

# ESSAY

## MAKING EXPERIMENTAL RULES WORK

ZACHARY J. GUBLER\*

*Both theory and practice suggest that there are potentially significant gains associated with an experimental approach to lawmaking, that is to say, adopting laws on a pilot basis in order to generate empirical data that can be used to inform decisions about the optimal long-term policy. Yet, with few exceptions, those legislative entities that are best positioned to engage in experimentation—administrative agencies—rarely do so, probably at least in part because of interest group opposition. This Article suggests that a somewhat obscure, though significant, rulemaking by the Securities and Exchange Commission (SEC or Agency) holds important clues about how one might make policy experimentation happen more often and work better when it does.*

*The case study involves the SEC's efforts to remove the longstanding rules that regulate short sales, whereby investors seek to profit from a stock price decline by selling borrowed stock that gets returned to the lender, with interest, at a later point in time. This case study represents one of the few instances where the SEC has adopted an experimental approach to rulemaking. The case study yields two important insights about policy experimentation more generally. First, the substantive challenges to policy experimentation, including sampling issues and concerns over data mining, are probably surmountable, as long as agencies are particularly attuned to potential biases created by the experiment. Second, the procedural challenges to policy experimentation, which include possible interest group opposition and the costs that judicial review places on experimental agency rulemakings, are more problematic.*

*This second insight suggests that it might be necessary to take steps to encourage greater experimentation. The Article sketches the outline of one such approach under which agency experiments would get special judicial deference and the notice-and-comment*

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\*Associate Professor of Law, ASU O'Connor College of Law. Special thanks go to Rhett Larson, Alex Lee, Kaipo Matsumura, Sofia Ranchordas, Troy Rule, Erin Sharff, and participants at the ASU Junior Scholars Colloquium and the National Business Law Scholars Conference. The usual disclaimers apply.

*process would be reconceptualized in the experimental context to allow for public participation and scrutiny only after the experiment has run its course. This approach would effectively subsidize experimentation while at the same time respecting the principles of transparency and accountability that underlie the administrative process.*

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#### INTRODUCTION

In July 2007, the SEC adopted a rule that garnered little attention outside of the executive suite and a relatively obscure corner of the investing world.<sup>1</sup> The action that the SEC took eliminated a rule that had been in place since 1938.<sup>2</sup> That original rule effectively prevented traders from short selling (or, in other words, betting that a stock would decline in

1. See Regulation SHO and Rule 10a-1, Exchange Act Release No. 55,970, 72 Fed. Reg. 36,348, 36,348 (July 3, 2007) (to be codified at 17 C.F.R. pts. 240, 242) [hereinafter Price Test Removal Adopting Release].

2. See Amendments to Regulation SHO, Exchange Act Release No. 59,748, 74 Fed. Reg. 18,042, 18,044 (Apr. 20, 2009) (to be codified at 17 C.F.R. pt. 242).

price) at successively lower prices in a declining market.<sup>3</sup> The motivating concern was that the infamous stock market crash of 1929 was caused in no small part by aggressive short selling, and this rule, known as the “Uptick Rule,” was adopted in an effort to delay such a cascade of downward pressure on the stock market.<sup>4</sup> After sixty-nine years, the SEC eliminated this rule.<sup>5</sup> Of course, in and of itself, this is perhaps not remarkable. SEC rules come and go all of the time.<sup>6</sup> In fact, the SEC was arguably in a house-cleaning mood already, as it had streamlined its regulations only a few years before.<sup>7</sup> So, it is perhaps not surprising that this somewhat arcane example of de-regulation has been largely overlooked.<sup>8</sup>

But in this instance, this oversight was a mistake, not so much because of the substance of the rule that the SEC adopted but because of the unusual process that led to its adoption.<sup>9</sup> That process may hold clues to rethinking how law is made in the United States. The reason this rulemaking is so potentially consequential is because it represents perhaps the only time in the modern era when the SEC has adopted an experimental approach to

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3. See Jonathan R. Macey et al., *Restrictions on Short Sales: An Analysis of the Uptick Rule and Its Role in View of the October 1987 Stock Market Crash*, 74 CORNELL L. REV. 799, 803–04 (1989); Michael R. Powers et al., *Market Bubbles and Wasteful Avoidance: Tax and Regulatory Constraints on Short Sales*, 57 TAX. L. REV. 233, 233 (2004).

4. See 7 LOUIS LOSS ET AL., SECURITIES REGULATION 115 (4th ed. 2012); Henry T.C. Hu, *Too Complex to Depict? Innovation, “Pure Information,” and the SEC Disclosure Paradigm*, 90 TEX. L. REV. 1601, 1689–90 (2012).

5. See Amendments to Regulation SHO, 74 Fed. Reg. at 18,045.

6. A number of scholars have examined the historical ebb and flow of securities regulation. See, e.g., Erik F. Gerding, *The Next Epidemic: Bubbles and the Growth and Decay of Securities Regulation*, 38 CONN. L. REV. 393 (2006); Stuart Banner, *What Causes New Securities Regulation? 300 Years of Evidence*, 75 WASH. U. L.Q. 849, 850 (1997); Joseph A. Grundfest, *Punctuated Equilibria in the Evolution of United States Securities Regulation*, 8 STAN. J.L. BUS. & FIN. 1, 1 (2002) (describing how capital market events stimulate regulation “between relatively tranquil periods of common law interpretation”); Larry E. Ribstein, Commentary, *Bubble Laws*, 40 HOUS. L. REV. 77, 77–78 (2003) (describing a historic cycle of stock market bubbles inflating, then bursting, followed by increased regulation); John C. Coffec, Jr., *The Political Economy of Dodd-Frank: Why Financial Reform Tends to Be Frustrated and Systemic Risk Perpetuated*, 97 CORNELL L. REV. 1019, 1020–21 (2012).

7. See Securities Offering Reform, Securities Act Release No. 33-8591, 85 SEC Docket 2871 (Aug. 3, 2005).

8. A few scholars have demonstrated some recent interest in the Securities and Exchange Commission’s (SEC’s) short sale pilot program. See, e.g., Hu, *supra* note 4, at 1689–94; Robert P. Bartlett, III, *Making Banks Transparent*, 65 VAND. L. REV. 293, 301 & n.25 (2012); James D. Cox & Benjamin J.C. Baucom, *The Emperor Has No Clothes: Confronting the D.C. Circuit’s Usurpation of SEC Rulemaking Authority*, 90 TEX. L. REV. 1811, 1842–44 (2012).

9. See *infra* Part II; see also Amendments to Regulation SHO, Exchange Act Release No. 59,748, 74 Fed. Reg. 18,042, 18,045 (Apr. 20, 2009) (to be codified at 17 C.F.R. pt. 242); Hu, *supra* note 4, at 1692–94.

lawmaking.<sup>10</sup> Typically, in proposing or adopting a final rule, the SEC engages in a lot of basic conceptual economic thinking. They identify theoretical benefits that a policy might confer on investors, firms, and the capital markets more generally. They then compare these theoretical benefits to theoretical costs that might arise as a result of the policy.<sup>11</sup> They might consider empirical studies that have some connection (although rarely a direct one) to the policy question at hand.<sup>12</sup> They respond to concerns raised by commentators and make the case for the regulatory action they are undertaking like a lawyer would make a case in court. At the end of the process, the work product, reflected in an adopting release, resembles something like an appellate brief or maybe a law review article.

Here, the process could not have been more different. The SEC constructed a real-world experiment.<sup>13</sup> They created a laboratory out of the market, dividing it into two groups—a control group for whom the status quo would apply and an experimental group that would be exempt from the SEC's longstanding Uptick Rule.<sup>14</sup> And then they stood back to see what would happen. The exchanges gathered data about how the market responded to the experimental and control groups, as reflected in measures of volatility, price, trading activity, and the like.<sup>15</sup> And then when the experiment was over, the SEC convened a public roundtable where, in addition to the SEC's own in-house economists,<sup>16</sup> a number of academics analyzed and discussed the data that the experiment had generated.<sup>17</sup> Instead of constructing a legal brief or a law review article, the SEC was actually engaging in social science.

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10. See Zachary J. Gubler, *Experimental Rules*, 55 B.C. L. REV. 129, 129 (2014).

11. For a discussion of the origins of the SEC's cost-benefit analysis and a criticism of the expectations the D.C. Circuit has for this analysis, see Bruce Kraus & Connor Raso, *Rational Boundaries for SEC Cost-Benefit Analysis*, 30 YALE J. ON REG. 289 (2013).

12. For an example of such "suggestive studies," as used in the context of the SEC's adoption of its ill-fated proxy access rule, see Yoon-Ho Alex Lee, *An Options Approach to Agency Rulemaking*, 65 ADMIN. L. REV. 881, 884–85 (2013).

13. See Price Test Removal Adopting Release, Exchange Act Release No. 55,970, 72 Fed. Reg. 36,348, 36,349 (July 3, 2007) (to be codified at 17 C.F.R. pts. 240, 242).

14. See Short Sales, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008 (Aug. 6, 2004) (to be codified at 17 C.F.R. pts. 240–42) [hereinafter Pilot Adopting Release].

15. See *id.*

16. See Office of Economic Analysis (OEA), SEC, Economic Analysis of the Short Sale Price Restrictions Under the Regulation SHO Pilot (Feb. 6, 2007), <https://www.sec.gov/news/studies/2007/regshopilot020607.pdf> [hereinafter OEA Report].

17. See *id.* The SEC subsequently provided a transcript of the public roundtable. See *SEC Roundtable On the Regulation SHO Pilot*, SEC (Sept. 15, 2006), <http://www.sec.gov/about/economic/shopilottrans091506.pdf> [hereinafter Reg. SHO Pilot Transcript].

The outcome of this policy experimentation was almost as surprising as the process itself. The data was widely interpreted as favoring the position that the Uptick Rule should be eliminated,<sup>18</sup> a position that important interest groups, most prominently the New York Stock Exchange (NYSE), had long since opposed.<sup>19</sup> And yet, in the face of the experimental data, these interest groups reversed their long-held positions and capitulated to the rule change.<sup>20</sup>

In recent years, there has been a growing interest in experimental approaches to policymaking, reflected both in the academic<sup>21</sup> and popular literatures.<sup>22</sup> And yet there are also significant obstacles that stand in the way of effective policy experimentation. Perhaps this explains the fact that despite its vaunted benefits, as a practical matter, policy experimentation is actually quite rare in many parts of the lawmaking world.<sup>23</sup> Less than one percent of SEC rules are structured as experiments.<sup>24</sup> And few other agencies fair better along this dimension.<sup>25</sup> One potential obstacle to experimentation is interest groups, who may have good reasons to oppose

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18. See Amendments to Regulation SHO, Exchange Act Release No. 59,748, 74 Fed. Reg. 18,042, 18,045–46 (Apr. 20, 2009) (to be codified at 17 C.F.R. pt. 242).

19. See Letter from Darla C. Stuckey, New York Stock Exchange, Inc. (NYSE) Corporate Sec'y, to Jonathan G. Katz, Sec'y, SEC (Mar. 1, 2004), available at <http://www.sec.gov/rules/proposed/s72303/dstuckey03012004.htm> [hereinafter 2004 NYSE Comment Letter]; Short Sales of Securities, Exchange Act Release No. 17,347, 45 Fed. Reg. 80,834 (Dec. 8, 1980) (to be codified at 17 C.F.R. pt. 240); Hu, *supra* note 4, at 1692–94; see, e.g., NYSE Research Department, *Institutional Investor Holdings of NYSE-Listed Stocks - 1975* (Mar. 1977), available at [http://3197d6d14b5f19f2f440-5c13d29c4c016cf96cbbfd197c579b45.r81.cfl.rackcdn.com/collection/papers/1970/1977\\_0301\\_NYSEHoldings.pdf](http://3197d6d14b5f19f2f440-5c13d29c4c016cf96cbbfd197c579b45.r81.cfl.rackcdn.com/collection/papers/1970/1977_0301_NYSEHoldings.pdf).

20. Compare 2004 NYSE Comment Letter, *supra* note 19, with Letter from Mary Yeager, Assistant Sec'y, NYSE, to Nancy M. Morris, Sec'y, SEC (Feb. 14, 2007), available at <http://www.sec.gov/comments/s7-21-06/s72106-34.pdf> [hereinafter 2007 NYSE Comment Letter].

21. See Michael Abramowicz et al., *Randomizing Law*, 159 U. PA. L. REV. 929, 933–34 (2011); Cox & Baucom, *supra* note 8, at 1842–44; Jacob E. Gersen, *Temporary Legislation*, 74 U. CHI. L. REV. 247, 267 (2007); Lee, *supra* note 12, at 904–05; Yair Listokin, *Learning Through Policy Variation*, 118 YALE L.J. 480, 483–86 (2008); Charles F. Sabel & William H. Simon, *Minimalism and Experimentalism in the Administrative State*, 100 GEO. L.J. 53, 60–61, 78 (2011); Charles K. Whitehead, *The Goldilocks Approach: Financial Risk and Staged Regulation*, 97 CORNELL L. REV. 1267, 1295–96 (2012); George K. Yin, *Temporary-Effect Legislation, Political Accountability, and Fiscal Restraint*, 84 N.Y.U. L. REV. 174, 187–94 (2009); Gubler, *supra* note 10, at 129. But see Rebecca M. Kysar, *Lasting Legislation*, 159 U. PA. L. REV. 1007, 1007 (2011).

22. See JIM MANZI, UNCONTROLLED: THE SURPRISING PAYOFF OF TRIAL-AND-ERROR FOR BUSINESS, POLITICS, AND SOCIETY 109–11 (2012).

23. See Gubler, *supra* note 10, at 152.

24. See *id.*

25. See *id.*

experimentation as a general matter.<sup>26</sup> If an interest group has sufficient influence to compel a particular regulatory result, that interest group will prefer, everything else equal, that that result be adopted on a permanent basis rather than a temporary one in the context of an experiment.<sup>27</sup> The dominant interest group might fear that if the experimental results fail to support its preferred policy outcome, then it might lose influence with the agency, as the NYSE did in the case of short selling deregulation.<sup>28</sup> Alternatively, even if the agency adopts the interest group's preferred policy outcome in the face of such unsupportive experimental results, the dominant interest group may be concerned that the resulting rule, unsupported by the evidence, will fail to survive judicial review.<sup>29</sup>

Another obstacle to policy experimentation might be the costs of experimentation from the agency's perspective. These costs are largely attributable to the Administrative Procedure Act (APA)<sup>30</sup> in general and "hard look review," in particular, which requires that an agency spend considerable time and resources establishing a record that can hold up to not just procedural, but substantive review by courts.<sup>31</sup> This omnipresent threat is not just theoretical, as many agencies, including the SEC, have seen an increasing trend in recent years of the D.C. Circuit vacating or remanding rules under this searching standard of review.<sup>32</sup> These procedural costs fall disproportionately on policy experiments, like the one involving the Uptick Rule, because experimental rules effectively require two rounds of regulatory action—one to establish the experiment in the first place and a second round that is taken in response to the data generated by the experiment.<sup>33</sup> These two rounds of regulatory action are accompanied, predictably, by two rounds of judicial review and all of the

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26. *See id.* at 156.

27. *See id.*

28. *See id.*

29. *See id.*

30. *See* Administrative Procedure Act, 5 U.S.C. § 500 *et seq.* (2012).

31. *See* *Motor Vehicle Mfrs. Ass'n of the United States, Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43–44 (1983); *Citizens to Pres. Overton Park, Inc. v. Volpe*, 401 U.S. 402, 416 (1971); *see also* Thomas J. Miles & Cass R. Sunstein, *The Real World of Arbitrariness Review*, 75 U. CHI. L. REV. 761, 761, 763 (2008) (explaining that the U.S. Supreme Court's 1983 decision in *Motor Vehicle Manufacturers Ass'n v. State Farm Mutual Automobile Insurance Co.* was "widely taken to ratify both procedural and substantive components of the hard look doctrine," which had been developed by the D.C. Circuit).

32. *See, e.g.*, *Bus. Roundtable v. SEC*, 647 F.3d 1144, 1146, 1156 (D.C. Cir. 2011); *Am. Equity Inv. Life Ins. Co. v. SEC*, 572 F.3d 923, 925 (D.C. Cir. 2009); *Chamber of Commerce of the United States v. SEC*, 443 F.3d 890, 893, 909 (D.C. Cir. 2006); *Chamber of Commerce of the United States v. SEC*, 412 F.3d 133, 136, 145 (D.C. Cir. 2005); *Timpinaro v. SEC*, 2 F.3d 453, 455, 461 (D.C. Cir. 1993).

33. *See* Gubler, *supra* note 10, at 158–59.

regulatory costs that such review entails.<sup>34</sup>

Finally, in addition to these procedural obstacles to policy experimentation, there are substantive ones as well. How should agencies design policy experiments? What should the public's role be in that discussion? What problems and pitfalls should the agency try to avoid? What steps should the agency take to avoid inferences that are biased? To what extent must an agency pre-specify the hypothesis that the experiment is designed to test and the model that it will use to test that hypothesis?

The SEC's experiment in short sale deregulation provides an unusual opportunity to analyze how one agency that rarely engages in policy experimentation overcame both procedural and substantive obstacles. This analysis results in two central observations. First, it is fairly reasonable to assume that agencies can overcome the substantive obstacles to policy experimentation. However, doing so requires a high degree of self-awareness on the part of agencies to ensure the lack of biases in designing policy experiments.<sup>35</sup> Second, this analysis suggests that the procedural obstacles to policy experimentation are substantial. In fact, the SEC managed to overcome these in this instance through what can only be described as a form of bait-and-switch, although that almost certainly was not the intention with which the SEC began.<sup>36</sup> Thus, if we want to encourage policy experimentation, it may be necessary to reduce these procedural obstacles.

To this end, I sketch a potential policy approach that I refer to as "deferred notice-and-comment rulemaking for experimental rules." The idea is to adopt a different, more streamlined process with respect to agency experimentation than that which applies to regular agency rulemakings. Under this proposed approach, any rule that an agency adopts on a temporary basis (i.e., subject to a sunset provision) for the purpose of running an experiment should be subject to deferential judicial review or no review at all.<sup>37</sup> Upon completion of the experiment, the agency would then be required to conduct a public roundtable where academics would be expected to provide analysis of the experimental results.<sup>38</sup> The proceedings of this roundtable would then automatically become a part of the record of any subsequent regulatory action that the agency takes in response to the experimental results.<sup>39</sup>

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34. *See id.*

35. *See infra* notes 164–185 and accompanying text.

36. *See infra* notes 185–210 and accompanying text.

37. *See infra* notes 213–214 and accompanying text; *see also* Gubler, *supra* note 10, at 163–66.

38. *See infra* notes 212–216 and accompanying text.

39. *Id.*

This approach could be expected to encourage greater experimentation by administrative agencies. It would do so by reducing the threat of judicial review, thereby making experimental rules more attractive to interest groups. Also, by reducing the work that agencies must do to survive hard look review, this proposal would also make experimental rules more attractive to the agencies themselves. At the same time, the proposal would preserve the principles of accountability and transparency that underlie the rulemaking process by requiring public scrutiny of the data generated by the experiment. And of course, once the agency adopts some regulatory action in response to the experimental results, that action would be subject to the full-blown rulemaking process.<sup>40</sup>

The discussion proceeds as follows: Part I provides an overview of policy experimentation, explains why agencies are particularly well suited for carrying out policy experimentation, and suggests possible explanations for the dearth of policy experimentation among administrative agencies. Part II presents a case study of the experimental process that the SEC adopted for determining whether to eliminate the so-called Uptick Rule, which regulated the price at which short sales could be executed in a declining market. Part III provides an analysis of the short sale deregulation case study, concluding that while the substantive obstacles to policy experimentation might be surmountable, the procedural obstacles pose greater difficulties. For this reason, this Essay sketches a policy proposal for reducing these obstacles in an effort to encourage greater policy experimentation. It also discusses how this policy proposal might be implemented within the current structure of the APA.

## I. POLICY EXPERIMENTATION AND EXPERIMENTAL RULES

When making a decision under extreme uncertainty, the optimal approach is often some sort of experiment.<sup>41</sup> The experiment itself might be costly, but the information that it generates about the ultimate decision often will more than justify these costs.<sup>42</sup> Thus, it is not surprising that in a variety of different contexts, ranging from venture capital to clinical trials,

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40. *Id.*

41. See Gersen, *supra* note 21, at 267; Manzi, *supra* note 22, at xvi–xvii; Listokin, *supra* note 21, at 483, 491. According to Professor Gersen:

If policy outcomes are entirely determined by the available information set, then a staged decision procedure is more likely to select the optimal policy than a single-stage enactment. . . . Put differently, when initial decisions are likely to be wrong, staged decision procedures facilitate the correction of errors, and this is particularly likely to be the case in policy contexts dominated by uncertainty.

Gersen, *supra* note 21, at 267.

42. For an informal model illustrating this point, see Listokin, *supra* note 21, at 488–97.



decisionmakers elect to undertake a trial-and-error approach.<sup>43</sup>

There is a growing literature that examines how such an experimental approach might be (and sometimes is) applied in the lawmaking context,<sup>44</sup> but there are two obstacles that stand in the way of effective policy experimentation.<sup>45</sup> The first obstacle is the path dependency of law, that is to say, the fact that law can be resistant to change.<sup>46</sup> If laws are not easily reversed and modified, then a policy experiment will avail very little. After all, what is the point of knowing what the optimal law should look like if the current law cannot be modified to resemble that ideal? Furthermore, even if law is easily reversed and modified, the benefits of a policy experiment may still be illusory if lawmakers lack proper incentives to apply experimental data in order to make better laws. In other words, effective policy experimentation cannot take place unless the lawmaking process has the capacity for learning.<sup>47</sup>

A rule that is subject to a sunset provision and is promulgated by administrative agencies has the potential to overcome these two obstacles of effective policy experimentation.<sup>48</sup> This type of rule might be thought of as a “multi-stage” rule, consisting of an experimental stage prior to the sunset and a more permanent stage after the agency takes some permanent regulatory action in response to the experimental results.<sup>49</sup> A multi-stage rule of this type overcomes law’s natural path dependency because it automatically expires as a result of the sunset provision. Moreover, when this type of rule is adopted by an agency pursuant to the APA, it is subject to “arbitrary and capricious” review.<sup>50</sup> This ensures that any information generated by the initial stage of the rule—prior to the sunset—will be taken into account during the second stage of the rule, when regulators must decide what type of regulatory action to take in response to the experimental data.<sup>51</sup> This Essay refers to a multi-stage rule adopted for the

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43. See, e.g., 1 JOSEPH W. BARTLETT, EQUITY FINANCE: VENTURE CAPITAL, BUYOUTS, RESTRUCTURINGS AND REORGANIZATIONS § 9.2 (2d ed. 1995); see Richard Simon, *Optimal Two-Stage Designs for Phase II Clinical Trials*, 10 CONTROLLED CLINICAL TRIALS 1, 1–2 (1989).

44. See *supra* note 21 and accompanying text.

45. See Gubler, *supra* note 10, at 139–41.

46. See *id.*

47. See *id.*

48. See *id.* at 141–49.

49. See *id.* at 131.

50. See 5 U.S.C. §§ 706(1)–(2)(A) (2012) (“The reviewing court shall – (1) compel agency action unlawfully withheld or unreasonably delayed; and (2) hold unlawful and set aside agency action, findings, and conclusions found to be – (A) arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law. . . .”).

51. See Gubler, *supra* note 10, at 143–44.

purpose of experimentation as an “experimental rule.”<sup>52</sup>

If policy experimentation is so beneficial, and experimental rules are the optimal vehicle for engaging in policy experimentation, then one would naturally expect to find numerous examples of such rules among those actions taken by administrative agencies. But it turns out that this is not the case. In fact, fewer than one percent of all rules promulgated by the SEC fall into this experimental category.<sup>53</sup> With some notable exceptions, other agencies display a similar lack of experimentation.<sup>54</sup>

What might explain the dearth of experimental rules? One potential explanation might be interest groups. There are reasons to believe that an interest group with the clout to compel a particular regulatory result will prefer that that result be implemented through a single-stage rule instead of an experimental rule.<sup>55</sup> From the dominant interest group’s perspective, there are at least two problems with the experimental rule. First, the interest group might be concerned that if the results of the experiment fail to support its preferred policy outcome, it might lose the ability to compel that same, or a similar, regulatory result in the face of the unsupportive evidence.<sup>56</sup> Empirical uncertainty creates political cover for any legislative body, including agencies that might be beholden to interest groups.<sup>57</sup> As uncertainty over the optimal policy wanes, so might the interest group’s political clout.<sup>58</sup> Alternatively, even if an agency is willing to adopt the dominant interest group’s preferred policy outcome in the face of such unsupportive experimental results, that interest group might be concerned that the resulting rule will fail to survive judicial review.<sup>59</sup>

Another reason for the dearth of experimental rules might have something to do with the APA. Under the APA, all final agency rules are subject to “arbitrary and capricious review.”<sup>60</sup> Traditionally, the shorthand “hard look review” was applied to this standard as a reference to the fact that the court would examine the rulemaking record to ensure that the agency had taken a “hard look” at the issue.<sup>61</sup> However, this standard of review subsequently became increasingly searching, as courts themselves

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52. This term originally appeared in Gubler, *supra* note 10, at 130–31.

53. *See id.* at 152–53.

54. *See id.*

55. *See id.* at 154–62.

56. *See id.*

57. *See* Gubler, *supra* note 10, at 154–62.

58. *See id.*

59. *See id.*

60. *See supra* notes 50–52 and accompanying text.

61. *See* Merrick B. Garland, *Deregulation and Judicial Review*, 98 HARV. L. REV. 505, 526–27 (1985); Cass R. Sunstein, *Deregulation and the Hard-Look Doctrine*, 1983 SUP. CT. REV. 177, 181 (1983).

applied an independent “hard look” to make sure that they agreed with the substance of the agency’s rulemaking.<sup>62</sup> Thus, the modern incarnation of “hard look” review is not simply procedural but substantive as well.<sup>63</sup>

Predictably, this searching review imposes substantial costs on agencies, which must spend enormous amounts of time and resources to build the type of record that is likely to survive this heightened form of judicial review.<sup>64</sup> The problem is that these costs fall disproportionately on agency experiments. This is because experimental rules entail two rounds of agency action—one to establish the experiment in the first place and another representing the agency’s response to the data generated by the experiment. These two rounds of regulatory action are accompanied, predictably, by two rounds of judicial review and all of the regulatory costs that such review entails. Consequently, from the agency’s perspective, it is more costly to engage in policy experimentation instead of simply adopting a single-stage rule at the outset.<sup>65</sup>

In addition to these procedural challenges to policy experimentation, there are substantive challenges as well. Many of these challenges have to do with experimental design. What is the hypothesis to be tested? What is the model to be used for testing that hypothesis? How should the experiment be designed to avoid various statistical problems that might complicate the inferences that the agency might ultimately draw from the experiment? To what extent must an agency pre-specify the hypothesis that the experiment is designed to test and the model that it will use to test that hypothesis?

Given these obstacles to policy experimentation, it might be surprising that experimental rules are ever used at all. But they are on occasion.<sup>66</sup> The next Part considers one of the few times, perhaps the only time in the modern era, when the SEC has adopted an experimental rule. This case study holds the potential to achieve a better understanding of how we might overcome these procedural and substantive obstacles to policy experimentation.

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62. See Garland, *supra* note 61, at 526–27.

63. See *Motor Vehicle Mfrs. Ass’n of the United States, Inc. v. State Farm Mut. Auto Ins. Co.*, 463 U.S. 29, 43 (1983); *Citizens to Pres. Overton Park, Inc. v. Volpe*, 401 U.S. 402, 416 (1971); Sunstein, *supra* note 61, at 181; see also Miles & Sunstein, *supra* note 31, at 761, 763.

64. See, e.g., Cass R. Sunstein & Adrian Vermuele, *Interpretation and Institutions*, 101 MICH. L. REV. 885, 932 (2003) (“It is now well-documented that [hard look] review has contributed to the ‘ossification’ of notice-and-comment rulemaking, which now takes years, in part as a result of the effort to fend off judicial challenges.”).

65. See Gubler, *supra* note 10, at 175–77.

66. *Id.* at 152–53.

## II. A CASE STUDY OF EXPERIMENTATION: THE REG. SHO PILOT

The SEC's foray into regulatory experimentation took place in the somewhat arcane world of short sales. These types of transactions are best understood by comparison to their polar opposite, the long position. In the financial context, a long position is one where the investor is exposed to fluctuations in the price of the relevant asset such that she makes money when the asset price increases and loses money when the asset price decreases. The archetypical example of a long position is the ownership of an asset. An investor who owns stock in IBM has a long position with respect to IBM—her financial position with respect to the company is positively correlated with its stock price. If the price of IBM stock increases, then so does the value of the investor's financial position and vice versa. A short position, by contrast, exhibits precisely the opposite relationship between the asset's price and the value of that investment. Thus, an investor who is short IBM gains when IBM's stock price decreases and loses when that stock price increases.<sup>67</sup>

There are many ways that modern financial markets allow investors to put a short position into effect, including through the use of derivatives and other complex financial instruments. The traditional approach, however, is through a short sale. A short sale occurs when an investor sells stock that she has borrowed from another investor.<sup>68</sup> The investor must of course return the stock to the lender at a later time.<sup>69</sup> As stock is fungible, rather than returning the actual shares that she borrowed and subsequently sold off, the investor instead simply purchases the requisite amount of shares in the market when the repayment becomes due and then returns those shares to the lender in order to close out her position.<sup>70</sup> By selling the stock immediately after borrowing it, the investor effectively locks in the stock's current market price. The investor's hope is that the market price at the later time when she must repay the borrowed stock will be less than the price of the stock at the time she borrowed and immediately sold it off. Thus, in a short sale, the investor's gain, or loss, is equal to the difference between the price at which she sells the borrowed stock and the price at which she must purchase the stock at the market price at the time of repayment, less interest paid for the privilege of borrowing the stock in the first place.<sup>71</sup>

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67. See Short Sales, Exchange Act Release No. 48,709, 68 Fed. Reg. 62,972, 62,973 (Nov. 6, 2003) (to be codified at 17 C.F.R. pts. 240, 242) [hereinafter SHO Pilot Proposal].

68. *Id.*

69. *Id.*

70. *Id.*

71. *Id.*

In the United States, the regulatory focus on short sales began shortly after the stock market crash of 1929. Many policymakers, including President Hoover himself, believed that the crash had been accelerated, if not caused outright, by short sellers whose bearish bets placed unwarranted pressure on stock prices, thereby creating a self-fulfilling prophecy of market doom.<sup>72</sup> Indeed, the Senate Report for what would become the Securities Exchange Act of 1934<sup>73</sup> cited the belief that short selling “unsettles the market, forces liquidation, depresses prices, accelerates declines, and has no economic value or justification.”<sup>74</sup> In response to these types of concerns, and at the behest of a Congress that had instructed it to “purge the market of short selling abuses,”<sup>75</sup> the SEC adopted in 1938 the so-called Uptick Rule,<sup>76</sup> which allowed unrestricted short selling in a rising market but intervened in a declining market, prohibiting short selling at successively lower prices. The hope was that the rule would limit “bear raids”<sup>77</sup> of the type that critics believed to be at the core of the 1929 crash.<sup>78</sup>

To be sure, the Uptick Rule had its detractors. Indeed, the rule represented a fairly unusual and remarkable departure from the policy of government price neutrality with respect to securities regulation.<sup>79</sup> It was not until much later, however, beginning in the 1970s, that economists went even further, arguing that short selling is actually a necessary ingredient for creating an efficient capital market.<sup>80</sup> For a market to be efficient, prices need to reflect all available information concerning asset prices, including not only the most optimistic opinions but the most

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72. See Hu, *supra* note 4, at 1689–90.

73. See 15 U.S.C. § 78a *et seq.* (2012).

74. See LOSS ET AL., *supra* note 4, at 115 (quoting S. Rep. No. 73-1455, at 50 (1934)).

75. See SHO Pilot Proposal, Exchange Act Release No. 48,709, 68 Fed. Reg. 62,972, 62,972 (Nov. 6, 2003) (to be codified at 17 C.F.R. pts. 240, 242) (internal quotations omitted).

76. *Id.*

77. A “bear raid” is when traders sell stock short in the hope of profiting from a chain reaction of selling caused by a combination of margin calls, stop loss orders, or simply by the trader’s own dissemination of false, negative information regarding the stock in question. See Macey et al., *supra* note 3, at 802.

78. See SHO Pilot Proposal, 68 Fed. Reg. at 62,974 (identifying one of the three objectives of the Uptick Rule as “eliminating short selling as a tool for driving the market down”).

79. See Hu, *supra* note 4, at 1612–13.

80. See, e.g., Edward M. Miller, *Risk, Uncertainty, and Divergence of Opinion*, 32 J. FIN. 1151, 1166 (1977) (hypothesizing, “In a market with little or no short selling the demand for a particular security will come from the minority who hold the most optimistic expectations about it.”).

pessimistic ones as well.<sup>81</sup> The Uptick Rule, however, banishes the most pessimistic opinions from the marketplace, thereby leading to the overpricing of shares.

Influenced by the growing consensus of economists, and no doubt in response to influential investors who desired more flexibility in their investment options, the SEC in 1975 commenced a rulemaking proceeding with the purpose of short sale deregulation.<sup>82</sup> This attempt, however, never made it out of the starting gate. Industry participants, led by the exchanges in general and the NYSE in particular,<sup>83</sup> opposed de-regulation,<sup>84</sup> and the SEC ultimately decided to retain the Uptick Rule in 1980.<sup>85</sup>

For years, the SEC's short sale deregulation efforts appeared to be stuck in limbo while the economists' view that short selling undermines market efficiency became almost an article of faith of the profession.<sup>86</sup> Eventually, the SEC managed to revive its efforts in 2003 with the proposal of a pilot study to explore the need for short sale price tests.<sup>87</sup> The pilot study was actually proposed as only a very small piece of a larger proposal to update short sale regulation more generally. The release containing the proposed pilot study was mainly concerned not with eliminating short sale regulation, but rather with improving it by fixing two rather arcane but nevertheless important issues that had resulted from the SEC's rules for short sales.<sup>88</sup>

The first issue, known as naked short selling, refers to the phenomenon where a short seller sells the securities without having first borrowed them, in effect selling an asset that the investor does not own or even possess.<sup>89</sup> Naked short selling leads to a litany of problems. For example, it leads to pricing problems, where the buyer of the securities would have priced the sale differently, or would not have entered into the contract at all, if it had

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81. *See id.* at 1165–66.

82. *See* Short Sales of Securities, Exchange Act Release No. 17,347, 41 Fed. Reg. 56,530, 56,530–42 (Dec. 28, 1976) (to be codified at 17 C.F.R. pt. 240).

83. *See, e.g.*, NYSE Research Department, *Institutional Investor Holdings of NYSE-Listed Stocks - 1975* (Mar. 1977), available at [http://3197d6d14b5f19f2f440-5c13d29c4c016cf96cbbfd197c579b45.r81.cfl.rackcdn.com/collection/papers/1970/1977\\_0301\\_NYSEHoldings.pdf](http://3197d6d14b5f19f2f440-5c13d29c4c016cf96cbbfd197c579b45.r81.cfl.rackcdn.com/collection/papers/1970/1977_0301_NYSEHoldings.pdf).

84. *See* Hu, *supra* note 4, at 1692.

85. *See* Short Sales of Securities, 45 Fed. Reg. at 80,834.

86. *See* Pedro A.C. Saffi & Kari Sigurdsson, *Price Efficiency and Short Selling*, 24 REV. FIN. STUD. 821, 824–25 (2011) (observing, “It is generally accepted that short-sale constraints affect the efficiency of security prices.”) (internal citations omitted).

87. *See* SHO Pilot Proposal, Exchange Act Release No. 48,709, 68 Fed. Reg. 62,972, 62,972. (Nov. 6, 2003) (to be codified at 17 C.F.R. pts. 240, 242).

88. *See id.* (specifically, in a release that consisted of almost 48,000 words, the section describing the proposed pilot program clocked in at just over 1,200 words, or only 3% of the release).

89. *See id.* at 62,973.

known that it would not receive the securities for an extended period of time.<sup>90</sup> Additionally, naked short selling could deprive the buyer of the right to vote the securities if the buyer did not receive the securities by the record date for the relevant vote, thereby stripping the buyer of a valuable aspect of stock ownership.<sup>91</sup> In the release, the SEC proposed a number of modifications to existing regulations to address the naked short selling problem, the centerpiece of which was a rule that would prohibit a broker-dealer from executing a short sale order unless it had first borrowed the securities or had reasonable grounds to believe that it would be capable of delivering the securities on the delivery due date, perhaps because the security in question is a widely-traded, highly-liquid one.<sup>92</sup>

The second issue that the SEC sought to fix in the proposing release was the problem of a lack of uniformity in the application of short sale price tests. At the time the proposing release was issued, the SEC's short sale price test, Rule 10a-1, only applied to transactions in securities listed on a "national securities exchange,"<sup>93</sup> a term of art that, at the time, included the NYSE and the American Stock Exchange (AMEX) but left out other important trading markets, including the National Association of Securities Dealers Automated Quotations (NASDAQ).<sup>94</sup> Whether price tests applied to short sales of securities listed in these other markets depended on whether that market had adopted its own price tests.<sup>95</sup> The result was a patchwork of rules with some markets subject to the SEC rule, other markets, like the NASDAQ, subject to different, self-imposed rules, and still other markets subject to no rules at all.<sup>96</sup> As the SEC noted, this type of rule variation gave rise to regulatory arbitrage and general confusion.<sup>97</sup> For this reason, the SEC proposed adopting a single price test that would apply to all markets equally.<sup>98</sup> The proposed rule would have applied uniformly to all short sales regardless of the market on which the security in question

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90. *See id.*

91. *See id.*

92. *See id.* & n.35.

93. *See* SHO Pilot Proposal, Exchange Act Release No. 48,709, 68 Fed. Reg. 62,972, 62,973 (Nov. 6, 2003) (to be codified at 17 C.F.R. pts. 240, 242).

94. A lot has changed in the market for exchanges since the SEC issued this proposing release. In particular, the National Association of Securities Dealers Automated Quotations (NASDAQ) has since become a national securities exchange for regulatory purposes, and the American Stock Exchange (AMEX) was subsequently acquired by the NYSE and is now known as the "NYSE MKT." *See Fast Answers: Exchanges*, SEC (Aug. 30, 2012), <http://www.sec.gov/divisions/marketreg/mrexchanges.shtml>.

95. *See* SHO Pilot Proposal, 68 Fed. Reg. at 62,979.

96. *See id.* at 62,975–76.

97. *See id.* at 62,976.

98. *See id.* at 62,981.

was listed.<sup>99</sup> Unlike the Uptick Rule, however, which applied to a stock's *sale price*, the proposed rule—what the SEC called the “uniform bid test”—would have applied to the *offering price* of stock, called “bids.”<sup>100</sup> Otherwise, it was substantially similar to the Uptick Rule.<sup>101</sup> As the SEC explained, it is impossible to impose the Uptick Rule on a uniform basis.<sup>102</sup> Whereas some securities markets have a centralized auction, others are held together through a network of dealers, and they do not produce the type of price information necessary on a rolling basis to allow for the operation of a test based on the last sales price of a security.<sup>103</sup> Both types of market structures—auction-based and dealer-based—would allow for a bid test.

It was within the context of proposing these two rule changes that the SEC proposed a pilot program called the SHO Pilot (the SHO Pilot or Pilot).<sup>104</sup> As the SEC explained, after adopting the proposed uniform bid test, it would then suspend application of that bid test with respect to a group of securities that the SEC would identify using an unspecified “objective method.”<sup>105</sup> There were two stated goals behind the SHO Pilot. The first was to “assess whether short sale regulation should be removed, in part or in whole, for actively traded securities.”<sup>106</sup> However, the SEC also explained that the Pilot would allow it to assess how well “the proposed bid test achieves the three objectives of short sale regulation through the comparison of trading activity of similar stocks subject to the test and those not subject to the test.”<sup>107</sup> Thus, the Pilot was presented in the proposing release as an attempt to test the continued relevance of price tests in general and the effectiveness of the proposed uniform bid test in particular. The discussion of the SHO Pilot lasted for only about one and one-half pages of a release that consisted of thirty-eight pages in the Federal Register.

Given the disproportionate amount of space in the proposing release devoted to the naked short selling issue and the uniform bid test, it is

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99. *See id.* at 62,972, 62,978.

100. *See id.* at 62,972, 62,976.

101. *See* SHO Pilot Proposal, Exchange Act Release No. 48,709, 68 Fed. Reg. 62,972, 62,978–80 (Nov. 6, 2003) (to be codified at 17 C.F.R. pts. 240, 242) (stating that one other difference was that, unlike the Uptick Rule, the proposed uniform bid test would not under any circumstance have allowed a short sale to be effected at a price equal to the consolidated best bid, even if that consolidated best bid was greater than that prior best bid. Although, in the same proposing release, the SEC floated such an alternative.).

102. *See id.* at 62,979.

103. *See id.* at 62,979–80.

104. *See id.*

105. *See id.* at 62,983.

106. *See id.*

107. *See* SHO Pilot Proposal, Exchange Act Release No. 48,709, 68 Fed. Reg. 62,972, 62,983 (Nov. 6, 2003) (to be codified at 17 C.F.R. pts. 240, 242).



perhaps not surprising that commenters tended to spend more time in their comment letters discussing those two issues rather than the proposed Pilot program. But with respect to those commenters who addressed the proposed Pilot program, opinion was divided between investors who generally favored the Pilot (or, failing that, favored bypassing the experiment altogether and proceeding with short sale deregulation straightaway) and the exchanges, or exchange-related entities, who were opposed to the SHO Pilot.

The primary opponents to the proposed Pilot were the NYSE and the Specialists Association, a lobbying group representing the specialists who work on the NYSE trading floor and are tasked with making markets and, in particular, securities. The NYSE dusted off the arguments that it had used to scuttle the SEC's short sale deregulatory efforts in the 1970s, expressing concern for bear raids and asserting, "Short sale price restrictions assist in providing balanced protection for all market participants, including both professional traders and individual investors."<sup>108</sup> The NYSE also outlined a fallback position in the event that the SEC proceeded with the elimination of price tests, consisting of a regime that would allow the individual exchanges to determine how best to regulate short sales.<sup>109</sup> The NYSE left little doubt that under that exchange-choice scenario, it would retain the Uptick Rule.<sup>110</sup> Indeed, it asserted that it "strongly believe[d]" that price restrictions were appropriate regardless of which entity—the SEC or the Exchanges themselves—implemented them.<sup>111</sup> Finally, the NYSE expressed concern for the proposed length of the SHO Pilot, calling the proposed two-year duration "an exceptionally long time, particularly without any quick mechanism to shorten or end it should the pilot prove dislocating to market prices."<sup>112</sup>

The Specialists Association of the NYSE was even more adamantly opposed to the Pilot than the NYSE, opining that the proposal was simply a "bad idea."<sup>113</sup> They argued that the "experiment is likely to have unwarranted and unintended adverse effects on the markets for securities included in the experiment, operating to the detriment of the issuers of the

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108. *See* 2004 NYSE Comment Letter, *supra* note 19.

109. *See id.*

110. *See id.* ("The Exchange strongly believes that price restrictions on short sales are appropriate and should be permitted to retain them in the absence of federal regulations to the contrary.");

111. *See id.*

112. *See id.*

113. *See* Letter from David Humphreys, President, The Specialist Association, to Jonathan G. Katz, Secretary, SEC (Feb. 13, 2004), available at <http://www.sec.gov/rules/proposed/s72303/s72303-374.pdf>.

included securities.”<sup>114</sup> They further asserted that the management of listed companies viewed short sale price tests as “an enormously important attribute of exchange listing” and that management “fear[ed], legitimately,” that the Pilot would “undermine proper pricing, tend to discourage new decisions to invest, and weaken the resolve of current holders of their companies’ stocks to refrain from selling them in times of market stress.”<sup>115</sup>

The NASDAQ, by contrast, was not opposed to the Pilot, at least in theory, although its endorsement was not particularly ringing. Rather, it stated that the proposed Pilot was “a valid approach to studying the continued efficacy of short sale regulation on highly liquid securities.”<sup>116</sup> Nevertheless, the NASDAQ also identified a number of problems with the Pilot as proposed. In particular, it expressed concern for the proposal’s vagueness, noting the market’s need for more clarity regarding the SEC’s method for selecting the firms that would participate in the Pilot program.<sup>117</sup> Additionally, the NASDAQ opined that the proposed two-year duration of the Pilot was too long.<sup>118</sup> It explained that the Pilot “should last only as long as absolutely necessary to produce meaningful data for studying the continued efficacy of short sale price regulation,” expressing the belief that a six-month or twelve-month Pilot program was probably sufficient to achieve that goal.<sup>119</sup>

On August 6, 2004, the SEC announced that it was adopting the SHO Pilot program. In a surprise move, the SEC would not move forward with the proposed uniform bid test.<sup>120</sup> Thus, while the Pilot was originally proposed, at least in part, as a means to test the desirability of the new price test (i.e., the proposed uniform bid test), at its adoption, in the absence of the new price test, it instead became a means to test the desirability of short sale price tests more generally. The SEC adopted the SHO Pilot through a separate order (the Pilot Order),<sup>121</sup> a procedural decision that, as the SEC explained, would allow it “to act quickly should adverse findings result from

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114. *See id.*

115. *See id.*

116. *See* Christopher R. Concannon, NASDAQ, to Jonathan G. Katz, Secretary, SEC (Mar. 25, 2004), available at <http://www.sec.gov/rules/proposed/s72303/ccconcannon03252004.htm>.

117. *See id.*

118. *See id.*

119. *See id.*

120. *See* Pilot Adopting Release, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008, 48,024 (Aug. 6, 2004) (to be codified at 17 C.F.R. pts. 240–42).

121. *See* Order Suspending the Operation of Short Sale Price Provisions for Designated Securities and Time Periods, Exchange Act Release No. 50,104, 69 Fed. Reg. 48,032, 48,032 (Aug. 6, 2004) [hereinafter Pilot Order].

any Pilot.”<sup>122</sup> In particular, the separate order would allow the SEC to vary the duration of the Pilot accordingly.<sup>123</sup> Several commenters had expressed concerns about the proposed length of the experiment, including the NYSE and the NASDAQ.<sup>124</sup> In response, the SEC shortened the experiment’s proposed length from two years to one, explaining that a one-year study “will allow the Commission sufficient time to gather and analyze data necessary to reach conclusions regarding trading behavior in the absence of short sale price restrictions.”<sup>125</sup> However, the SEC was also quick to clarify that it could, “by further order, terminate, extend the period of, or modify the Pilot as it determines necessary or appropriate in the public interest or for the protection of investors.”<sup>126</sup> The Pilot was to begin on January 3, 2005, and terminate on December 31, 2005.<sup>127</sup>

In the adopting release, the SEC filled what many commenters had identified as a yawning gap in the proposing release—how the SEC would select the companies whose securities would be subject to the experimental rule. The selection formula was fairly straightforward. Beginning with the Russell 3000 index,<sup>128</sup> the SEC would omit companies that had only recently gone public and eliminate those companies whose stock was not subject to price tests because it was not traded on the NASDAQ, NYSE, or AMEX. The SEC would then sort the resulting companies into three groups, depending on which of the three major markets on which the stock traded. It then would sort the stock in each of those three categories from highest to lowest according to average daily dollar volume over the one year prior to the issuance of the adopting release. Finally, the SEC would select every third stock in each of those three groups to be included in the experimental group with respect to which price tests would be suspended. The remaining stocks would act as the control group.<sup>129</sup>

Although it clarified in the adopting release the method for selecting the stocks to include in the experimental group for the Pilot, the SEC provided less clarity with respect to the criteria that it would use for assessing the

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122. *See* Pilot Adopting Release, 69 Fed. Reg. at 48,013.

123. *See id.* at 48,024.

124. *See supra* notes 110–118 and accompanying text.

125. *See* Pilot Order, 69 Fed. Reg. at 48,033.

126. *Id.*

127. *Id.*

128. The SEC did not directly address why it decided to use the Russell 3000 index instead of the Russell 1000 index, as indicated in the proposing release, but it clearly must have decided that the experiment would benefit from a larger sample and that there was sufficient liquidity among Russell 3000 stocks to minimize potential risks involved in the Pilot.

129. *See* Pilot Order, Exchange Act Release No. 50,104, 69 Fed. Reg. 48,032, 48,032 (Aug. 6, 2004).

results of the experiment, which had been another prominent criticism of the SEC's original proposal. In the adopting release, the SEC explained that the experiment would allow it to "obtain empirical data to help assess whether short sale regulation should be removed, in part or in whole, for actively-traded securities, or if retained, should be applied to additional securities."<sup>130</sup> The experiment would also allow the SEC to "study trading behavior in the absence of a short sale price test on the stocks selected by comparing the trading behavior of the control group."<sup>131</sup>

The SEC ultimately modified the Pilot Order twice. Within a couple of months of issuing the original Pilot Order, the SEC issued a new order (the "Second Pilot Order"), resetting the Pilot to begin approximately four months later than initially planned.<sup>132</sup> It explained that the change was necessary "to make systems changes necessary to comply with the Pilot."<sup>133</sup> Then, on April 20, 2006, only eight days before the Pilot was to expire pursuant to the Second Pilot Order, the SEC issued another order extending the termination date of the Pilot by more than one year to August 6, 2007. The SEC explained that it still planned on evaluating the data that it had collected based on the termination date of April 28, 2006, that it had set under the Second Pilot Order. But the Agency explained that it wished to maintain the status quo with respect to price tests while it worked to complete its analysis and determine the direction to take from a policy perspective.<sup>134</sup>

The Pilot generated a significant amount of data to be analyzed. There were two main groups of experts upon whom the SEC relied to perform this analysis. The first was the SEC's own Office of Economic Analysis (OEA). This division, a precursor to the current Division of Economic and Risk Analysis, housed several trained economists.<sup>135</sup> As the SEC stated, the

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130. *See id.*

131. *See id.*

132. *See* Order Delaying Pilot Period for Suspension of the Operation of Short Sale Price Provisions, Exchange Act Release No. 50,747, 69 Fed. Reg. 70,480, 70,481 (Dec. 6, 2004) [hereinafter Delay Order].

133. *See* Order Extending Term of Short Sale Pilot, Exchange Act Release No. 53,684, 71 Fed. Reg. 24,765, 24,765 (Apr. 26, 2006) [hereinafter Extension Order]. The Pilot Order required brokers and dealers to mark short sale orders of securities that were part of the experimental group "short exempt" so they would not be subject to price tests. However, the broker-dealer community informed the SEC after the Pilot Order was issued that they would have to make systems changes in order to facilitate this requirement and that those systems changes would take longer than the time allotted to them under the Pilot Order. *See* Delay Order, 69 Fed. Reg. at 70,481.

134. *See* Extension Order, 71 Fed. Reg. at 24,765.

135. Since then, the OEA has merged with two other divisions to form the Division of Risk, Strategy, and Financial Innovation, whose mission is to bring interdisciplinary

OEA “gathered the data made public during the Pilot, analyzed this data and provided the Commission with a draft summary report on the Pilot.”<sup>136</sup> The second group of experts was the academic community more generally. A key feature of the SEC’s pilot was its transparency. The SEC wanted independent researchers to be able to analyze the data generated by the experiment and thereby contribute to the debate about the optimal approach for regulating short sales. To this end, the SEC established a process for sharing the Pilot data with the public at large. Specifically:

Nine [self-regulatory organizations (SROs)] began publicly releasing transactional short selling data on January 3, 2005. The nine SROs were the AMEX, ARCA, BSE, CHX, NASD, Nasdaq, National Stock Exchange, NYSE and Phlx. The SROs agreed to collect and make publicly available trading data on each executed short sale involving equity securities reported by the SRO to a securities information processor. The SROs published the information on a monthly basis on their Internet Web sites.<sup>137</sup>

The SEC then encouraged outside researchers to analyze this data. In response to this invitation, the SEC received three studies authored by a total of six different business school professors.<sup>138</sup> These four studies—the OEA report and the three academic studies—all shared the same goal: to research how short sale price restrictions affect market quality. To this end, the studies considered four aspects of market quality: short selling activity, liquidity, volatility, and efficiency.<sup>139</sup>

As a theoretical matter, short sale price restrictions could affect the market along any or all of these dimensions. Most obviously, price restrictions might be expected to limit short selling activity since, by definition, they prevent certain short sellers from selling at their desired price, even if there is a ready and willing buyer on the other side of the trade. Consequently, trades that would occur in the absence of price restrictions might not occur when subjected to such restrictions. Price restrictions, in that case, would reduce short selling activity. But even if short selling activity is unaffected, price restrictions might nevertheless affect how quickly trades are executed. In other words, price restrictions might constrain liquidity in the market. Price restrictions might also reduce

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expertise to bear on complex risk and financial innovation questions. See Mary L. Schapiro, Chairman, SEC, Address at SEC Speaks, Looking Ahead and Moving Forward (Feb. 5, 2010), available at <http://www.sec.gov/news/speech/2010/spch020510mls.htm>.

136. See Amendments to Regulation SHO and Rule 10a-1, Exchange Act Release No. 54,891, 71 Fed. Reg. 75,068, 75,069 (Dec. 13, 2006) (to be codified at 17 C.F.R. pts. 240, 242) [hereinafter Price Test Removal Proposal].

137. *Id.* at 75,069 n.11.

138. See *id.* at 75,069 & n.12 (listing the academic papers received).

139. See *id.* at 75,068–69.

market efficiency more generally by reducing the speed at which prices adjust to available information. By prohibiting short sellers from selling at the market price in a declining market, price restrictions reduce the speed at which prices adjust to market news, particularly when that news is bad. And finally, by reducing the amount of knowledge the market possesses at any point in time, price restrictions might increase the market's reaction when the news finally does become public and increase volatility.

The reports conducted by the OEA and outside academics all examined the effect of price restrictions on these various market characteristics. Their findings were a little surprising—they found that price restrictions led<sup>140</sup> to a small reduction in short selling activity<sup>141</sup> and, surprisingly, dampened volatility,<sup>142</sup> but had no effect on efficiency and an indeterminate but possibly positive effect on liquidity.<sup>143</sup> The OEA and some of the academics also considered whether any of these effects were more or less pronounced depending on the significance of the stock in question, as measured by trading volume. The only difference in the analysis when the data was segmented according to size was with respect to volatility. It appeared that price restrictions led to an increase in the volatility of large stocks but, unexpectedly, to a decrease in the volatility of small stocks. For this reason, the SEC acknowledged that one concern with removing price restrictions is the potential harm that it might cause to smaller stocks.<sup>144</sup>

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140. In reality, the OEA report and the academic studies were careful to avoid language suggesting causation. However, the SEC was not as careful. I use similarly non-careful language here.

141. In particular, the studies found a negative correlation between price tests and the volume of short sales; however, this finding was not economically significant. In the absence of price tests, there is more short selling, but the average horizon over which short positions are held decreases. OEA Report, *supra* note 16, at 36. So, the bottom line is that “price restrictions do constrain short selling somewhat.” *Id.* at 45.

142. See Price Test Removal Proposal, Exchange Act Release No. 54,891, 71 Fed. Reg. 75,068, 75,073 (Dec. 13, 2006) (to be codified at 17 C.F.R. pts. 240, 242) (reporting the OEA's findings of no “significant impact” on daily volatility but some dampening of intraday volatility).

143. See *id.* (noting that with respect to certain measures of liquidity like bid-ask depth, price restrictions appeared to have some effect, whereas there was no observed effect with respect to other measures of liquidity like bid-ask spread). The OEA concluded that there was no effect on liquidity, but it is probably fairer to say that the effect is indeterminate. At least one of the academic studies showed a positive correlation between price tests and liquidity. One possible reason for the liquidity result is that in the absence of price restrictions, short sellers are essentially liquidity demanders because they are trying to sell their stock. But with the price restrictions, they are a bit more like liquidity suppliers, like market makers, even though they are still selling stock, because they do not have as much choice in the price at which they can sell. Since price restrictions then add more liquidity suppliers to the market, liquidity might increase in the presence of price restrictions.)

144. *Id.*

The SEC then convened a public roundtable to discuss these findings.<sup>145</sup> The roundtable panelists were all economists,<sup>146</sup> and every panelist was in favor of eliminating price restrictions for short sales. Interestingly, these economists acknowledged that the studies of the Pilot data suggested some marginal benefits to market quality as a result of price restrictions, particularly with respect to liquidity.<sup>147</sup> However, the general sense was that this reason was not sufficient to justify regulation. Richard Lindsay, a former Yale economist and industry insider, seemed to capture the mood when he opined, “Substantial benefits are needed to justify a regulation. . . . All I’ve been hearing today is [about] . . . marginal benefits here and there, kind of, maybe significant. . . . If it’s not, sort of, screaming at you from the data, then you shouldn’t bother.”<sup>148</sup>

The panel also touched on one of the original justifications for price restrictions—bear raids. The question was framed as whether removing the Uptick Rule might have greater effects during periods of significant market volatility. The general response from roundtable panelists was that it would not.<sup>149</sup> There was no empirical evidence to support that prediction for the simple reason that the Pilot did not cover a period of significant market volatility. One panelist pointed out that “bear raids are very uncommon” but without acknowledging the possibility that the infrequency of this type of market manipulation might be due to the very rule the panelists were arguing should be eliminated.<sup>150</sup> This possibility seems more likely given that the same panelist acknowledged a much more serious problem to be the “pump and dump,” which is effectively the mirror image of the bear raid.<sup>151</sup> It is market manipulation that, unlike bear raids, seeks to inflate rather than deflate a stock’s price. Unlike bear raids, pump and dump is not subject to a rule intended to prevent its occurrence.<sup>152</sup>

Following the public roundtable, the SEC issued a proposal to eliminate short sale price tests altogether.<sup>153</sup> The SEC’s stated reasons were

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145. *Id.* at 75,074.

146. *Id.* The roundtable involved the presentation of three papers, one of which considered the effect that price tests had on market quality when the tests were originally adopted in 1938 and two of which analyzed the data generated by the Pilot. Each of these papers was in turn critiqued by another economist.

147. *See* Reg. SHO Pilot Transcript, *supra* note 17, at 6.

148. *Id.* at 114–15.

149. *See id.* at 66.

150. *Id.* at 96.

151. *Id.*

152. *See id.* (indicating that the price is pushed up by the manipulator).

153. Price Test Removal Proposal, Exchange Act Release No. 54,891, 71 Fed. Reg. 75,068, 75,075 (Dec. 13, 2006) (to be codified at 17 C.F.R. pts. 240, 242) (explaining that no price test of any SRO should apply to short sales).

influenced by the roundtable discussion. The first reason was that there is no uniformity in the application of price tests in different markets.<sup>154</sup> The SEC acknowledged that this reason alone did not necessarily weigh in favor of eliminating price tests entirely. One could achieve uniformity through a uniform price test as well, but the SEC explained that “based on our review of the applicability of current price test restrictions, in particular, the need for such price test restrictions in light of today’s market structure and the Pilot Results, we do not believe that any price test restrictions are currently necessary.”<sup>155</sup> The SEC then explained that it interpreted the results of the Pilot to suggest that “removal of current price test restrictions would not have a significant impact on market quality.”<sup>156</sup> In other words, the SEC argued that the costs of removing price tests would be relatively minimal.

The fact that a given action’s costs are minimal does not necessarily mean that the action should be undertaken. In other words, the SEC still needed to make a case for the benefits of removing price restrictions. The SEC took two stabs at this goal, neither of which is entirely satisfactory. First, the SEC observed that one of the primary reasons for adopting short sale price tests was to prevent bear raids, and that the absence of bear raids during the Pilot was evidence that the reason was less salient in the modern day.<sup>157</sup> This argument is highly problematic, and the SEC was undoubtedly aware of this, given the passing way in which it made the observation. Second, the SEC said the following:

We believe that the high levels of transparency and sophisticated surveillance for securities traded on exchanges and other regulated markets would allow manipulative or abusive short selling activity to be detected and pursued in the absence of price test restrictions. Moreover, the general anti-fraud and anti-manipulation provisions of the federal securities laws would continue to prohibit trading activity designed to improperly influence the price of a security.<sup>158</sup>

In some ways, however, this is not a wholly convincing argument either, as some of the roundtable participants pointed out when they identified the continuing problems with “pump and dump” type market manipulation. So, despite these better systems, pump and dump is still a problem. If these improved systems have not addressed the problem of pump and dump, why should we think they will address the problem of bear raids? Nevertheless, the SEC adopted the proposed rule in July 2007, effectively eliminating the

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154. *See id.* at 75,068, 75,075 (noting the current disparate state of the regulation).

155. *Id.* at 75,075 & n.89 (explaining that the results of the Pilot suggest that “removal of current price test restrictions would not have a significant impact on market quality.”).

156. *Id.* at 75,075.

157. *See id.* (observing that there was no evidence of any manipulative short selling).

158. *See id.*



Uptick Rule and prohibiting exchanges from adopting their own short selling price restrictions.<sup>159</sup>

The reaction to the SEC's proposal to eliminate price tests altogether had been relatively muted.<sup>160</sup> The most surprising reaction, however, was from the NYSE, which supported eliminating the Uptick Rule.<sup>161</sup> Even more surprising, the NYSE also reversed course in its opposition to a rule that would prohibit SROs from creating their own price tests.<sup>162</sup> This was the opposite position the NYSE had taken when the SEC originally proposed the Pilot. The Pilot therefore seems to have had a dramatic influence at least on the NYSE.

### III. ANALYSIS AND IMPLICATIONS

How might we summarize the experience with the SEC's experimental approach to short sale deregulation? Overall, it seems that the experiment was a success. It generated valuable empirical data that would not have been available otherwise, and this data allowed the SEC to take a more principled approach to evaluating the desirability of short sale price restrictions. The Pilot caused a powerful interest group—the NYSE—to rethink a position that it had taken consistently for over twenty-five years, which makes it difficult to argue that the Pilot was anything but consequential.

Nevertheless, the Pilot was far from perfect. In particular, it failed to test the central purpose behind short sale price restrictions—to deter bear raids. But it did a good job shedding light on the magnitude of the costs associated with price restrictions. In addition, although it did not test the effect of price tests on bear raids, it did uncover other potential benefits of price tests, including that they may increase liquidity in the market. This allowed the SEC to test its assumptions in carrying out the cost-benefit analysis with respect to price tests and caused the SEC to conclude that the evidence weighed in favor of deregulation.

In some ways, the Pilot's success is surprising. Commentators and scholars have identified several substantive challenges to designing and

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159. See Regulation SHO and Rule 10a-1, Exchange Act No. 55,970, 72 Fed. Reg. 36,348, 36,348 (July 3, 2007) (to be codified at 17 C.F.R. pt. 240, 242) (intending to create a more consistent regulatory environment).

160. See *id.* at 36,350 (noting that although the comments “varied . . . [m]ost commenters, including (individual traders, academics, brokers-dealers, MFA, STA, NYSE, and SIFMA) advocated removing all price test restrictions.”).

161. See 2007 NYSE Comment Letter, *supra* note 20 (writing that it was pleased to respond to a request for comments).

162. See *id.*

implementing legislative or regulatory experiments.<sup>163</sup> More surprising, however, is the fact that the Pilot occurred in the first place because there are arguably even greater procedural challenges that are thought to prevent such experiments from taking place at all.<sup>164</sup> This Part considers how the SEC was able to overcome these substantive and procedural challenges in order to identify how we might increase the frequency and quality of such experimental rules in the future. It concludes that while most of these obstacles are capable of being overcome, certain obstacles pose particularly thorny problems. The procedural challenges—and specifically, the challenge of interest group opposition to experimental rules—deserve particular attention. The SEC has sidestepped these procedural challenges in the case of the SHO Pilot because of an almost serendipitous convergence of events that is unlikely to materialize in the future. This Part concludes that policy changes may be in order to reduce these procedural challenges to policy experimentation.

### A. Analysis

#### 1. Overcoming the Substantive Challenges to Experimental Rules

There are several challenges to designing an experiment for purposes of testing the desirability of a legal rule. The SHO Pilot case study illustrates how agencies might overcome or manage these challenges.

##### a. Nonrepresentative Behavior

Several commentators have pointed out that one problem with a legislative or regulatory experiment is that subjects may behave differently during the course of the experiment than they would normally because of the experiment's temporary nature.<sup>165</sup> If the behavior of subjects during the experiment is not representative of how people will behave under a more permanent version of the law, then the results of the experiment will not be particularly relevant in assessing the desirability of the more permanent law. In other words, the nonrepresentative behavior problem may bias the results of an experimental rule. For example, if a tax cut were temporary, everyone might race to take advantage of that benefit before it

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163. See Gerscn, *supra* note 21, at 277–78 (noting the problem of responding to temporary legislation); Kysar, *supra* note 21, at 1045–46 (describing over- and underproduction problems); Abramowicz et al., *supra* note 21, at 948–61 (pointing out the benefits of randomized studies over nonrandomized ones).

164. See Gubler, *supra* note 10, at 154–62.

165. See Gubler, *supra* note 10, at 148–49; Gerscn, *supra* note 21, at 277–78; Kysar, *supra* note 21, at 1045; Abramowicz et al., *supra* note 21, at 954–57.

goes away.<sup>166</sup> Depending on the type of tax cut, taxpayers might accelerate the sale of capital assets to benefit from temporary capital gains taxes, or they might accelerate *inter vivos* gifts to take advantage of a temporary increase in the estate tax exemption. Regardless, the resulting data in that case would be skewed as a result of the over-responsiveness of the rule's beneficiaries. Regulated entities might also under-respond to temporary rules embodied in experiments. For example, some argue that if an environmental regulation that required significant compliance costs were temporary, then regulated entities might forego incurring those costs if they believe that the regulation will not be made permanent, and therefore they might be able to escape penalties for non-compliance.<sup>167</sup>

Although the nonrepresentative behavior problem poses a legitimate challenge to the success of experimental rules, it is not, as some commentators seem to suggest,<sup>168</sup> an intractable one. Rather, it is a problem that regulators in charge of designing regulatory experiments simply must manage. Certain experiments are going to be more susceptible to this form of bias than others. For example, an experiment, like a tax cut, that confers a benefit on industry actors will cause over-responsiveness on the part of these actors only if the relevant conduct can be accelerated to take advantage of the benefit. While this might be true of a tax cut, it will not be true of all experiments that confer potentially temporary benefits.<sup>169</sup>

In some cases, an experiment might pose nonrepresentative behavior problems with respect to certain types of inferences that the agency might draw but not for others. This was actually the case with the SHO Pilot. The experiment itself increased the likelihood, and therefore the expected cost, of being caught for engaging in a bear raid during the course of the experiment. It did so simply because of the increased regulatory attention that was focused on short selling during the experimental period. For this reason, the experiment was unlikely to generate unbiased results regarding the effect of price tests (or rather the absence of price tests) on the incidence of bear raids. Consequently, the SEC fundamentally erred in relying on the absence of bear raids during the experiment as a reason for eliminating price tests.<sup>170</sup>

With that said, however, the other inferences that the SEC drew from the SHO Pilot were likely unaffected by the nonrepresentative behavior problem. In particular, the SEC drew inferences about the effect of short

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166. See, e.g., Kysar, *supra* note 21, at 1045.

167. *Id.*

168. See *id.* at 1045–46.

169. See Gubler, *supra* note 10, at 148–49.

170. See *supra* notes 149–152 and accompanying text.

sale deregulation on various measures of market quality, including trading activity, volatility, liquidity, and efficiency.<sup>171</sup> It seems unlikely that the temporary nature of the experiment would alter trading behavior in a way that would undermine these inferences. This is because, unlike tax planners, traders operate on a much tighter timeframe and do not have the luxury of accelerating a trade that they otherwise would have made three years from today in order to reap the benefits of the relaxed short sale rules. For this reason, the inferences the SEC drew about the experiment's effect on market quality were probably unaffected by this concern over the effect of the experiment's temporary nature on subject behavior.

The point is that certain types of experiments will present a nonrepresentative behavior problem, and others will not. Still others, like Regulation SHO (Reg. SHO), will present the problem but only with respect to certain types of inferences that may be drawn from the experimental results. As long as an agency is aware of these limitations of the experiment, they should be able to manage this problem. While the SEC did a fairly good job of managing this problem in the SHO Pilot, it could certainly have done better.

*b. Nonrepresentative Population*

Another problem that besets regulatory experiments, like the SHO Pilot, has to do with the possibility that the experimental subject group is nonrepresentative of the population as a whole.<sup>172</sup> If the experimental context differs in some relevant way from the context in which the policy would be implemented on a permanent basis, then any inferences drawn from the experiment would be biased. For example, an experiment testing the effect of increasing speed limits on accident rates in one state with newer, wider highways, less traffic, and drier weather might have very little relevance in analyzing the effect of increasing speed limits in a neighboring state with older, narrower, more congested highways with wetter weather.

The SEC actually did a fairly good job in the SHO Pilot of controlling for such non-representative sample issues, but this was almost not the case. In its original proposal for the SHO Pilot, the SEC had proposed running the experiment using the Russell 1000 index,<sup>173</sup> which is limited to

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171. See *supra* notes 140–143 and accompanying text.

172. See Abramowicz et al., *supra* note 21, at 954–57.

173. See SHO Pilot Proposal, Exchange Act Release No. 48,709, 68 Fed. Reg. 62,972, 62,983 (Nov. 6, 2003) (to be codified at 17 C.F.R. pts. 240, 242). The smallest firm in the Russell 3000 index has a market cap of \$169 million whereas the smallest firm in the Russell 1000 index has a market cap of \$2.2 billion. See Russell Investments, *Russell U.S. Indexes* (Jan. 2015), <http://www.russell.com/documents/indexes/us-index-comparison.pdf>.

relatively larger firms. However, the stated purpose of the experiment was to gather data about the effect of price restrictions on measures of market quality, including measures like liquidity, volatility, and efficiency.<sup>174</sup> And yet, it seems reasonable to assume that price restrictions might affect firms differently along these dimensions, depending on the size of the firm. For this reason, it was much preferable to run the experiment with a larger variety of firms, like the Russell 3000, which the SEC ultimately did in their adopting release.<sup>175</sup>

*c. Data Mining*

A truly scientific approach to policy experimentation would require the agency on an ex ante basis to identify the theory, specify the model for testing that hypothesis, and then carry out the test.<sup>176</sup> Depending on the results of the test, the agency would then either reject or fail to reject the theoretically-driven hypothesis being tested. In other words, a strictly scientific approach to experimentation eschews “data mining,” that is to say, the “practice of examining the data after they have been collected for statistically significant differences in outcomes that were not prespecified in the hope of finding statistical significance somewhere.”<sup>177</sup>

However, agencies may be reluctant to pre-specify theoretically-driven hypotheses for fear of tying their hands with respect to policy decisions. This may account for why the SEC was not more transparent in pre-specifying its hypotheses in the SHO Pilot. After all, the problem was not the lack of a theory to test. Indeed, for more than thirty years prior to the SHO Pilot, economists had been working on modeling Professor Miller’s original conjecture that short selling is necessary for efficient markets.<sup>178</sup> Thus, the SEC might have announced that the SHO Pilot was designed to test that theory. In that case, the hypothesis to be tested might have been that the experimental and control groups would show no difference with respect to certain measures of market quality (which might be thought to relate to market efficiency). If the results had allowed the SEC to reject that

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174. See SHO Pilot Proposal, 68 Fed. Reg. at 62,983.

175. See Pilot Order, Exchange Act Release No. 50,104, 69 Fed. Reg. 48,032, 48,032 (Aug. 6, 2004).

176. See Richard Lempert, *The Inevitability of Theory*, 98 CALIF. L. REV. 877, 887–89 (2010) (“The distinction between theory as a priori expectation and theory as post hoc explanation matters. When a theory and hypotheses drawn from it are specified prior to research and analysis, explanations in terms of the theory are more credible than when the results of a completed analysis are given a theoretical interpretation.”).

177. See D. James Greiner et al., *The Limits of Unbundled Legal Assistance: A Randomized Study in a Massachusetts District Court and Prospects for the Future*, 126 HARV. L. REV. 901, 984 (2013).

178. See *supra* notes 82–88 and accompanying text.

hypothesis, then that would have lent support to the economists' view that short selling matters for market efficiency. If on the other hand, the results had shown no difference along these dimensions between the two groups of companies, then the SEC would have had to fail to reject that hypothesis. In that case, the economists' view might still have been correct but the SHO Pilot would not have provided any evidence to that effect.

And yet, the SEC was never specific about what theory it was testing. The reason might have been political. If the SEC had specifically identified the theoretically-driven hypothesis above and if the results had caused them to fail to reject that hypothesis, the SEC would have had difficulty at that point doing anything other than maintaining the status quo. The reasoning would have been as follows: "The economists have theorized that short sale price restrictions affect market efficiency, but our pilot does not show any evidence to support that theory. Therefore, that is not a reason to eliminate the uptick rule." In other words, the SEC would have effectively tied its hands by pre-specifying the hypothesis that it was testing.

Instead, the SEC preserved policymaking flexibility by not pre-specifying a theoretically-driven hypothesis. The results of the SHO Pilot did in fact show little or no difference between the experimental and control groups as to market quality factors.<sup>179</sup> And yet, instead of viewing this as evidence against eliminating the Uptick Rule, which would likely have been the case if the SEC had pre-specified the theoretically driven hypothesis above, the SEC instead viewed it as evidence in favor of eliminating the Uptick Rule.<sup>180</sup> The reasoning was as follows:

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179. See *supra* notes 140–143 and accompanying text (noting that the studies found no difference between the two groups as to efficiency or liquidity and only small differences with respect to short selling activity and volatility).

180. See Price Test Removal Proposal, Exchange Act No. 54,891, 71 Fed. Reg. 75,068, 75,075 (Dec. 13, 2006) (to be codified at 17 C.F.R. pts. 240 and 242) ("Based on the Pilot Results, we believe that removal of current price test restrictions would not have a significant impact on market quality. The Pilot Results found little evidence suggesting that the removal of the price test restrictions would harm market volatility, price efficiency, or liquidity.").

We think as a theoretical matter that short sale price restrictions might limit market efficiency, even though we do not have any empirical evidence to that effect. We do however have empirical evidence suggesting that the elimination of price restrictions imposes few if any costs on market quality. In the absence of any obvious benefits of price restrictions, we should eliminate the uptick rule.<sup>181</sup>

Other agencies undertaking regulatory experiments like the SHO Pilot are likely to be similarly motivated to avoid pre-specifying theoretically-driven hypotheses in an effort to preserve policymaking flexibility. In other cases, they may not even have a theory to test. In either case, the concern is that such post-hoc specification and theorizing could lead to data mining, or, in other words, claims that the experiment was “rigged” to reach a particular result.

One approach would be to simply create rules that would hold agency experimentation to the standard of the hard sciences, but this might be easier said than done. And because of the political reasons suggested above, such rules might only result in agencies opting to engage in no experimentation at all.<sup>182</sup> And yet those agencies would still be expected to discharge their lawmaking obligations. If this is the case, we must ask whether it is preferable to have agencies make policy determinations in a data vacuum (because the pre-specified model fails to generate statistically significant data or because the agency decides to forego experimentation altogether) or with data that might be the result of data mining. The answer is probably to allow for a less rigorous approach to experimentation in favor of facilitating the use of data in policy decisions. And indeed, the literature on policy experimentation tends to adopt a more flexible definition of experimentation that would allow for such a result.<sup>183</sup> While it

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181. I have paraphrased the SEC's implicit logic for the purpose of discussion in this Article. See generally Price Test Removal Adopting Release, Exchange Act Release No. 55,970, 72 Fed. Reg. 36,348, 36,349–50, 36,355 (July 3, 2007) (to be codified at 17 C.F.R. pts. 240, 242) (restating the SEC's implicit logic in the adopting release).

182. *But cf.* Wendy E. Wagner, *Congress, Science, and Environmental Policy*, 1999 U. ILL. L. REV. 181, 181, 183–84, 186–88, 283–86 (1999) (arguing that an over-reliance on the scientific method in the environmental context may lead to results that are socially undesirable).

183. See, e.g., Jeroen van der Heijden, *Experimental Policy-Design: What “Works”?* *Lessons from the Australian and Dutch Building Sectors* 3–4 (Regulatory Insts. Network, Working Paper No. 2014/26, 2014), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2395703](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2395703) (explaining that experimentalism should “not be understood in the more ‘traditional’ scientific sense of the word—i.e., the following of a widely agreed upon procedure to understand what outcomes occur if a particular factor is manipulated, whilst aiming at repeatability of the experiment. Experimentation in policy-design as discussed in the literature is often a highly localised process of testing, piloting, or demonstrating of a particular policy-design seeking to learn

is certainly preferable to pre-specify theories in advance, empirical work can still be valuable without it.<sup>184</sup>

For example, even without a theory to test, it nevertheless would be useful to know whether there are important effects on market quality factors when short sale price tests are in place. That's effectively what the SHO Pilot did. In these cases of post-hoc model specification and theorizing, however, researchers need to be particularly careful not to be driven by biases.<sup>185</sup>

## 2. *Overcoming Procedural Hurdles to Experimental Rules*

Experimental rules present not only substantive challenges but procedural ones as well. Two of the most significant procedural challenges are the APA's standard of review of agency rules and interest group opposition to experimentation more generally.

### a. *The APA*

The APA establishes procedural rules that agencies must follow in carrying out their various regulatory goals. With respect to formal rulemakings, like the SHO Pilot, the APA requires the agency to undergo a notice-and-comment process, meaning that the agency must (i) notify the public of the proposed rule; (ii) solicit public comments; and (iii) issue a final rule containing "a concise general statement of [the rule's] basis and purpose."<sup>186</sup>

This process is extraordinarily costly, in part because of the need on the part of the agency to build up the type of record (embodied in the "concise general statement") that is likely to survive "hard look" review.<sup>187</sup> Typically, such a record includes "detailed statements of the rule's purposes, factual predicates, and anticipated effects, as well as responses to major criticisms and alternatives elicited during the notice-and-comment process."<sup>188</sup> This can be a painstaking process to say the least. Notice-and-

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about its potential in overcoming particular public problems").

184. *See, e.g.*, Lempert, *supra* note 176, at 888–89 (discussing a well-known study that the author conducted, which examined the effects of affirmative action at Michigan Law School, observing that the study was "not concerned with testing theory," but rather that the authors simply "wanted to know whether Michigan's minority students had successful post-law-school careers and how their career success compared to that of Michigan's white alumni").

185. *See id.* at 888.

186. 5 U.S.C. § 553(b)–(c) (2000).

187. *Id.*

188. Evan J. Criddle, *Fiduciary Foundations of Administrative Law*, 54 UCLA L. REV. 117, 152 (2006).



comment procedures could pose a challenge to experimental rules for two reasons.

First, as discussed previously, there are reasons why one might wish to hold agencies to a more lax definition of experimentation than the one provided by the hard sciences.<sup>189</sup> Indeed, the literature on policy experimentation generally adopts a definition of experimentation that would allow agencies to engage in data mining, or, in other words, the making of decisions about statistical testing after the data has been generated.<sup>190</sup> And yet, this more lax definition of experimentation in the lawmaking context may not be compatible with the APA's notice-and-comment procedures, which require agencies to be very specific about proposed rules, including experimental ones, so that the public has a meaningful opportunity to participate in the rulemaking process.<sup>191</sup>

The second reason that notice-and-comment procedures could pose a particular challenge to experimental rules has to do with the costs of those procedures. Notice-and-comment procedures are costly, largely because "hard look" review requires agencies to not only justify the reasonableness of the procedural aspects of the rule but also the substance as well.<sup>192</sup> Consequently, adopting releases are typically extremely lengthy advocacy briefs that address not only the agency's position but why the agency rejected alternative positions and arguments. As illustrated by the SHO Pilot, an agency-sponsored experiment, because of its multi-stage nature,<sup>193</sup> will have to go through two notice-and-comment rulemakings before the policy in question can become permanent. And the costs associated with such an exercise may make experimental rules nearly prohibitive. As commentators have pointed out, the modern requirements of notice-and-comment rulemaking, particularly as a result of "hard look" review, undoubtedly have had systemic effects on agencies, causing them to forego

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189. See *supra* notes 176–185 and accompanying text.

190. See *supra* note 184, at 888–89 and accompanying text.

191. See, e.g., *SEC v. Chenery Corp.*, 332 U.S. 194, 196–97 (1947) (declaring that the basis upon which an administrative action rests "must be set forth with such clarity as to be understandable" and that "[i]t will not do for a court to be compelled to guess at the theory underlying the agency's action; nor can a court be expected to chisel that which must be precise from what the agency has left vague and indecisive").

192. See, e.g., Mark Seidenfeld, *Demystifying Deossification: Rethinking Recent Proposals to Modify Judicial Review of Notice and Comment Rulemaking*, 75 *TEX. L. REV.* 483, 498–99 (1997); Sidney A. Shapiro, *Substantive Reform, Judicial Review, and Agency Resources: OSHA as a Case Study*, 49 *ADMIN. L. REV.* 645, 652 (1997); Jodi L. Short, *The Political Turn in American Administrative Law: Power, Rationality, and Reasons*, 61 *DUKE L.J.* 1811, 1858 (2012); Sunstein & Vermeule, *supra* note 64, at 932.

193. See *supra* notes 45, 50–52 and accompanying text.

notice-and-comment rulemaking for other types of policymaking.<sup>194</sup> These effects are likely to be even greater with respect to experimental rules.

To what extent did these APA challenges affect the SHO Pilot? At the very least, these challenges did not prevent the Pilot from going forward, since the Pilot was not even challenged in court, let alone vacated by judicial action. But that does not mean that these potential challenges had no effect on the Pilot, nor does it mean that these challenges will not become even more salient in the future. Indeed, the Pilot actually provides a useful illustration of these APA challenges. This is because in the Pilot, the SEC never answered many of the most important experimental design questions associated with adopting this type of experimental rule.<sup>195</sup> With respect to some of these questions, the SEC retained the discretion to change its answer later on down the road. For example, the SEC never identified what hypothesis it was testing, nor did it identify what criteria it would use to determine how to assess the experiment, a lapse that attracted criticism from various quarters.<sup>196</sup> And while the SEC did identify the duration of the experiment, it created a mechanism through which it could alter that duration with little effort.<sup>197</sup>

It is not clear why the SEC left these questions unanswered. It might have been unsure about the right answers and therefore wanted to retain discretion to alter the experiment along any or all of these dimensions down the road. In fact, the SEC said as much in explaining why it was retaining the discretion to alter the experiment's duration.<sup>198</sup> If this is the case, then the first type of APA challenge discussed above—stemming from the lack of pre-specification inherent in experimental policymaking—might be evident in the SHO Pilot.

Alternatively, the SEC's open-ended approach to these experimental design questions might reflect an attempt to overcome the second type of APA challenge discussed above, stemming from the costs of notice-and-comment rulemaking, particularly with respect to experimental rules.<sup>199</sup>

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194. See, e.g., Sunstein & Vermeule, *supra* note 64, at 932 ("It is now well-documented that such review has contributed to the 'ossification' of notice-and-comment rulemaking, which now takes years, in part as a result of the effort to fend off judicial challenges. In light of the risk of invalidation, many agencies have turned away from notice-and-comment rulemaking altogether—with the National Highway Traffic Safety Administration (NHTSA), for example, attempting to promote automobile safety through ex post recalls, which is generally regarded as a senseless way to proceed.") (internal quotation marks omitted).

195. See *supra* notes 125–127 and accompanying text.

196. See *id.*

197. See *id.*

198. *Id.*

199. See *supra* notes 191–194 and accompanying text.

To be sure, the SEC undertook notice-and-comment rulemaking with respect to Reg. SHO more generally. But the small portion of Reg. SHO devoted to the SHO Pilot seems to fall stunningly short of the notice-and-comment requirements. Indeed, the description of the Pilot in the SEC's proposing release contains so little detail that it is a wonder that commenters had anything to comment about.<sup>200</sup> Indeed, most of the comments on Reg. SHO were not focused on the SHO Pilot but on what seemed to be the more significant proposal to adopt a new type of price test. It is possible, although admittedly speculative, that the SEC took this approach because of the costs of notice-and-comment rulemaking, especially for experimental rules. In other words, perhaps the SEC decided to leave the description of the experimental design of the Pilot open-ended so as to avoid the costs of addressing public comments. In taking this approach, perhaps the SEC was wagering that the public would pay more attention to what at the time was certainly regarded as the more important aspects of the proposed regulation.

Thus, it is possible that the SEC took this open-ended approach in identifying the SHO Pilot's experimental design either because of the lack of pre-specification inherent in regulatory experimentation itself or in an effort to reduce some of the costs of the notice-and-comment process. If this is true, then in taking this approach, the SEC was running a significant risk of being successfully challenged in court. Of course, in retrospect, that wager paid off. However, there's no guarantee that it will pay off in the future, especially because of the D.C. Circuit's apparently increasingly willingness to apply greater scrutiny to SEC final rules.<sup>201</sup>

The fact that the SHO Pilot was likely overshadowed by the other features of Reg. SHO undoubtedly goes some distance in explaining why the SHO Pilot was never challenged in court, thereby allowing the SEC to avoid the challenges that the APA poses to experimental rules.<sup>202</sup> But this also likely helped the SEC overcome what is possibly an even greater obstacle to experimentation—interest group opposition.

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200. See *supra* notes 107–108 and accompanying text.

201. See, e.g., Cox & Baucom, *supra* note 8, at 1812–13; Jill E. Fisch, *The Long Road Back: Business Roundtable and the Future of SEC Rulemaking*, 36 SEATTLE U. L. REV. 695, 695–96, 729–30 (2013); Kraus & Raso, *supra* note 11, at 290–91.

202. To be sure, once the SEC adopted its final release of Regulation SHO (Reg. SHO) and revealed to the world that it was basically forfeiting all of the aspects of Reg. SHO proposed in the release except for the Pilot, commenters might have challenged the rule at that point for being arbitrary and capricious. However, very few commenters had even addressed the SHO Pilot during the notice-and-comment phase. Potential plaintiffs might have been uncertain about how a court would view a challenge to a rule after the fact when there had been so little public interest in the rule during the notice-and-comment process.

*b. Interest Groups*

Public choice theory predicts that small, organized groups will have a greater influence over legislation than larger, more diffuse groups.<sup>203</sup> For this reason, in order to understand why laws look the way they do, or to predict how laws might look in the future, it is necessary to consider the role of interest groups in the lawmaking process. From this perspective, interest groups may very well disfavor experimental rules. To see this, consider a given policy, X, and an interest group that has the political clout to compel an agency to adopt X. If the interest group prefers to maximize the duration of X, it will prefer to adopt X through a permanent rule than through an experimental rule. The reason has to do with judicial review. Under the experimental alternative, the policy would have to survive two rounds of judicial review, once when the policy is originally adopted on a temporary basis to facilitate the experiment and once again when the policy is adopted on a permanent basis following the experiment. By contrast, under the permanent rule alternative, the policy would only be subject to judicial review once when it is originally adopted.<sup>204</sup> Moreover, with respect to the experimental rule, the policy would have to survive a second round of judicial review that follows on the heels of an experiment, the results of which may very well decrease the odds of surviving that second round of judicial review.<sup>205</sup>

For these reasons, even an interest group that favors a given policy might nevertheless disfavor an experimental approach to lawmaking because of

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203. See generally Peter H. Aranson, *Theories of Economic Regulation: From Clarity to Confusion*, 6 J.L. & POL. 247 (1990); Guy Halfteck, *Legislative Threats*, 61 STAN. L. REV. 629 (2008); Michael E. Levine, *Why Weren't the Airlines Reregulated?*, 23 YALE J. ON REG. 269 (2006); Michael E. Levine & Jennifer L. Forrecc, *Regulatory Capture, Public Interest, and the Public Agenda: Toward a Synthesis*, 6 J.L. ECON. & ORG. 167 (1990); Fred S. McChesney, *Rent Extraction and Rent Creation in the Economic Theory of Regulation*, 16 J. LEGAL STUD. 101 (1987) (explaining the fundamentals of public choice theory and expanding the theory to accommodate agency inaction); Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON. 211 (1976); Richard A. Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. & MGMT. SCI. 335 (1974); George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971).

204. See Gubler, *supra* note 10, at 154–62 (providing a more detailed explanation of this interest group analysis).

205. Of course, there are going to be situations when there is no dominant group (or groups) favoring or disfavoring a particular policy, and in those situations perhaps an experimental approach could be viewed as a form of Coasean bargaining. This may be less common than one might think, especially if one takes into account that an experimental approach may be opposed not only by those who favor the policy but prefer the permanent, non-experimental adoption of the policy, but also those groups who are opposed or indifferent to the policy but nevertheless oppose the experimental approach because of the costs that the experiment itself will impose on them.

the implications of judicial review. But what if the agency is more public-spirited and thinks that the experiment is the right thing to do regardless of interest group influence? Even in that case, judicial review may deter the agency from taking on the experiment because interest groups opposed to the experiment may challenge the agency's rule under hard look review.

Reg. SHO illustrates both how interest groups can pose a challenge to experimental rules and how experimental rules can affect interest group influence. The NYSE was the 500-pound gorilla both times the SEC tried to adopt an experimental rule for testing the continued relevance of price tests. The NYSE basically scuttled the attempts in the 1970s,<sup>206</sup> and they were opposed to the SHO Pilot as well.<sup>207</sup> But their opposition to the SHO Pilot did not ultimately prevent the SEC from adopting the Pilot. There are probably two reasons for this. The first is the increasing consensus among economists that a price test's interference with market efficiency causes more harm than good.<sup>208</sup> This increasing pressure likely caused the SEC to want "to do the right thing" rather than follow the lead of interest groups like the NYSE.

The second possible explanation for why the SHO Pilot was different has to do with the fact that interest groups were undoubtedly more focused on other aspects of Reg. SHO than the proposed Pilot. When the SEC originally proposed Reg. SHO, the Pilot constituted a very small part of the overall regulation. Moreover, in the Reg. SHO proposing release, the primary purpose of the Pilot seemed to be to test the SEC's proposed uniform bid test, which was clearly the centerpiece of Reg. SHO, not to test the desirability of price tests more generally. However, between issuing the proposing release and the adopting release, the SEC had eliminated much

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206. See *supra* note 19 and accompanying text.

207. One might wonder why the NYSE and the Specialists Association were so opposed to the elimination of short sale price restrictions. The answer probably has to do with the specialist structure of the NYSE. The Uptick Rule provided valuable information to specialists about how short sellers, who are typically very sophisticated investors, view the market. This is because in order to administer the Uptick Rule, the SEC required broker-dealers to mark a trade as "short" or "long." The specialists receive this information, which gives them a sense of where the market might be going. But the specialists themselves were not subject to the Uptick Rule and therefore could benefit from this information in a way that other investors could not. Thus, the Uptick Rule conferred benefits on the specialists but without any costs. See Reg. SHO Pilot Transcript, *supra* note 17, at 151 ("Make no mistake that there are constituencies that care very much for this rule besides just the corporate managers, and so forth. In particular, anybody who sees the order flow that's marked as an advantage, because it's well known that the short sellers tend to be better informed than other sellers. So anybody who sees a marked order flow has a strong interest in maintaining this rule as long as it's not too binding on their own trading.").

208. See *supra* notes 82–88 and accompanying text.

of what had been proposed as Reg. SHO, but for the Pilot, and the SHO Pilot had taken on a new purpose—to test the continued relevance of price tests more generally.<sup>209</sup>

Thus, in the SHO Pilot, the SEC seems to have avoided the interest group opposition to experimental rules in a similarly serendipitous way as it had side-stepped the challenges that the APA poses to experimental rules. In particular, the SEC had effectively engaged in what in retrospect can only be described as a bait-and-switch. When Reg. SHO was originally proposed, the interest groups, including the NYSE, did not focus on the Pilot but rather on the proposed uniform bid rule. By the time it became clear that the Pilot was going to be the main event, the interest groups had already effectively had their say. To be sure, there is no indication that this bait-and-switch was part of some grand plan on the part of the SEC from the beginning. Quite the contrary. Rather, the circumstances simply conspired to create this result.

*B. Implications: A Deferred Notice-and-Comment Period for Experimental Rules?*

Reg. SHO is the only experiment the SEC has conducted in at least the past decade, amounting to less than 1% of all rules promulgated by the SEC during that period.<sup>210</sup> While it is difficult to identify the optimal level of experimentation, it seems likely that it is more than 1% of the SEC's activity. Moreover, the evidence suggests that the SEC is not an anomaly and that other agencies, with few exceptions, also engage in very little experimentation.<sup>211</sup> As the analysis above suggests, reasons for this lack of experimentation may include the costs of notice-and-comment rulemaking under the APA and interest group opposition to experimentation more generally. Moreover, the SHO Pilot should not be used as an example of how agencies might overcome these obstacles to experimentation, since the SEC's success in that regard seems to be due largely to a serendipitous confluence of events that are unlikely to be replicable in the future.<sup>212</sup> That raises the question how we might encourage greater experimentation among agencies. In this Subsection, I sketch one potential policy approach along these lines, which I call “deferred notice-and-comment for

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209. The media picked up on the Pilot's surprise. Peter Chapman, *Price Test Rules for Short Selling Go Under the Microscope*, TRADERS MAGAZINE (Dec. 2006), <http://www.tradersmagazine.com/issues/20070101/2676-1.html?zkPrintable=true> (“When Reg SHO was first proposed, the SEC had no intention to completely eliminate price tests. The plan was to replace the tick test of Rule 10a-1 with a new bid test.”).

210. See Gubler, *supra* note 10, at 151–52.

211. See *id.*

212. See *supra* notes 191–203 and accompanying text.

experimental rules.” This reconceptualization of the administrative process for experimental rules would consist of two elements: heightened judicial deference for experimental rules and a public roundtable to discuss the experimental results following the experimental period. I discuss each below.

*1. A Principle of Deference with Respect to Experimental Rules*

In prior work, I have suggested that we might subsidize experimentation by adopting a more deferential standard of review, or no review at all, with respect to experimental rules.<sup>213</sup> Such an approach would make experimental rules a relatively more attractive lawmaking vehicle from the perspective of interest groups, since it would reduce some of the uncertainty inherent in these types of rules. That uncertainty is a function at least in part of “hard look” review, and under an experimental rule, a policy is subject to such review twice—once when the experimental rule is adopted and then again when the agency takes some action on a permanent basis in response to the experimental results. Reducing the scrutiny that courts apply at least to the initial adoption of the experimental rule would reduce some of the uncertainty of experimentation, thereby making experimental rules relatively more attractive.

This approach would also mitigate the two challenges that the APA poses to experimental rules. The first of those two challenges has to do with the potentially open-ended nature of regulatory experimentation, as opposed to more scientific varieties of experimentation. The open-ended and fluid nature of regulatory experimentation makes it more difficult for agencies to provide definitive answers to questions of experimental design prior to the start of the experimental period. And yet, hard look review typically requires such definite answers. Consequently, these types of rules are less likely to survive judicial review. A more deferential standard of judicial review would lessen the agency’s burden with respect to experimental design.

Furthermore, the APA’s notice-and-comment rulemaking procedures impose significant costs on experimental rules. These rules contemplate two separate phases of judicial review, and therefore two separate notice-and-comment procedures—one at the time the experiment is adopted and one at the time the agency decides what action to take in response to the experimental results. Thus, the regulatory costs of forming policy through an experimental rule are likely significantly greater than doing so without experimentation. Adopting a more deferential standard of review, or no

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213. See Gubler, *supra* note 10, at 163–65.

review at all, would mitigate these costs as well.

## 2. *Public Roundtable*

On the one hand, a principle of deference to experimental rules might encourage greater experimentation at agencies.<sup>214</sup> It would do so by removing some of the uncertainty associated with the judicial review of experimental rules, thereby making such rules relatively more attractive to interest groups. At the same time, a principle of deference would make experimental rules relatively more attractive to agencies by mitigating some of the challenges that the APA poses with respect to these types of rules.<sup>215</sup>

But on the other hand, a principle of deference to experimental rules also potentially undermines the purpose of notice-and-comment rulemaking more generally, since it would effectively allow an agency to experiment with very little (if any) judicial oversight, leaving the agency with little or no incentive to actually elicit the public's comments or pay attention to such comments. It is this objection that I wish to respond to here by suggesting that one might accompany this sort of deference to experimental rules with a reconceptualization of the notice-and-comment process, as it applies to experimental rules.

One might accomplish such a reconceptualization by requiring the agency that adopts an experimental rule to also sponsor a public roundtable discussion of the experimental results. Such a requirement might draw on the experience of the SEC in the SHO Pilot, where the SEC invited academics to conduct studies on the experimental results, which were then presented and discussed at a public roundtable. One might then require those studies and the results of the public roundtable to be part of the record of any subsequent action that the agency proposes in response to the experiment. Of course, any subsequent agency action would then be subject to "hard look" review.

In this way, one might reconceptualize the notice-and-comment process

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214. See, e.g., Thomas O. McGarity, *Some Thoughts on "Deensifying" the Rulemaking Process*, 41 DUKE L.J. 1385, 1453–54 (1992); Richard J. Pierce, Jr., *The Unintended Effects of Judicial Review of Agency Rules: How Federal Courts Have Contributed to the Electricity Crisis of the 1990s*, 43 ADMIN. L. REV. 7, 27–29 (1991) (explaining that what differs is the underlying purpose of these proposals; prior proposals of deference were to avoid the ossification of agency rules created by hard look review); see also Gubler, *supra* note 10, at 134 n. 25 (pointing out that this is not the first time someone has proposed a more deferential standard of review with respect to agency rules). Compare McGarity, *supra* note 214, at 1451–54, 1462 (applying greater judicial deference to all agency rules), with Pierce, *supra* note 214, at 7–9 (applying greater judicial deference to experimental rules only in an effort to encourage greater experimentation through a type of legal subsidization).

215. McGarity, *supra* note 214, at 1453–54.



for experimental rules as a deferred process that takes place after the experimental rule has been adopted and the experiment has been made. Combining this deferred notice-and-comment procedure for experimental rules along with a reduced standard of review (or no review at all) with respect to these rules would allow us to subsidize experimentation without forfeiting the values of transparency and democratic participation that underlie notice-and-comment rulemaking.

### 3. *Implementation: An Experimental Basis for “Good Cause” Under § 553*

How might this “deferred notice-and-comment process for experimental rules” be implemented? It turns out that there is already an existing structure within the APA that might facilitate implementation. Section 553 of the statute provides that an agency may forego the notice-and-comment step, as well as the corresponding judicial review, if the agency finds “good cause” to dispense with the rulemaking process because that process would be “impracticable, unnecessary, or contrary to the public interest.”<sup>216</sup> Rules adopted pursuant to § 553’s “good cause” exception, often called “interim rules,” do not require the agency to follow any other procedures before the rule goes into effect.<sup>217</sup> However, as a practical matter, agencies sometimes solicit public comments for the post-effective period at the time that they adopt the interim rule.<sup>218</sup> When they do this, agencies are effectively committing to replace, at a later time, the interim rule with a final rule that will benefit from the full-blown notice-and-comment process.<sup>219</sup>

These “interim final rules,” a term coined by Professor Asimow,<sup>220</sup> are very similar to the “deferred notice-and-comment process for experimental rules” that I have proposed here. The major difference is that under § 553’s good cause exemption, the agency is not legally required to solicit any post-effective public comments, let alone conduct a public roundtable to discuss such comments, such rules are typically not subject to sunset provisions. Nevertheless, there are enough similarities that this structure could be used to implement the proposal I make here. Courts typically

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216. 5 U.S.C. § 553(b)(B) (2012).

217. *See, e.g.,* Michael Asimow, *Interim-Final Rules: Making Haste Slowly*, 51 ADMIN. L. REV. 703, 704–07 (1999).

218. *See id.* at 710–11 (explaining that agencies may solicit public comments in this context even if they are not legally obligated to, presumably for a combination of tactical and prudential reasons).

219. *See id.*

220. *Id.* at 705 (clarifying that Professor Asimow defines “interim final rules” as “rules adopted without prior public participation that invite post-effective public participation”).

construe § 553's good cause exemption very narrowly,<sup>221</sup> limiting interim rules to cases of exigent circumstances (for example, an imminent implementation deadline) or cases of public health and safety. However, Congress could expand these circumstances to include cases where there is a need for experimentation. In such cases, agencies would be permitted to adopt an experimental rule and forego the rulemaking process. However, consistent with the proposal outlined above, agencies would also need to be required to solicit post-effective comments and engage in a public roundtable. Although this last feature of the implementation would depart dramatically from the way the good cause exception currently works, since the statute does not currently require agencies to solicit post-effective comments, it is consistent with arguments that have been made for amending § 553.<sup>222</sup> Regardless, this could be a feature of the statutory provision that only applies to the experimental basis for good cause anyway, thereby leaving the rest of the statute unaffected.

To be sure, this type of reconceptualization would need some fine-tuning so that it does not unintentionally make agency rulemakings generally immune from judicial review. Otherwise, agencies might decide to experiment, not because they necessarily need the type of information that experimentation provides, but rather because they wish to avoid the costs of judicial review. From an efficiency perspective, that is almost certainly not the optimal outcome. However, there are likely to be reputational norms that prevent this from happening. After all, under this reconceptualization, agencies are required to have a public comment period of sorts, which would include experts and non-experts alike, the difference being that the public comment period for experimental rules would take place after, rather than before, the rule is adopted. It seems likely that unnecessary experimentation would quickly be unveiled as such at a public roundtable of this sort.

Similarly, the fact that agencies would be required to organize a public roundtable to discuss the results of an experiment would presumably also incentivize agencies to get the design of the experiment right, even though those types of questions would be subject to deference by courts or no judicial review at all. The details would clearly need to be worked out. But this type of reconceptualization, coupled with greater judicial deference to experimental rules, might be necessary to ensure that regulatory experiments like the SHO Pilot, with their attendant benefits, occur more regularly and are more effective when they do.

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221. *See id.* at 719.

222. *See, e.g., id.* at 733–36.

## CONCLUSION

Regulatory experiments, like the SEC's short sale Pilot program, can be valuable tools to help mitigate the risks involved in making law in the face of extreme uncertainty regarding the law's costs and benefits. But there are both substantive and procedural challenges to such regulatory experiments. The SEC's short sale Pilot program is an important case study of how one agency overcame these challenges. Although the SEC did a fairly good job managing the potential sources of bias that are inherent in regulatory experiments, there are things that the SEC could have done better, and for these reasons, this aspect of the case study should be used as a roadmap for future regulatory experiments.

More generally, the case study suggests that these substantive challenges, while valid, are nevertheless probably manageable. Rather, procedural challenges are the greatest potential roadblocks for regulatory experimentation, and the SEC's success in overcoming these procedural challenges with respect to its short selling experiment is probably the product of serendipity more than anything else. For these reasons, it may be desirable to take steps to reduce these procedural challenges. The approach sketched here, conceived as an amendment to the APA's § 553, would relax the scrutiny that reviewing courts apply to rules that agencies adopt on a temporary, experimental basis. The agency would then be required to make the results of the experiment available to the public and conduct a public roundtable to discuss those results after completing the experiment. The transcript of that public roundtable would then automatically become part of the record of any subsequent rulemaking that the agency attempts in response to the experiment.

This approach would reduce some of the procedural challenges to regulatory experiments, making them more likely without sacrificing the principles of transparency, accountability, and democratic participation at the heart of agency lawmaking. In the end, the SEC's experiment with short selling deregulation turns out to be extremely important, not so much because of what it says about the arcane world of short sales, but rather because of what it tells us about how we might harness the value of experimentation to make better laws.

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