prospective analysis of rules and rule changes; that is, it is intended to describe how FINRA will evaluate significant new rule proposals, including amendments to existing rules. But the framework is also important as part of our broader objective to ensure that the rules we adopt continue to be relevant and appropriately designed. The principles outlined in Section III, below, will inform our process for reviewing rules retrospectively, which we will describe more fully in a separate document.

---

2. See, for example, U.S. Securities and Exchange Commission's Current Guidance on Economic Analysis in SEC Rulemakings (March 2012) [http://www.sec.gov/divisions/riskfin/rsfi\\_guidance\\_econ\\_analy\\_secrulemaking.shtml](http://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.shtml); Financial Services Authority Central Policy, [Practical Cost-Benefit Analysis for Financial Regulators Version 1.1 \(June 2000\)](#); Adler, M. and Posner, E. (1999), [Rethinking Cost-Benefit Analysis](#) (John M. Olin Law & Economics Working Paper No. 72), Chicago, IL: The Law School, The University of Chicago.

## II. Legal Requirements Regarding FINRA Rulemaking

Although the Securities Exchange Act of 1934 (Act) does not set out requirements for self-regulatory organizations (SROs) to conduct formal economic analyses of proposed rules, FINRA has historically taken into account the costs and burdens of its rulemaking. Moreover, FINRA is committed to enhancing its economic impact assessments of rules going forward. As a matter of practice, FINRA's goal is to design its proposed rules to most efficiently achieve the intended regulatory benefit.

Pursuant to Section 19(b)(1) of the Act, FINRA must submit to the SEC a "concise general statement of the basis and purpose" of any proposed rule change. To approve a FINRA-proposed rule, Section 19(b)(2) of the Act requires the SEC to find that the proposal is "consistent with the requirements of [the Act] and the rules and regulations" thereunder. Under Section 15A(b)(6) of the Act, an association of broker-dealers shall not be registered as a national securities association unless the SEC determines that its rules are designed, *inter alia*, "to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade" and, "in general, to protect investors and the public interest." Section 15A(b)(9) further requires the SEC to determine that such rules "do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of [the Act]."

When promulgating an SEC rule or reviewing a proposed SRO rule and the SEC is required to consider or determine whether an action is necessary or appropriate in the public interest, the SEC, as part of its public interest analysis under Section 3(f) of the Act, must "consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation." To aid the SEC in its consideration of rule proposals, the SEC's Form 19b-4 requires each FINRA rule filing to include a statement regarding the burden on competition.

## III. Framework

### a. Core Principles

Ultimately, strong economic impact analysis provides a number of benefits. For regulators like FINRA, it helps ensure that rules are well explained; well designed to provide a regulatory solution that is appropriately flexible, targeted and effective; and well considered, including their potential direct and indirect costs. For the public and other stakeholders, the analysis makes clear the regulatory intent of a rule proposal, describes the anticipated effects of the options considered, and provides the rationale and evidence that support the action. The analysis helps commenters focus on the key assumptions and information that motivate the rule proposal, permitting them to provide more directed and impactful comments.

In this context, we have identified three core principles that define FINRA's approach to conducting economic impact assessments for rulemaking.

## 1. Consult with key stakeholders in the development of rules

Effective rulemaking reflects a strong understanding of current market conditions and practices, the specific ways rule alternatives would affect market participants and how different market participants are likely to respond to the adopted rule. We believe key stakeholders are a critical source of information for these considerations. Retail or institutional investors are often best situated to evaluate how they will benefit from market protections. And FINRA-regulated entities best understand how a rule proposal will likely affect their businesses, from both an operational and cost perspective, and what actions are required to comply with a given rule. Collectively, these stakeholders—and others—are typically well positioned to provide qualitative and quantitative information to ensure that FINRA's rules are crafted to be efficient and effective.

Consultation can cover a range of activity, spanning from informal conversation with firms and investors to formal requests for comment, all of which are vital parts of thorough rulemaking. FINRA typically consults both formally and informally to obtain information that establishes the basis of the economic impact assessment.

Industry input on potential costs or burdens of rules is a critical part of our consultation process. Among other things, through its robust committee structure, FINRA benefits from extensive industry comment at multiple stages of the rulemaking process, including prior to filing a proposed rule with the SEC. FINRA's 15 advisory committees have subject matter expertise (*e.g.*, the Market Regulation Committee, Corporate Financing Committee and Technology Advisory Committee) or represent subsets of the broader broker-dealer industry. Three of these committees review most rule proposals: the Small Firm Advisory Board, the Compliance Advisory Committee and the newly created Regulatory Advisory Committee, composed of representatives chosen to ensure diversity in geography, size and business models.

In many cases, FINRA uses its *Regulatory Notices* to formally solicit opinion, information and data regarding the need for regulatory action and the potential impacts of regulatory alternatives. These Notices provide a mechanism by which FINRA can obtain input not only from regulated firms, but also from the public.

We intend to rely upon FINRA's Board and relevant advisory committees, leading academics and investors as key sources of information in developing our economic impact assessments. As well, FINRA will seek to identify knowledgeable parties among regulators, securities industry members and groups, and the private sector to better inform rules as they are developed.

## ***2. Provide clarity about the objectives and potential impacts of rule proposals and alternatives considered***

How FINRA's economic impact assessment informs rulemaking should be clear in our public notices for rulemaking. Proposed rule changes should be transparent about why we seek to establish or amend a rule, how the specific rule proposal addresses a regulatory need better than reasonable alternatives, and what evidence or assumptions we relied upon in reaching that judgment. The transparency should extend beyond the "what" and the "how" of a FINRA rule. Rule filings should provide insight into our evaluation of the economic impacts to help the public understand why FINRA reached its position. A rule proposal should discuss the strengths and limitations of the information underlying the analysis and explain how uncertainties may impact the analysis.

## ***3. Obtain supporting evidence where practicable***

Economic impact assessments seek to identify and anticipate how markets and market participants will alter their behavior in response to a new rule. To do this, it is important that we know whom a proposal impacts (*e.g.*, investors, brokers, others), what participants will be required to do to implement a rule (*e.g.*, firms developing a new system to capture and deliver required disclosures), the costs and benefits of new compliance activities and how behaviors will change (*e.g.*, investors will be better advised of a conflict and will take more care in making decisions). In addition, we will want to understand how different types of market participants may be affected (such as institutional versus retail investors or large versus small firms).

FINRA believes that the public interest is best served by rulemaking when it is evidence-based where practicable.<sup>3</sup> But the success of evidence-based policymaking depends on the availability and quality of the evidence that underlies it.<sup>4</sup> To that end, FINRA will seek to obtain reliable and pertinent information to develop its rules. This information may be in the form of data we already collect, additional data we seek from firms or data and information we request from the public through *Regulatory Notices*.

---

3. Evidence Based Policy (EBP) is developing as a field of study unto itself. See, for example, the work of the Australian Government Productivity Commission's [materials](#) in support of its conference "Strengthening Evidence-based Policy in the Australian Federation."

4. Adler and Posner, *op. cit.* p. 5. The authors note, for instance, a critique of cost-benefit analysis has been "...not theoretical, but practical and ideological. As a practical matter, researchers had a great deal of trouble obtaining relevant data, especially for the purpose of valuing environmental resources, human life, and other hard-to-measure goods. The claim that the benefits of a project exceed its costs is not persuasive when the benefits and the costs appear to rely on arbitrary valuations."

We recognize, however, that evidence is not always available or easily obtained.<sup>5</sup> In some cases, it may be impossible to quantify an identified cost or benefit, or the cost of obtaining reliable evidence and the burden on regulated firms is not justified. In those cases, FINRA's assessment should be clear about what is known and what is inferred, the assumptions used to generate estimates and conclusions, and the risks and limitations in using those estimates. We intend to rely on both the quantitative and qualitative information available in developing and evaluating rules.

#### b. Questions to be Addressed by FINRA's Economic Impact Assessment

In developing our own standards for conducting economic impact assessments, FINRA seeks to adopt the best practices in the field. Worldwide, there is gaining consensus on the broad outline and methods for an effective cost benefit or economic analysis for rulemaking.<sup>6</sup>

Consistent with those best practices, and to allow FINRA to best communicate with the public concerning our economic impact assessment, we expect that in significant future rule proposals we will address, as appropriate, the following questions:

- What is the problem, issue or practice that necessitates regulatory action?
- What is the objective of the regulatory action?
- What is the baseline against which to measure the likely economic consequences of the proposed regulatory action?
- What is the proposed solution and how does it address the problem?
- What are the reasonable alternative options available?
- What are the anticipated economic impacts associated with the options, including the costs and benefits and distributional impacts, in particular as to efficiency, competition and capital formation?

In future rulemakings, the development of this analysis will be part of our presentations to and discussions with committees and our Board, as part of the governance process. The analysis will be evaluated by our Chief Economist and reflected in the rule filings we submit to the SEC.

---

5. Ideally, the economic impact assessment would permit the comparison of the costs and benefits of the different regulatory options under consideration with a similar degree of specificity. Where it is not possible to quantify the impact of one or more policy options available, FINRA will seek to obtain qualitative information that permits the staff to ascertain whether a given policy option will likely result in net benefits to the public and to compare the policy options available.

6. See, for example, [Executive Order 12866](#); [European Commission Impact Assessment Guidelines](#); or [Canadian Cost-Benefit Analysis Guide](#).

Depending on the nature of the proposed rule, the answers to these questions may be integrated into the public rule filing or presented in a separate section. We may integrate the answers in a filing to provide a consistent and coherent discussion of the economic impact and to avoid unnecessary redundancy in our statements.

### c. Inclusion of Separate Economic Impact Assessment in Rulemaking

As a general matter, FINRA rulemaking proposals should discuss the elements outlined above in sufficient detail to provide the public the rationale and evidence in support of the proposed rule. The extent of the economic analysis contained in this discussion will vary depending on the nature, scope, urgency and significance of the rulemaking, and the availability of data. In particular, a more limited statement of economic impact is warranted under two circumstances. The first is where the rule is narrow in focus, making minor adjustments to existing rules or primarily administrative, or it appears that any burden imposed by the rule will be of minimal significance only. The second is in the limited circumstances where delay involved in carrying out the full assessment would be prejudicial to the interests of the public.<sup>7</sup>

---

7. As a matter of practice, most regulators define a set of regulatory actions that are not significant enough to require a full impact analysis. See, for example, Financial Services Authority Central Policy, [\*Practical Cost-Benefit Analysis for Financial Regulators Version 1.1 \(June 2000\)\*](#).