

“Economic Analysis and Cost-Benefit Analysis: Substitutes or Complements?”

By Chester S. Spatt

Securities and Exchange
Commission and

Carnegie Mellon University

The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or of the author's colleagues upon the staff of the Commission.

Economics Analysis and Decisions

- Economics provides a valuable structure for understanding quantity allocations and pricing
- Helpful for assessing the effect of policy interventions
- Interaction between economic margins and “unintended” consequences—of course, these are consequences
- Economics is an empirically oriented discipline

Cost-Benefit Analysis

- Application of economics principles to particular rules and proposals
- Should not be limited to what is easily quantifiable
- Relevant to consideration of alternatives
- What is known and can be inferred from economic principles

Reg SHO

- Potential removal of pricing restrictions
- Natural experiment
- Stratified sample
- Public provision of data
- Staff and academic studies
- Public roundtable

Employee Stock Options

- **Some large users of options argue they are hard to value at the time of grant—Interesting that such firms extensively use options**
- **The cost to the firm rather than the benefit to the employee is key for disclosure**
- **Expensing may eliminate potential bias in favor of use (“overuse” ?) of options as a compensation tool, since not previously reflected on the P&L**

Employee Stock Options (cont.)

- The effect of employee risk aversion and transferability restrictions influences valuation through exercise decisions
- Analogy to mortgage-backed securities is powerful for understanding pricing and developing implementable models
- Methods available and potentially reliable

Employee Stock Options (cont.)

- Efforts to develop instruments that replicate the cash flows and the valuation of employee stock options could be beneficial as well
- Could facilitate hedging by the firm and encourage new forms of compensation
- Measurement goal reflects what a willing buyer and seller would pay with respect to the cost of the firm's exposure

Employee Stock Options (cont'd.)

- Consequently, potential tension between claims that a market instrument and mechanism will lead to valuations that are a fraction of model prices and the language of the standard
- Model prices are not hypothetical and indeed are relied upon heavily by market professionals, so market and model pricing is closely intertwined

Executive Compensation: Section 162(m) surtax

- Section 162(m)—surtax on non-contingent salary over \$1,000,000
- Induces substitution to risky compensation
- “Expected” market compensation to risk averse executive would need to increase
- “Unintended consequence” of higher expected compensation
- Perry and Zenner (2001): Real compensation increased after 162(m)

1992 Executive Compensation Disclosures

- Potential substitutions to less transparent compensation, such as executive pensions
- Disclosure of “all” compensation to avoid distortions

Dynamics of Disclosure

- Dynamic between practices and rules
- Example of IRS tightening “loopholes”
- “Dynamic Scoring”
- Refinement of disclosure rules over time

Does Disclosure Increase Compensation?

- Agency hypothesis
- The compensating differential
- Bargaining power; Information on the compensation of *other* executives
- Canadian evidence—greater incentives and compensation

Mutual Fund Governance

- Staff studies released for public comments analyzed the statistical properties of mutual fund returns and certain potential inherent limitations
- A recent Circuit Court decision reflects the importance of economic analysis in rulemaking

Daylight Savings Time

- Non-financial example
- Costs and benefits of shift in time treatment—during four weeks
- Will this reduce U.S. energy consumption materially?
- Unintended consequences of the shift—coordination in electronic calendars

Concluding Comments

- Regulations can have unintended consequences as different economic actors close to different economic margins
- Cost-benefit analysis and economic analysis important; cost-benefit should reflect the broader consequences of the rule making