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Behaviorism in Finance and Securities Law

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I. INTRODUCTION

For much of the 1990s and early 2000s, behavioral economics, which studies departures from rationality in decision making, seemed a lot more fun than classical economic analysis. Psychologists had identified a fascinating set of anomalies. Most of us value assets—whether they are coffee mugs, houses, or no doubt private islands—more highly if we already own them and are considering selling them than if we do not own them and are deciding how much we would pay for them.[1] Israeli parents usually picked up their child on time when the only punishment was the stigma of violating the norm against late pickup; but tardiness rates shot up after the daycare center started imposing a small fine on parents who arrived late.[2] These and other biases raised questions about the widespread assumption—which lay at the heart of law and economics, the dominant scholarly methodology—that individuals tend to act rationally, consistently and in their own self interest.[3]

The Achilles heel of behavioral economics was the difficulty of distilling it to a single, coherent methodology. "To date," as one legal scholar put it a decade ago, "behavioral economics has not (and may not ever) develop a single theory that explains or predicts the full range of human behavior, as rational choice theory claims to do."[4] The absence of a unifying theory is not a prerequisite for taking behavioralism's findings seriously, of course, but it did impede acceptance of the new approach. In part because of its multi-faceted nature, the

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1 This bias, the endowment effect, is one of the most extensively demonstrated of the behavioral biases. *See, for, example,* Daniel Kahneman, Jack L. Knetsch and Richard H. Thaler, *Experimental Tests of the Endowment Effect and the Coase Theorem*, 98 J Pol Econ 1325 (1990).

2 Uri Gneezy and Aldo Rustichini, *A Fine is a Price*, 29 J Leg Stud 1 (2000).

3 For a succinct statement of the traditional economic view as it applies to law, see Richard A. Posner, *The Economic Approach to Law*, 53 Tex L Rev 757, 761 (1973) (characterizing the economic approach to law as based on "the assumption that the people involved with the legal system act as rational maximizers of their satisfactions").

4 Stephen M. Bainbridge, *Mandatory Disclosure: A Behavioral Analysis*, 68 U Cinn L Rev 1023, 1035 (2000).

regulatory significance of behavioralism's findings also was often unclear. If chief executives tend to be overconfident and many corporate acquisitions are motivated by hubris, does this call for new corporate regulation or might a regulatory response make matters worse?

These kinds of limitations have sometimes posed insurmountable obstacles for burgeoning legal movements.[5] Not so for behavioral economics. The biases are real, and the number of behavioralists on law and business faculties continues to grow. In 2008, Richard Thaler and Cass Sunstein's book *Nudge* made the best seller list,[6] as did Daniel Kahneman's latest book in 2011.[7] More importantly, behavioral economics has made dramatic inroads into the administrative process. From 2009 to 2012, Sunstein was the head of President Obama's Office of Information and Regulatory Affairs. In a widely read memo, he explicitly encouraged the executive agencies under OIRA oversight to consider behavioral factors when they design rules.[8]

In this Essay, I take stock of the behavioral economics movement, focusing in particular on its interaction with traditional cost-benefit analysis and its implications for agency structure. The usual strategy for such a project—a strategy that has been used by others with behavioral economics—is to marshal the existing evidence and critically assess its significance. My approach in this Essay is somewhat different. Although I describe behavioral economics and summarize the strongest criticisms of its use, the heart of the Essay is inductive, and focuses on a particular context: financial and securities regulation. My choice of terrain is not accidental. Three years ago, Congress completely revamped American financial regulation, changing both rules and regulatory institutions.[9] In some areas, such as the creation of the new Consumer Financial Protection Bureau, behavioral findings featured prominently in the debate prior to enactment. In others, such as the inclusion of rules designed to prohibit banking regulators from bailing out large financial institutions, behavioral insights were implicit; and in still others, such

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[5] Law and literature is the leading recent example. See, for, example, Jane B. Baron, *Law, Literature and the Problems of Interdisciplinarity*, 108 Yale L J 1059 (1999) (exploring the absence of a single methodology).

[6] Richard H. Thaler and Cass R. Sunstein, *Nudge: Improving Decisions About Health, Wealth, and Happiness* (2008).

[7] Daniel Kahneman, Thinking, Fast and Slow (2011).

[8] Memorandum from Cass R. Sunstein, Adm'r, Office of Info & Regulatory Affairs, to the Heads of Executive Departments and Agencies 1 (June 18, 2010)[hereinafter Sunstein Memo], *available at* http://www.whitehouse .gov/sites/default/files/omb/assets/inforeg/disclosure_principles.pdf."

[9] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat 1376 (2010).

as a provision authorizing the Securities and Exchange Commission to facilitate directorial nominations by minority shareholders, it appears to have been absent altogether. The very unevenness of the assimilation, together with the richness of the behavioral literature in this context, makes the new regulatory landscape fertile grounds for exploring the promise and perils of behavioral economics.

To lay the foundation for the Essay, I begin by briefly describing behavioral economics and by surveying the most significant critiques of its use. I then turn to the heart of the Essay, a consideration of how behavioral economics has informed, or might inform, the work of the Consumer Bureau; SEC rulemaking on proxy access; and our assessment of the efforts of the new financial legislation to ban bailouts. I conclude, among other things, that behaviorism's relevance is quite different for rules and rules making, on the one hand, and regulatory structure, on the other. Although I write from outside the behavioral economics tradition, my hope is that even behavioralists will find the analysis to be of some interest— if only to spur them to look more closely at the a few of the issues raised in this Essay.

II. **WHAT IS BEHAVIORAL ECONOMICS?**

The label of this new economic methodology that revels in anomalies is itself anomalous. "Behavioral" seems to imply that behavioral economics is concerned with behavior, while traditional economic analysis isn't. But this distinction does not hold, even as a rough approximation: traditional economics is of course preoccupied with behavior. The elegant but misleading label honors the spirit of behavioralism's founding fathers, Daniel Kahneman and Amos Tversky, who called their evidence that emotion and incomplete rationality distort human decision making "Prospect Theory." When questioned by a scholar who "began to wonder why its name bore no resemblance to its subject matter," Kahneman said, "'We just wanted a name that people would notice and remember.'"[10]

Perhaps the best yardstick for distinguishing traditional and behavioral economics is expected utility. Traditional economics assumes that an individual's decision making can be

[10] Peter L. Bernstein, *Against the Gods: The Remarkable Story of Risk* 270 (1996) (recounting conversation with Kahneman).

predicted by a standard utility function. "Expected utility theory assumes that preferences are defined over consequences rather than over changes from some reference point," as a recent survey article puts it, "and that changes in the probability of a consequence are treated linearly."[11] Behavioral economists study behavior that appears to deviate from this baseline. A rational consumer would carefully monitor her credit card use and would avoid cards that impose high fees for missed payments or for exceeding her credit availability if either of these is likely to be an issue. If consumers are subject to hyperbolic discounting, on the other hand, they may underestimate future costs, focusing far more on the current benefits of their credit card use.[12]

In the past several years, the Office of Management and Budget has explicitly called for a greater consideration of behavioral findings. According to a 2009 report, "[s]uch approaches, rooted in several decades of work in social science, can serve to improve rules by incorporating insights that come from relaxing assumptions usually invoked in neoclassical economic theory. With an accurate understanding of human behavior," the report concludes, "agencies would be in a position to suggest innovative, effective, and low-cost methods of achieving regulatory goals."[13] The following year, OIRA head Cass Sunstein encouraged regulators to consider the behavioral implications of different default rules, as well as the possibility of an "active choosing" approach-- that is, requiring people to make a choice, if regulators are unsure which default rule would be best.[14]

These initial efforts are both groundbreaking and tentative. A trio of environmental law scholars have recently offered a much more elaborate framework for integrating "extra-rational" behavior into the administrative process, hinting at where the behavioral turn may be headed.[15] Under their approach, regulators would use a two step process, first considering the monetary effect of a potential regulation—the traditional focus of cost benefit analysis—and then

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[11] Lisa A. Robinson & James K. Hammitt, *Behavioral Economics and Regulatory Analysis*, Risk Analysis 1, 3 (2011).
[12] See, for, example, Oren Bar-Gill, *Seduction by Plastic*, 98 NW U L REV 1377, 1401 (2004).
[13] Office of Mgmt & Budget, Excec Office of the President, 2009 Report to Congress on the Benefits and Costs of Federal Regulations and Unfunded Mandates on Stat, Local , and Tribal Entities 35 (2010), *available at* http://www.whitehouse.gov/sites/default/files/omb/assets/legislative_reports/2009_final_BC_Report_01272010.pdf.
[14] Sunstein Memo at 10-12 (cited at note 8).
[15] Michael P. Vandenbergh, Amanda R. Carrico, and Lisa Schultz Bressman, *Regulation in the Behavioral Era*, 95 Minn. L. Rev 716 (2011).

exploring its "social outcomes," such as people's desire for "social status within valued social groups and social inclusion," and their desire "to avoid social sanctions."[16] Although the second step is taken most directly from behavioral economics, the authors propose that regulators consider behavioral factors in both steps. The assessment of monetary outcomes in the first step would include considerations such as hyperbolic discounting, people's tendency to overweight the "cognitive costs" of assessing options, and the effects of framing on the decisions people make.[17] In their assessment of social outcomes in the second step, regulators would consider both rational factors such as inadequate information, and extra-rational influences such as framing and the effects of cognitive dissonance.[18]

III. POTENTIAL OBJECTIONS TO THE BEHAVIORAL TURN

Both the Sunstein memo and the far more fully worked out Vandenbergh et al framework invite regulators to consider aspects of decision making that go beyond the assumptions of classical economics. As noted by the OMB report, the potential upsides of incorporating behavioral insights into the administrative process are enormous. But the behavioral revolution is likely to be fiercely contested as it moves from laboratories and the best seller lists to the administrative process. In this part, I briefly outline five possible objections to the behavioral economics revolution. In the parts that follow, I consider the strengths and weaknesses of behavioral economics for three different facets of the new financial architecture.

Merton Miller famously dismissed behavioral economics as "a lot of so-called anomalies in search of a theory."[19] Miller's aphorism captures a common objection to behavioral economics. Unlike with classical economics, which offers a simple model of human behavior as self-interestedly rational, behavioral economics has identified a wide range of decision making biases that do not always fit neatly together. Even if these findings can be reconciled with one another, they are difficult to distill to a straightforward model of human behavior. They come off as a series of qualifications linked by "and." "Despite efforts at categorization," as two

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[16] Id at 723.
[17] Id at 745-49.
[18] Id at 749-60.
[19] Miller is quoted to this effect in *Forbes,* available at http://www.forbes.com/global/2000/0612/0312068a_print.html.

skeptics put it, "no underlying theory behind why we operate under biases has emerged."[20] Although Vandenbergh, Carrico and Bressman nicely address this concern by singling out particular biases, their framework does not reduce to a single theory or purport to exclude biases other than those they include.

Miller's aphorism also implies a second objection. His sarcastic adjective "so-called" suggests many of the anomalies may dissolve on inspection. It is hard to imagine a critic claiming that decision making is *never* distorted by biases. Although behavioral economists have often relied on experiments with students, which is not always the most reliable source of evidence, some distortions are well-documented outside of the laboratory. The sensitivity of employees' retirement fund choices to the default setting, for instance, which features prominently in *Nudge*, has been demonstrated by evidence of actual financial decisions rather than surveys or students.[21] But some behavior that appears to reflect behavioral biases may actually be rational. A good recent illustration is the proliferation of exotic mortgages during the real estate bubble. While the surge in complex, adjustable rate mortgages that consumers could not plausibly honor if rates rose seems irrational now, it may not have been as irrational, at least for some mortgage holders, in an environment in which the Federal Reserve had committed to keep interest at historically low rates and many of the consumers would not have qualified for an ordinary mortgage.[22] Similarly, earlier studies have suggested that consumers' willingness to assign all of their household assets as collateral for a loan may not be irrational, as is often thought, but may be a powerful commitment device.[23]

According to a third objection, even if decision making biases are widespread, markets will cause institutions to correct for them, thus making regulatory intervention unnecessary. Lenders' handling of troubled loans nicely illustrates one form of "cognitive repair." If a borrower has difficulty repaying a loan, banks and other lenders routinely move from the loan

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[20] Stephen J. Choi and A.C. Pritchard, *Behavioral Economics and the SEC*, 56 Stan L Rev 1, 10 (2003).
[21] Thaler and Sunstein, *Nudge* at 105-119 (cited at note 6) (describing suboptimal retirement savings decisions and studies showing the effect of the default option).
[22] As Jason Johnston pointed out at a *University of Pennsylvania Journal of Business Law* conference at the University of Pennsylvania Law School in November, 2011..
[23] Robert E. Scott, *Rethinking the Regulation of Coercive Creditor Remedies,* 89 Col L Rev 730 (1989).

department to a workout group, rather than leaving the original loan officer in charge.[24] This separation of responsibilities corrects for the possibility that a loan officer who was enthusiastic enough about the borrower to authorize the initial loan may not be able to objectively assess whether the debtor can repay. Markets also may counteract decision making biases more directly. If a financial institution tries to take advantage of decision making biases, it may be underpriced by competitors.[25] If markets are competitive and corrections widespread, decision making biases may be less important in practice than they at first appear. If markets are segmented or subject to cross subsidies, on the other hand, they may not counteract consumer biases.

A fourth objection argues that even if decision making biases are common and often are not corrected by market adjustments, regulation may not be an effective response. After all, the reasoning goes, regulators themselves are also subject to biases.[26] By itself, the possibility that regulators' decision making also is biased does not necessarily counsel against regulatory intervention. Only if we conclude that regulation will be worse if flawed regulators take the insights of behavioral economics into account than under existing perspectives (such as the use of traditional cost benefit analysis) are regulators' decision making biases a reason to dismiss behavioral economics. Seen in this light, the flawed regulator objection is really part of a more general objection about the likely consequences of fully embracing behavioral economics. According to this fifth objection, widespread reliance on behaviorial economics would indeed make regulation worse—most likely by inviting excessive regulation. One source of concern is the different regulatory presumptions wired into neoclassical and behavioral economics. Neoclassical economics begins with an implicit bias against regulation. Under standard cost-benefit analysis, for instance, a regulation is not justified unless it will provide benefits that

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[24] See, for, example, Robert K. Rasmussen, *Behavioral Economics, the Economic Analysis of Bankruptcy Law and the Pricing of Credit*, 51 Vand L Rev 1679 (1998); Chip Heath, Richard Larrick and Joshua Klayman, *Cognitive Repairs: How Organizational Practices Can Compensate for Individual Shortcomings*, 20 Res Org Behav 1 (1998).

[25] This argument is a close cousin to the argument that uniformed customers will not be taken advantage of in most markets if a relatively small number of informed customers exist. See Alan Schwartz & Louis L. Wilde, *Imperfect Information in Markets for Contract Terms: The Examples of Warranties and Security Interests*, 69 Va L Rev 1387, 1450 (1983).

[26] This is a central theme of Choi & Pritchard's behavioral analysis of the SEC. Choi and Pritchard, 56 Stan L Rev at 20-36 (cited at note 20) (cataloguing biases of SEC).

exceed its costs. Behavioral economics starts with the opposite assumption. It assumes that our decision making is biased, thus implying the need for correction.[27]

While this by itself might persuade a thorough-going Hayekian that behavioral economics must be pernicious, for others it only begins the analysis. Why in particular might the regulatory presumption be problematic? One possibility is that adding behavioral biases to regulators' menu of considerations could invite more interest group manipulation than currently exists. Interest groups are already heavily involved in the administrative process, of course. But the plethora of potential decision making biases might give interested parties a broader menu of arguments to seize in their effect to secure self protective legislation. Behavioral economics might give traditional lenders additional ammunition for campaigns to cripple or ban nontraditional lenders, for instance, or buttress managers' efforts to secure protection against short-sellers. In each of these areas, new, arguably problematic rules might be easier to justify if behavioral considerations were included than under traditional cost benefit analysis.

Regulators themselves also may behave differently when behavioral considerations are fully incorporated into the regulatory process. If regulators were convinced that decision making biases were having untoward effects, they might begin with regulatory nudges, as Thaler and Sunstein propose, but shift increasingly to "shoves" if the nudges did not produce the desired result.[28] In short, the assumption that decision making is often subject to biases might magnify the influence of individual interest groups, create a slippery slope to heavy-handed regulatory interference in the markets, or both.

The five objections (or four, if the fourth objective is collapsed into the fifth) seem to me the most serious concerns about the behavioral revolution in law. To some extent, I have tested

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[27] See, for, example, *Philip E. Tetlock P Barbara A. Mellers, The Great Rationality Debate,* 13 Psychol Sci 94, 97 (2002) ("It should not be surprising that Kahneman and Tversky's research program is more enthusiastically embraced by economists on the left, who have long doubted that markets are infallibly self-correcting and suspected that people sometimes need to be protected from themselves, than by economists on the laissez-faire right, who worry about what kind of 'micro' case is not being manufactured for new meddlesome forms of government intervention.").

[28] Thaler and Sunstein are well aware of this objection. They argue in response that concerns about a regulatory slippery slope should not be a basis for "duck[ing] the question whether [particular] proposals have merit in and of themselves," that their proposals do not call for top down regulation, and that in many contexts, "some kind of nudge is inevitable." Thaler and Sunstein, *Nudge* at 240 (cited at note 6).

each of the objections as I have raised it. It would perhaps be possible to continue in that vein, and to draw conclusions about the promise and perils of behavioral economics. But I propose to shift to a more inductive mode, and to explore the implications of behavioral economics for three key dimensions of the new financial landscape ushered in by the Dodd-Frank Act three years ago.

IV. THE CONSUMER FINANCIAL PROTECTION BUREAU

Because the intellectual case for the new Consumer Financial Protection Bureau that was created by the Dodd-Frank Act relied in part on the insights of behavioral economics, it is the obvious place to start.[29] The Consumer Bureau had an unusually well-defined intellectual pedigree: it can be traced directly to two articles by Elizabeth Warren, a short article in 2007 and a much more extensive co-authored article the following year. After briefly summarizing the two articles and the contours of the new bureau, I will attempt to assess several of its most striking features from the perspective of behavioral economics.

The central motif of the initial article, "Unsafe at Any Rate," is the contrast between toasters, which are effectively regulated, and consumer finance, which is not. "It is impossible to buy a toaster that has a one-in-five chance of bursting into flames and burning down your house," Warren begins.[30] "But it is possible to refinance an existing home with a mortgage that has the same one-in-five chance of putting the family out on the street—and the mortgage won't even carry a disclosure of that fact to the homeowner. Similarly," she continues, "it's impossible to change the price on a toaster once it has been purchased. But long after the papers have been signed, it is possible to triple the price of the credit used to finance the purchase of that appliance." "Why," Warren asks, are customers protected when they buy toasters, but not "when they sign up for routine financial products like mortgages and credit cards?"[31]

The answer, Warren argued, is that consumer goods are carefully regulated by the Consumer Product Safety Commission, whereas mortgages and credit cards "are regulated by a

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29 The Consumer Financial Protection Bureau was created by Title X of the Dodd-Frank Act. It formally commenced in July 2011, a year after the legislation was signed.
30 Elizabeth Warren, *Unsafe at Any Rate*, Democracy, 8 (Summer 2007).
31 Id.

tattered patchwork of federal and state laws that have failed to adapt to changing markets."[32] The logical solution, she contended, was to establish a new regulator with the authority to provide the same kind of protection for mortgages and credit cards that consumers have with toasters and other appliances. Such an agency "would promote the benefits of free markets by assuring that consumers can enter credit markets with confidence that the products they purchase meet minimum safety standards."[33]

In the more recent article, Warren and Oren Bar-Gill of New York University surveyed a wide range of data about credit card use.[34] Drawing extensively on the insights of behaviorial economics, they argued that existing safeguards were not sufficient to protect consumers. The terms of existing credit card and mortgage contracts exploit consumers' tendency to underestimate future costs.[35] Neither ex post judicial review nor oversight by existing regulators could adequately safeguard consumers' interests.[36] Because of their concern for the financial health of banks, which may benefit from practices that gouge consumers, the Federal Reserve and other banking regulators face an intractable conflict of interest;[37] and the other regulators with a stake in consumer regulation, such as the Federal Trade Commission, have only limited authority or are spread too thin.[38] To solve this dilemma, they proposed "the creation of a single federal regulator … that will be put in charge of consumer credit products."[39]

Warren got far more of what she called for than anyone would have imagined at the outset of the debates that led to the Dodd-Frank Act.[40] Although the new Consumer Bureau is technically a bureau of the Federal Reserve, it has extraordinary independence. Most agencies must ask Congress for funding each year, and are subject to tight political oversight; the

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[32] Id at 9.
[33] Id at 17.
[34] Orin Bar-Gill and Elizabeth Warren, *Making Credit Safer*, 157 U Penn L Rev 1, 26-56 (2008).
[35] See, for, example, id at 49 ("The prevalence of universal default clauses [in credit cards] can be explained, at least in part, as a strategic response by issuers to this underestimation bias").
[36] Id at 70-79 (limitations of judicial review); Id at 75-97 (limitations of current regulators).
[37] Id at 86-95.
[38] Id at 95-95 (FTC).
[39] Id at 98-100.
[40] The legislative history, which begins with a lunch Warren had with Lawrence Summers, is described in David Skeel, *The New Financial Deal: Understanding the Dodd-Frank Act and its (unintended) Consequences* 50-51 (2011).

Consumer Bureau, by contrast, is financed directly (and generously) by the Federal Reserve.[41] The Bureau has wide-ranging powers to promulgate consumer protection rules, hold hearings, and to bring enforcement actions on consumers' behalf.[42] Only if two-thirds of the new Financial Stability Oversight Council's members conclude that one of the Consumer Bureau's rules poses a threat to financial stability can the rule be overturned.[43]

To assess the implications of the Consumer Bureau for behavioral economics, it will be useful to consider three different issues. First, just how essential was behavioral economics to the case for a new Consumer Bureau? Second, are the Consumer Bureau's scope and powers well-designed to deal with the most pressing behavioral concerns? Finally, and most tentatively, how should behavioral economics figure in the Bureau's operations going forward?

As we have already seen, the original case for a new consumer regulator was erected on an extensive behavioral foundation, focusing especially on lenders' efforts to take advantage of consumer biases. But the significance of the behavioral contribution is somewhat deceptive. Sandwiched between seventy pages of behavioral data and a brief overview of the proposed consumer regulator in the Bar-Gill and Warren article is a careful analysis of the limitations of existing regulators and rules that sounds much more like traditional economic analysis. The authors point out the problematic incentives of existing regulators and the weakness of existing rules, as noted earlier.[44] This shift to more traditional analysis suggests a simple thought experiment. What if the behavioral analysis were simply lopped off? Would the case for a new consumer regulator disappear? Surely not. A more traditional analysis of consumer finance would focus on concerns such as consumers' limited information and the possibility of fraud. Given these concerns—which echo the arguments that led to the creation of the Securities and Exchange Commission in the New Deal[45]—and the debilities of the existing regulators, a strong

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[41] Dodd-Frank Act § 1017 (Consumer Bureau entitled to up to 11% of the Fed's funding in 2012, and 12% thereafter). Skeel, *The New Financial Deal* at 107 (cited at note 40) (noting that the funding would amount to an estimated $500 million in 2011).

[42] Skeel, *The New Financial Deal* at 106-109 (cited at note 40) (describing Consumer Bureau's powers).

[43] Dodd-Frank Act § 1023.

[44] See note 36 and accompanying text.

[45] See, for, example, Rosalie Genova, *Building Dodd-Frank's New Regulatory Institutions: Lessons from the Case of the SEC* (unpublished manuscript, June 2, 2011) (comparing SEC and Consumer Financial Protection Bureau); see

case for revamped consumer protection would remain. One could make this case without ever mentioning terms like hyperbolic discounting.

This does not mean that the behavioral economics is irrelevant, however. The mandate one envisions for a new consumer regulator will look different if the behavioral evidence is compelling than if it is not. If consumers systematically underweight the possibility that they will incur future fees and lenders are not discouraged by competitive markets from taking advantage of consumers' vulnerability,[46] for instance, one might conclude that the Consumer Bureau should intervene directly, rather than focusing solely on disclosure and fraud, the traditional mandate of analogous consumer champions such as the SEC. I will have more to say about this below.

As actually enacted, the Consumer Bureau is subject to a handful of limitations that seem curious at the very least from a behavioral perspective. Car loans are excluded from the Bureau's authority.[47] In addition, the Bureau is authorized to suggest but not to impose a "plain vanilla" mortgage option and it is forbidden from imposing interest rate ceilings on consumer loans.[48] The exclusion of car loans was a tribute to old fashioned interest group politics: the auto industry persuaded lawmakers to protect them from new oversight by excluding them from the new bureau's remit. If consolidating consumer regulation in a single regulator like the Consumer Bureau was a good idea, the auto loan exclusion cannot be explained in any other terms. The most one might say is that the loss is not great from a behavioral perspective.[49] Although disclosure and fraud are both concerns with auto loans, car loans do not seem to be as central to the behavioralist case for the new Consumer Bureau case as credit cards and mortgages.

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also Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 Va L Rev 1025, 1026 (2009) (noting SEC's emphasis on protecting retail investors at its founding).

[46] As Bar-Gill and Warren argue. See Bar-Gill & Warren, 157 U Penn L Rev at 49 (cite at note 34) (consumer underestimation of future costs); see also id at 21-22 (failure of market to correct with respect to uninformed consumers).

[47] Dodd-Frank Act § 1029.

[48] Dodd-Frank Act § 1032 (authorizing Consumer Bureau to offer, but not to require, model forms); id § 1027(o) (prohibiting usury limits).

[49] The Consumer Bureau has recently suggested that it may seek to regulate car dealer loans indirectly, by policing any discrimination by the financial institutions that provide funding arranged in part by a car dealer. See Consumer Financial Protection Bureau Bulletin 2-13-02 (March 21, 2013).

The treatment of plain vanilla contracts is more interesting. In the months prior to the enactment of Dodd-Frank, Warren promoted plain vanilla mortgages as a response to concerns about mortgage regulation, and she was earlier involved in a private initiative involving credit cards.[50] Under a plain vanilla option, lenders would be required to offer a simple mortgage—such as a thirty year mortgage with a fixed rate of interest and straightforward terms—along with their more exotic mortgage options. Disappointed in the failure of the private initiative, Warren concluded that innovations such as the plain vanilla option needed to be imposed by regulation.[51]

The plain vanilla option can be defended in either traditional or behavioral economic terms. A model contract reduces the information asymmetry between lenders and consumers, the traditional reasoning might go, and makes it easier for consumers to compare options. The plain vanilla mortgage would serve as the default choice, much as the thirty year mortgage has done in the past. The behavioral case is somewhat similar, but with important differences. Even if consumers are fully informed, some behavioral economists might argue, hyperbolic discounting may prevent them from appreciating the risks of non-vanilla terms.[52] For behavioralists who take this perspective, it is not clear that disclosure alone will solve this problem, since consumers who discount hyperbolically may underappreciate risks even if the risks are disclosed in the clearest of terms. Making plain vanilla mortgages mandatory would solve the hyperbolic discounting problem, but would also impose a serious cost: consumers who could not qualify for a plain vanilla contract might lose their access to mortgages and credit cards. From a behavioralist perspective, making plain vanilla the default rule might nicely thread the needle. If defaults are sticky, consumers who quality might gravitate to the plain vanilla option, leaving the nontraditional loans for consumers who do not qualify or have other reasons for choosing an exotic loan.

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[50] *See* Jeff Gelles, *On the Record: How Pew Trusts Aided Credit Card Reform*, Trust Mag (Fall 2010) (recounting Warren's efforts to persuade credit card lenders to offer a "clean card"), available at http://www.pewtrusts.org/news_room_detail.aspx?id=61901.

[51] Id.

[52] For skepticism about the ability to counteract behavioral biases through disclosure, see, for, example Lauren E. Willis, *The Financial Education Fallacy,* 101 Am Econ Rev 429 (2011); Lauren E. Willis, *Against Financial Literacy Education*, 94 Iowa 197 (2008). Bar-Gill is more sanguine about the benefits of disclosure. See for, example, Oren Bar-Gill*, Seduction by Contract: Law, Economics and Psychology in Consumer Markets* (2012).

Given that plain vanilla terms can be defended in either traditional or behavioral terms, what does it matter which perspective is used? It matters in two respects. First, the need for a plain vanilla option is much more pressing if one is persuaded by the behavioralist arguments, since many behavioralists are more skeptical that the flaws in the market can be addressed by disclosure and competition.[53] Second, if plain vanilla were implemented, and large numbers of consumers opted for other contracts, behaviorally minded regulators might be more likely to second guess the choices. They might suspect that lenders are pushing consumers into the alternative and more lucrative contracts.[54]

From lenders' perspective, the principal threat of a plain vanilla requirement would seem to come from one or both of two places, both of them behavioral. One possibility is that extra rational factors do influence consumer decision making, and that a plain vanilla requirement would diminish lenders' ability to take advantage of this. The other is that regulators believe, rightly or wrongly, that extra-rational factors are in play, and regulators may be more likely to question deviations from plain vanilla as a result. In this case, lenders fear that regulators will intervene and impose costs on them even when the consumer behavior is entirely rational. If this reasoning is correct, it underscores the risk of translating behavioral conclusions into legislation unless we are highly confident that behavioral factors are driving the consumer decision making in question.

Does the constraint on the Consumer Bureau that made its way into the final legislation—the authorization only to suggest, not to require a plain vanilla contract—remove this risk? Probably not. Although the Consumer Bureau cannot mandate inclusion, it can promise lenders that contracts based on a model contract will fully satisfy the Bureau's disclosure requirements.[55] More importantly, the Dodd-Frank Act instructed regulators to promulgate rules for qualified mortgages and qualified residential mortgages that will be presumed to satisfy the Dodd-Frank

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[53] See, for, example, Bar-Gill and Warren, 157 U Penn L Rev at 21-22 (cited at note 34) (arguing that markets do not counteract lenders' temptation to take advantage of consumer biases).

[54] Interestingly, with mortgages, Dodd-Frank itself has targeted this concern directly by prohibiting compensation agreements from tying compensation to the profitability of the contract a consumer agrees to. Dodd-Frank § 1403.

[55] Dodd-Frank Act § 1032.

Act's ability-to-pay requirements.[56] These rules will function very similarly to a plain vanilla rule, given the benefits to lenders of qualifying for the safe harbor..

The final key provision is the prohibition on interest rate regulation. Traditional economists are likely to be comfortable with the ban. Although usury laws are designed to protect vulnerable consumers, they also can make it harder for their ostensible beneficiaries to borrow, because creditors may refuse to lend if they cannot charge an interest rate that reflects the risk of nonpayment. With their paternalistic bent, behaviorists might be expected to chafe at the ban on intervention. But the case is more problematic than one might suspect. Although behavioralists worry about the vulnerability of consumers who underestimate future costs, the most compelling evidence of hyperbolic discounting relates to the fees saddled on consumers for missing payments[57]-- the "tricks and traps," in Elizabeth Warren's evocative phrase—not the basic interest rate.[58] If fees are the worry, a rate ceiling will not help. Indeed, fees are precisely the trick that lenders have often used to evade usury regulation in the past.[59] It is thus possible that usury regulation would exacerbate the very problem it was designed to solve. The other major problem with usury regulation is the nature of the regulation. As exemplified by Thaler and Sunstein's advocacy for nudges, many behaviorists prefer that behavioral insights be used to set default rules, rather than as a basis for top-down regulation. "[W]e libertarian paternalists do not favor bans," as Thaler and Sunstein put it, in response to calls for a prohibition of predatory lending. "Instead, we prefer an improvement in choice architecture that will help people make better choices and avoid loans that really are predatory."[60] Like a prohibition on predatory lending, usury regulation is invariably mandatory; it is far more than a nudge and is for that reason problematic even for many behaviorists.[61]

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[56] Dodd-Frank Act § 1412 (qualified mortgage), § 941 (qualified residential mortgage).

[57] See, for, example, Bar-Gill & Warren, 157 U Penn L Rev at 47-52 (cited at note 34) (describing fees and penalty interest rates).

[58] Warren, Democracy (cited at note 30).

[59] To circumvent usury laws to make business loans, a prominent history of American credit explains, "lenders discounted a note at the legal rate, then tacked on various charges in the form of fees, premiums, and commissions, in order to shave down the stated interest rate to the legal maximum." Lendol Calder, *Financing the American Dream: A Cultural History of Consumer Credit* 116 (1999).

[60] See, for, example, Thaler and Sunstein, *Nudge* at 139 (cited at note 6).

[61] Warren herself is a traditional paternalist rather than a behavioralist in this regard. She has strongly advocated for new usury regulations. See, for, example, Elizabeth Warren and Amelia Warren Tyagi, *The Two- Income Trap Why Middle Class Mothers and Fathers are Going Broke* 144 (2003).

At this point, it is possible to draw a surprising conclusion about the three sets of restrictions we have considered: although each seems flatly inconsistent with the concerns of behavioral economics, the extent of the conflict shrinks dramatically on inspection. Car loans are not at the heart of behavioralists' concerns about consumer finance; the qualified mortgage requirements and the Consumer Bureau's authority to suggest model contracts may function like a requirement that plain vanilla contracts be offered; and behavioralist support for interest rate restrictions is thinner than one might initially suspect. The restrictions thus pose only minor obstacles for a behavioralist vision of consumer protection.

The behaviorist dimension of the Consumer Bureau has grown steadily since its initial conception. The earliest call for a new regulator did not rely on behavioral insights; the behavioral dimension was added later, with the Bar-Gill and Warren article. But it has become central to the Consumer Bureau's mission. So much so, that the Bureau hired a leading behaviorist to help with its initial initiatives.[62] Nor is the growing focus on behavioral factors limited to regulators. There is considerable evidence that lenders and consumer goods firms use (and in some cases have long used) psychological evidence to structure the products and services they offer.[63] The Bureau is likely to provide the broadest and clearest test in American regulation of the efficacy of behaviorist prescriptions.

V. PROXY ACCESS

In contrast to its centrality to the debate whether to create the new Consumer Bureau, behavioral economics has largely been absent from the discussion on proxy access—the proposal to subsidize shareholder nomination of directorial candidates. The task in this context is therefore more speculative. But it is not hard to imagine how behavioralism could enter into the proxy

[62] See, for, example, Maya Jackson Randall and Justin Lahart, *Harvard Economist to Join Consumer* Bureau, Wall St J, (May 11, 2011) *available at* *http://online.wsj.com/article/SB10001424052748704681904576317503890946370.html*.

[63] See, for example, Graeme Wood, *Anthropology Inc.*, The Atlantic (March 2013)(chronicling companies' use of consulting firms that study consumer psychology). For an argument that behavioralists have underappreciated the extent to which firms are better able to manipulate consumer biases than regulators are, see Lauren E. Willis, *When Nudges Fail: Slippery Defaults*, U Chicago L Rev (forthcoming 2013), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2142989).

access debate; indeed, the SEC currently faces a predicament with proxy access that may invite a behavioral turn.

The proxy issue dates back almost to the founding of the SEC. "[T]he SEC first considered a rule that would have required issuers to include shareholder-nominated director candidates in 1942," as one commentator summarizes.[64] "This consideration was part of the rule-making process that resulted in the adoption of the shareholder proposal rule, now Rule 14a-8, rule-making that resulted from the changes to the proxy solicitation process that reduced in-person attendance at shareholder meetings."[65] Pressure to provide a mechanism for including at least some shareholder nominees for director mounted in the 2000s, and proxy access was given explicit statutory imprimatur by the Dodd-Frank Act.[66] A month after Dodd-Frank's enactment, the SEC promulgated a new proxy access rule.[67] Under the new rule, a shareholder or group of shareholders that had held at least 3% of a company's stock for at least 3 years could nominate directorial candidates for up to 25% of the board.[68]

Of particular interest for present purposes is the quick demise of the rule and the reasons for this premature death. The rule was challenged shortly after its promulgation by the SEC's principal nemeses, the Business Roundtable and the Chamber of Commerce, as an arbitrary and capricious rulemaking in violation of the Administrative Procedure Act. In a curt, dismissive opinion by Judge Ginsburg, the D.C. Circuit agreed, invalidating the rule.[69] Although the SEC "has a 'statutory obligation to determine as best it can the economic implications of [a] rule,'" Judge Ginsburg wrote, including its effect on "'efficiency, competition, and capital formation,'" the SEC failed for the third time in recent memory to carry out its responsibilities.[70] "Here the Commission inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified;

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64 Jill E. Fisch, *The Destructive Ambiguity of Federal Proxy Access*, Emory L J (forthcoming 2012), manuscript at 8.
65 Id.
66 Dodd-Frank Act § 971 (codified as amended at 15 U.S.C. § 78n (a)(2)(Supp. IV 2010)).
67 The new rule, Rule 14a-11, was never permanently published in the Code of Federal Regulations due to the litigation over its validity. See Fisch, Emory L J at 5 n 12 (cited at note 61).
68 The rule is described in detail in *id.* at 15-16.
69 *Bus Roundtable v SEC*, 647 F3d 1144, 1156 (DC Cir 2011).
70 Id at 1148.

neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commentators."[71]

As Judge Ginsburg summarized the cost-benefit calculus, the SEC justified the new rule as reducing costs for shareholders who would otherwise be forced to bear the expense of nominating directors, and as "mitigat[ing] collective action and free-rider concerns."[72] Although the SEC acknowledged that companies might incur costs in opposing shareholder nominees, it made no effort to determine how significant the costs might be. Most interestingly, Judge Ginsburg chastised the SEC for "rel[ying] upon insufficient empirical data when it concluded that [the new rule would] improve board performance and increase shareholder value by facilitating the election of dissident shareholder nominees."[73] Ignoring numerous contrary studies, the SEC "instead relied exclusively and heavily upon two relatively unpersuasive studies, one concerning the effect of 'hybrid boards' … and the other concerning the effect of proxy contests in general, upon shareholder value."[74] Judge Ginsburg's two final criticisms were that the SEC failed to consider the cost to companies of special interest campaigns by unions or pension funds whose representatives were unlikely to be elected, and that the SEC's prediction as to how many new contests would result was almost entirely speculative.[75]

Whatever the significance of the D.C. Circuit's repeated invalidation of SEC rules over the past decade, a matter that has been subject to considerable speculation, the *Business Roundtable* case strongly implies that SEC rulemaking needs to include a careful sifting of the relevant empirical evidence. Even if it was not so intended, this call may be seen as an invitation for the SEC to incorporate the findings of behavioral economics. Empirical evidence is, after all, the very foundation of the behavioral turn. While behavioral economics was peripheral to the proxy access debate prior to *Business Roundtable*,[76] that now may change.

[71] Id at 1148-49.
[72] Id at 1149.
[73] Id at 1150.
[74] Id at 1151.
[75] Id at 1151-52 (special interests); 1152-54 (number of elections).
[76] The work that comes closest to introducing this dimension is an article by Troy Paredes, who subsequently became an SEC commissioner and in that capacity resolutely opposed a mandatory proxy access rule. *See, e.g.,* Troy A. Paredes, Commissioner of the SEC, Statement at Open Meeting to Propose Amendments Regarding Facilitating Shareholder Director Nominations, (May 20, 2009), *available at*

Much of the existing behavioral literature on corporate and securities law is concerned with the biases of individual investors, and thus has little direct relevance to the proxy access issue.[77] Although less well-developed, the behavioral literature on managers and board dynamics might be a more promising avenue for the SEC to pursue as it builds an empirical case for a new proxy access rule.[78] A well-known study found support for the "hubris" hypothesis that managers are often overoptimistic about their capacities, and engage in empire-building as a result.[79] Other work, some of it quite early, explores the psychology of board interactions, including the dangers of group think within a board of directors.[80] Although none of these studies is a precise fit, one can easily imagine applications. If directors are prone to groupthink, for instance, proxy access may provide a mechanism for injecting alternative perspectives into the boardroom. Concerns about status quo bias might support proxy access for similar reasons. In addition to strengthening the SEC's general case, these studies might also help justify particular and otherwise puzzling features of a proxy access rule, such as the requirement that nominating shareholders disavow any attention to take over the firm.[81]

There are two obvious criticisms of SEC use of behavioral studies in this fashion. The first is that it seems unnecessary. Traditional economics seems fully capable of explaining the

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www.sec.gov/news/speech/2009/spch052009tap.htm (arguing for "state law" approach). Paredes proposed the use of a "devil's advocate" director to assure that boards fully consider all sides of the decisions they pursue. Troy A. Paredes, *Too Much Pay, Too Much Deference: Behavioral Corporate Finance, CEOs, and Corporate Governance*, 32 FLA ST U L REV 673 (2005).

[77] Choi and Pritchard's important article on behavioral economics and the SEC focuses on institutional biases at the SEC, not individual investor biases on the private side. See Choi & Pritchard, 56 Stan L Rev at 7-14 (cited at note 20) (cataloguing biases such as availability heuristic, overconfidence and overoptimism, the endowment effect, and confirmation bias).

[78] The source of a remarkably high percentage of the best work on cognitive biases in this context has been Don Langevoort. See, for, example, Donald C. Langevoort, *The Behavioral Economics of Mergers and Acquisitions,* 12 Transactions: Tenn J Bus L 65 (2011); Donald C. Langevoort, *Diversity and Discrimination from a Corporate Perspective: Grease, Grit and the Personality Types of Tournament Survivors*, in Mitu Gulati and Micheal Yelnosky, eds, *NYU Selected Essays on Labor and Employment Law: Behavioral Analyese of Workplace Discrimination* 141 (2007); Donald C. Langevoort, *The Organizational Psychology of Hyper-competition: Corporate Irresponsibility and the Lessons of Enron*, 70 Geo Wash L Rev 968 (2002).

[79] Richard Roll, *The Hubris Hypothesis of Corporate Takeovers*, 59 J. Bus. 197 (1986); see also Bernard Black, *Bidder Overpayment in Takeovers*, 41 Stan L Rev 597 (1989).

[80] James D. Cox and Harvey Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 Law & Contemp Prob 83 (1984); Claire Hill and Brett McDonnell, Disney, *Good Faith and Structural Bias*, 32 J Corp L 833 (2007).

[81] For a very different explanation of the contours of the SEC's rule, see Fisch, Emory L J at 55 (cited at note 61) (suggesting that the SEC may have watered down its rule for fear of causing harm).

case for and against proxy access. Advocates of proxy access argue that it is necessary to overcome the collective action problems that prevent shareholders from effectively policing a firm's directors.[82] Critics of proxy access question the seriousness of shareholders' collective action problem, arguing that each firm should be permitted to decide how to handle proxy access, and/or worry that proxy access could undermine directorial decision making or be misused.[83] Traditional empirical studies—such as the study singled out in *Business Roundtable*, which found that corporations underperform after dissident shareholder nominees are elected—can help to determine whether the case for proxy access is more compelling than the critique.

Superfluity is not a compelling reason to rule behavioral insights out of bounds, of course. But a second criticism might be: the range of apparent behavioral findings is so broad that the SEC could find empirical evidence *of some kind* to support any rule it wished to promote. This argument is a close parallel to the fatal flaw in "other constituency" statutes that invite corporate managers to consider the interests of a variety of constituencies—including employees, creditors and the local community, rather than just shareholders—in deciding how to respond to a takeover offer.[84] The problem with these statutes is that they make it nearly impossible to second guess the managers' decision, because any decision can be justified as desirable for some constituency.[85] Similarly, the use of behavioral studies might seem to enable the SEC to justify any rule it promulgates, thus undermining the oversight envisioned by the Administrative Procedures Act.

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[82] For, example, Lucian A. Bebchuk and Scott Hirst, *Private Ordering and the Proxy Access Debate* 6 (Harvard Law Sch., Discussion Paper No. 653, 2009), *available at* http://papers.ssrn.com/sol3/ papers.cfm?abstract_id=1513408 (advocating rejection of no-access as the default and implementation of an opt-out process with necessary safeguards to increase shareholder power).

[83] See, for, example, Joseph Grundfest, *The SECs Proposed Proxy Access Rules: Politics, Economics, and the Law*, 65 Bus L. 361, 363 (2010) (arguing that it makes more sense to support a fully enabling approach to proxy access that allows all publicly traded corporations to determine the rules governing shareholder access to corporate proxy by majority vote).

[84] See, for, example, Brett H. McDonnell, *Corporate Constituency Statutes and Employee Governance*, 30 Wm Mitch L Rev 1228, 1235 (2004)(identifying the concern that a multiple-master fiduciary duty is essentially unenforceable as the principal objection to other constituency statutes).

[85] Recognition of this problem predates the advent of other constituency statutes by decades. In a famous debate with Merrick Dodd, Adolph Berle pointed out that broadening the constituencies to which directors are accountable would actually diminish their accountability. A.A. Berle, Jr., *Corporate Powers as Power in Trust*, 44 Harv L Rev 1049 (1931).

Although these objections point to serious limitations of behavioral economics in this context, they would not justify banning the use of its findings altogether. If the phenomenon in question can be fully explained in terms of traditional economic incentives, behavioral studies will be less useful, especially if compelling empirical evidence supports the traditional explanation. Indeed, once again analogizing to other constituency statutes, one can argue that behavioral findings should be presumptively excluded under these circumstances, and that regulators should simply use standard cost-benefit analysis. But if traditional rationality assumptions are more tenuous, behavioral findings can be given greater emphasis in the regulatory process. This will often be the case in the absence of markets or where market correctives are impaired in some way.

As the ongoing debate suggests, proxy access is not an issue on which decisive empirical evidence exists. There may well be room for evidence that corporate boards are subject to characteristic biases, and that proxy access could help to counteract the biases. Given the manipulability of behavioral findings, however, this evidence should probably be discounted unless is backed by realistic data on the potential cost of proxy access, and about its effects on corporate performance—precisely the concerns that were raised by Judge Ginsburg in the *Business Roundtable* case.

VI. THE FEDERAL RESERVE'S EMERGENCY POWERS

I turn finally to another context in which, as with the Consumer Bureau, Congress sought to constrain regulators who had been given expansive new power. While vesting banking regulators with vast authority, the Dodd-Frank Act also prohibits them from bailing out systemically important financial institutions. The two most explicit of these interventions forbid the Federal Reserve from providing rescue financing for individual financial institutions,[86] and instruct the FDIC and other financial regulators to liquidate rather preserve any financial institution they take over under the new resolution powers created by the Dodd-Frank Act.[87]

Consider how behavioral and traditional economics might assess the anti-bailout concerns of the new legislation. One prominent behavioral model of governmental oversight

[86] Dodd-Frank Act § 1101.
[87] I*d* § 214.

emphasizes the benefits of expertise, but also worries that experts suffer from characteristic cognitive biases such as overconfidence and as a myopic tendency to ignore other possible alternatives.[88] During the crisis as today, the Federal Reserve was the epitome of a highly expert regulator. Its staff arguably is the most highly trained of any American agency or regulator. But the Federal Reserve's expertise was severely limited in at least one respect. Its economists were banking and financial institution scholars, with little apparent understanding of bankruptcy, even though bankruptcy was the principal mechanism for resolving an investment bank's or a financial holding company's financial distress.[89] Faced with the choice whether to bail out a financial institution or to leave it to bankruptcy, they naturally gravitated toward bailouts.[90]

In behavioral terms, bank regulators' perspective was thus problematic during the 2008 crisis. This does not necessarily mean that prohibiting bailouts was the ideal response to regulators' cognitive biases, however.[91] If bailouts are never appropriate, a mandatory prohibition might make sense, although even here there are potential risks, as discussed below. But if bailouts are sometimes warranted, a behaviorist would favor correctives to close the gap in regulators' expertise.[92] Adding bankruptcy experts to the staffs of the Federal Reserve and other banking regulators (as appears to have been done to some extent after the crisis) might more directly address the particular problem without removing the bailout option altogether.

A traditional economic account would focus more narrowly on the regulators' incentives. In the standard public choice account, regulators have a structural incentive to prefer bailouts

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[88] *See* Jeffrey J. Rachlinski and Cynthia R. Farina, *Cognitive Psychology and Optimal Government Design*, 87 Cornell L Rev (2002).

[89] For, example, David A. Skeel, Jr., *Bankruptcy Phobia*, 82 Temple L Rev 333, 342 (2009) (identifying this as a major reason bankruptcy was avoided during the crisis).

[90] Lehman was the obvious exception. For an argument that Lehman has been seriously misunderstood, see Skeel, *The New Financial Deal* at 20-23 (cited at note 40).

[91] See generally Thaler and Sunstein, *Nudge* at 139 (cited at note 6) ("And of course, we libertarian paternalists do not favor bans").

[92] Rachlinski and Farina, Cornell L Rev at 582 (cite at not 85) (emphasizing, as a key benefit of Congress, that it has "the capacity to counteract the cognitive vulnerabilities of lay decision making through institutional structures and practices that can develop both substantive and decisional expertise"); *id.* at 587 (arguing that the psychological model views agencies much more positively than does public choice, especially if the agency is "well structured—designed to exploit the cognitive superiority of true expertise while compensating for its cognitive vulnerabilities").

rather than bankruptcy or other insolvency resolution.[93] Even if bailouts are economically inefficient, the reasoning goes, regulators are more likely to be held responsible for a disastrous collapse today than for the longterm costs of a bailout.[94] The incentive is especially strong if regulators' tenure is short, because delaying the day of reckoning may pass the responsibility on to the regulators' successors. Should bailouts therefore be banned? Here a traditional economic account would focus on whether the ban is likely to work. Will it actually prevent undesirable bailouts? Although the efficacy of Dodd-Frank's ban is of course untested, many traditional economists are highly skeptical.

If we compare the two approaches, the behavioral and traditional accounts appear to be two roads to more or less the same place.[95] Both suggest reasons for concern about the stance of regulators in 2008, but also offer cautions about the Dodd-Frank Act's attempt to prohibit ad hoc bailouts. Their principal differences seem to lie primarily in their differing presumptions about the regulators' motives. Traditional analysis is generally more skeptical, whereas behaviorism tends to assume more benign motives.[96] Other than this, it is not immediately apparent that behaviorism offers necessary adjustments to the traditional account.

If we take a broader perspective, however, the potential contributions of a cognitive perspective are more evident. The reaction of many ordinary Americans to the 2008 bailouts was highly critical, as captured in complaints that Wall Street was bailed out but Main Street was not. A behaviorist would suspect that this perception may influence consumer behavior in measurable ways. A recent study based on an on-line survey of respondents offers evidence that

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93 See, for, example, Jonathan R. Macey and Geoffrey P. Miller, *Kaye, Scholer, FIRREA, and the Desirability of Early Closure: A View of the Kaye, Scholer Case from the Perspective of Bank Regulatory Policy*, 66 S. Cal L Rev 1115, 1140 (1993).

94 Id.

95 The similarities are even larger if we note that behaviorism would acknowledge that regulators may be inclined to avoid the risk of being held responsible for a bad outcome, and that the availability heuristic may make the possibility of a disaster more vivid to banking regulators than to others. Federal Reserve Chairman Ben Bernanke's oft-noted obsession with avoiding the mistakes made by the Federal Reserve during the Great Depression is a good illustration.

96 See for, example, Rachlinski and Farina, Cornell L Rev at 608 (cited at note 85) (comparing public choice and psychological models in this regard, and warning, with respect to public choice, that "a formally endorsed, widely promulgated model of civic behavior which blames bad outcomes on the inevitability of greedy, self-serving action might itself become outcome determinative").

it will.[97] In one set of questions, subjects were told that they held an underwater mortgage. Those who also were informed that their bank had been bailed out were considerably more willing to walk away from an underwater mortgage than those whose bank had not been rescued.[98]

This kind of evidence would inform a behaviorist's analysis of the Dodd-Frank Act's ban on bailouts. If the bans are genuinely designed to discourage bailouts, a behaviorist might conclude that they are desirable (or at the least, defensible), despite the constraints on regulators' flexibility. If the provisions purport to prohibit bailouts, but clearly will not, on the other hand, a behaviorist might fear that they will reinforce ordinary Americans' perception that Wall Street has been, and will be treated, differently than Main Street. The ban would thus exacerbate consumers' cynicism about regulatory priorities.

These psychological effects would not fit comfortably within a traditional cost-benefit style analysis. To the extent they are included, they are generally treated as exogenous effects. Thus, a traditional public choice model might predict a shift in the views of the median voter in response to an economic crisis.[99] In behavioral economics, by contrast, the effects are endogenous to the lawmaking process and can therefore be taken more fully into account. This kind of evidence may be particularly difficult to incorporate effectively into the administrative rulemaking process, since it raises the manipulation concerns we saw in the last section, and considers costs that occur beyond the immediate context of rule itself. But it is evidence that is clearly relevant to an assessment of the anti-bailout rules.

VII. **LESSONS FOR FINANCIAL REGULATION**

My analysis of the behavioral implications of several key components of the new financial regulatory landscape suggests that it will not be easy to incorporate behavioral economics into financial and securities regulation effectively. Because the psychological biases identified by

[97] Tess Wilkinson-Ryan, *Breaching the Mortgage Contract: The Behavioral Economics of Strategic Default*, 64 Vand L Rev 1547 (2011).

[98] Id at 1568 (reporting that "24.8% of subjects said that they would be willing to default at a higher home value if the bank had been bailed out").

[99] See, for, example, William Wilson Bratton and Joseph A. McCahery, *The Equilibrium Content of Corporate Federalism,* 41 Wake Forest L Rev 619 (2006).

behaviorists are so varied, they often are difficult to translate into clear policy prescriptions. Even with respect to exotic mortgages, where the behavioral evidence seems most robust, it is not always clear whether consumer behavior was distorted by biases or was generally rational.

The seriousness of these complications, and the centrality of behavioral factors, seems to vary considerably in different contexts, however. In this final section, I will tentatively suggest, based on the analysis of the preceding sections, that behavioral evidence should be scrutinized differently depending on the context. I will propose in particular that alternative standards be used for incorporating behavioral evidence into the rulemaking process, on the one hand, and assessing the regulatory architecture, on the other.

Rules and rule making are what most scholars have in mind when they debate the findings of behavioral economics. It is here that the uncertain significance of behavioral findings seems to figure most strongly. The surge in exotic mortgages in the 2000s may have reflected either hyperbolic discounting or consumers' rational response to the extraordinary interest rate environment, or both. The most obvious dangers of incorporating behavioral findings in this context are the possibility that regulators will misinterpret consumer behavior and over-regulate as a result, or, as I speculated with proxy access, that the variety of behavioral findings will make it harder to scrutinize regulators' rulemaking.

Given the risk of over-regulation when behavioral findings are incorporated into rulemaking, it makes sense to begin with a presumption against its use, and in favor of traditional cost-benefit analysis. The presumption should be weakest with respect to decisions that are made by individuals and are not subject to market correction due to segmented markets or other factors, and should be much stronger if market correctives are present. Cost benefit analysis would thus remain primary, and behavioral economics secondary, in the rule making process.

In the other major context, the regulatory institution itself, there is less need to subordinate the behavioral findings. As reflected in our discussion of the Federal Reserve, behaviorism's bias toward regulation figures much less prominently in this context. To the contrary, it and traditional economic methodologies such as public choice analysis offer alternative insights as to the best way to structure regulatory institutions; behaviorism tends to emphasize the importance of properly channeled expertise, while public choice attempts to limit the distortions of self interested behavior.[100] The Dodd-Frank Act makes numerous structural changes to financial regulators that would lend themselves to analysis in behavioral as well as traditional terms.

Of particular interest in this regard the creation of a new Financial Stability Oversight Council (FSOC) to oversee systemic risk.[101] Chaired by the Treasury Secretary, FSOC is comprised of the heads of each of the major financial regulators, as well a member picked by the president to represent the insurance industry.[102] In one respect, behavioralists might applaud the new FSOC. As part of Title I of the Dodd-Frank Act, which created the FSOC, Congress established a new Office of Financial Research that could serve as a major new source of information for the FSOC and other regulators.[103] The structure of the FSOC itself, by contrast, is quite problematic. By relying on existing regulatory heads, the FSOC's structure may invite its members to simply defend the stances of their own agencies and without bringing any new expertise to the table.[104] These impediments could have been avoided by vesting authority in a single new regulator rather than a council of existing regulators.

The distinction between rules and institutions is porous, as such distinctions inevitably are. Although Dodd-Frank's anti-bailout provisions could be characterized as "rules," for instance, I focused primarily on institutional implications of the provisions as a device for constraining the Federal Reserve and other financial regulators. Despite the occasional blurriness of the rules-institutions distinction, the case for treating behavioralism differently in the two contexts seems compelling, at least in the financial and securities landscape I have occupied in this Essay.

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[100] Rachlinski and Farina, Cornell L Rev (cited at note 85).

[101] Dodd-Frank Act § 111.

[102] Id.

[103] Dodd-Frank Act § 151.

[104] From a public choice perspective, the FSOC is problematic for different but related reasons. There is a significant risk it will be dominated by the Treasury Secretary, for instance, and thus subject to political pressures that compromise its independence. The decision to house the new Office of Financial Research in the Treasury, Dodd-Frank Act § 151 is another unfortunate structural decision that could undermine independence.