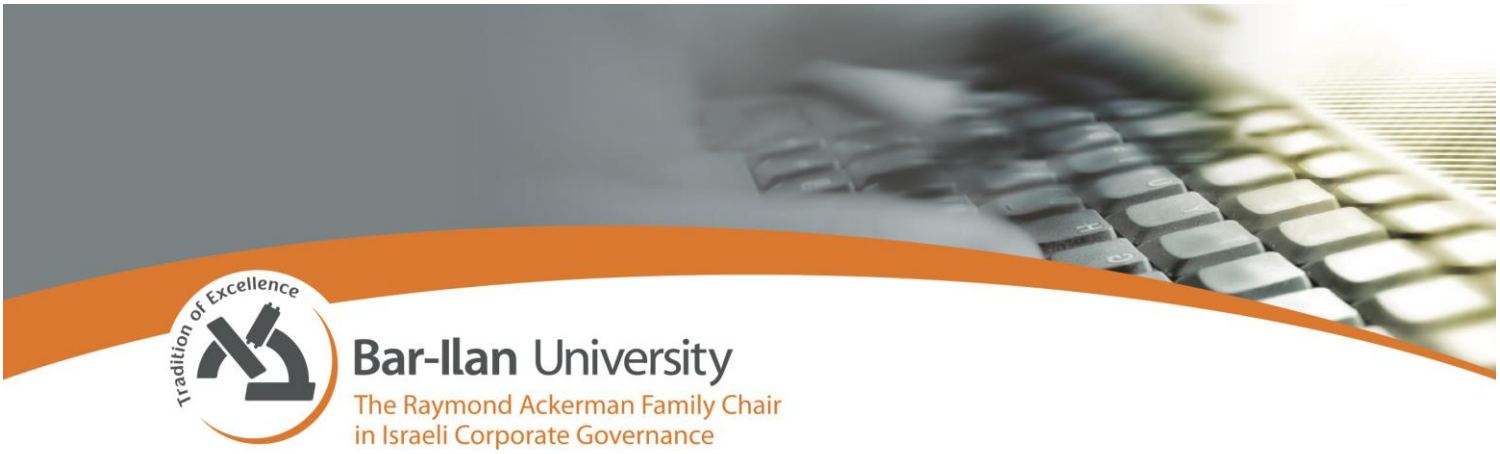

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Regulatory Inertia and Interest Groups: Empirical Evidence from Securities Regulation

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Regulatory Inertia and Interest Groups:

How the Structure of the Rulemaking Process Affects the Substance of Regulations

Asaf Eckstein*

Various forces may undermine efficient regulation. This Comment concentrates on two such forces: regulatory inertia and regulatory vulnerability to undue external influences. Regulatory inertia is best described as the tendency of regulators to adhere to their original proposed rules and to resist change, even when that change may make rules more effective. Undue external influences consist of the power and leverage that narrow interest groups often exert on regulators in order to ensure favorable regulation, often at the expense of the public welfare.

This Comment examines the effects of these two forces on the Israel Securities Authority (ISA) rulemaking process during the years 2003 to 2010, and explores whether this process was flexible and open to changes and whether it was significantly influenced by small interest groups. The ISA process provides us with a unique opportunity to examine both forces. Since the ISA has limited rulemaking power, its rules must pass through three stages that together last almost two years. At stage 1, a rule is valid for one year but can be extended for an additional year if the ISA considers its extension essential and the Minister of Finance provides consent (stage II). Within two years of passage, the ISA can request that the Minister of Finance and the Knesset (Israeli parliament) Finance Committee anchor the rule into secondary legislation (stage III). If the rule is not anchored into secondary legislation it expires. At each of these stages the rules are published for public review.

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Next, the Comment examines the rulemaking process of the Securities and Exchange Commission (SEC), focusing on rules enacted between the years of 2006 and 2009. Unlike the ISA, the SEC has very broad rulemaking authority. Moreover, rules promulgated by the SEC may last indefinitely, and do not need the specific support of secondary legislation. Rather, all SEC rulemaking is authorized by the SEC's enacting legislation, as long as the agency can demonstrate that its rules are within the scope of its legislative mandate. The SEC, like all American administrative rulemaking entities, engages in "notice and comment rulemaking." The SEC publishes a notice of its proposed rules, and solicits comments from the general public. The SEC must then consider all of the comments it receives before promulgating the final version of its proposed rules (although the rules need not actually incorporate all, or even any, of the public comments that the SEC receives).

The Comment shows that the structure of the ISA rulemaking process causes its final rules to exhibit a high level of regulatory inertia and immunity from external influence. A substantial majority of ISA rules passed through all three stages without material changes, suggesting that regulators resist change throughout the rulemaking process. This conclusion is sustained by a review of (1) ISA plenum (board) protocols, which reflect stages 1-3 plenum discussions; (2) Knesset Finance Committee protocols, which reflect the Committee discussions at stage III; and (3) SEC rulemaking in the years 2006 to 2009. The Comment explains the aforementioned conclusion by reference to ISA institutional features, with an emphasis on the lack of transparency inherent in ISA rulemaking; the lack of legislative, executive, or judicial supervision over the ISA rulemaking process; and the general lack of participatory and supervisory mechanisms within ISA internal structure itself. In contrast, the structure of SEC rulemaking promotes flexibility and revision, fighting against regulatory inertia. The SEC's process is exceptionally transparent, and its promulgated rules are frequently challenged in court under the Administrative Procedure Act (APA). For better or for worse, the SEC is much less affected by regulatory inertia, which also suggests that it is vulnerable to undue external influence from small special interest groups.

Introduction

Regulation lacks an exhaustive definition.[1] Yet, it is clear that its ultimate goal is to direct the behavior of various constituencies, in order to enhance public interests and social welfare.[2] As such, regulation must be creative, dynamic, flexible, and adaptive to varied conditions, changes, and developments in the market it governs.[3] To achieve such a goal, regulators should be attentive to regulated constituencies on the one hand and regulatory beneficiaries on the other hand, without favoring one at the expense of the other.[4] This Comment focuses on two forces that may undermine the above-mentioned ideals, adversely affecting the regulatory process and in turn leading to suboptimal regulation. The first force is the regulator's tendency toward inertia; that is, the regulator's tendency to adhere to its original decisions instead of considering alternatives. This occurs when regulators do not initiate necessary changes in entrenched regulatory schemes,[5] or when they initiate proposals for a change but remain locked-in to their proposal without making material

[1] Regulation may refer to a specific set of commands, namely a binding set of rules; it may also in a more broad sense cover all state actions designed to influence behavior; and in the most general sense it may concern all forms of social or economic influence, not merely state institutions. *See* ROBERT BALDWIN ET AL., UNDERSTANDING REGULATION: THEORY, STRATEGY, AND PRACTICE 2–3 (2d ed. 2012); *see also* Anthony Ogus, *Regulation Revisited*, 2 PUBLIC LAW 332, 333 (2009) ("Without entering into niceties, I take it to refer to obligations imposed by public law designed to induce individuals and firms to outcomes which they would not voluntarily reach. Regulation is largely enforced by public officials and compliance is aided by the threat or imposition of some sanction. As such, regulation covers a vast array of state controls over industrial and commercial activities.").

[2] BALDWIN, *supra* note 1, at 2–3; s*ee also* David Levi-Faur, *Regulation and Regulatory Governance*, *in* HANDBOOK ON THE POLITICS OF REGULATION (David Levi-Faur ed., 2011); Julia Black, *Critical Reflections on Regulation*, 27 AUSTL. J. LEG. PHIL. 1, 21–25 (2002).

[3] *See* IAN AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE 4 (1992); Robert Baldwin & Julia Black, *Really Responsive Regulation*, 71 MOD. L. REV. 59 (2008).

[4] Simply put, regulated constituencies are constituencies regulated by the regulator, whereas regulatory beneficiaries are those who expect to benefit from the regulation of others.

[5] *See, e.g.*, Thomas O. McGarity, *Some Thoughts on 'Deossifying' the Rulemaking Process*, 41 DUKE L.J. 1385, 1436 (1992) (referring to "barriers to writing a rule in the first place"); Joseph A. Grundfest, *Advice and Consent: An Alternative Mechanism for Shareholder Participation in the Nomination and Election of Corporate Directors*, (Stanford Law & Economics Olin Working Paper No. 274, 2003), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=481021 ("Experience teaches that regulations are subject to a variant of Newton's First Law of Mechanics, also known as the Law of Inertia: A regulation, once adopted, stays adopted, even if its costs exceeds its benefits, unless it is acted upon by a sufficiently powerful political force—which is a rare event indeed.").

amendments.[6] The second force is the regulator's vulnerability to undue influence by narrow interest groups seeking to ensure favorable regulation at the expense of the public welfare.

Researchers have already evaluated—theoretically and empirically—the impact of interest groups' force on various agencies' rulemaking, within the notice and comment procedure required under the American Procedure Act.[7] They examined changes made between the proposed and final rules; however, their research has not yielded a clear picture. For example, Susan Webb Yackee analyzed forty rules promulgated by four government agencies and found that agencies often altered content of rules in favor of interest groups.[8] Other scholars drew opposite conclusions. For example, Marissa Martino Golden analyzed eleven rules promulgated by three agencies in 1998,[9] Nixon, Howard, and DeWitt analyzed twenty-one SEC rules promulgated during 1998,[10] and William F. West examined forty-two rulemaking proceedings conducted by fourteen agencies,[11] and all researchers concluded that interest groups do not exert unreasonably high levels of influence during the notice and comment period.

This Comment analyzes Israel Securities Authority (ISA) rulemaking process during the years 2003 to 2010, and explores whether this process was flexible and open to changes and whether it was dominated by small interest groups at the expense of the broad public. This analysis continues the line of research mentioned above, while offering a data set, which has several unique advantages. The ISA holds limited rulemaking power, allowing it to promulgate legislative rules ("ISA rules" or "rules") that require publicly traded companies to disclose

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[6] E. Donald Elliott, *Re-Inventing Rulemaking*, 41 DUKE L.J. 1490, 1494–95 (1992); *see geneally* Stephanie Stern, *Cognitive Consistency: Theory Maintenance and Administrative Rulemaking*, 63 U. PITT. L. REV. 589 (2001-2).

[7] In short, the notice and comment procedure consists of: general notice of proposed rulemaking in the Federal Register; opportunity for "interested persons" to submit written comments on the proposed rule, and, at the option of the regulatory agency, opportunity for oral presentations; agency consideration of the comments; and publication of the final rule in the Federal Register. *See infra* Part III.A for a detailed description of this procedure.

[8] Susan Webb Yackee, *Sweet-Talking the Fourth Branch: The Influence of Interest Group Comments on Federal Agency Rulemaking*, 16(1) J. PUB. ADMIN. RESEARCH & THEORY 103 Jan. 2006, at 103.

[9] Marissa Martino Golden, *Interest Groups in the Rule-Making Process: Who Participates? Whose Voices Get Heard?*, 8 J. PUB. ADMIN. RESEARCH & THEORY 245 (1998).

[10] David C. Nixon, Robert M. Howard, & Jeff R. DeWitt, *With Friends Like These: Rule-Making Comment Submissions to the Securities and Exchange Commission*, 12 J. PUB. ADMIN. RESEARCH & THEORY 59 (2002).

[11] William F. West, *Formal Procedures, Informal Procedures, Accountability, and Responsiveness in Bureaucratic Policymaking: An Institutional Policy Analysis*, 64 PUB. ADMIN. REV. 66 (2004).

material information necessary to protect the interests of the public investing in the companies.[12] The rules promulgated by the ISA have a limited lifetime and are subject to approvals and comments at three different stages. First, a rule is valid for one year (stage I). [13] The ISA can extend the rule for an additional year if it is convinced that the rule is still essential, and the Minister of Finance has provided consent (stage II).[14] Within this one or two year period after passage, the ISA must choose whether to initiate the anchoring of the rule into primary or secondary legislation or whether to abandon the rule. The Comment concentrates on rules that were anchored into secondary legislation, following the approval of Ministry of Finance and Knesset (Israeli parliament) Finance Committee (stage III). At each stage, the rule is subject to the approval of the ISA plenum[15] and is published for public review.[16] As described above, this unique process includes three-phases (unlike ordinary notice and comment procedures that include one phase) and lasts almost two years (unlike ordinary notice and comment procedures that often lasts only few months), providing an excellent opportunity to examine a twofold question—*whether the ISA rulemaking process is vulnerable to inertia and consequently is not sufficiently receptive to change once it is initiated, and whether the rulemaking process is overly influenced by small and organized interest groups at the expense of the public welfare*.

This Comment then compares the findings regarding the ISA rulemaking process to empirical data collected from the notice and comment rulemaking process of the SEC. It examines several procedural mechanisms that influence SEC rulemaking, and which are not present in ISA rulemaking. It concludes that the SEC's regulatory process better fights regulatory inertia than the ISA's process; however, it may leave the SEC more vulnerable to undue influence from interest groups.

As the Comment discusses in Section II.B, in the years 2003 to 2010, the ISA promulgated twenty-seven rules; eighteen of them (about 67%) were adopted into secondary legislation. Five additional rules are currently being adopted in Amendment 21 of the Joint

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[12] Securities Law, 5728-1968, § 36A(a), SH No. 541, p. 234 (Isr.).

[13] *Id.* § 36A(c) (Isr.).

[14] *Id.* § 36A(c) (Isr.).

[15] The ISA plenum will be composed of members appointed by the Minister of Finance whose number shall not exceed thirteen. Some members are appointed from the public while others are civil servants; and one is an employee of the Bank of Israel. *See id.* §3(a) (Isr.).

[16] *Id.* § 44E(c) (Isr.).

Investments Trust Law of 1994.[17] This means that about 85% of the rules (twenty-three out of twenty-seven rules) were eventually anchored and made permanent. Moreover, of the remaining four rules that were not anchored, one was merely a temporary rule and therefore its anchoring was not needed; another rule was re-promulgated in 2011 and is currently being adopted into secondary legislation; and a third rule was absolutely technical and the fact it was not anchored does not make much difference. This Comment analyzes the eighteen rules that were promulgated, extended, and anchored into secondary legislation by comparing each rule at stage I with its corresponding version at stage III. As the Comment shows, changes made in stages I to III were mostly minor and technical and included wording modifications and clarifications. If at all, these changes were usually made to the detriment of regulated constituencies and imposed an added regulatory burden on them.

In addition, the Comment reviews the ISA plenum protocols, which reflect stages 1 to 3 plenum discussions, and Knesset Finance Committee protocols, which reflect the Committee discussions at stage III and also shed light on stages I and II. These include more than eighty protocols, encompassing thousands of pages of discussion and analysis. During these discussions, ISA staff summarized changes made in the rules during each stage according to the comments received by the public as well as specific constituencies. Changes ranged from "no changes" to "slight," "few," or "clarifying" changes.[18] To better evaluate these findings and to put them in perspective, SEC rules (promulgated in the years 2006 to 2009) are used as a comparative group. Contrary to the ISA rules, in the majority of SEC cases, SEC rules were more flexible and responsive; in addition, a variety of comments by regulatory stakeholders

[17] Interview with Adv. Oria Shilony, ISA's Legislation Department (I do not have the exact date). In 2008, ISA promulgated, among other rules, four specific rules: Disclosure of Data Pertaining to Valuations of ILNs and Indexed Products; Disclosure of Effective Costs to Investors in ILNs vs. Direct Investment in Underlying Assets; Disclosure of Description of Indices in Indexed Products; Disclosure of Financial and Other Details Pertaining to Indexed Products. *See* Israeli Securities Authority, ISA ANNUAL REPORT 2008, at 104–05, available at http://www.isa.gov.il/sites/isaeng/1489/1512/Documents/IsaFile_4543.pdf. In 2010, ISA promulgated, among other rules, one specific rule: Disclosure of Credit Risks, Market Risks, and Public Holdings in Financial Instruments. *See* Israeli Securities Authority, ISA ANNUAL REPORT 2010, at 114, available at http://www.isa.gov.il/sites/isaeng/1489/1512/Documents/IsaFile_5816.pdf. These five rules are in the process of being anchored in the Joint Investments Trust Law of 1994 (Amendment 21). *See infra* note 79.

[18] *See, e.g.*, protocol number 9-2006 (Dec. 12, 2006), at 4; protocol number 7-2007 (July 17, 2007), at 10; protocol number 7-2009 (Sept. 6, 2009), at 6-7.

caused the SEC to waive or modify some significant components of the rules, as discussed in Part III.C *infra*.

Thus, the conclusion reached is that during 2003 to 2010, the ISA "suffered" from some degree of inertia during its rulemaking process. However, this process does not appear to have been unduly influenced by interest groups (largely groups representing publicly traded companies, in this context) at the expense of the public welfare. This Comment provides potential explanations for these findings by pointing to ISA institutional characteristics, with an emphasis on the ISA rulemaking process, which lacks transparency and other procedures that could, if implemented, force the ISA to consider regulatory alternatives; the lack of ISA supervision by legislative, executive, or judicial branches; and the ISA internal structure, which lacks participatory and supervisory mechanisms. The difference in structure between the SEC and ISA rulemaking procedures suggests that regulatory inertia and undue interest group influence are linked; mechanisms that fight one of those factors tend to make the rulemaking scheme more vulnerable to the other. As it stands now, ISA rulemaking is largely immune to undue outside influence, at the expense of suffering from significant inertia. SEC rulemaking exhibits the opposite situation. Further research and experimentation are required to determine which set of rulemaking procedures can minimize both inertia and undue influence, and thereby foster a regulatory environment responsive to productive change while at the same time best isolated from the influences of narrow interest groups seeking advantage at the expense of public welfare.

The Comment proceeds as follows. Section I lays the groundwork by providing a theoretical overview of behavioral theories and other theories that explain regulatory inertia on the one hand and public choice approaches that explain undue influence on the regulator on the other hand. Section II describes the study of ISA rulemaking: it explains the construction of the sample, the analytical comparison of rules with their corresponding proposals, and the review of protocols. It then presents its findings. Section III repeats this process for SEC rulemaking. Section IV discusses the findings and concludes, with a high probability, that during the regulatory process analyzed in the Comment, the ISA suffered from some degree of regulatory inertia and was immune from public choice influences. ISA rulemaking's lack of transparency and other procedural checks and balances, ISA institutional independence, and ISA internal structure and culture account for these findings. This section also concludes that the SEC’s rulemaking process suffers from a low degree of inertia, but that interest groups may exert a

high level of undue influence. This situation stems from the SEC's high degree of transparency, the procedural mechanisms designed to minimize the regulatory burden on regulated entities, and the relatively high level of either judicial or legislative oversight in the SEC's rulemaking process.

I. Regulatory Inertia and Interest Groups Influence

Inefficient regulation may be the product of various factors that relate to the regulator's abilities and characteristics. This Comment focuses on two prominent factors: regulator's tendency towards inertia, usually explained by behavioral theories and other theories point to lack of incentives and high cost of adaption, and regulator's vulnerability to undue influences, explained by public choice theory. Behavioral literature has long espoused the idea of bounded rationality, commonly believed to have been proposed by Herbert Simon in the 1950s.[19] This idea essentially claims that cognitive abilities are limited, and that actors are subject to various biases and assumptions that render their behavior less than completely rational.[20] The manner by which cognitive heuristics and biases distort information processing and (as a result) decision making has since developed into flourishing behavioral literature. Today, this literature enjoys a rapidly expanding influence on legal scholarship[21] and maintains an important status in many areas of the law:[22] judge and jury decision making, tort and environmental law, contract law, consumer protection, bankruptcy law, criminal law, tax law, and family law. Attention is also given to regulation of securities and corporations.[23] In general, cognitive heuristics and biases can adversely affect regulator decision making; some of

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[19] *See* Herbert A. Simon, *A Behavioral Model of Rational Choice,* 69 Q.J. ECON. 99, 99-101 (1955).

[20] *See* Christine Jolls, Cass R. Sunstein, & Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1477 (1998).

[21] *See generally* Jeffrey J. Rachlinski, *The Psychological Foundation of Behavioral Law and Economics*, U. ILL. L. REV. 1675 (2011) (providing an excellent overview).

[22] *See* Alafair S. Burke, *Improving Prosecutorial Decision Making: Some Lessons of Cognitive Science*, 47 WM. & MARY L. REV. 1587, 1592 (2006); *see also* Donald C. Langevoort, *Behavioral Theories of Judgment and Decision Making in Legal Scholarship: A Literature Review*, 51 VAND. L. REV. 1499, 1500 (1998).

[23] *See,* Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1 (2003); *see also* Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 NW. U. L. REV. 135 (2002); Donald C. Langevoort, *The SEC as a Lawmaker: Choices About Investor Protection In The Face of Uncertainty*, 84 WASH. U. L. REV. 1591 (2006); Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC'S Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975 (2006).

them, in particular, can cause the regulator's adherence to its decisions, or in other words can cause to regulatory inertia. This Comment will briefly touch upon the most pertinent heuristics and biases.

Confirmation bias, which refers to the regulator's tendency to justify his or her decisions instead of critically evaluating their true worth and effects, is the most prominent bias.[24] Regulators often ignore data pointing to inadequacies of their decisions and research suggests that some factors may aggravate confirmation biases; for instance, the greater and more ambiguous and complex the evidence underlying the regulatory decision, the more the regulator is susceptible to confirmation bias.[25] In addition, when a regulatory decision is made public and the regulator is held accountable for her decisions, the power of confirmation bias increases.[26] Finally, actual or perceived negative consequences that may arise from changing the regulator's decision may escalate confirmation biases regarding this decision.[27]

There are many more biases that contribute to regulatory inertia as well. The *endowment bias* or effect describes the great value individuals place on their possessions;[28] in our case, the worth regulators place on regulations they have created. The *status quo bias* predicts that regulators may simply prefer to maintain the prevailing state.[29] The *overconfidence bias* refers to the danger that an overconfident regulator with expertise in one area may feel an inflated confidence that clouds her assessment of her decision making. Such a regulator is not likely to look back at past decisions and critically re-evaluate them, even when

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[24] *See* Peter C. Wason, *On the Failure to Eliminate Hypotheses in a Conceptual Task*, 12 Q. J. EXPERIMENTAL PSYCHOL. 129 (1960) (coining the term "confirmation bias").

[25] *See* Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: The Problem of Market Manipulation*, 74 N.Y.U. L. REV. 630, 648 (1999).

[26] *See* Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, 146 U. PA. L. REV. 142 (1997); *see also* Barry M. Staw, *Knee-Deep in the Big Muddy: A Study of Escalating Commitment to a Chosen Course of Action*, 16 ORG. BEHAV. & HUM. PERFORMANCE 27 (1976).

[27] *See* Staw, *supra* note 27 (claiming that although we would expect that negative consequences arising from a regulator's decisions would undermine its commitment to these decisions, paradoxically, negative consequences may actually increase these commitments and undergo the risk of further negative consequences).

[28] *See* Richard H. Thaler, *Toward a Positive Theory of Consumer Choice*, 1 J. ECON. BEHAV. & ORG. 39, 44 (1980).

[29] *See, e.g.*, William Samuelson & Richard Zeckhauser, *Status Quo Bias in Decision Making*, 1 J. RISK & UNCERTAINTY 7 (1988).

ostensibly forced to do so.[30] The *anchoring and adjustment bias* describes how the starting point of decision makers magnetizes their subsequent movements.[31] The *groupthink bias*, coined by social psychologist Irving Janis in 1972 and used to describe an undue form of concurrence among group members, derives mainly from group members' desire to minimize tensions within the group and to conform to group culture.[32] The *conformity bias* tends to cause an individual's own opinions to be influenced by and conform with those of a majority group.[33] In our context, the groupthink and conformity biases may lead the regulator's employees to suppress their personal doubts, defer to the consensus, and consequently reduce the range of considerations reviewed by the regulator.[34] Finally, inertia may be influenced by the *availability heuristic* and *hindsight bias*. According to the *availability heuristic*, identified by Tversky and Kahneman in the early 1970s, the frequency and probability of an occasion are assessed by the ease with which the regulator rethinks its occurrence.[35] Relatedly, the *hindsight bias* describes the tendency to place great emphasis on the probability of past events that occurred relative to those that did not occur.[36] Both of these two biases may cause the regulator to think regressively rather than progressively. Lastly, regulators prefer to be proactive rather than passive and often fall prey to the *precautionary bias* or principle—described pictorially by

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[30] *See* Dale Griffin & Amos Tversky, *The Weighing of Evidence and the Determinants of Confidence*, 24 COGNITIVE PSYCHOL. 411, 412 (1992). (noting that one critic described expert prediction as "often wrong but rarely in doubt"); *see also* Hanson & Kysar, *supra* note 26.

[31] According to the traditional explanation, when asked to estimate, most individuals begin with the initial value as an anchor or starting point and adjust as they get closer to the wanted estimate. Even though, the adjustment is typically insufficient and the estimation usually deviates in the direction of the anchor point. *See* Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty*, 185 SCIENCE 1124, 1128–30 (1974).

[32] IRVING L. JANIS, VICTIMS OF GROUPTHINK: A PSYCHOLOGICAL STUDY OF FOREIGN-POLICY DECISIONS AND FIASCOES 8–9 (1972); *see* Cass R. Sunstein, *Deliberative Trouble? Why Groups Go to Extremes?*, 110 YALE L.J. 71, 103 (2000) ("An independent agency that is all Democratic, or all Republican, might polarize toward an extreme position, likely more extreme than that of the median Democrat or Republican, and possibly more extreme than that of any member standing alone.") (discussing that a groupthink bias may even cause to the group polarization); *see also*, David Schkade, Cass R. Sunstein & Reid Hastie, *What Happened on Deliberation Day*, 95 CALIF. L. REV. 915, 917 (2007); Cass R. Sunstein, David Schkade & Lisa Michelle Ellman, *Ideological Voting on Federal Courts of Appeals: A Preliminary Investigation*, 90 VA. L. REV. 301, 306 (2004).

[33] *See* Solomon E. Asch, *Opinions and Social Pressure*, 193(5) SCIENTIFIC AMERICAN 31 (1955).

[34] *See* Choi & Pritchard, *supra* note 24, at 33–34.

[35] *See* Tversky & Kahneman, *supra* note 32, at 1127.

[36] *See generally*, Baruch Fischhoff & Ruth Beyth, *"I Knew it Would Happen": Remembered Probabilities of Once-Future Things*, 13 ORGANIZATIONAL BEHAVIOR & HUMAN PERFORMANCE 1 (1975).

Sunstein as "better safe than sorry"[37] and as a "plea for a kind of regulatory insurance."[38] With respect to the inertia phenomenon, the precautionary bias may predict that once the regulator begins to regulate, her desire to be safe prevents her from taking a step back and withdrawing the regulation.

Beside the behavioral explanations mentioned above, regulatory inertia is sometimes explained by the regulator's lack of incentives for change and the high cost of adapting regulations to account for changed goals or influences. With respect to the incentives, it is quite clear that the regulator and its employees are committed to their initial project and therefore lack incentives to abandon this project in favor of an alternative one, even if information unfavorable to pursuing the project is revealed.[39] With respect to the costs, it is common knowledge that adaption to changes has costs. In our context, these costs derive directly from investing in alternative regulatory tools and creating new regulatory responses[40] and indirectly from the delay in the regulatory process.[41]

After discussing the common causes for regulatory inertia, this Comment now turns to public choice theory, which in turn helps explain the manner by which interest groups influence the regulatory process. Public choice theory explains how the behavior and decision making of *politicians* and *bureaucrats* are often politically driven rather than ideologically or professionally driven.[42] According to this theory, politicians base their decisions on the

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[37] *See* Cass R. Sunstein, *Beyond the Precautionary Principle*, 151 U. PA. L. REV. 1003, 1004 (2003).

[38] *Id*. at 1007; *see also* Donald C. Langevoort, *The SEC as a Lawmaker: Choices About Investor Protection In The Face of Uncertainty*, 84 WASH. U. L. REV. 1591, 1611 (2006) (indicating that the conspicuous cause for the precautionary principle is the asymmetric reputational payoff to key officials of the regulatory agency, as they find it difficult to take credit for good outcomes, while bad ones generates intense criticism and harm their reputation.)

[39] *See, e.g.*, Marcel Boyer & Jacques Robert, *Organizational Inertia and Dynamic Incentives*, 59 J. ECON. BEHAV. & ORG. 324, 326–27 (2006) ("Agents who are asked to switch to task/project B before completing task/project A (and seeing the outcomes of their efforts) and later to switch to C before completing B may end up investing no effort in raising the probability of success of the task/project under the expectation that it will not be completed.").

[40] *See generally*, Steven Tadelis & Oliver E. Williamson, *Transaction Cost Economics*, THE HANDBOOK OF ORGANIZATIONAL ECONOMICS 159, 162 (Robert Gibbons & John Roberts eds., 2013).

[41] *See, e.g.*, Jim Rossi, *Participation Run Amok: The Costs of Mass Participation for Deliberative Agency Decisionmaking*, 92 NW. U. L. REV. 173, 179–80 (1997) (arguing that while deliberative decisions require participation, beyond a certain threshold participation imposes high costs on the administrative process and entail delays).

[42] DANIEL A. FARBER, INTRODUCTION TO PUBLIC CHOICE AND PUBLIC LAW x-xii (2007).

public's demand for regulation and their own desire for reelection. Thus, in normal times (unlike crises and post-crises as the Comment discusses below), narrow and well-organized interest groups take advantage of the public's passivity,[43] and exert influence on politicians to push forward policy that is favorable to them. The interest groups' influence on politicians is possible due to the groups' willingness to pay for favorable regulation with votes and resources, such as campaign contributions,[44] and due to politicians' tendency to seek attractive employment opportunities within the regulated industries upon termination of their public service (this is known as the "revolving door" theory).[45]

Furthermore, the ability and ease in which interest groups can act, in contrast to disorganized and often unresponsive or over responsive manner in which the broad public usually acts, is explained by Mancur Olson's collective action problem.[46] According to Olson, collective action demands coordination and organization—difficult, expensive conditions that the broad public has trouble initiating.[47] In contrast, small groups face relatively low costs and ease in organization.[48] Furthermore, individuals within larger groups gain less per capita from successful collective actions than individuals in small groups.[49] Hence, the incentive for group action diminishes as group size increases—larger groups are less able to act together to promote a common interest than smaller ones. [50]

Yet, the question remains, why do *bureaucrats* cooperate with interest groups as well? The answer lies in the iron triangle, a term used by political scientists, which describes the three-way policy-making relationship that exists between politicians, bureaucrats, and interest

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[43] This assumption is especially strong with respect to areas regulated by securities regulators that, despite significantly affecting public welfare, are shielded from public view. *See* PEPPER D. CULPEPPER, QUIET POLITICS AND BUSINESS POWER: CORPORATE CONTROL IN EUROPE AND JAPAN xv–xvi (Cambridge Univ. Press 2011) (focusing on hostile takeovers and claiming that although they "have momentous political and economic consequences . . . the rules governing them seldom command public attention").

[44] G. J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3, 12 (1971).

[45] *Id.*

[46] MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS (1965).

[47] *Id.* at 11.

[48] *Id.* at 33–37.

[49] *Id.* at 34.

[50] *Id.* at 34–35.

groups.[51] According to this relationship, politicians support the regulatory policies that interest groups favor in exchange for their support. Bureaucrats, who seek to maximize their budgets and authority,[52] understand that politicians can reward and punish them—through job appointments or removals, public hearings, and investigations, and by controlling their budgets and scope of regulatory authority[53]—are therefore likely to comply with politicians' need to please interest groups. In addition to the iron triangle dynamic, another factor that gives interest groups a disproportionate influence over bureaucrats is their advantage in providing information and guidance to bureaucrats regarding the needs and capabilities of regulated markets.[54] Finally, as in the case of the relationship between interest groups and politicians, the revolving door of employment between bureaucrats and interest groups can make bureaucrats very responsive to interest groups needs and demands.[55]

The dynamics described above fit the characteristics of the Israeli financial market remarkably well. The Israeli market is a very concentrated market, controlled by approximately twenty business groups that nearly all are family-owned.[56] Highly specialized institutional

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[51] One of the earliest formulations of the "iron triangle" concept was made by political scientist Grant McConnell, in PRIVATE POWER AND AMERICAN DEMOCRACY (1966).

[52] WILLIAM A. NISKANEN, BUREAUCRACY AND REPRESENTATIVE GOVERNMENT (1971).

[53] Jacob E. Gersen, *Designing Agencies*, *in* RESEARCH HANDBOOK ON PUBLIC CHOICE AND PUBLIC LAW 333, 339 (Daniel A. Farber & Anne Joseph O'Connell eds., 2010); Mathew D. McCubbins, Roger G. Noll, & Barry R. Weingast, *Administrative Procedures as Instruments of Political Control*, 3 J. L., ECON., & ORG. 243 (1987); Mathew D. McCubbins, Roger G. Noll, & Barry R. Weingast, *Structure and Process, Politics and Policy: Administrative Arrangements and the Political Control of Agencies*, 75 VA. L. REV. 431 (1989).

[54] *See* Rachel E. Barkow, *Insulating Agencies: Avoiding Capture Through Institutional Design*, 89 TEX. L. REV. 15, 23 (2010); *see also* Nicholas Bagley & Richard Revesz, *Centralized Oversight of the Regulatory State*, 106 COLUM. L. REV. 1260, 1285 (2006); Sidney A. Shapiro, *The Complexity of Regulatory Capture: Diagnosis, Causality, and Remediation*, 17 ROGER WILLIAMS U. L. REV. 221, 234–41 (2012).

[55] *See* Lawrence G. Baxter, *"Capture" in Financial Regulation: Can We Channel It Toward the Common Good?*, 21 CORNELL J. L. & PUB. POL'Y 175, 185 (2011); *see also* John C. Coates, *Private vs. Political Choice of Securities Regulation: A Political Cost/Benefit Analysis*, 41 VA. J. INT'L L. 531, 563 (2001); Arthur E. Wilmarth, *Turning a Blind Eye: Why Washington Keeps Giving in to Wall Street*, 81 U. CIN. L. REV. 1283, 1406–17 (2013) (implementing the revolving door concept with respect to the SEC). *See generally* Ross D. Eckert, *The Life Cycle of Regulatory Commissioners*, 24 J. L. & ECON. 113 (1981).

[56] These groups control 160 publicly traded companies, approximately 40% of the market. Ten privately-owned business groups control 30% of the companies listed on the Tel Aviv Stock Exchange (TASE). *See* ISRAEL SELF ASSESSMENT ACCORDING TO METHODOLOGY FOR ASSESSING THE IMPLEMENTATION OF THE OECD PRINCIPLES ON CORPORATE GOVERNANCE AS PART OF PROCESS OF ACCESSION TO THE OECD (Dec. 2008), *available at*

investors (such as banks, insurance companies, retirement or pension funds, hedge funds, investment advisors, and mutual funds), who invest on behalf of retail investors, act in conjunction with these controlling business groups and are often directly owned by them.[57] Indeed, because institutional investors hold voting rights and can actively engage in corporate governance, they have great potential to influence the managements of corporations controlled by the controlling groups, and thus to curb the groups.[58] However, the effectiveness of institutional investors has been questioned because of conflict of interests derives from their contacts with the business groups[59] and because of lack of proper incentives.[60]

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http://www.isa.gov.il/Download/IsaFile_7411.pdf; *see also* Ronen Barak & Beni Lauterbach, *Estimating the Private Benefits of Control from Partial Control Transfers: Methodology and Evidence*, 2 INT'L J. CORP. GOVERNANCE (2011); ASSAF HAMDANI, THE ISRAEL DEMOCRACY INSTIT., CONCENTRATED OWNERSHIP AND BUSINESS GROUP IN ISRAEL: A LEGAL ANALYSIS (Policy Paper No. 78, 2009) [in Hebrew]. U.S. publicly traded companies, in contrast, have widely dispersed ownership. *See, e.g.*, Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. FIN. 537 (2004); Rafael La Porta, Florencio Lopez-De-Silanes, & Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999).

[57] HAMDANI, *supra* note 57, at 44.

[58] Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992); Marcel Kahan & Edward B. Rock, *Hedge Fund in Corporate Control*, 155 U. PA. L. REV. 1021, 1047–62 (2007).

[59] *See* Assaf Hamdani & Yishay Yafeh, *Institutional Investors as Minority Shareholders*, 17 REV. FIN. 691, 692 (2013) (discussing the effectiveness of the institutional investors in the Israeli market). *See also* Gerald F. Davis & E. Han Kim, *Business Ties and Proxy Voting by Mutual Funds*, 85 J. FIN. ECON. 552 (2007); Burton Rothberg & Steven Lilien, *Mutual Funds and Proxy Voting: New Evidence on Corporate Governance*, 1 J. BUS. & TECH. L. 157 (2006-07) (discussing the U.S. context).

[60] Lucian A. Bebchuk & Zvika Neeman, *Investor Protection and Interest Group Politics*, 23 REV. FIN. STUD. 1089 (2010). Bebchuk and Neeman claim that because corporate insiders—managers and controlling shareholders in publicly traded companies, who have some control over companies decisions—capture the full benefits of any lobbying by their companies for lower levels of investor protection while their companies bear some of the costs of such lobbying, they have an advantage in the competition for influence over politicians. On the other hand, institutional investors can be expected to invest less in lobbying against weak investor protection than would be optimal for the class of outsider investors as a whole. While institutional investors must themselves bear the costs of lobbying, they capture only part of the benefits to outside investors resulting from improved investor protection because some investors hold shares in companies directly, not through institutional investors, and some institutional investors (for example, mutual fund managers) may capture only a fraction of the increase in the value of portfolios managed by them that better investor protection would produce. As a result, to obtain a given improvement in investor protection, institutional investors will be willing to spend less than the total benefit that such an improvement will produce for outside shareholders.

Finally, it should be emphasized that public choice theory focuses on normal times when interest groups take advantage of apathy and indifference among the broader public.[61] Crises and crashes destabilize this equilibrium. Crises usually cause panic, which together with extensive media coverage catches the attention of politicians. Risk-averse politicians, whose objective is reelection, wish to satisfy their anxious constituents and demand that the bureaucrats "do something" to ameliorate the cause of the unrest.[62] Bureaucrats, in turn, are likely to react with a significant regulatory response[63]—not necessarily an optimal response, but one that is sufficient to satisfy the public.[64] After outlining the behavioral and public choice factors underlying regulatory inertia and interest group influence this Comment now turns to describe the study of the ISA rulemaking.

II. The Study of ISA Rulemaking

A. The ISA Rulemaking Process

ISA holds limited rulemaking power.[65] Thus, ISA rules have a limited life during which they must pass three different approval and commentary phases.[66] This process lasts almost

[61] *See generally*, Mathew D. McCubbins, Roger G. Noll, & Barry R. Weingast, *Administrative Procedures as Instruments of Political Control*, 3 J. L., ECON., & ORG. 243, 247–51 (1987).

[62] *See, e.g.*, Alexander Dyck, David Moss & Luigi Zingales, *Media versus Special Interests*, 56 J.L. & ECON. 522–23 (2013) (explaining the important role the media may play in "minimizing collective action costs for dispersed actors," and how the media "may help to tip the political balance against concentrated interests.").

[63] *See* Stuart Banner, *What Causes New Securities Regulation? 300 Years of Evidence*, 75 WASH. U. L. Q. 849, 850 (1997); *see also* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005); Larry E. Ribstein, *Bubble Laws*, 40 HOUS. L. REV. 77, 92 (2003); Erik F. Gerding, *The Next Epidemic: Bubbles and the Growth and Decay of Securities Regulation*, 38 CONN. L. REV. 393, 418–24 (2006); Charles K. Whitehead, *Reframing Financial Regulation*, 90 B.U. L. REV. 1, 2–3 (2010); Christopher M. Bruner, *Corporate Governance Reform in a Time of Crisis*, 36 J. CORP. L. 309, 333-34 (2011); A.C. Pritchard, *The SEC At 70: Time for Retirement?*, 80 NOTRE DAME L. REV. 1073, 1078-83 (2005); Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 17 REV. FIN. 691, 692 (2013); John C. Coffee, Jr. & Hillary A. Sale, *Redesigning The SEC: Does The Treasury Have a Better Idea?*, 95 VA. L. REV. 707, 727 (2009); Roberta Romano, *Regulating in the Dark*, (Yale Law & Economics Research Paper No. 442, 2012); John C. Coffee, Jr., *The Political Economy of Dodd-Frank: Why Financial Reform Tends to be Frustrated and Systemic Risk Perpetuated*, CORNELL L. REV. 1019 (2011-12).

[64] *See* Herbert A. Simon, *Rational Choice and the Structure of the Environment*, 63 PSYCHOL. REV., no. 2, 1956, at 129 (identifying and illustrating that idea as early as the 1950s); *see also* Charles E. Lindblom, *The Science of "Muddling Through"*, 19(2) PUB. ADMIN. REV., Spring 1959, at 79.

[65] *See* Securities Law, 5728-1968, § 44E, SH No. 541, p. 234 (Isr.).

two years, much more than typical regulatory processes of other agencies with general rulemaking power. The three-phase structure of the ISA regulatory process, together with its extended period, allow us to examine possible regulatory inertia on the one hand and potential influence of public choice pressures on the other. This section describes the ISA regulatory process regarding rules promulgated under the Israeli Securities Law. It should be noted that while in 2013 the ISA adopted a new procedure for initiating rules,[67] which was meant to improve the ISA rulemaking process, this Comment focuses on the years 2003 to 2010 and thus describe the ISA procedure used in these years. Analyzing the former procedures yields a much larger data set, making the analysis better informed and more useful.

Section 36A(b) of the Securities Law empowers the ISA to create legally binding rules that impose a duty on publicly traded companies to disclosure information important to investors—in financial statements, periodic reports or immediate reports.[68] ISA staff holds discretionary power to draft rules.[69] Section 36A(e) of the Securities Law provides the President of the Institute of Certified Public Accountants (ICPA) a voice vis-à-vis the draft.[70] From here, the draft continues to the ISA plenum for discussion, comments, and approval and is published on ISA website, allowing for public comments.[71] After the ISA receives the comments and responds as it sees fit, the rule comes into force and the ISA publishes it on the ISA website (stage I).[72] A rule is valid for one year.[73] Yet, under Section 36A(c) of the Securities Law, if the ISA is convinced that a rule is still essential and has received the consent of the Minister of Finance, it may extend the rule for an additional year (stage II).[74] Similar to

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[66] *Primary and Secondary Legislation Process*, ISRAEL SECURITIES AUTHORITY, http://www.isa.gov.il/sites/ISAEng/1485/Law/Pages/1502.aspx (last visited Mar. 26, 2015).

[67] *See An Internal Procedure for Initiating Regulation by the Securities Authority*, ISRAEL SECURITIES AUTHORITY, http://www.isa.gov.il/Download/IsaFile_7067.pdf (last visited June 10, 2015) (in Hebrew).

[68] Securities Law, 5728-1968, § 36A, SH No. 541, p. 234 (Isr.).

[69] 2012 REPORT ON THE ACTIVITIES OF THE ISRAEL SECURITIES AUTHORITY 28 (describing the drafting responsibilities of the ISA's Legislation Department).

[70] *Id.* § 36A(e).

[71] *Primary and Secondary Legislation Process*, ISRAEL SECURITIES AUTHORITY, http://www.isa.gov.il/sites/ISAEng/1485/Law/Pages/1502.aspx (last visited Mar. 26, 2015)

[72] *Id.*

[73] Securities Law, § 36A(c) (Isr.).

[74] *Id.*

stage I, stage II includes an ICPA hearing, ISA plenum approval, and public comments before ministerial consent may be granted.[75]

Within two years of passage, the ISA must choose whether to initiate the anchoring of the rule in primary or secondary legislation or whether to abandon the rule. If the ISA chooses to anchor the rule, ISA staff will formulate the guiding principles for the proposed legislation.[76] This stage includes research of the issue, internal discussion, and consultation with relevant governmental ministries (mainly the Ministry of Finance and the Ministry of Justice).[77] Afterwards, the ISA staff composes an initial draft of the proposed enactment along with explanatory notes—in line with the guiding principles already formulated.[78] The draft is submitted to the ISA plenum, who decides whether or not to approve the ISA initiative for legislation under the proposed draft.[79] In a case where the plenum approval is given, the initiative is published online on the ISA website for public comments. This section focuses only on anchoring of rules into secondary legislation. Therefore, it skips anchoring rules into primary legislation.

Following approval by the plenum and the public review, the Ministry of Finance and Ministry of Justice approve the draft wording and send it on to the Knesset Finance Committee.[80] The Committee then invites the ISA, the Attorney General, other ministry representatives and concerned parties to an open discussion on the legislation.[81] The Committee is entitled to invite experts on matters tabled for discussion to take part in its debates.[82] Once the Knesset Committee has discussed and approved the regulations, the Minister of Finance signs the regulations, which are published in Israeli Official Register

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[75] *Primary and Secondary Legislation Process*, ISRAEL SECURITIES AUTHORITY, http://www.isa.gov.il/sites/ISAEng/1485/Law/Pages/1502.aspx (last visited Mar. 26, 2015)

[76] It usually takes place during the second year of the rule lifetime and after the rule has been extended at stage II. *See id.*

[77] *Id.*

[78] *Id.*

[79] *Id.*

[80] *Id.*

[81] *Id.*

[82] *Id.*

(*Reshumot (Kovetz HaTakanot*)) (the "Official Register") (stage III).[83] Finally, it is worth noting that the ISA rulemaking process, as discussed above, lacks the type of checks and balances that are often employed by advanced regulatory agencies, such as the SEC, to ensure better regulation. This Comment further explains this point in Parts III.B and IV below.

B. The Sample

Twenty-seven rules were promulgated by the ISA from 2003[84] to 2010.[85] The sample includes eighteen rules that passed stages I, II and III, or in other words were promulgated, extended, and anchored.[86] The nine other rules were not included in the sample since they were not anchored into secondary legislation—four expired and five are in the process of being anchored in the Joint Investments Trust Law of 1994 (Amendment 21).[87] ISA staff provided the complete list of rules that were promulgated in the years 2003 to 2010, which the author verified against ISA annual reports for each year that described the rules that were promulgated, extended, and anchored.[88] Additional information regarding the list was collected from ISA plenum protocols, the Knesset Finance Committee protocols, and direct contacts with ISA staff. After creating a complete list, the version of each eighteen rules at stage I and III was identified for the sake of an analytical comparison, which is described in detail later in this Comment. The majority of stage I versions were available on the ISA website or were provided by the ISA staff. Stage III versions were available in the Official Register.[89] In September 2013, the

[83] *Id*. The "Reshumot" is an official publication of the State of Israel. The binding wording of the regulations or the amendment to the regulations, and the date of their coming into force is as published in Reshumot (Kovetz HaTakanot – Subsidiary Legislation).

[84] Section 36A of the Securities Law grants the ISA the power to promulgate rules was enacted in 1988 and has not been changed since then. *See* Securities Law, 5728-1968, § 36A, SH No. 541, p. 234 (Isr.). However, up until 2003 the ISA did not promulgate any rules.

[85] As the Comment will explain *infra*, the sample includes only rules that were promulgated, extended, and anchored into secondary legislation by 2012—when the author began this research. Rules that were promulgated in 2011 were not anchored yet and therefore were not included in the sample.

[86] Interview with Adv. Shilony, supra note 17.

[87] *Id*. *See also* 2012 REPORT ON THE ACTIVITIES OF THE ISRAEL SECURITIES AUTHORITY 160–61 (the Joint Investments Trust Bill (Amendment 21) of 2012 was approved by the Knesset in the first reading on July 9, 2012, and is pending review of the Knesset Finance Committee prior to the second and third readings).

[88] Interview with Adv. Shilony, supra note 17. The reports refer to the Official Register which publishes the secondary legislation. The reports are available on the ISA website.

[89] *Id.*

author submitted a formal request for information to the ISA for inputs that were received with respect to each of the eighteen rules at stages I to III. Unfortunately, the ISA reply indicates that there is no record of inputs received regarding some of the rules, and regarding other rules, access to inputs was denied.[90]

C. Analytical Comparison of Versions of the Rules and Review of Protocols

The author first compared the rules at stage I and III by disaggregating each rule's version into its basic sections; elaborate sections were delineated even further. The author then compared stage I sections to their stage III counterparts to determine whether the stage I versions of the rules were adopted in stage III and if so, to what extent. This process was completed for all eighteen rules. Answers were coded into three categories: "not adopted," "completely adopted," or "partially adopted." Partially adopted sections included an explanation on the extent to which they were adopted.

Second, the author reviewed the sections (or subsections) included in stage III version to determine whether they initiated in stage I. Sections not included in stage I, or in other words added at stage III, were coded as either "stringent" or "lenient" according to their nature, along with an explanation.[91]

Finally, in order to measure the changes between stage I and III, each section of a rule was categorized into one of four categories according to its nature: "definition,"[92] "disclosure requirement,"[93] "validity,"[94] or "exemption."[95] Whereas the significance of a change with

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[90] A formal letter sent by Adv. Offir Eyal form the ISA's Legal Department on Nov. 20, 2013. According to the ISA answer, the disclosure of comments may constitute an invasion of privacy of commenters, disrupt the proper functioning of the ISA, or its ability to carry out its duties, and requires an unreasonable allocation of resources.

[91] A stringent addition adds to the regulatory burden imposed on regulated constituencies by requiring them to invest more time, effort, or financial resources to generate, maintain, or provide information to or for the ISA, specific constituencies, or the broader public. Lenient addition means the opposite.

[92] A section (or subsection) interprets other sections included in the rule. In the case that a definition refers to the meaning of a term used in other existing legislation or regulation, the author considered it adopted.

[93] The heart of each rule applies to regulated public companies and orders the type of information they are required to disclose, the extent of disclosure, and the manner of disclosure. Each rule frequently includes more than one disclosure requirement.

[94] “Validity" means the "validity of law" order. Such an order means that the rule (or specific section included in the rule) is not meant to replace another legislation or regulation.

[95] The exemption excludes specific constituencies from obeying the rule.

respect to a disclosure requirement is the greatest, significance of a validity order is the lowest. As we see, this analytical comparison only offers an approximation of the weight of the changes made to the rules. At present, there is no accurate manner to calculate the exact scope of change since different sections of the rules may carry varying significance and weight.[96]

Together with the analytical comparison described above, and in order to better understand the changes that occurred during stages I, II, and III, and to look for evidence of possible regulatory inertia or public choice symptoms, the author reviewed all protocols of monthly ISA plenum discussions[97] that took place from 2004 to 2011 (seventy-six protocols that include thousands of pages altogether).[98] The author conducted a similar review of Knesset Finance Committee protocols that reflect word-for-word discussions that took place during stage III but also shed light on stages I and II.[99]

A summary of changes made with regard to each of the eighteen rules that were analyzed in this Comment is tabulated in the Appendix (the Appendix is focused on disclosure requirements).[100] At this stage, the Comment illustrates the above by using a representative example—the Disclosure of Contracts of Assets' Acquisition rule that was promulgated by the

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[96] Suppose, for example, a rule that consists of four sections. If one of the four sections was not adopted in the secondary legislation and the three other sections were completely adopted, without any changes, would it be correct to conclude that the rule was changed by 25%? The answer would be positive only if the four sections have exactly the same nature and importance. In every other case, the answer would be negative. In order to gain a more accurate calculation, values relative to the changes that were adopted need to be formulated. A survey of the relevant respondents—experts from the academy, representatives of regulated constituencies on the one hand, and regulatory beneficiaries on the other hand—proved the best method to provide relative values. However, this can be saved for further study.

[97] Through the years, the format of the protocols changed: Protocols during the period 13.4.2004-21.11.2006 are summaries of the discussions and protocols during the period 12.12.2006-23.11.2011 are transcripts of the discussions.

[98] The first protocol available on the ISA website is from 13.4.2004. Furthermore, although the Comment analyzes rules that were promulgated between 2003 and 2010, discussions that took place in 2011 involve the extension and anchoring of rules that were promulgated in 2009 and 2010. The protocols are available on the ISA website: *Minutes from Debates in Plenary Authority*, ISRAEL SECURITIES AUTHORITY, http://www.isa.gov.il/%d7%94%d7%95%d7%93%d7%a2%d7%95%d7%aa%20%d7%95%d7%a4%d7%a8%d7%a1%d7%95%d7%9e%d7%99%d7%9d/135/Pages/default.aspx [in Hebrew] (last visited June 10, 2015).

[99] See the Knesset website for a list of protocols, *Committee Protocols*, THE KNESSET (June 11, 2015), http://www.knesset.gov.il/protocols/heb/protocol_search.aspx [in Hebrew].

[100] The table focused on the changes made with respect to disclosure requirements.

ISA in 2005. A stage I version of this rule was not found on the ISA website but was provided to the author by ISA staff. According to the ISA 2007 annual report, the stage III version was found in the Official Register No. 6560.[101] The comparison of stages I and III is listed in the following table.

Sections included in the rule's version at stage I	**Whether the section was adopted and to what extent**	**Whether the section was supplemented with lenient or stringent addition**
Definition: found in section one	Completely adopted	No
Disclosure requirement regarding the negotiation phase: listed in three sections	Completely adopted	Validity order was added
Disclosure requirement regarding the signing of the Memorandum of Understanding or similar document: listed in two sections	Completely adopted	No
Disclosure requirement regarding the signing of the agreement: listed in one section that has eleven subsections	Partially adopted: ten and a half subsections adopted	Stringent addition was added to the ninth subsection
Disclosure requirement	Completely adopted	No

[101] Israeli Securities Authority, ISA ANNUAL REPORT 2007, http://www.isa.gov.il/הודעות%20ופרסומים/Reports/176/Documents/IsaFile_2797.pdf, at 64–65 [in Hebrew].

regarding the closing phase: listed in one section		
Appendix I: listed in seven sections	Completely adopted	Stringent addition was added to the appendix
Appendix II: listed in six sections	Partially adopted: five out of six sections were adopted	Lenient addition was added
Appendix III: listed in four sections	Completely adopted	Stringent addition was added to one of the sections
Appendix IV: listed in four sections	Completely adopted	No

Table 1: Comparison of Stage I and Stage III Versions of ISA Rule Regarding the Disclosure of Contracts of Assets' Acquisition

Finally, it should be noted that analytical comparison was not made between rules' versions at stage I and stage II and between versions at stage II and stage III. This is because most of the updated versions of rules at stage II (after extension) were not available. However, this limitation does not affect the study significantly. As shown in the next part of the Comment, ISA plenum protocols indicate that few changes, if any, occur during stage II. Moreover, analytical comparisons between versions at stage I and III shows non-significant changes. Thus, it can be inferred that the stage II amendments are even less significant.

D. The Findings

The findings of the analytical comparison are divided into two complementary parts: first, statistics concerning the sample, and second, the nature of changes between stages I and III. With respect to the sample, eighteen out of twenty-seven rules (about 67%) that were promulgated in the years 2003 to 2010 were anchored into secondary legislation. Taking into account the additional five rules that are in the process of being anchored in Amendment 21 of

the Joint Investments Trust Law of 1994,[102] twenty-three out of twenty-seven rules (about 85%) were anchored. Finally, three out of the four rules that were not anchored and expired—disclosure of consent to perform a peer review of audits;[103] disclosure pertaining to the adoption of the International Financial Reporting Standards (IFRS);[104] disclosure of the fair value of financial assets and liabilities used to finance purchase of assets and presented according to different measurement bases;[105] and disclosure of investment property[106]—merit attention.

It is quite clear that the rule regarding the fair value of financial assets and liabilities used to finance purchase of assets is technical and the fact that it was not anchored does not make much difference. Moreover, it is obvious that the rule regarding the adoption of IFRS dealt with preparation of the adoption of IFRS that took place before the rule expired.[107] Thus, it was a temporary rule and its anchoring was not needed. Finally, the rule with regard to investment property has been re-promulgated by the ISA in 2011 as part of the Improved Financial Reporting Project, and it is currently being adopted in secondary legislation.[108]

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[102] *See supra* note 87.

[103] Peer review means review of the work of one Certified Public Accountant (CPA) (or CPA firm), by another CPA (or CPA firm). The rule requires companies to disclose whether or not they consent to transfer the information which they hold, and which is required to perform the peer review with respect to the CPA (or CPA firm) who serves as their audit. If a company refuses to transfer the information, the reasons (in detail) and the decisions not to transfer must be included in the disclosure.

[104] The rule was published on November 26, 2006 and requires companies to disclose preparations for the adoption of IFRS, which became mandatory and was fully implemented, by all reporting corporations on, January 1, 2008.

[105] According to the IFRS, applied by companies as of the beginning of 2008, many assets previously presented on a cost basis may now be presented on a fair value basis. Thus, where an asset is purchased by means of a financial liability, the asset and the liability are presented according to different measurement bases, and only one is presented at fair value. In such a case, the rule requires a complementary disclosure in the board of directors' report in order to achieve comparability between the fair value of assets and that of their related liabilities.

[106] International standards allow investment property to be presented at fair value. Fair value is essentially based on estimates, assumptions, and various assessments. The rule requires companies to provide disclosures that enable users of financial statements to compare trends and changes in the fair value of investment properties, calculation of fair value, and other relevant data.

[107] *See* Israeli Securities Authority, ISA ANNUAL REPORT 2012, http://www.isa.gov.il/sites/isaeng/1489/1512/Documents/IsaFile_7850.pdf, at 60–61.

[108] *See id.* at 55–56. At the beginning, this information has been received due to interview with Adv. Shilony, *supra* note 17.

With respect to the eighteen rules that were promulgated, extended, and anchored and that are the focus of the Comment, the analysis shows that the majority of sections (and subsections) included in rules' versions at stage I were adopted during stage III, notwithstanding minor and technical changes; mostly wording modifications and clarifications. A summary of the analysis of all eighteen rules is available in Appendix A. It is notable that these changes usually added to the regulatory burden imposed on the regulated corporations. The evidence collected from the review of protocols strengthens the conclusion that ISA rules change little between stages I and III. First and foremost, ISA plenum protocols included explicit statements by ISA senior staff declaring that rules were extended at stage II—with "slight" or "insignificant" amendments, or with minor amendments for clarification purposes.[109] Sometimes, the staff declared that a rule was extended without any change.[110] ISA staff made similar statements when it passed a new rule for the approval of the plenum at stage I[111] or asked the plenum to approve an initiative for anchoring of an existing rule at stage III.[112] A review of Knesset Finance Committee discussions provided similar statements.[113]

In addition, the protocols exposed the limited supervisory effectiveness of the ISA plenum, the Minister of Finance, and the Knesset Finance Committee. Rarely did plenum members oppose specific matters included in staff initiatives to promulgate a new rule or to extend or anchor an existing one. Even then, their resistance did not lead to a denial of the initiative.[114] At the most, the plenum requested clarifications or specific improvements.[115] The plenum's limited influence on the ISA staff was evident, especially at stage II in which the plenum requested amendments according to comments by the public, ICPA, regulatory

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[109] *See, e.g.,* protocol number 9-2006 (Dec. 12, 2006), at 4; protocol number 7-2007 (July 17, 2007), at 10; protocol number 7-2009 (Sept. 6, 2009), at 6-7.

[110] *See, e.g.,* protocol number 7-2009 (Sept. 6, 2009), at 6-7 (refers to three rules); protocol number 6-2010 (June 16, 2010), at 3,4,7; protocol number 1-2010 (Jan. 24, 2010), at 28-29; protocol number 12-2011 (Sept. 21, 2011), at 8.

[111] *See, e.g.,* protocol number 8-2010 (Oct. 24, 2010), at 29-30.

[112] *See, e.g.,* protocol number 2-2009 (Feb. 8, 2009), at 6.

[113] *See, e.g.,* the Knesset Finance Committee, protocol of meeting from Dec. 27, 2006, at 2-3 (refers to three rules), and from Aug. 10, 2011, at 3.

[114] In that respect it is worth referring to one of the plenum meetings, during which a plenum member stated that the plenum approves the ISA staff's initiatives in "99.9% of the cases." *See* protocol number 8-2008 (Sept. 14, 2008), at 11.

[115] *See, e.g.,* protocol number 3-2010 (Mar. 21, 2010), at 18.

stakeholders, or just plenum members themselves. The staff, in response, asked to avoid amendments at this stage in order to maintain regulatory continuity, mainly (as the staff declared) in favor of regulated constituencies, and promised to reconsider these changes during stage III.[116] It should be emphasized that even today, there is no mechanism to ensure that ISA staff seriously consider stage II comments in stage III. Finally, more than once plenum members have asked ISA staff to involve them at an earlier stage when they can most effectively influence policy direction.[117] With respect to the Minister of Finance, his limited role in rule review and modification is evident in the fact that he has never refused to approve a rule's extension. Furthermore, the plenum protocols suggest that he plays a very deferential role; he has a near absolute trust in the ISA's professional judgment.[118]

With regard to the Knesset Finance Committee, it is worth noting that during some of the discussions that took place at stage III, ISA staff emphasized the fact that the rules (which were previously presented to the Knesset Committee for anchoring) had operated for two years already and the regulated market was familiar with them.[119] This fact warrants serious attention considering the request of ISA staff itself to postpone consideration of comments from stage II to stage III.[120] It appears that the ISA actively eschews input at earlier stages of the rulemaking process in order to entrench its own preferred version of a rule and later uses that entrenchment to argue against rule modifications. Furthermore, the author also found one case in which anchoring of three rules into secondary legislation was discussed and approved only four days

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[116] *See, e.g.*, protocol number 7-2009 (Sept. 6, 2009), at 6 (refers to three rules); protocol number 6-2010 (June 16, 2010), at 3-7 (refers to two rules); protocol number 1-2010 (Jan. 24, 2010), at 28-29.

[117] During one of the plenum meetings, a plenum member stated that the regulatory initiative before the plenum for approval is a "very cooked pastry." The term is translated from Hebrew and means an over-cooked dish. *See* protocol number 8-2008 (Sept. 14, 2008), at 11. During the same meeting, other plenum member stated that after the initiatives become public "it is much more difficult to stop them and to invalidate them." *See Id.*, at 14.

[118] *See, e.g.*, protocol number 12-2011 (Sept. 21, 2011), at 27-28. There, representative of finance ministry stated that the ministry usually adopts the ISA initiatives since the professional body is the ISA and "it is not really that the ministry is doing the work." He added that the approval of the ministry is a blanket approval since the ISA does the all work and the ministry just take a view seen from high above to examine that regulation is done "reasonably." Finally, the representative summarized that the ministry is indeed considered a supervisory authority, but the professional work is done by the ISA.

[119] *See, e.g.*, the Knesset Finance Committee, protocol of meeting from Dec. 27, 2006, at 2-3 (refers to three rules); Knesset Finance Committee, protocol of meeting from Feb. 12, 2008, at 4-5; and Knesset Finance Committee, protocol of meeting from June 2, 2008, at 5.

[120] *See supra* note 124 and accompanying text.

before their expiration.[121] In yet another case, a Member of Knesset complained that the subject of the rules that the Committee was asked to approve was too complex to be approved so quickly.[122] He added that he "does not understand anything regarding the subject matter of the rule that he is being asked to anchor and Knesset Members lack all independent thought regarding the approval process."[123] Finally, it seems that the Committee absolutely respects the ISA judgment and does not interfere with ISA discretion regarding the necessity for anchoring of its rules.[124]

III. The Study of SEC Rulemaking

The regulatory process of the SEC serves as an excellent comparison for the foregoing study of ISA rulemaking. While the ISA often embraces the philosophy and policy choices of the SEC, the participatory and oversight mechanisms in the SEC rulemaking process are quite different than those discussed in the ISA rulemaking process. As discussed in *supra*, SEC rules go through significantly more change throughout the adoption than ISA rules. The comparison between the SEC and ISA demonstrates how disparate rulemaking mechanisms can drastically affect the final content of rules promulgated by agencies with similar goals and ideas.

This part of the Article lays the groundwork for a later discussion of the different mechanisms employed by the ISA and the SEC, and the potential ramifications these mechanisms may have on a rule's susceptibility to regulatory inertia or undue influence. In the remainder of this section, the essay outlines the SEC rulemaking process and presents the procedural mechanisms that accompany it and are relevant to this discussion. The Article then turns to the study of SEC rulemaking—the sample construction, and the analysis methodology and results.

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[121] See the Knesset Finance Committee, protocol of meeting from Dec. 27, 2006, at 2 (refers to three rules).

[122] See the Knesset Finance Committee, protocol of meeting from Dec. 27, 2006, at 5.

[123] See the Knesset Finance Committee, protocol of meeting from Dec. 27, 2006, at 5.

[124] *See, e.g.*, protocol number 6-2008 (Jul. 20, 2008), at 10; protocol number 11-2008 (Dec. 14, 2008), at 19.

A. The SEC Rulemaking Process

The SEC holds general rulemaking power that allows it to promulgate rules for an indefinite period as, and when, it deems necessary.[125] According to the notice and comment procedure set within the Administrative Procedure Act (APA), the SEC publishes a general notice of a proposed rule in the Federal Register.[126] This allows "interested persons an opportunity to participate" in rulemaking through the submission of comments.[127] The SEC considers the comments that it receives.[128] If it believes necessary, the SEC will incorporate comments into the final version of the rule.[129] The SEC then publishes the final rule in the Federal Register, the Code of Federal Regulation, and on its website.[130] Within the rule's final version, the SEC describes the main comments received and the regulatory response given to them.

B. Procedural Mechanisms

Unlike the ISA, the SEC—pursuant to statutes and executive orders—is subject to procedural mechanisms that require it to analyze regulatory alternatives while proposing a new rule. The SEC is required not only to publish the analysis, but also to solicit comments on the analysis, respond to those comments, and publish its responses.[131] In this section, the Comment reviews the most prominent procedural mechanisms. For convenience, it refers to the SEC in particular, although these mechanisms apply to most U.S. regulatory agencies in general.

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[125] The SEC's rulemaking power derives from the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, the Investment Advisers Act of 1940, and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

[126] *See* 44 U.S.C. §§ 3501–3521 (2006) (explaining that the SEC publishes a general notice of the proposed rule in the Federal Register and publishes the proposal on its website and in other places at the same time to promote public participation in its rulemaking process.).

[127] 5 U.S.C. §§ 553(b)–(c) (2006) (describing exceptions to the APA's notice and comment requirement, including an exception for "interpretive rules" and "general statements of policy"). For further reading, see STEPHEN G. BREYER ET AL., ADMINISTRATIVE LAW AND REGULATORY POLICY: PROBLEMS, TEXT AND CASES 519–20 (7th ed. 2011); 1 RICHARD J. PIERCE, JR., ADMINISTRATIVE LAW TREATISE § 7.10, at 671–77 (5th ed. 2010).

[128] *Rulemaking, How it Works,* U.S. SEC. & EXCH. COMM'N (Apr. 6, 2011), http://www.sec.gov/answers/rulemaking.htm.

[129] *Id.*

[130] *See Rulemaking, How it Works,* U.S. SEC. & EXCH. COMM'N (Apr. 6, 2011), http://www.sec.gov/answers/rulemaking.htm.

[131] *See* 5 U.S.C. §§ 601–614 (2012)

The first mechanism is the Regulatory Flexibility Act (RFA), the purpose of which is to ensure that the SEC considers the needs and capabilities of small entities.[132] According to the RFA, when the SEC is required by the APA, or any other law to publish a general notice of proposed rulemaking, it must prepare and publish an initial regulatory flexibility analysis that describes the proposed rule's influence on small entities.[133] In addition, the SEC must prepare a concluding regulatory flexibility analysis in the final promulgation stage.[134] This analysis must contain updated information that was included in the initial analysis, a summary of significant issues raised by the public in response to the initial analysis, a summary of the SEC's assessment of such issues, and a statement of any changes made in the proposed rule as a result of such comments.[135] The RFA demands that the SEC publish the final regulatory flexibility analysis in the Federal Register—thus making it available to the public.[136]

The second mechanism is the Paperwork Reduction Act (PRA), which, among other purposes, is meant to "minimize the paperwork burden for individuals, small businesses."[137] According to the PRA, if the SEC proposes a rule that includes a new "information collection" requirement,[138] the SEC must then review the requirement,[139] provide notice of the requirement

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[132] *See* 5 U.S.C. §§ 601–612 (2012).

[133] *See* 5 U.S.C. § 603 (2012). The initial regulatory flexibility analysis includes a description of the reasons why action by the SEC is being considered; a statement of the objectives of and legal basis for the proposed rule; a description of the projected reporting, recordkeeping, and other compliance requirements of the proposed rule, including an estimate of the classes of small entities which will be subject to the requirement and the type of professional skills necessary for preparation of the report or record; an identification, to the extent practicable, of all relevant federal rules that may duplicate, overlap, or conflict with the proposed rule; a description of any significant alternatives to the proposed rule which accomplish the stated objectives of applicable statutes and which minimize any significant economic impact of the proposed rule on small entities.

[134] *See* 5 U.S.C. § 604(a) (2012).

[135] *Id.*

[136] 5 U.S.C. § 604(b) (2012); For further reading regarding the RFA, *see* JAMES T. O'REILLY, ADMINISTRATIVE RULEMAKING: STRUCTURING, OPPOSING, AND DEFENDING FEDERAL AGENCY REGULATIONS 176–91 (2d ed. 2011).

[137] 44 U.S.C. § 3501(1) (2012).

[138] *See* 44 U.S.C. § 3502(3)(A) (2012) (defining the "collection of information" as "obtaining, causing to be obtained, soliciting, or requiring the disclosure to third parties or the public, of facts or opinions by or for an agency . . . .").

[139] 44 U.S.C. § 3507(a)(1)(A) (referencing 44 U.S.C. § 3506(c)(1) (2012), which requires the review to include an evaluation of the need for the collection of information; a functional description of the information to be collected; a plan for the collection of the information; a specific, objectively supported estimate of the burden; a test of the

in the Federal Register, consult with members of the public and affected agencies concerning each proposed collection of information, solicit comments to evaluate the proposed collection of information, evaluate the comments that it receives,[140] and obtain the approval of the Office of Information and Regulatory Affairs (OIRA).[141] If the OIRA chooses to approve the proposed collection of information, a final rule is published in the Federal Register to explain the manner in which the collection of information requirement contained in the final rule responds to any comments received from the public and the reasons why comments which did not affect the final rule were not incorporated.[142]

Third, over the last three decades, U.S. presidents have issued different Executive Orders designed to eliminate excessive red tape, especially by requiring regulatory agencies to assess the expected impacts of their initiated rules through Cost Benefit Analyses (CBAs), which are subject to review by the OIRA.[143] In the context of this analysis, special emphasis should be given to Executive Orders 12,866 and 13,563, which require agencies to assess all costs and benefits of available regulatory alternatives in deciding whether and how to regulate.[144] Although the SEC was usually exempted from these Executive Orders[145] because it

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collection of information through a pilot program, if appropriate; and a plan for the efficient and effective management and use of the information to be collected, including necessary resources).

[140] 44 U.S.C. § 3507 (a)(1)(B) refers to § 3506(c)(2).

[141] The OIRA was established as a part of the Office of Management and Budget (OMB). 44 U.S.C § 3503(a) (2012). The OMB serves the President of the U.S. in implementing his vision across the Executive Branch. *See The Mission and Structure of the Office of Management and Budget*, THE WHITE HOUSE, http://www.whitehouse.gov/omb/organization_mission/ (last visited Apr. 11, 2015). The OIRA administers the regulatory process and oversees the regulatory agencies to make sure they obey the PRA and the Executive Orders discussed below. *See* 44 U.S.C. § 3503(b) (2012). For additional reading on the OIRA and OMB, see Steven Croley, *White House Review of Agency Rulemaking: An Empirical Investigation*, 70 U. CHI. L. REV. 821 (2003); Bagley & Revesz, *supra* note 44, at 1263–68.

[142] 44 U.S.C. § 3507 (d)(2) (2012). For additional reading on the PRA, see O'REILLY, *supra* note 103, at 170–76.

[143] Exec. Order No. 12,866 §§ 1(a), 1(b)(3), 4(c), 58 Fed. Reg. 51,735, 51,735–36, 51,738 (Oct. 4, 1993); Exec. Order No. 13,563 § 1(b), 76 Fed. Reg. 3821 (Jan. 21, 2011). Exec. Order 12,866 was amended by Exec. Order 13,258 and Exec. Order 13,422. Exec. Order 13,497, signed January 30, 2009, revoked those amendments. *See also Executive Order 12866 Regulatory Planning and Review*, OIRA, http://www.reginfo.gov/public/jsp/Utilities/EO_Redirect.jsp (last visited June 11, 2015) (explaining amendment of Exec. Order 12,866 by Exec. Order 13,258 and Exec. Order 13,422 and further repeal of amendments by Exec. Order 13,497).

[144] *Id.*

is classified as an "independent agency,"[146] it has routinely followed them nonetheless.[147] Moreover, a series of cases from the U.S. Court of Appeals for the District of Columbia Circuit have invalidated SEC rules because of SEC's failure to adequately assess potential costs and benefits.[148] Finally, in 2011, under Executive Order 13,579, President Obama expanded Executive Order 13,563 requirements to include independent agencies.[149]

C. Methodology and Findings

The methodology used to analyze the SEC rules is similar to the methodology used for the ISA: the SEC final rules were compared with their corresponding proposals and differences were analyzed for indications of regulatory inertia or undue influence. The comparison, which is available in Appendix B, includes rules that were promulgated in 2006, 2007, 2008, and 2009 (sixteen rules in total). To ensure an unbiased selection, the rules in the SEC sample were selected according to their date of publication in descending order. For each year between 2006 and 2009, the four rules that were the last to be issued were selected. The sample excluded very short rules that were entirely technical and therefore did not allow for substantial examination; rules that did not have a link to their proposal; rules that referred to more than one proposal; or temporary rules. The final versions of SEC's rules were available on the SEC website and were linked to their corresponding proposals.

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[145] *See* Robert W. Hahn & Cass R. Sunstein, *A New Executive Order for Improving Federal Regulation? Deeper and Wider Cost-Benefit Analysis*, 150 U. PA. L. REV. 1489 (2002).

[146] 44 U.S.C. § 3502(5) (2012) (defining "independent regulatory agencies" and including the SEC and other regulatory agencies in that definition).

[147] *See* U.S. Sec. & Exch. Comm'n, Memorandum on Current Guidance on Economic Analysis in SEC Rulemakings (Mar. 16, 2012), *available at* http://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf ("No statute expressly requires the Commission to conduct a formal cost-benefit analysis as part of its rulemaking activities. But as SEC chairmen have informed Congress since at least the early 1980s–and as rulemaking releases since that time reflect–the Commission considers potential costs and benefits as a matter of good regulatory practice whenever it adopts rules."). *See also* PAUL ROSE & CHRISTOPHER J. WALKER, CENTER FOR CAPITAL MARKETS COMPETITIVENESS, THE IMPORTANCE OF COST-BENEFIT ANALYSIS IN FINANCIAL REGULATION, at v (2013), *available at* http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/CBA-Report-3.10.13.pdf.

[148] For an excellent overview, *see generally* Bruce Kraus & Connor Raso, *Rational Boundaries for SEC Cost-Benefit Analysis*, 30 YALE J. ON REG. 289 (2013); Leen Al-Alami, *Business Rountable v. SEC: Rising Judicial Mistrust and the Onset of a New Era in Judicial Review of Securities Regulation*, 15 U. PA. J. BUS. L. 541 (2013).

[149] Exec. Order No. 13,579, 76 Fed. Reg. 41,587 (July 14, 2011).

The final rules and their corresponding proposals are linked to a list of comments on the proposed rules. Further, the main comments received—throughout all stages by virtue of RFA, PRA, and Executive Orders—and the responses given to them are included in the version of the final rules. This information sheds light on SEC amendments and, more importantly, helped better understand the happenings behind them. As the analysis shows, the SEC revised or omitted some aspects of rules proposals due to comments by industry participants, federal government agencies, individuals, law firms, professional associations, and public interest groups. These changes were substantive in nature and are not just technical or for the sake of clarity alone.

IV. Discussion

A. Regulatory Inertia and Immunity from Undue Influences

The findings of this study show—through the analytical comparison, review of protocols, and the analysis of SEC's rulemaking—a lack of material changes in the ISA rules during three main promulgation stages that together last almost two years. These findings constitute apparent evidence for a high degree of inertia within the ISA rulemaking process. Indeed, proof of regulatory inertia relies on two cumulative conditions—lack of material change and justifications for change. This Comment provides explicit evidence to support the lack of material change only. However, justifications for a change can be justifiably inferred because (1) regulation will rarely, if ever, be optimal in its first incarnation[150] and (2) it is likely that reasons for material change will arise during the rulemaking stages. This is especially true given the ISA prolonged rulemaking process and considering the frequent, material modifications made during the SEC rulemaking analyzed in this essay. The exact causes for the mentioned inertia are hardly testable in the context of this analysis. This is especially true with respect to potential behavioral causes[151] and in the absence of information regarding the

[150] To begin with, regulators cannot predict in advance the true effect of regulation after its implementation. *See* Michael Greenstone, *Toward a Culture of President Regulatory Experimentation and Evaluation*, *in* NEW PERSPECTIVES ON REGULATION 111, 113 (David Moss & John Cisternino eds., 2009). This is especially true with respect to the financial market, considering its complexity. *See* Jill E. Fisch, *The Long Road Back: Business Roundtable and the Future of SEC Rulemaking*, 36 SEATTLE U. L. REV. 695, 713 (2013).

[151] The difficulty in applying behavioral theories—usually tested in laboratory environment and conditions—on the "real world" environment is widely discussed in Alan Schwartz, *The Rationality Assumption in Consumer Law*, CTR. FOR LAW & ECON. (Mar. 2013), http://www.lawecon.ethz.ch/education/lawecon/education/lawecon/readings/consumer_regulation.pdf.

comments received with respect to the ISA rules.[152] Still, potential explanations will be discussed later in the next part of the Comment.

Furthermore, study results may also challenge the common wisdom of public choice theory. As discussed in Section III.A *supra*, Israeli interest groups enjoy significant power and a high market concentration.[153] In this context, business groups control the publicly traded companies that are subject to the ISA rules and have a related interest to undermine the rules for three main reasons. First, the vast majority of the rules require extensive disclosure with regard to many significant areas and topics and therefore impose a significant burden on the companies and the business groups.[154] Second, because the rules are so detailed and elaborate, they leave the ISA with almost no room for discretion and in turn leave business groups with no reason to anticipate lenient interpretation and enforcement of the rules in the future.[155] Third, except for the period of the global financial crisis (July 2007 to 2009), the Comment examines a period of normalcy in which the public demand for regulation should have been negligible, at least in theory.[156] Even accounting for the fact that the global crisis has been followed in Israel by antagonism towards the Israeli "tycoons"[157] and by anti-business sentiment in Israeli public

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[152] *See supra* text accompanying note 90.

[153] *See supra* notes 57–58.

[154] It is enough to take a quick glance at the Israeli financial media to understand that disclosure duties incorporated into the ISA rules and the legislation that adopts the rules cause the groups great concern. In that context, the ISA is accused quite often of using disclosure rules to extend its domain into substantive corporate governance beyond its jurisdiction. See Asaf Eckstein, *Who Guards the Israeli Securities Authority and Who is Involved in its Rulemaking?*, 19 IDC. L. REV. (2015) (in Hebrew), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2558678

[155] This relationship between "Law in the Books" (in our context, the rulemaking level) and "Law in Action" (in our context, the enforcement and interpretation level), was first coined and described by Roscoe Pound, *See Law in Books and Law in Action*, 44 AM. U. L. REV. 12 (1910). In this respect, one might argue that although the regulation was made to the detriment of the interest groups, the ISA can interpret and enforce the rules in their favor. As I stated above, this is not the case with respect to the ISA rules analyzed in this Comment.

[156] Indeed, one might argue that in the years 2010 to 2012—during which some rules included in this Comment's sample were promulgated, extended, and anchored—the collective trauma from the global crisis has remained fresh in mind and thus 2010-2012 might be considered as a crisis period. In the same vein, others may point to the years after 2001 to 2002, during which financial scandals such as Enron, Worldcom, and Adelphia were revealed, as a post-crisis period. However, it is quite clear that shortly after a crisis or scandal is over, the broad public's memory fades and its demand for regulation disappears.

[157] The term applied by Israelis to the local businessmen who have built or acquired corporate empires.

debate,[158] the sample addresses the period from 2003 through the first half of 2007, which reflects normal times. Thus, according to the public choice insights, during these years, one would expect Israeli interest groups to force the ISA to withdraw its initiatives (in other words, to abandon the existing rulemaking process) or at least to soften them.[159]

Indeed, one might argue that this Comment concentrates on the three distinct stages following the ISA publication of a rule proposal, while interest groups often interact directly with the regulator through informal channels.[160] Thus, during the pre-proposal stage of rulemaking, they may lobby the regulator to influence the content of a rule before the rule is proposed at the first phase.[161] This possibility is hardly testable in the context of this analysis because the ISA does not document and publish inputs being received during the proposal development stage.[162] Regardless, such a preliminary influence is less plausible in our context, not only because some amendments were eventually made to the detriment of the interest groups,[163] but also because it is unlikely that such an influence remained intact over the ISA extended rulemaking period of almost two years. Ultimately, in the beginning of January 2014, the author interviewed Mr. Nathan Shilo, Legal Adviser to the Association of Publicly Traded

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[158] This atmosphere has been reflected in the media attacks on Israel's business magnates for their debt settlements and in the social justice protests, a series of ongoing demonstrations in Israel beginning in July 2011 involving hundreds of thousands of protesters opposing the continuing rise in the cost of living.

[159] In this context it is interesting to refer to Fisch, *supra* note 150, at 723 (providing examples of cases in which "political pressure has led the SEC to postpone or scale back a number of controversial rule proposals").

[160] *See* Nina A. Mendelson, *Regulatory Beneficiaries and Informal Agency Policymaking*, 92 CORNELL L. REV. 397, 429–31 (2007).

[161] *See*, Susan Webb Yackee, *The Politics of Ex Parte Lobbying: Pre-Proposal Agenda Building and Blocking During Agency Rulemaking*, 22 J. OF PUB. ADMIN. RESEARCH & THEORY 373, 373 (2012).

[162] Contrary to the ISA rulemaking process, some American regulatory agencies' rulemaking process begins with Advanced Notice of Proposed Rulemaking (ANPRM) procedure, which documents the proposal development stage. However, most of the time ANPRM is voluntarily made by these agencies and in fact, the bulk of federal regulations do not begin with an ANPRM. See Section III.B *supra*.

[163] This can be also explained in several ways. First, according to the public choice literature, interest groups might demand regulation because "even if it costs them a good bit, it costs competitors or potential competitors more." *See* Donald C. Langevoort, *The SEC as a Lawmaker: Choices About Investor Protection In The Face of Uncertainty*, 84 WASH. U. L. REV. 1591, 1599 (2006). Second, one might argue that amendment are more apparent than real, made in order to manipulate the public's subjective perception of the regulation's effectiveness and thus to allow regulator to take credit for the change in perceived risk. *See id.* at 1600; *see also* Amitai Aviram, *The Placebo Effect of Law: Law's Role in Manipulating Perceptions*, 75 GEO. WASH. L. REV. 54 (2006); Amitai Aviram, *Bias Arbitrage*, 64 WASH. & LEE L. REV. 789 (2007).

Companies, which acts as a representative of the public companies in Israel.[164] According to Mr. Shilo, the Association has always responded and submitted recommendations and comments on the ISA's rulemaking or modification initiatives only *after* the initiatives were published on the ISA website.[165] The Association is typically not involved in the formulation of the initiatives.[166]

In light of the above analysis, how then can one explain the ISA tendency towards inertia and the colossal "failure" of the Israeli interest groups? In the view of the author, the answer lies in ISA institutional features, which provide it with a high degree of institutional independence.[167] Such independence can enhance ISA immunity from public choice influence on the one hand[168] and might cause ISA isolation, which can turn to some degree of inertia, on the other hand. The remainder of this section discusses these institutional features by dividing them into three levels: ISA rulemaking process, the regulatory environment within which the ISA is operating, and ISA structure and culture. It should be noted, in advance, that the effect of the institutional features on the potential for undue public choice influence is not monotonous; in other words, while some of the features may mitigate undue influence, others may exacerbate it. Thus, it is important to evaluate the overall picture that emerges—indicating the ISA's ability to resist undue influence.

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[164] The Association is a non-profit organization founded in 1991 to represent the interests of the companies listed on the Tel Aviv Stock Exchange (TASE) before various government institutions and authorities in the areas of legislation, regulation, supervision, and performance. The Association aspires to accelerate the process of deregulation in the Israeli capital market, while reducing government involvement in business activity in general, and the capital market in particular.

[165] Interview with Mr. Nathan Shilo, Legal Adviser, Association of Publicly Traded Companies (Jan. 2014).

[166] *Id.*

[167] For an excellent overview of features and criteria traditionally associated with institutional independence, *see, e.g.*, Fabrizio Gilardi & Martino Maggetti, *The Independence of Regulatory Authorities*, in HANDBOOK ON THE POLITICS OF REGULATION (David Levi-Faur ed., 2011); *see also* Barkow, *supra* note 55.

[168] *See* Steven P. Croley, *Beyond Capture: Toward a New Theory of Regulation*, *in* HANDBOOK ON THE POLITICS OF REGULATION 50, 57 (David Levi-Faur ed., 2011) (commenting that decisions by independent and non-independent administrators should be analyzed under different regulatory theories because the two administrators operate within different regulatory environments and under different constraints).

B. ISA Institutional Features

The ISA regulatory process is not governed by procedural statute or executive orders, and thus, it is not constrained by strict procedures.[169] With respect to transparency duties, the Securities Law and Freedom of Information Law require the ISA to uphold transparency principles.[170] However, these principles are relatively insignificant, mainly because the relevant order in the Securities Law allows the ISA a very wide room for discretion to decide whether or not to publish its materials, and Freedom of Information Law requires the ISA to publish only the final version of its rules.[171] In practice, the ISA does not disclose preliminary consultations it conducts during formulation of regulatory initiatives.[172] Moreover, until 2013, when the new procedure for initiating rulemaking was adopted, the ISA did not publish either the comments that it received regarding its initiatives within comments periods or the amendments that were made in response to the comments.[173]

Simply put, transparency plays two fundamental roles—participatory and supervisory. With respect to the participatory role, transparency opens the rulemaking process, encourages participation of the public and specific constituencies in the process, and invites them to contribute their knowledge and skills. Participation allows a spectrum of regulatory alternatives that could minimize regulatory inertia. With respect to the supervisory role, transparency allows the public to monitor the rulemaking process by revealing non-efficient regulation in real time and by making it easier to detect such regulation in retrospect. Moreover, transparency can force the regulator to consider various inputs, making it difficult for the regulator to ignore them and thus minimizing regulatory inertia. These participatory and supervisory functions also contribute to better rulemaking by offsetting the influence of regulated industries and helping to prevent regulator capture.[174]

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[169] *See* Eckstein, *supra* note 154.

[170] According to Securities Law, 5728-1968, § 9B, "The Authority shall publish those of its decisions which, it its opinion, are of principled significance." According to Freedom of Information Law, § 6(c), "a public authority shall publish its legislative rules."

[171] Eckstein, *supra* note 154.

[172] *Id.*

[173] *Id.*

[174] *See, e.g.*, Michael Asimow, *Public Participation in the Adoption of Interpretive Rules and Policy Statements*, 75 MICH. L. REV. 520, 574 (1977); Stephen M. Johnson, *Good Guidance, Good Grief!*, 72 MO. L. REV. 695, 702–03

Furthermore, the ISA is not obliged as a matter of law (or pursuant any executive order) to conduct an economic Regulatory Impact Analysis (RIA) of its contemplated regulations and, as a matter of practice, the ISA does not conduct a systematic RIA.[175] An in-depth discussion of RIA's pros and cons is beyond the scope of this Comment; however, it is helpful to point out the significant role of RIA as a mechanism to force the regulator to consider different approaches and regulatory alternatives and reveal the factors that underlie its regulations—both may mitigate the risk of regulatory inertia and the unwarranted effect of undue external influence.[176] To conclude, the fact ISA rulemaking lacks procedural safeguards, such as transparency and RIA, may cause the ISA to experience an elevated level of regulatory inertia. With respect to possible influence of the Israeli interest groups on proposed regulation, it appears as though the lack of transparency creates a gap between the regulator and the general public, to whom the regulator is ultimately accountable. If inefficiencies are difficult for interest groups to expose, then a generally disinterested public is unlikely to pressure regulators for more effective rules.

Similar to the procedural mechanisms discussed above, the ISA regulatory environment also provides it with significant freedom. At the outset, indirect and direct relationships with the executive, legislative, and judicial branches ensure the ISA significant independence. With respect to the indirect relationships, in accordance with the Securities Law, the ISA Chairman and commissioners (ISA board members) are appointed for fixed terms by the Minister of Finance.[177] Some commissioners are appointed from the public, others are civil servants, and one is an employee of the Bank of Israel.[178] The Minister of Finance can remove them only for specific causes under the statutory for-cause removal restriction.[179] Also, although the ISA

(2007); David Fontana, *Reforming the Administrative Procedure Act: Democracy Index Rulemaking*, 74 FORDHAM L. REV. 81, 91 (2005).

[175] Eckstein, *supra* note 154, at 38–39.

[176] For further reading regarding the contribution of RIA's prevention of undue influence under the cost-benefit analysis, *see* Paul Rose & Christopher J. Walker, *Dodd-Frank Regulators, Cost-Benefit Analysis, and Agency Capture*, 66 STAN. L. REV. ONLINE 9, 15 (2013).

[177] Securities Law, 5728-1968, §§ 3–4, SH No. 541, p. 234 (Isr.).

[178] *See supra* note 15.

[179] *See* Securities Law, §4(d) (Isr.). These causes are: repeated failure to be present at four consecutive meetings or six meetings within a calendar year; failure to continue meeting the membership conditions, including conflict of interests restrictions; and violation of the restrictions placed on engaging in securities transactions. *See id.* §§ 4(d), 6(a).

budget is approved by the Minister of Finance and the Knesset Finance Committee,[180] the ISA budget is funded by fees levied on regulated entities for services, and the ISA receives no allocations from the government budget.[181]

With regard to direct intervention, over the last two decades, the ISA was almost absolutely free from judicial intervention. Only three petitions were submitted to Israel's High Court of Justice (*Bagatz*) against ISA rulemaking—none of them yielded judicial review of ISA rulemaking.[182] This situation is significantly different than the situation of the SEC. More than once, SEC rules were struck down by courts because the SEC failed to adequately assess the rules' potential costs and benefits or failed to consider available alternatives.[183] Thus, lack of judicial intervention can help in explaining the ISA's tendency toward inertia, as well as the SEC's flexibility and willingness to modify proposed rules. Furthermore, given that "the ability of interest groups to challenge rules in the courts provides a rationale for bureaucrats to be responsive to interest group comments,"[184] lack of judicial intervention in the ISA rulemaking can explain ISA immunity against interest groups' influence.

With respect to the executive and legislative branches, the situation is more complicated. Currently, the ISA holds limited rulemaking power. This subjects the ISA rulemaking initiatives to the approval of the Minister of Finance and Knesset Finance Committee,[185] which exposes the ISA to potential political intervention.[186] Implicit evidence of political intervention

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[180] *Id.* § 11.

[181] *Id.* § 55. The budget is funded by annual fees payable by companies that are subject to the Securities Law and the Joint Investment Trust Law of 1994; by fees payable for applications to receive permits to publish prospectuses and private offerings; by licensing fees payable by investment advisors and investment portfolio managers, and by fees payable by the Tel Aviv Stock Exchange. Under § 55A of the Securities Law, the Minister of Finance sets the fee schedules and the Knesset Finance Committee approves them. *Id.* § 55A.

[182] HCJ 10381/07 Ronen Adini vs. Israel Sec. Auth. and Mr. Moshe Terry (2007); HCJ 3803/11 Israel Capital Mkt. Tr. Ass'n, HCJ 4694/11 Ass'n of ETNs in the Tel Aviv Chamber of Commerce and Ass'n of (non-bank) Stock Exch. Members, and HCJ 5437/11 Mutual Fund Managers Ass'n vs. the State of Israel, the Minister of Fin., the Israel Sec. Auth., the Knesset of Israel and the Minister of Justice (the three petitions were heard together); HCJ 8136/11 Mutual Fund Managers Ass'n vs. the Minister of Fin. and the Israel Sec. Auth.

[183] *See supra* note 148 and accompanying text.

[184] Yackee, *supra* note 8, at 108.

[185] *See supra* Part II.A.

[186] This situation was criticized by the International Monetary Fund (IMF) in MONTETARY AND CAPITAL MKT. DEP'T. INT'L MONETARY FUND, IMF COUNTRY REPORT NO. 12/87, ISRAEL: DETAILED ASSESSMENT OF IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION, 26 (April 2012), *available at*

was provided by Zohar Goshen following his retirement as the ISA chairman.[187] However, as this Comment has shown, at least with respect to rules analyzed here, rarely does the Minister of Finance or the Knesset Finance Committee intervene, leaving the ISA with wide discretion. Moreover, this intervention is dwarfed in comparison to the intervention of OIRA, which is also susceptible to interest groups influence,[188] vis-à-vis SEC rulemaking despite the fact that the SEC holds formal rulemaking power.[189] Further evidence for ISA immunity from intervention of executive and legislative branches can be found in the ISA's exclusion from two initiatives that were designated to restrain Israeli regulatory agencies and are currently being approved—the regulatory impact assessment system developed by the Ministry for Industry, Labour and Trade, and Small- and Medium-sized Enterprises (SME) Bill submitted by the government to the Israeli Knesset.[190]

Beyond the ISA relationship with the three branches as discussed above, two elements regarding the ISA environment also deserve attention. The first element relates to the interest groups regulated by the ISA. Generally, the ISA regulates not only publicly traded companies, but also mutual funds, licensing portfolio managers, investment advisors, and investment marketers.[191] Thus, public companies must "share" the ISA with the other groups and,

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http://www.imf.org/external/pubs/ft/scr/2012/cr1287.pdf ("Authorities should proceed with proposals to amend the legislation to make clear that decisions of a purely regulatory character are to be made by the ISA.") *See also id*. at 32 ("A number of these provisions enable the ISA to give the minister advice on the regulatory decision. Nonetheless, some provisions are regulatory in nature and it potentially intrudes on the independence of the ISA for decisions of this kind to be made at the political level.")

[187] *See* Sever Plotzker, *In Goshen Land*, YEDIOTH AHRONOTH (May 6, 2011) at 36 (7 Days Weekend Supplement) (confessing that he (Professor Goshen) was exposed to "political attempts of intervention").

[188] Bagley & Revesz, *supra* note 55, at 1309–10 (noting that "OIRA may even have particular susceptibilities to public choice pressures," because its not covered by the Administrative Procedure Act and the review it conducts is not transparent).

[189] *See supra* Part III.B.

[190] The first initiative enhances systematic form of regulatory impact assessments and the second initiative creates a legal basis for government recognition of the importance of SMEs, requiring all regulating bodies to take SMEs' needs into consideration when making decisions that impact Israeli businesses.

[191] *See* ISRAELI SECURITIES AUTHORITY, REPORT ON THE ACTIVITIES OF THE ISRAEL SECURITIES AUTHORITY FOR 2013 17 (2014), *available at* http://www.isa.gov.il/sites/ISAEng/1489/1512/Documents/ISA_Report__2013.pdf; *The ISA's Functions*, ISRAELI SEC. AUTHORITY, http://www.isa.gov.il/sites/isaeng/ABOUT/Pages/Role-of-the-ISA.aspx.

therefore, may have relatively little chance to influence the ISA.[192] Further, the public companies on the one hand and the other groups on the other hand may have opposing interests,[193] which can reduce their influence on the ISA. Moreover, different interests may emerge not only among different groups, but also within the group of public companies itself. Thus, better companies may have strong incentives to prefer tough regulation in terms of broad disclosure and better investor protection to lower the cost of capital and to maximize the value of their shares.[194] Lastly, other groups not directly regulated by the ISA benefit from ISA regulation and they would oppose efforts to diminish or weaken the ISA's rules.[195] These groups comprise the providers of the legal or economic services in the securities industry—lawyers (the Israeli Bar Association or private law firms), accountants (the Israeli Institute of Certified Public Accountants (ICPA), Institute of Internal Auditors, or private audit firms), analysts, and rating agencies. These groups benefit from negotiating, interpreting, and litigating the terms of ISA regulation on behalf of the regulated groups and their interests often do not directly align with the regulated entities themselves.[196]

The second element relates to other regulators that operate alongside the ISA. It has been argued elsewhere that competition between regulators "may help alleviate the public choice problem facing regulators," because each regulator's desire to attract issuers looking for better regulation that ensures investor protection, which in turn would lower capital cost and to maximize the value of their shares.[197] Indeed, the ISA shares the mission of protecting the

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[192] *See*Jonathan R, Macey, *Organizational Design and Political Control of Administrative Agencies*, 8 J.L. ECON. & ORG. 93, 99 (1992) ("The interest group that is regulated by a single regulatory agency will be able to influence that agency to a far greater extent than the interest groups that must 'share' their agency with a variety of other interest groups.").

[193] *See* Donald C. Langevoort, *The SEC as a Lawmaker: Choices About Investor Protection In The Face of Uncertainty*, 84 WASH. U. L. REV. 1591, 1599 (2006).

[194] *See id*. ("Better companies will want protection from claims by 'lemons' competing with them for capital . . . ."); *see also* John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229 (2007–08) with respect to enforcement levels.

[195] *See, e.g.,* Asaf Eckstein, *Great Expectations: The Peril of an Expectations Gap in Proxy Advisory Firm Regulation*, 41 DEL. J. CORP. L. (forthcoming 2016), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2469158.

[196] *See id.* ("[P]roviders of professional services . . . are likely to support a regulation's proffered necessity . . . . Increased regulation tends to be a source of income and prestige for these professionals, and challenging the efficacy of new regulation would diminish their own potential for personal returns.").

[197] Stephen J. Choi, *Channeling Competition in the Global Securities Market*, 16 TRANSNAT'L L. 111, 113–14 (2002).

Israeli financial market with two other supervisory authorities—the supervisor of banks and the commissioner of the capital market.[198] However, the ISA has the sole responsibility of regulating public companies.[199] Thus, it seems that other regulators that operate alongside the ISA do not have much effect on the rulemaking that is the focus of this analysis.

Finally, understanding the ISA structure and culture can explain the ISA's ability to resist undue influence on the one hand and its tendency towards inertia on the other hand. First and foremost, the ISA has very few participatory and supervisory mechanisms. With respect to participatory mechanisms, the ISA structure does not include Internal Representative Mechanisms (IRMs) to represent regulated industries and regulatory beneficiaries. Beyond their ability to inform the regulator and improve the quality of its regulation, IRMs have the potential to detect regulatory flaws in real time;[200] think outside the regulator's expectation and entrenched methodologies, diminish groupthink bias;[201] and reduce the asymmetrical influence that regulated industries may exert on the regulator as compared to regulatory beneficiaries.[202] Thus, IRMs can forestall the inertia and the "captive regulator" problems. The above can explain the reason that IRMs have been adopted by many regulatory agencies: for instance, the British FCA relies on four independent panels;[203] the German BaFin is supported by the Advisory Board (Fachbeirat),[204] the Insurance Advisory Council,[205] the Securities Council,[206]

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[198] MONETARY AND CAPITAL MKT. DEP'T INT'L MONETARY FUND, *supra* note 183, at 8–9.

[199] *Id.* at 8.

[200] *See* Brett McDonnell & Daniel Schwarcz, *Regulatory Contrarians*, 89 N.C. L. REV. 1629, 1637–39 (2010-11).

[201] *See supra* notes 33 and accompanying text.

[202] *See* McDonnell & Schwarcz, *supra* note 197, at 1653.

[203] The FCA relies on the Practitioner Panel, Smaller Business Practitioner Panel, the Markets Practitioner Panel and the Consumer Panel, established by virtue of §1N, §1O, §1P, and §1Q (respectively) of Financial Services Act 2012 (2012 Act) to represent the view of consumers and industries that are likely to be affected by the FCA's regulation, to direct their inputs to the regulatory process, and to advise the FCA from their perspectives. Financial Services Act 2012, c.1 (Eng.). Under §1M and §1R of 2012 Act, the FCA has a statutory duty to consider comments made by the panels and "from time to time publish in such manner as it thinks fit responses to the representations." *Id.*

[204] Bundesanstalt für Finanzdienstleistungsaufsicht [FinDAG] [Act Establishing the Federal Financial Supervisory Authority], Apr. 22, 2002, BUNDESGESETZBLATT, Teil I [BGBL. I] at § 8 (Ger.); *see also* AVELIEN HAAN-KAMMINGA, SUPERVISION ON TAKEOVER BIDS: A COMPARISON OF REGULATORY ARRANGEMENTS 151–52 (2006); Eva Hupkes et al., *The Accountability of Financial Sector Supervisors: Principles and Practice* 42 (IMF, Working Paper No. 05/51, 2005); Jonathan Westrup, *Independence and Accountability: Why Politics Matters*, *in* DESIGNING

and the Advisory Council;[207] and the Australian ASIC is assisted by the Consumer Advisory Panel (CAP),[208] and the Business Consultative Panel.[209]

With respect to supervisory mechanisms, the ISA structure lacks internal mechanisms, such as the Office of Inspector General and the Ombudsman Office within the SEC[210] or the

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FIN. SUPERVISION INSTITUTIONS: INDEPENDENCE, ACCOUNTABILITY AND GOVERNANCE 117, 143 (Donato Masciandaro & Marc Quintyn eds., 2007).

[205] Gesetz über die Beaufsichtigung der Versicherungsunternehmen [Versicherungsaufsichtsgesetz][VAG][Act on the Supervision of Insurance Undertakings], Dec. 17, 1992, BGBL. 1993 I at 2, last amended by Gesetz [G], Mar. 26, 2007, BGBL. I at 378, art. 44, § 92 (Ger.), *available at http://www.gesetze-im-internet.de/vag/index.html*, *translation available at* http://www.bafin.de/SharedDocs/Aufsichtsrecht/EN/Gesetz/vag_010512_va_en.html; *see also Insurance Advisory Council: Tasks and Functions of the Insurance Advisory Council*, BAFIN, http://www.bafin.de/EN/BaFin/Organisation/BaFinBodies/InsuranceAdvisoryCouncil/insuranceadvisorycouncil_node.html (last visited June 11, 2015).

[206] Wertpapierhandelsgesetz [WpHG] [Securities Trading Act], Sept. 9, 1998, BUNDESGESETZBLATT, Teil I [BGBL. I] at § 5 (Ger.); *see also* IRIS CHIU, REGULATORY CONVERGENCE IN EU SECURITIES REGULATION 121–22 (2008); HAAN-KAMMINGA, *supra* note 201, at 152; *Securities Council: Functions and Composition of the Securities Council*, BAFIN, http://www.bafin.de/EN/BaFin/Organisation/BaFinBodies/SecuritiesCouncil/securitiescouncil_node.html (last visited June 11, 2015).

[207] Wertpapiererwerbs- und Übernahmegesetz [WpÜG] [Securities Acquisition and Takeover Act], Dec. 20, 2001, BGBL. I at 3822, last amended by Gesetz [G], Dec. 22, 2011, BGBL. I at 3044, art. 2(46), § 5 (Ger.), *available at* http://www.gesetze-im-internet.de/wp_g/index.html, *translation avaiable at http://www.bafin.de/SharedDocs/Aufsichtsrecht/EN/Gesetz/wpueg_en.html; see also Advisory Council: Functions and composition of the Advisory Council*, BAFIN http://www.bafin.de/EN/BaFin/Organisation/BaFinBodies/AdvisoryCouncil/advisorycouncil_artikel.html?nn=2692296 (last visited June 11, 2015).

[208] *ASIC's Consumer Advisory Panel*, ASIC, http://asic.gov.au/about-asic/what-we-do/how-we-operate/stakeholder-liaison/asics-consumer-advisory-panel/ (last updated Feb. 2, 2015).

[209] *06-228 Influential Business Leaders Join ASIC's New Business Consultative Panel*, ASIC (July 7, 2006), http://asic.gov.au/about-asic/media-centre/find-a-media-release/2006-releases/06-228-influential-business-leaders-join-asics-new-business-consultative-panel/.

[210] *See* Office of Inspector Gen., SEC, *OIG Home*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/about/offices/inspector_general.shtml (last visited Mar. 25, 2015) (describing OIG authority and function); *see also* McDonnell & Schwarcz, *supra* note 197, at 1661–64; Dodd-Frank Wall Street Reform and Consumer Protection Act Pub. L. 111-203, H.R. 4173 § 919D (codified as amended at 15 U.S.C. § 78d(g)(8) (2010)) (establishing the Ombudsman's Office).

Complaints Commissioner acts within the FCA,[211]to investigate complaints arising in connection with the exercise of or failure to exercise their relevant functions. The impact of these mechanisms on inertia is blindingly obvious. If no person or entity reviews regulators' decisions to make sure that regulators are doing a good job, the tendency, overall, will be that regulators are less motivated to engage in critical review of their own decisions or respond to suggestions or complaints.

With respect to ISA culture, the ISA includes many departments and offices with various responsibilities. The overwhelming majority of ISA employees are lawyers.[212] Thus, it seems that within the period analyzed in this Comment, ISA orientation was legal rather than economic. In light of this observation, it is worth noting that according to an opinion voiced from time to time, although not empirically based, a lawyer-dominated agency is likely to find "more value to regulation than there really is."[213] This can explain this Comment's findings that demonstrate one-way regulation to the detriment of regulated public companies. Finally, with respect to the revolving doors hypothesis (constitutes significant part of the public choice theory[214]), one can point out cases in which ISA employees found attractive post-ISA positions within the regulated industries. However, it is possible that they were hired by regulated industries simply because they signaled an uncompromising agenda.[215]

Conclusion

Two questions are in the heart of the policymaking debate for many years—whether or not regulators are sufficiently open to regulatory changes during the rulemaking process they conduct and whether or not this process is dominated by small cohesive interest groups acting

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[211] Financial Services Act 2012, c.1, §§ 84-88 (Eng.); *e.g.*, *Complaints Scheme*, FIN. CONDUCT AUTHORITY (Jan. 4, 2013), http://www.fca.org.uk/your-fca/complaints-scheme.

[212] Telephone Interview with ISA staff.

[213] *See, e.g.*, Donald C. Langevoort, *The SEC as a Lawmaker: Choices About Investor Protection In The Face of Uncertainty*, 84 WASH. U. L. REV. 1591, 1610 (2006).

[214] *See supra* notes 45, 51 and accompanying text.

[215] *See* Ed deHaan et al., *Does the Revolving Door Affect the SEC's Enforcement Outcomes: Initial Evidence from Civil Litigation* (Rock Ctr. for Corporate Governance at Stan. Univ., Working Paper No. 187, 2015), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2125560 (distinguishing between "rent seeking" hypothesis that predicts a situation in which SEC lawyers relax enforcement efforts in order to curry favor with prospective employers in the private sector and "human capital" hypothesis that predicts a situation in which SEC lawyers exert more enforcement effort to signal their expertise).

to ensure favorable regulation at the expense of the public welfare. This Comment examines these two questions within the unique features of the ISA rulemaking process and compares this process to the rulemaking process of the SEC. The Comment provides apparent evidence that in the years from 2003 to 2010, the ISA rulemaking process was not open to material changes. Instead, the ISA tended to be "sticky" to its initial rules proposals and the rulemaking process tended towards inertia. Furthermore, this process was not dominated by the regulated interest groups at the expense of the public welfare. In contrast, the SEC was much more open to change and responded to the input it received from members of the public and regulated constituencies. The Comment explains these findings by pointing to ISA institutional characteristics, with emphasis on ISA rulemaking process that lacks transparency and regulatory impact analysis that could force the ISA to consider regulatory alternatives and justify its decisions; ISA freedom from intrusive supervision of legislative, executive, or judicial branches; and ISA internal structure, which lacks participatory and supervisory mechanisms. The SEC employs numerous mechanisms ensuring stability and flexibility, most notably those inherent in the American notice and comment rulemaking process. The SEC is also subject to significant oversight, particularly judicial, which provides further motivation to consider all possible alternatives and viewpoints before promulgating rules.

In the end, it would be exceedingly difficult to make a qualitative decision determining which rulemaking system operates better. The ISA is clearly much more prone to regulatory inertia; however, the SEC is vulnerable to outside influence from the regulated entities. In general, the aspects of the ISA structure and rulemaking process discussed here tend to create an environment where initial decisions become entrenched and difficult to modify. The aspects of the SEC structure and rulemaking process discussed here tend to create an environment where initial rulemaking proposals are subjected to intense scrutiny and debate, making the final version of a rule often differ significantly from the initial proposal. Measuring the overall effectiveness of one system compared to another has never been attempted and would be a daunting task indeed. However, were such a measurement to be completed accurately, it could be possible to quantify the optimal levels of inertia and vulnerability to external influence. This would be a tremendous achievement in the field of regulatory study and this Comment attempts to take an initial step toward that goal by identifying individual mechanisms and characteristics which influence these two important benchmarks.

Appendix A – A Summary of Analysis of ISA Rules

	The Directive	
1-2003	Disclosure regarding reporting currency of the reporting public company	The rule includes one disclosure requirement that was adopted with material change.
2-2003	Disclosure regarding directors having accounting and financial expertise	The rule includes two disclosure requirements: first requirement listed in three sections: first section has 3 subsections – all of them were completely adopted. Second requirement listed in three sections: first section was completely adopted; second section was largely adopted; third section was completely adopted.
3-2003	Disclosure on minimum disclosure necessary for a valuation of assets, relation to it and guideline regarding inclusion	The rule includes two disclosure requirements: first requirement listed in three sections: first section has 2 subsections that were completely adopted; second and third sections (do not include subsections) – were completely adopted. Second requirement listed in three sections – first and third sections were completely adopted; second section was largely adopted.
4-2004	Disclosure pertaining to the internal auditor of a corporation	The rule includes one disclosure requirement listed in eight sections: first section has 5 subsections – completely adopted; second section has 2 subsections – only one of them was adopted; third section has 3 subsections – completely adopted; fourth section (does not include subsections) was completely adopted; fifth section (does not include subsections) was completely adopted; sixth section (does not include subsections) was completely adopted; seventh section has 2 subsections – completely adopted; eighth section has 2 subsections – completely adopted.
5-2004	Disclosure regarding critical accounting estimates	The rule includes one disclosure requirement listed in six sections (that do not include subsections) – all of them were completely adopted.
6-2005	Disclosure of Contracts of Assets' Acquisition	The rule includes five disclosure requirements: first requirement listed in three sections – all of them were completely adopted. Second requirement listed in two sections – all of them were

		completely adopted. Third requirement listed in eleven sections – ten and a half sections were completely adopted. Fourth requirement listed in one section that was completely adopted. Fifth requirement is an appendix listed in four sections: first section has 7 subsections – all of them were completely adopted; second section has 6 subsections – 5 out of them were completely adopted; third section has 4 subsections – all of them were completely adopted; fourth section has 4 subsections – all of them were completely adopted.
7-2005	Disclosure of auditor's fees	The rule includes five disclosure requirements: first requirement listed in three sections – all of them were completely adopted. Second requirement listed in two sections – all of them were completely adopted. Third requirement listed in two sections – all of them were completely adopted. Fourth requirement listed in one section – completely adopted. Fifth requirement listed in one section – completely adopted.
8-2006	Disclosure of pro forma figures in financial reports	The rule includes eleven disclosure requirements: first requirement is a title – completely adopted. Second requirement listed in two sections – completely adopted. Third requirement listed in one section – completely adopted. Fourth requirement listed in two sections – completely adopted. Fifth requirement listed in one section – completely adopted. Sixth requirement listed in three sections – completely adopted. Seventh requirement listed in one section – completely adopted. Eighth requirement listed in one section – completely adopted. Ninth requirement listed in one section – completely adopted. Tenth requirement listed in one section – completely adopted. Eleventh requirement listed in one section – completely adopted.
9-2007	Disclosure pertaining to the executives remuneration	The rule includes seven disclosure requirements: first requirement listed in four sections – completely adopted. Second requirement listed in three sections: first section has 4 subsections – completely adopted; second section has 6 subsections – completely adopted; third section has 3 subsections – only 2 of them were adopted. Third requirement listed in two sections – completely adopted. Fourth

		requirement listed in three sections – completely adopted. Fifth requirement listed in one section that has four subsections – completely adopted. Sixth requirement listed in one section – was not adopted. Seventh requirement listed in one section – completely adopted.
10-2007	Disclosure with respect to approval of financial statements	The rule includes two disclosure requirements: first requirement listed in one section – completely adopted. Second requirement listed in two sections – completely adopted.
11-2008	Disclosure regarding authorized signatories in a corporation	The rule includes two disclosure requirements: first requirement listed in two sections – partially adopted. Second requirement listed in one section – was not adopted.
12-2008	Disclosure of all corporate liabilities according to repayment dates	The rule includes two disclosure requirements: first requirement listed in ten sections: first section (does not include subsections) – completely adopted; second section has two subsections – completely adopted; third section (does not include subsections) – completely adopted; fourth section (does not include subsections) – completely adopted; fifth section (does not include subsections) – completely adopted; sixth section (does not include subsections) – completely adopted; seventh section has 3 subsections – 2 of them were completely adopted, and the other one was largely adopted; eighth section has two subsections – completely adopted; ninth section has two subsections – completely adopted; tenth section has two subsections – completely adopted. Second requirement – completely adopted.
13-2008	Disclosure of expected cash flow for the repayment of corporate liabilities	The rule includes definition (imposes disclosure duties) and one disclosure requirement: Definition listed in five sections: first, third, fourth and fifth sections – completely adopted; second section has 4 subsections – completely adopted. Disclosure requirement listed in two sections – completely adopted.
14-2008	Disclosure of self-acquisition plans and self-acquisitions	The rule includes two disclosure requirements: first requirement listed in three sections: first section has ten subsections – all of them were completely adopted; second section (does not include subsections) – completely adopted; third section (does not include

		subsections) – completely adopted. Second requirement listed in one section – was not adopted.
15-2009	Disclosure regarding independent directors	The rule includes two disclosure requirements: first requirement listed in three sections: first section has 3 subsections: first subsection was completely adopted; second subsection includes 2 sub-subsections – only one of them was adopted; third subsection was completely adopted. Second section was completely adopted. Third section has 3 subsections – completely adopted. Second requirement includes two sections: first section was completely adopted; second section has two subsections – completely adopted.
16-2009	Disclosure of dividend distributions	The rule includes one disclosure requirement listed in five sections: first, second, third, fifth sections (do not include subsections) – completely adopted. Fourth section includes 5 subsections – all of them were completely adopted.
17-2009	Disclosure regarding debt settlements	The rule includes three disclosure requirements: first requirement listed in five sections: first section is a definition that imposes disclosure duties – completely adopted (with changes); second and fourth sections were completely adopted; third section was not adopted; fifth section was largely adopted. Second requirement listed in two sections: first section is a definition that includes five conditions – all of them were completely adopted; second section has 24 complex subsections: subsections 1- 11, 13, 17 - 18 and 20 – 25 – were completely adopted; subsections 14 – 16 – were largely adopted; subsections 12 and 19 – were not adopted. Third requirement listed in one section that includes complex disclosure duty that was completely adopted.
18-2010	Disclosure required in projected cash flow reports	The rule includes two disclosure requirements: first requirement listed in nine sections: first section has 3 subsections that were adopted with changes; second and fourth sections – were partially adopted; the other sections - were completely adopted. Second requirement listed in five sections – four of them were completely adopted, and the fifth section was not adopted.

Appendix B – A Summary of Analysis of SEC Rules

	The Rule	
1 - Release No. 33-8878 (2007)	Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance with International Financial Reporting Standards Without Reconciliation to U.S. GAAP	
2 - Release No. 33-8878 (2007)	Revisions to the Eligibility Requirements for Primary Securities Offerings on Forms S-3 and F-3	
3 - Release No. 33-8876 (2007)	Smaller Reporting Company Regulatory Relief and Simplification	
4 - Release No. 34-56914 (2007)	Shareholder Proposal Relating to the Election of Directors	
5 - Release No. 33-8995 (2008)	Modernization of Oil and Gas Reporting	
6 - Release No. 34-58774 (2008)	"Naked" Short Selling Antifraud Rule	
7 - Release No. 33-8957 (2008)	Commission Guidance and Revisions to the Cross-Border Tender Offer, Exchange Offer, Rights Offerings, and Business Combination Rules and Beneficial Ownership Reporting Rules for Certain	

	Foreign Institutions	
8 - Release No. IA-2968 (2009)	Custody of Funds or Securities of Clients by Investment Advisers	
9 - Release No. 33-9089 (2009)	Proxy Disclosure Enhancements	
10 - Release No. 34-61050 (2009)	Amendments to Rules for Nationally Recognized Statistical Rating Organizations	

Unfortunately, because of rare problem with the email, I could not restore the complete list of SEC's rules. I have also failed to find all of the relevant hardcopies. Thereby, Appendix B is composed of 4 rules from 2007, 3 from 2008 and 3 from 2009. Do you want me to change the text of the Article accordingly? Also, I have no prepared analysis like the analysis appeared in Appendix A. I compared the SEC's final rules with their corresponding proposals and differences were analyzed on the hard copies that I have. Further, the Federal Register versions of the final rules reflect the amendments that were made in response to comments.