EXPERIMENTAL RULES

ZACHARY J. GUBLER

Abstract: When forming policy under conditions of extreme uncertainty, the optimal approach seems to be a process by which the policy decision is divided into multiple stages, or in other words, an experimental approach. The optimal legal vehicle for such policy experimentation is what this Article refers to as “experimental rules,” which are rules that terminate automatically and are designed for the express purpose of generating data during the sunset period that can then be used to determine the optimal policy strategy for the long run. Yet it turns out that agencies rarely adopt such “experimental rules” in the real world. This Article argues that the reason has to do with the political economy, which appears to disfavor experimental rules either because they are more temporary and therefore less valuable to interest groups or because they are more costly to adopt. To overcome these political economy constraints and encourage policy experimentation, this Article proposes having courts apply greater deference to experimental rules (at least during the initial, experimental phase of the multi-stage process). This approach would have the effect of nudging actors in the political economy toward experimental rules, thereby avoiding the possibility of sub-optimal policies becoming entrenched in permanent rules. It would also preserve rules that might otherwise be vacated by courts at least long enough to generate the necessary learning to determine whether they should be implemented on a more permanent basis.

INTRODUCTION

The conventional wisdom is that Thomas Edison went through over a thousand different filaments before creating an incandescent light bulb that could stay illuminated for a substantial period of time without burning out. Although perhaps an extreme example, this trial-and-error approach lies at the heart of the scientific process. Whether it is a pharmaceutical company developing a new drug candidate, a company deciding whether to introduce a new product, or a government agency deciding whether to implement a new policy, the process involves trying different approaches, learning from the results, and adjusting as necessary. Yet in the real world, the adoption of experimental rules is rare. This Article argues that the reason is political economy constraints, and proposes that courts apply greater deference to experimental rules during the initial, experimental phase of the multi-stage process, to encourage the adoption of experimental rules and avoid the possibility of sub-optimal policies becoming entrenched in permanent rules.

© 2014, Zachary J. Gubler. All rights reserved.

* Associate Professor of Law, Arizona State University Sandra Day O’Connor College of Law. For helpful feedback on this project, I would like to thank Michael Abramowicz, Bobby Bartlett, Adam Chodorow, David DePianto, Andy Hessick, Carissa Hessick, Zak Kramer, Rhett Larson, Alex Lee, Patrick Luff, Richard Painter, Mark Roe, Roberta Romano, Andrew Schwartz, and Matt Spitzer. The concept of experimental rules that I develop in this Article appeared in an op-ed on “crowdfunding” that appeared in the Wall Street Journal, Zachary J. Gubler, Inventive Funding Deserves Creative Regulation, WALL ST. J. (Jan. 31, 2013, 6:50PM), http://online.wsj.com/news/articles/SB10001424127887323468604578251913868617572, archived at http://perma.cc/T4FK-CSWE. All errors are the sole responsibility of the author. Comments welcome: Zachary.Gubler@asu.edu.

product, or a venture capital firm structuring its investment in a startup company, the process that yields the best results is one that consists of multi-stage decision making. The reason is obvious: data generated at an earlier stage can be used to inform decisions made at later stages in the process.

The benefits of experimentation could be realized in the governmental policy-making sphere as well, particularly in situations where the payoffs from a given policy are extremely uncertain. But in order to engage in policy experimentation, we must overcome two obstacles that do not exist to the same degree outside of the realm of government. The first obstacle is the path dependency of law (the fact that law can be resistant to change). If laws are not easily reversed and modified, the experiment will be a failure no matter how effective it is at generating information regarding the optimal policy. There still exists a second obstacle, however, because even if laws are reversible, the experiment will still be a failure if lawmakers lack incentives to take into account the information generated by the experiment in formulating more permanent policies. In other words, the lawmaking process must have the capacity for “learning” in order for there to be effective policy experimentation.

Rules adopted by federal agencies that are subject to sunset provisions arguably overcome both of these obstacles of policy experimentation. Such “multi-stage” rules overcome law’s natural path dependency, and therefore are reversible, because they automatically expire by virtue of the sunset provi-

---

2 See infra notes 45–49 and accompanying text.
3 See infra note 49 and accompanying text.
5 Sources of path dependency in the law are varied. See infra notes 65–74 and accompanying text (detailing sources of path dependency in law).
7 Models of learning under conditions of uncertainty have been commonplace in the economics literature for many years. In legal scholarship, these models have been most commonly applied with respect to adaptive management approaches to natural resources. See, e.g., Holly Doremus, Adaptive Management as an Information Problem, 89 N.C. L. Rev. 1455, 1456–62 (2011); J.B. Ruhl, General Design Principles for Resilience and Adaptive Capacity in Legal Systems—With Applications to Climate Change Adaptation, 89 N.C. L. Rev. 1373, 1375–76, 1388 (2011).
8 A “sunset” provision is a clause included in a law that limits the duration of that law’s own validity. Gersen, supra note 4, at 247.
Moreover, agency rules adopted pursuant to the Administrative Procedure Act ("APA") are subject to "arbitrary and capricious" review, which ensures that any information generated by the initial stage of the rule—prior to the sunset—will be taken into account during the second stage of the rule, where regulators must decide whether to extend the rule on a permanent basis, adopt a new rule in light of the experimental data, or revert to the status quo. This Article refers to a multi-stage rule adopted for the purpose of experimentation as an "experimental rule.”

Given the potential benefits of policy experimentation, one might expect to find experimental rules to be pervasive at the agency level. Yet the opposite seems to be the case. A mere one percent of all of the final rules adopted by the Securities and Exchange Commission (SEC) over the past ten years fall into this experimental category. The rest not only lack an obvious experimental purpose, but also lack a sunset provision and therefore are not multi- but “single-stage” rules. This is the case despite the fact that many, if not most, of the rules that the SEC promulgates have exactly the type of uncertain payoffs that would benefit the most from experimentation. Moreover, this phenomenon is not limited to the SEC, but instead appears to describe the pattern of rulemaking at many, if not most, federal agencies.

This Article presents a theory to explain this surprising result and develops a proposal to encourage greater policy experimentation at the SEC and other federal agencies. The theory draws on public choice literature, which

---

9 This Article uses the term “multi-stage rule” to mean the same thing as what Professor Jacob Gersen has termed “temporary legislation” —that is, a law that automatically terminates pursuant to a sunset provision. See id.

10 See 5 U.S.C. § 706(2)(A) (2012) (establishing arbitrary and capricious judicial review of agency actions). Arbitrary and capricious review would, of course, only apply if, after the expiration of the sunset, the agency affirmatively decided to extend the rule on a permanent basis or adopted a different rule. If the agency simply allowed the rule to expire and took no further action, no further judicial review would be necessary. See infra notes 168–169 and accompanying text.

11 See infra notes 119–127 and accompanying text.

12 This Article uses the term “single-stage” rule to mean the same thing as Professor Gersen’s term “permanent rule” —that is, a rule that is not subject to a sunset provision. See Gersen, supra note 4, at 247.

13 See infra notes 120–127 and accompanying text.

14 For example, over the past ten years, the Commodity Futures Trading Commission (CFTC) promulgated 259 rules, yet only two (0.8%) were structured as experimental rules. The results are similar at the Federal Trade Commission (FTC) (0.8%), the National Transportation Safety Board (none), and the Federal Energy Regulatory Commission (none). See infra notes 121, 129–130 and accompanying text.

views regulation as the product of the political economy—in which regulators take regulatory actions (or refrain from threatened actions) to the benefit of small, well-organized interest groups who, in exchange, promise regulators lucrative industry jobs and other types of career support. Applying a public choice analysis suggests that experimental rules might be disfavored in the political economy either because they are valued less by interest groups or because they are relatively costly to adopt.

Experimental rules may be valued less by interest groups because they are likely to be more temporary than permanent rules: the results of the experiment may undermine the rule and therefore prevent the rule’s readoption, or, if adopted, ensure that the rule is vacated on review after the rule sunsets. And even if the experimental data does not undermine the rule’s readoption after the sunset, the fact that the experimental rule automatically expires and therefore requires some agency action to make it permanent means that experimental rules place agencies in a better position to extract rents from interest groups by threatening to let the rule expire on its own terms without readoption. Thus, interest groups are likely willing to pay less for experimental rules than for permanent rules, and this willingness translates into less revenue

---

16 See Levine, supra note 15, at 270, 273. Scholars have characterized what legislators and regulators maximize in a number of different ways, including “power,” “budget,” and “political slack.” See DENNIS MUELLER, PUBLIC CHOICE III 359–70 (2003). This Article, however, adopts Professor Michael Levine’s concept of “career support” as the maximand because of both its breadth (it takes into account goals as varied as “reelection, reappointment and post-regulatory employment”) and its intuitive appeal. See Levine, supra note 15, at 273.

17 See infra notes 179–180 and accompanying text. Or, alternatively, interest groups may be successful in persuading the agency to adopt the rule on a permanent basis, but the conflicting data will make it unlikely that that rule will survive arbitrary and capricious review by the courts.

18 The term “rents” in this context refers to “returns to the owner of an asset in excess of the level of returns necessary for him to continue using the asset in its current employment.” MCCHESENY, supra note 15, at 10. One familiar example of rents is the producer surplus that the producer enjoys from being able to sell goods at a market price that is higher than the least that they are willing to sell for. This amount is represented in a supply-demand graph by the area between the equilibrium market price and the upward sloping supply curve. When regulators adopt regulation that favors one group of firms in an industry over another, it increases the costs of production and therefore shifts the supply curve up. In turn, that shift has the effect of increasing producer surplus, and therefore the rents available, for those firms that benefit from the regulation. These increased rents are considered bad rents since society is poorer for the lost exchanges of goods for which demanders were willing to pay the price of supply. Zachary J. Gubler, Public Choice Theory and the Private Securities Market, 91 N.C. L. REV. 747, 749 n.12 (2013). Regulators can then extract some of the rents created by regulation by threatening deregulation (either through repeal of a permanent rule or the threat of a refusal to extend an experimental rule on a permanent basis). See MCCHESENY, supra note 15, at 17. The firms that benefit from regulation will be willing to pay up to the value of the rents created by regulation in order to retain them. See id.

19 See infra notes 156–157 and accompanying text.
for regulators in the political economy because the number of interest groups that lobby a particular agency is fairly entrenched and static.20

Furthermore, experimental rules might simply be a relatively costly way of enacting policy. To make a policy permanent through the use of an experimental rule, interest groups must go through two notice-and-comment periods—first at the outset of the experiment and once again after the rule has automatically expired under the sunset provision.21 Consequently, the value that agencies can expect to receive in exchange for experimental rules in the political economy is less than they should expect for permanent rules.

Thus, this public choice analysis suggests why federal agencies seem to avoid adopting experimental rules despite their considerable social benefits. Nevertheless, this analysis also sheds light on how political economy elements may be harnessed to nudge regulators toward greater use of experimental rules. In particular, this Article argues that courts should take a more deferential approach when reviewing an experimental rule at any time prior to the rule’s sunset.22 This deferential review would ask only whether the agency, in promulgating the rule, took into account relevant factors, not whether the agency’s ultimate conclusions were reasonable.23 In other words, with respect to experimental rules only, courts should limit themselves solely to the procedural component of arbitrary and capricious review while foregoing the more substantive component that that standard of review typically entails.24

20 Cf. Mark J. Roe, Delaware’s Competition, 117 HARV. L. REV. 588, 639–40 (2003) (arguing that there are fewer interests involved in the production of corporate law in Delaware than there are in Washington, D.C. and that there is little chance of interests migrating to Delaware that are not already there). This stability of the interests that manage to capture an agency is implicit in the observation that interest groups are more likely to capture one, rather than multiple, agencies. See, e.g., KAREN M. HULT, AGENCY MERGER AND BUREAUCRATIC REDESIGN 8 (1987) (analyzing the ability of agencies to weaken the entrenched influence of external interest groups through agency mergers); Anne Joseph O’Connell, The Architecture of Smart Intelligence: Structuring and Overseeing Agencies in the Post-9/11 World, 94 CALIF. L. REV. 1655, 1677 (2006) (contending that an interest group will generally find it harder to capture several agencies than a single agency). Indeed, implicit in the notion of industry capture is the idea that there is a small, relatively stable group of interests to influence an agency. Where this is not true, capture is less likely. See, e.g., Bradford C. Mank, Is a Textualist Approach to Statutory Interpretation Pro-Environmentalist?: Why Pragmatic Agency Decisionmaking Is Better Than Judicial Literalism, 53 WASH. & LEE L. REV. 1231, 1277–78 & n.256 (1996) (citing numerous sources in support of this proposition).

21 See infra notes 178–180 and accompanying text.

22 See infra notes 187–193 and accompanying text.

23 See infra notes 193–194 and accompanying text.

24 See infra notes 189–194 and accompanying text. “Arbitrary and capricious” review, also called “hard look review,” contains both a procedural element, under which courts must consider whether the agency considered relevant factors in promulgating a given a rule, and a substantive element, under which courts must determine whether, nevertheless, the agency committed “clear error.” See Motor Vehicle Mfrs. Ass’n v. State Farm Mut. Auto Ins. Co., 463 U.S. 29, 43 (1983); Citizens to Pres. Overton Park, Inc. v. Volpe, 401 U.S. 402, 416 (1971); see also Thomas J. Miles & Cass R. Sunstein, The Real World of Arbitrariness Review, 75 U. CHI. L. REV. 761, 761, 763 (2008) (explaining that the U.S. Supreme Court’s 1983 decision in Motor Vehicle Manufacturers Ass’n v. State Farm Mutual Automobile Insurance Co. was “widely taken to ratified both procedural and substantive components of the hard look doctrine,” which had been developed by the D.C. Circuit).
Two benefits flow from this principle of deference for experimental rules. First, this principle of deference would encourage policy experimentation, thereby increasing the likelihood that agencies will ultimately achieve the optimal policy while diminishing the likelihood that sub-optimal policies will become entrenched as permanent. Under this principle of deference, an agency’s decision to adopt an experimental rule (which expires automatically at some later point of time) would have a much better chance of surviving judicial review than the decision to adopt a permanent rule. Consequently, this principle of deference would make experimental rules relatively more attractive to interest groups in the political economy, thereby nudging agencies toward greater policy experimentation.

The second benefit that would flow from this principle of deference is that it would diminish the likelihood that courts will vacate optimal policies enacted as experimental rules before they can generate sufficient data to evaluate the merits of the policy. The policies most likely to benefit from experimentation are those with uncertain payoffs—uncertain, because there is a lack of data for predicting the likely policy outcome. When courts review rules with such uncertain payoffs, and where the evidence points in two different directions, there is a greater probability of judicial error, including that a court might vacate a rule that is in fact optimal. The principle of deference would address this problem by requiring courts to defer to agencies when this uncertainty is particularly high.

To better illustrate these concepts, this Article uses the SEC’s proxy access rule as a case study. Adopted by the SEC as a permanent rule in 2010, the proxy access rule was subsequently vacated by the U.S. Court of Appeals.
for the D.C. Circuit in 2011, in *Business Roundtable v. SEC*.31 The SEC’s proxy access rule would have given shareholders of public companies greater power to nominate members of the company’s board of directors on the theory that such shareholder empowerment is necessary to reduce agency costs in the corporation and improve firm governance.32 The proxy access rule was years in the making and held out the promise of substantial benefits, but also threatened to create significant costs.33 Three conclusions can be drawn from this case study. First, proxy access was precisely the type of policy that could have benefited from experimentation because of its extremely uncertain payoffs, and therefore, that the SEC erred in adopting the policy as a permanent rule.34 Second, even if the SEC had adopted the policy as an experimental rule, the experiment would have been short-circuited by the D.C. Circuit’s opinion.35 Third, the principle of deference would likely have solved each of these problems, both by nudging the SEC toward experimentation and by giving the court a reason to allow the experiment to run its course.36

This Article consists of three parts. Part I identifies the benefits of policy experimentation and argues that it is best conducted through multi-stage rules at the federal agency level.37 It then demonstrates that despite the theoretical benefits of policy experimentation, the practice is actually quite rare among federal agencies.38 Part II uses a political economy theory to explain this lack of experimentation based on the notion that the potential rents that interest groups can obtain from experimental rules (and the corresponding value that regulators can extract in exchange for such rents) are much less than for permanent rules.39 Finally, Part III develops a proposal for encouraging experimental policy making, which consists of a principle of deference for experimental rules.40 It goes on to demonstrate how this deferential principle for experimental rules would have altered the D.C. Circuit’s decision in *Business Roundtable* that struck down the SEC’s proxy access rule.41

**I. EXPERIMENTAL RULES: DEFINITION AND COSTS AND BENEFITS**

This Part both analyzes the benefits to policy experimentation and contends that such experimentation is best carried out through multi-stage rules enacted by

---

31 647 F.3d 1144, 1146–47 (D.C. Cir. 2011); see Facilitating Shareholder Director Nominations, 75 Fed. Reg. at 56,668.
32 *Bus. Roundtable*, 647 F.3d at 1147.
33 See id. at 1148–49.
34 See infra notes 101–111 and accompanying text.
35 See infra note 265 and accompanying text.
36 See infra notes 266–268 and accompanying text.
37 See infra notes 42–118 and accompanying text.
38 See infra notes 119–140 and accompanying text.
39 See infra notes 141–180 and accompanying text.
40 See infra notes 181–269 and accompanying text.
41 See infra notes 197–246 and accompanying text.
federal agencies. Section A of this Part details the potential benefits of experimental rules.42 Section B then addresses two potential obstacles to an experimental approach to lawmaking, going on to explain how experimental rules overcome these initial obstacles.43 Finally, Section C addresses the scarcity of experimental rules at federal agencies.44

A. The Benefits of Experimentation

When faced with the challenge of having to making a decision under conditions of extreme uncertainty—for example, a CEO’s decision whether to introduce a new product line,45 a venture capitalist’s decision whether to invest in a startup,46 or a scientist’s decision whether to develop a new drug candidate47—it is usually optimal to divide the decision-making process into multiple stages and to design an experiment to be carried out during the earlier stages of the process.48 By doing so, any learning created during that experimental phase can be used to inform decisions made in later stages of the process.49

The benefits of experimentation could be realized in the governmental policy-making sphere as well.50 Imagine a hypothetical State’s policy decision whether to increase the highway speed limit to eighty miles-per-hour or to keep it at the current speed of seventy-five miles-per-hour. There are costs and benefits associated with this policy proposal. On the one hand, the higher speed limit will allow for a shorter commuting time. On the other hand, the higher speed may increase the risk of accidents. Assume that evidence from a neighboring state shows that when the neighboring state increased its speed

42 See infra notes 45–64 and accompanying text.
43 See infra notes 65–118 and accompanying text.
44 See infra notes 119–140 and accompanying text.
47 See Richard Simon, Optimal Two-Stage Designs for Phase II Clinical Trials, 10 CONTROLLED CLINICAL TRIALS 1, 1 (1989).
48 See MANZI, supra note 4, at xvi–xvii; Gersen, supra note 4, at 267; Listokin, supra note 4, at 483, 491; David Brooks, Op-Ed., Is Our Adults Learning?, N.Y. TIMES, Apr. 26, 2012, at A27. According to Professor Gersen:

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

Gersen, supra note 4, at 267.

49 In probability theory, this notion of staged decision making is captured in Bayes’s theorem, which is commonly interpreted as a theorem allowing for the updating of probabilities as new information is acquired. See JONATHAN BARON, THINKING AND DECIDING 121 (4th ed. 2000).
50 MANZI, supra note 4, at xi–xii, 209–11; Listokin, supra note 4, at 491; Whitehead, supra note 4, at 1295.
limit to eighty miles-per-hour, the benefits clearly outweighed the costs. But it is questionable how applicable that evidence is to the State, which has narrower and curvier roads than the neighboring state and more precipitation, and therefore, is at greater risk for accidents. The State could stick with the status quo or adopt the eighty miles-per-hour speed limit, either on a trial basis or a permanent one. In most cases, as long as the policy’s payoffs are uncertain but potentially high, the optimal approach will be an experimental one. In this case, the optimal approach is probably to adopt the higher speed limit, but on a trial basis, which preserves the State’s ability to revert to the old speed limit or to retain the new one, depending on the results of the experiment.51

Now consider another illustration, this time a real-world example of a policy adopted by the SEC in 2010.52 This policy, called “proxy access,” was intended to give shareholders of public companies greater power to nominate members of the company’s board of directors.53 The only real power that state corporate law grants to shareholders is the power to elect board members.54 This power is substantially reduced, however, by the costs that shareholders must incur in order to nominate their own selections for the board of directors, costs that derive from printing and circulating to the other shareholders a voting ballot known as a “proxy statement.”55 Consequently, the process heavily favors management’s—and not the shareholders’—nominees to the board.56 Proxy access was intended to change this dynamic by requiring the company to include shareholder nominated directors in the company’s proxy materials, thus defraying the substantial costs associated with the nomination process that prevents shareholders from realizing their power to elect board members.57

The potential for proxy access to create substantial benefits was matched only by the policy’s potential for generating equally significant costs. As for benefits, the policy had the potential for improving corporate governance by

51 In fact, the state of Utah did precisely this when it adopted, on a three-year trial basis, an eighty miles-per-hour speed limit on two separate stretches of the interstate. See Lee Davidson, Utah’s 80 MPH Zones to Be Permanent, More Test Zones May Come, SALT LAKE TRIB. (Sept. 21, 2012, 1:17 PM), http://www.sltrib.com/sltrib/politics/54927666-90/areas-higher-limits-mpth.html.csp, archived at http://perma.cc/A6M6-EZG6. When the resulting data showed no increase in accidents or fatalities under the new speed limit, the state adopted the eighty miles-per-hour speed limit on a permanent basis for those two areas. Id.
52 Facilitating Shareholder Director Nominations, 75 Fed. Reg. at 56,668.
53 Id. For background on proxy access by two scholars who question its relevance in light of other corporate governance developments, see Marcel Kahan & Edward Rock, The Insignificance of Proxy Access, 97 VA. L. REV. 1347, 1353–62 (2011).
54 See Kahan & Rock, supra note 53, at 1347, 1364.
57 See Kahan & Rock, supra note 53, at 1384.
minimizing the agency costs that result from placing control over corporate policy in the hands of someone other than the owners of the corporation (i.e., the shareholders). The fear is that corporate managers—who are essentially playing with other people’s money—might make decisions that could benefit them personally but at the expense of the firm. Thus, proxy access had the potential to reduce these agency costs (and therefore improve firm value) by empowering shareholders to nominate their own candidates to the board of directors, which is charged with hiring and firing management.

Still, the policy was not without its costs. Opponents argued that proxy access would be used primarily by those shareholders, such as unions and state pension funds, with “special interests” that deviated significantly from the interests of the rest of the shareholder base and therefore would not necessarily increase firm value—and could actually make matters worse.

Both proponents and opponents of the rule made plausible arguments, yet there was very little evidence available to the SEC to shed light on the ultimate issue of whether the rule was cost-effective. In other words, like a CEO’s decision whether to introduce a new product or a state legislature’s decision whether to increase the speed limit, proxy access was a policy with a highly uncertain payoff structure. Accordingly, the optimal formulation of the policy was likely as a rule adopted on a trial basis with an automatic expiration estab-

---

58 See Bebchuk, Shareholder Access, supra note 55, at 47; Bebchuk, Shareholder Franchise, supra note 55, at 679–80, 696.
60 See, e.g., Bebchuk, Shareholder Access, supra note 55, at 47; Bebchuk, Shareholder Franchise, supra note 55, at 696.
62 For an overview of the evidence relied on by both opponents and proponents of proxy access, see infra notes 209–229 and accompanying text. The lack of unambiguous empirical support either for or against proxy access largely explains the extreme rhetorical positions surrounding the issue. For example, proponents argued that it would help “restore shareholder confidence.” Walter Calls for Action on Proxy Access, Disclosure, Other Governance Topics, CORP. L. DAILY (BNA) (Feb. 19, 2009), http://news.bna.com.proxy.bc.edu/cldn/CLDNWB/split_display.adp?fedfid=11615079&vname =ecdbulallissues&fcsn=2&wsn=501784000&fn=11615079&split=0 (attributing phrase to then-SEC Commissioner Elisse Walter). Opponents, however, characterized it as a policy with the “potential to wreak havoc with American business.” David A. Katz & Laura A. McIntosh, Senate Bill Adversely Affects the Landscape, N.Y. L.J., May 27, 2010, at 5.
lished by a sunset provision. As this Article discusses later, however, the SEC rejected this option in favor of a permanent rule, which was ultimately vacated by the D.C. Circuit.

B. Obstacles and Potential Solutions to an Experimental Approach to Lawmaking

Although the benefits of experimentation for policy making are certainly theoretically compelling, there are two initial obstacles to experimentation in governmental policy that do not exist to the same degree in other fields.

1. Two Initial Obstacles: Law’s Path Dependence and the Lack of Learning Reinforcement

The first obstacle to policy experimentation is that a law may not be reversible, which of course would defeat the goal of the experiment. If the data generated from the experiment is going to be useful, then the hypothesis being tested must be either rejected or not. The experimental law, therefore, must be capable not only of being maintained but also of being displaced by an alternative, superior law. Laws, however, can be path dependent for several different reasons. First, laws can have network effects—laws may become entrenched because the more people that rely on them, the more valuable they become and the less likely they are to be displaced, even by a potentially superior law.
second source of path dependency stems from the settled expectations of parties who rely on the law and make investments based on the law. These investment-backed expectations can only be overcome at a cost and therefore may deter legal innovation. Finally, laws might be path dependent simply because they require the consensus of a large number of people to repeal them. In the case of Congress, a majority in both houses is necessary. In the case of administrative agencies, the source of the law’s path dependence is not necessarily the agency’s internal approval requirements, which are much less onerous than those of Congress. Instead, at the agency level, the source of law’s path dependence is the APA, which imposes significant procedural requirements on the agency’s ability to adopt a rule. Moreover, there may be political considerations that also deter agencies from repealing certain rules.

Although the path dependent nature of law is an important obstacle to an experimental approach to lawmaking, it is not the only, or even the most significant, one. In order to reap the benefits of experimentation in the lawmaking sphere, not only must law be susceptible to change, but legislators and regulators must be as well. In particular, there must be the capacity for learning. In other words, in order for the experimental approach to lawmaking to be effective, there must be some reason to believe that the lawmaker will take the data generated by the experimental rule into account in determining the optimal

---


68 Mark Roe argues that the rule in bankruptcy law barring bondholders from voting to approve certain types of recapitalizations, including those that would extend the maturity date or change the principle amount, is an example of such an investment-backed path dependency. See Roe, supra note 65, at 660.

69 See id. at 651 (referring to this source of path dependency as the “strong-form” variety because of its particularly forceful effect).

70 See U.S. CONST. art. I, § 7, cl. 2.

71 See 1 CHARLES H. KOCH, JR., ADMINISTRATIVE LAW AND PRACTICE § 4:42 (3d ed. 2010). Agency action must be authorized by the majority of a relatively small group of people comprising a board, commission, or council. Id.


73 KOCH, supra note 71, at § 4:10. See generally 5 U.S.C. § 553 (providing procedures for notice-and-comment rulemaking); id. §§ 553, 556, 557 (providing procedures for formal rulemaking).

74 See Gubler, supra note 18, at 786–90 (observing that the threat of a loss of political slack resulting from the repeal of portions of the Sarbanes-Oxley Act in an effort to jumpstart the initial public offering market may cause the SEC to look for alternatives, like the private securities market, for providing access to the types of services typically delivered by the public securities market).
policy.\textsuperscript{75} If the lawmaker is able to ignore that data, the experiment will be of little value.\textsuperscript{76}

2. How Experimental Rules Overcome These Initial Obstacles to Policy Experimentation

Experimental rules promulgated by a federal administrative agency have the potential of overcoming these obstacles to policy experimentation. Experimental rules have two defining features. First, they automatically expire by virtue of a sunset provision, and therefore, are a type of “multi-stage” rule—the first stage taking place prior to the sunset and the second stage taking place after the sunset.\textsuperscript{77} Second, an experimental rule is a particular type of multi-stage rule because it is adopted for the express purpose of generating data prior to the sunset (the first, or experimental, stage of the rule) that regulators subsequently take into account in determining whether to adopt the rule, or some variation of it, on a permanent basis (the second stage of the rule).\textsuperscript{78}

Thus, experimental rules promulgated by a federal administrative agency have the potential to overcome both of the primary obstacles to policy experimentation. First, experimental rules avoid the costs of repeal that are a primary source of law’s path dependency because they expire automatically by virtue of the sunset provision.\textsuperscript{79} Second, when experimental rules are promulgated by a federal administrative agency, judicial review of those agency rules helps to overcome the lack of learning reinforcement.\textsuperscript{80}

In the lawmaking context, judicial review serves as the mode for learning reinforcement because there is an absence of many of the factors that typically facilitate learning reinforcement in other areas. Outside of the lawmaking context, learning reinforcement relies on a combination of market forces and regu-
ulatory structures to ensure that decisionmakers “learn" from their experiments. For example, a business that introduces a new product will have to respond to feedback from the market regarding the desirability of that product in order to effectively compete in its industry. \(^81\) In the pharmaceutical industry, the Food and Drug Administration’s (FDA) review of an experimental drug trial ensures that any data generated during the trial will be reflected in a company’s final decision whether or not to bring the drug to market. \(^82\) Yet experimental laws are not necessarily subject to these same market or regulatory forces. To be sure, at the state level, there may be competition among alternative regulators. \(^83\) Likewise, at the federal level there may be competition from states \(^84\) or international jurisdictions. \(^85\) Nevertheless, there is considerable debate over whether this competition leads to better laws. \(^86\) Moreover, no equivalent of the FDA ensures that data generated by experimental laws is taken into account in final decisions. And although media plays an important role in keeping Congress in check, the public has little appetite for the type of in-depth, detail-oriented reporting on policy debates that would be necessary to enforce learning through experimentation at the federal level. \(^87\)


84 See, e.g., Roe, supra note 20, at 600 (arguing that in the market for corporate law, Delaware’s primary competition comes not from other states but from the U.S. Congress).


86 For example, the debate over the effects of competitive federalism in corporate law has been raging for more than thirty years with little sign of abating. See generally, e.g., ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 14–31 (1993); Bainbridge, supra note 61; Lucian Bebchuk et al., Does the Evidence Favor State Competition in Corporate Law?, 90 CALIF. L. REV. 1775 (2002); Lucian Arye Bebchuk & Allen Ferrell, Federalism and Corporate Law: The Race to Protect Managers from Takeovers, 99 COLUM. L. REV. 1168 (1999); Lucian Arye Bebchuk & Alma Cohen, Firms’ Decisions Where to Incorporate, 46 J.L. & ECON. 383 (2003); Cary, supra note 83; Robert Daines, Does Delaware Law Improve Firm Value?, 62 J. FIN. ECON. 525 (2001); Roberta Romano, Law as Product: Some Pieces of the Incorporation Puzzle, 1 J.L. & ECON. & ORG. 225 (1985); Ralph K. Winter, Jr., State Law, Shareholder Protection, and the Theory of the Corporation, 6 J. LEGAL STUD. 251 (1977).

87 Some scholars have suggested mechanisms to address this lack of learning reinforcement at the congressional level. For example, Roberta Romano has proposed a procedural mechanism under which a panel of independent experts would propose a bill in light of available data generated by legislation that is subject to a sunset provision. Roberta Romano, Regulating in the Dark, in REGULATO-
Judicial review can serve as the necessary check (even if an imperfect one) for increasing the probability that learning generated from a multi-stage decision-making process will be incorporated into final policy decisions. Not just any standard of review, however, will be effective to this end. For example, rational basis review, which requires that the law be supported by any conceivable rational basis, would do little to ensure that the results of the experiment influenced the ultimate legislative decision. It is for this reason that a federal statute is probably not the best vehicle for experimentation—even if it is subject to a sunset provision—because the rational basis review applied to federal statutes is unlikely to facilitate learning reinforcement.

Judicial review of final agency rules, however, is a different story. This is because arbitrary and capricious review, also called “hard look review,” entails both a procedural and substantive requirement that is likely to reinforce the type of learning generated by experimentation. Specifically, in order to survive arbitrary and capricious review, an agency must demonstrate that it followed a specified procedure, including that “it ha[s] responded to significant
points made during the public comment period, ha[s] examined all relevant factors, and ha[s] considered significant alternatives to the course of action ultimately chosen." The substantive element of arbitrary and capricious review, by contrast, requires the court itself to take a hard look at the agency’s decision. An agency “must articulate a ‘satisfactory’ explanation for its actions that does not ‘run counter to the evidence before the agency’ and that demonstrates a rational connection between the facts found and the choice made.” Under hard look review, therefore, agencies must justify their decision in technocratic terms, at a minimum taking into account all available data, basing all conclusions and predictions on sufficient evidence, and demonstrating that their conclusions are reasonable in light of this data. Thus, as long as an experimental rule generates useful data regarding the costs and the benefits of that rule, judicial review of final agency actions increases the probability that the final rule adopted by the agency will reflect this data, or in other words, that the agency will “learn” from the experiment.

Some might question this argument that judicial review can reinforce learning on the ground that judicial outcomes are not necessarily determined by the merits of the case. Some scholars have argued that interest groups have just as much, if not more, influence over the litigation process as they do over the legislative and rulemaking processes. Small, organized interest groups that are able to win out over more diffuse and less well-organized groups in the political economy are likely to have a similar advantage in the litigation context. They are likely to be willing and able to spend more on litigation and hire more skilled lawyers and therefore have a greater chance of prevailing

91 See id. at 545–56; Sunstein, supra note 89, at 210.
92 Garland, supra note 90, at 545 (quoting State Farm, 463 U.S. at 43).
93 See State Farm, 463 U.S. at 43. The Court stated:

[T]he agency must examine the relevant data and articulate a satisfactory explanation for its action including a “rational connection between the facts found and the choice made.” In reviewing that explanation, we must “consider whether the decision was based on a consideration of the relevant factors and whether there has been a clear error of judgment.” Normally, an agency rule would be arbitrary and capricious if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise.

Id. (citations omitted).
95 See, e.g., Wendy Wagner, Revisiting the Impact of Judicial Review on Agency Rulemakings: An Empirical Investigation, 53 WM. & MARY L. REV. 1717, 1771, 1789 (2012) (arguing that the net effect of judicial review provides regulated industry with leverage that may actually undermine a federal agency’s ability to act in the public interest).
96 See Elhauge, supra note 94, at 77.
before a court. If this were indeed the case, there might be cause to second-guess the assumption that judicial review will reinforce learning from policy experimentation. After all, if litigation outcomes are solely a function of the litigants’ comparative resource advantages, then it would be irrelevant how much data the court has regarding the costs and benefits of the rule under review.

It is extremely unlikely, however, that litigation outcomes are solely a function of comparative resource advantage. Surely, they must also depend on the merits of the case. The more the facts of the case favor one party at trial, the less influence a given level of resources will have on persuading the judge to rule in the other party’s favor. Where the evidence is more or less indeterminate, interest group resources will have the greatest influence on the litigation process. They will have comparatively less influence when the evidence is more determinate. In other words, the resources of interest groups are going to be the least influential in evidence-rich environments, like those created by the experimental period (pre-sunset) of an experimental rule.

The SEC’s ill-fated proxy access rule serves as an illustration of this point. In 2010, the SEC adopted the proxy access rule. Less than a month after the SEC adopted the proxy access rule, the Business Roundtable and the Chamber of Commerce, both corporate interest groups, challenged the rule in the D.C. Circuit. The court in Business Roundtable ultimately vacated the

97 Id.
99 And in fact, when viewed in the correct light, this is precisely what the empirical work on judicial decision making tends to demonstrate. See, e.g., Brian Z. Tamanaha, The Distorting Slant in Quantitative Studies of Judging, 50 B.C. L. REV. 685, 688 (2009) (arguing that when the empirical literature on judicial decision making is viewed not in terms of whether extra-legal factors matter in judicial outcomes but the extent to which they matter, “the results of these studies are reversed, and instead of discrediting the judiciary, they confirm the legal integrity of the bulk of judging”); see also Frank B. Cross, Decision Making in the U.S. Courts of Appeals 4–6, 147 (2007) (concluding that, contrary to many economic theories, litigants do not appear to play a role in judicial outcomes).
100 This view is consistent with an economic view of judging, where extra-legal norms (like resources) play more of a role in those cases where the judicial task is less fettered to authoritative texts and precedent, to be sure, but also to empirics. Cf. Richard A. Posner, The Supreme Court 2004 Term—Foreword: A Political Court, 119 HARV. L. REV. 31, 40 (2005) (explaining how extra-legal factors, including politics, have greater sway over the Supreme Court in constitutional cases, where it is less “tethered to authoritative texts, such as constitutional and statutory provisions, and to previous judicial decisions”).
102 Bus. Roundtable, 647 F.3d at 1146.
rule on the basis that it was “arbitrary and capricious.”

Interestingly, the demise of the proxy access rule in Business Roundtable supports the interest group criticism of judicial review while at the same time illustrating why this criticism is not particularly forceful when applied to experimental rules. At the SEC, the proxy access rule was supported by institutional shareholders but ultimately may owe its adoption to the increased public scrutiny of corporate governance issues in the wake of the financial crisis, which resulted in Congress instructing the SEC to adopt a proxy access rule in the Dodd-Frank Act. Yet these same political forces were probably less influential at the D.C. Circuit, given that Article III judges, with their lifetime appointments, are presumably insulated from such political vicissitudes. They are not insulated, however, from the influence of better financed litigants, which might explain why the Business Roundtable and the Chamber of Commerce ended up being more successful at the D.C. Circuit than they were at the SEC. To this point, the proxy access rule’s experience tracks the criticism that interest groups may have just as much influence, if not more, in the litigation process as they do in the legislation and rulemaking processes.

Notably, however, the evidence upon which the SEC relied for its cost-benefit analysis of the proxy access rule was decidedly indeterminate, even according to the court. Consequently, the Business Roundtable’s greater resources were particularly influential, perhaps even outcome determinative. Yet imagine how this dynamic would have changed if, consistent with the recom-

---

103 Id. at 1156.
104 See Stephen M. Bainbridge, Dodd-Frank: Quack Federal Corporate Governance Round II, 95 MINN. L. REV. 1779, 1786 (2011) (arguing that the political environment surrounding Dodd-Frank was typical of periods following economic bubbles, which often involve an upswing in populist anger alongside intense political pressure for action); Roberta Romano, The Sarbanes-Oxley Act and the Making of Quack Corporate Governance, 114 YALE L.J. 1521, 1528 (2005) (arguing that high salience events, like accounting fraud, can upend the traditional public choice balance, allowing policy entrepreneurs to get legislation passed that would not otherwise be possible in normal times).
107 There are many examples of interest groups that have sought judicial intervention after failing to gain traction in an agency’s rulemaking process. For example, in 2006, in American Federation of State, County, and Municipal Employees v. American International Group, Inc., the U.S. Court of Appeals for the Second Circuit rejected the SEC’s argument that insurer AIG could, pursuant to the so-called “election exclusion” under the federal proxy rules, exclude from its proxy statement a shareholder proposal proposed by the labor union AFSCME. See 462 F.3d 121, 123 (2d Cir. 2006). AFSCME’s proposal proposed that AIG itself adopt a proxy access rule in its corporate charter. See id. at 123–24; see also Gubler, supra note 18, at 784–85 (detailing the AFSCME decision).
108 See supra notes 52–64 and accompanying text.
mendations of some participants in the SEC’s notice-and-comment process, as well as several commentators, the SEC had decided to adopt an experimental version of its proxy access rule. Imagine further that the experimental rule had produced evidence that was substantial and that resolved one of the major questions at issue with proxy access, thereby supporting the SEC’s conclusion that the proxy access rule was indeed cost-effective. For example, imagine that the experiment had generated data suggesting that the proxy access rule was often used by shareholders that broadly represented shareholder interests and rarely used by shareholders with special interests (like unions and state pension funds) that deviated from those of the shareholder base as a whole. If the Business Roundtable had then brought a lawsuit challenging the proxy access rule despite that type of evidence favoring the rule, it is less likely that the Business Roundtable’s greater resources would have been the determining factor in the case, as the court would have been constrained by the more determinative evidence. Consequently, hard look review would have reinforced the learning generated by the experiment.

Thus, even if one is concerned about interest group influence on the judiciary, this concern should be at its lowest ebb in an evidence rich environment, when the facts of the case weigh in favor of a particular outcome. This is the case with judicial review of a final agency rule following the expiration of the initial stage of an experimental rule. For these reasons, interest group concerns should not undermine the assumption that judicial review can reinforce learning in the case of policy experimentation by agencies.

The foregoing analysis leads to two conclusions. First, as a laboratory of experimentation, Congress is probably not as effective as an administrative agency. Although Congress is perfectly capable of adopting experimental rules, there are no real mechanisms that ensure that later-stage decisions will reflect the data generated by the experiment. In other words, there is little or no learning reinforcement. There is, however, learning reinforcement with respect to rules adopted by administrative agencies, thanks to hard look judicial review, which necessarily requires agencies to take into consideration relevant factors and demonstrate that the conclusions that flow from these considerations are reasonable. Thus, the second conclusion to draw from the preced-

110 Bigger Mess, supra note 63 (quoting Wharton accounting professor Wayne R. Guay as advocating a sunset provision); Ribstein, supra note 63.
111 See supra notes 69–74 and accompanying text.
112 Although Congress may decide to adopt legislative rules (like the reconciliation process or PAYGO) in an effort to bind future action, these rules are “endogenous” and therefore can be modified by Congress at will when politically expedient. Kysar, supra note 6, at 1009.
113 See supra notes 89–93 and accompanying text.
ing discussion is that experimental rules will be most effective when adopted at
the agency level.

In Section C, this Article examines the use of experimental rules in the real world.114 Before proceeding with that empirical discussion, however, there is one preliminary criticism of experimental rules that is worth considering at this time. The criticism contends that because experimental rules may only be temporary (because they may not be readopted or replaced upon their automatic expiration), economic actors might behave differently under an experimental rule than they would under a single-stage rule—thereby compromising the experiment.115 This criticism suggests that an experimental rule could lead private parties to either over or underrespond to the experimental rule, which might skew the results of the experiment.116 For example, if a tax benefit were temporary, everyone might race to take advantage of the benefit during the period it is in effect, and the resulting data that is generated by the experiment might be skewed by overresponsiveness on the part of the beneficiaries of that rule. On the other hand, if an experimental rule is particularly costly to implement, private parties might refuse to implement it on the belief that it will not be re-enacted anyway, leading to underresponsiveness.117

Although these are no doubt legitimate concerns, they should not be fatal to attempts to encourage policy experimentation. First of all, there is no reason to believe that experiments will consistently be skewed in this manner. Private actors will overrespond to a policy only if they have the luxury of accelerating decisions and actions to take advantage of the temporary rule. Yet, some rules will limit the ability of individuals to suddenly alter their behavior in the hope of benefitting from the temporary rule. This was certainly the case with the SEC’s proxy access rule. The proxy access rule only applied to those investors who were not only aware of a mismanaged company, but who actually were owners of a certain amount (three percent) of stock of that company and had been for a specified time period (three years).118 Thus, unlike a temporary reprieve from the gift tax, for example, which would apply theoretically to every U.S. taxpayer and would be easily exploitable by the simple decision to give a gift now rather than later, an experimental proxy access rule would be limited to a relatively small class of people (investors in mismanaged companies) and even then would be very difficult to exploit on a short-term time frame (in light of the holding requirements).

Similarly, private actors will not always underrespond to a policy. Underresponsiveness by a private actor is likely to occur only if the value that the

114 See infra notes 119–140 and accompanying text.
115 Gersen, supra note 4, at 277–78; Kysar, supra note 6, at 1045.
116 Gersen, supra note 4, at 278; Kysar, supra note 6, at 1045.
117 Gersen, supra note 4, at 278; see Kysar, supra note 6, at 1045.
actor obtains from the policy is dependent on the ability to take advantage of the policy in the future, or in cases where, in order to take advantage of the policy, an actor would need to make a significant upfront investment that could only be recovered by taking advantage of the policy in the future. Yet, once again, proxy access does not exhibit either of these two features, and accordingly, an experimental proxy access rule is unlikely to be compromised by underresponsiveness.

Moreover, even if private actors do over- or underrespond to temporary rules, this altered behavior will not necessarily undermine the experiment. For example, with respect to the proxy access rule, overresponsiveness to the experimental rule might skew the results for purposes of determining whether, and to what extent, the rule will actually facilitate proxy contests. But it would not skew the results for the purpose of determining whether the rule would be used primarily by special interest shareholders—provided that there is no reason to believe that one type of shareholder is more likely to overrespond to the rule than any other type, which seems like a reasonable assumption. Finally, even if private actors do over- or underrespond to temporary rules, and this altered behavior in fact does undermine the experiment, the agency will be aware of this possibility and will have to take this fact into account in its decision whether to extend the rule or not after its expiration.

Thus, there is no reason to believe that the criticism leveled at temporary experimental rules should undermine the theoretical benefits that have been identified in association with such rules. The extent to which these theoretical benefits actually materialize in the real world depends on an empirical question: how often do agencies actually use experimental rules?

C. The Scarcity of Experimental Rules

It turns out that despite their theoretical benefits, experimental rules are not particularly widespread.\(^\text{119}\) Consider, for example, the case of the SEC. During the decade-long period ending on December 31, 2011, the SEC prom-

\(^{119}\) One might point to the common use of sunset provisions in tax legislation as a counterexample to this claim that there is a dearth of multi-stage rules. See Kysar, supra note 6, at 1021 (noting that “legislators have employed sunset provisions with increasing frequency in the United States, particularly in the tax-cutting context”). Sunset provisions, however, tend to be used in the tax context not for experimentation purposes but rather as a means of avoiding budgetary pressures on revenue-reducing legislation. See id. at 1018. A tax cut subject to a sunset provision will escape the PAYGO rules requiring revenue offsets that would otherwise hamper a permanent tax cut, even if the temporary cut is likely to be extended after the sunset expires. See id. at 1017–19. The types of policies that will benefit from experimentation are highly uncertain and therefore, by definition, are unlikely to be labeled revenue-reducing or revenue-increasing in the way that tax legislation can. Thus, PAYGO rules are unlikely to affect the types of policies this Article deals with. And in any case, PAYGO rules do not apply at all to administrative rules, which, for reasons previously discussed, are this Article’s main concern. See supra notes 8–10, 77–78 and accompanying text.
ulgated 302 final rules. Yet only three (or one percent) of those rules were structured as experimental rules, or in other words, as a multi-stage rule for the purpose of experimentation. All three of these rules dealt with policy issues.


121 This was determined by running the following LexisNexis search: “AGENCY(“Securities & Exchange Commission”) and (pilot or sunset) and ACTION (rule and not proposed and not interim) and date(geq (1/1/2002) and leq (1/1/2012)”. Before discussing the results of this search, however, it is helpful to explain why “interim temporary rules” were purposefully omitted from the determination of the number of experimental rules. An “interim temporary rule” is a rule that an agency can adopt immediately without going through the notice-and-comment rulemaking, if the agency determines that there is “good cause” to do so. 5 U.S.C. § 503(b)(3)(B) (2012); Michael Asimow, Interim-Final Rules: Making Haste Slowly, 51 ADMIN. L. REV. 703, 703 (1999). Often, these interim rules look like experimental rules. They are structured as a multi-stage decision for the purpose of generating data that can be used to determine the optimal rule at the final stage of the decision-making process. The “good cause” exemption is quite narrow, however, and therefore agencies rarely adopt these types of rules. Indeed, according to the SEC website, between 2007 and 2011, only fifteen rules were structured as interim final rules exempt from notice-and-comment whereas 154 were structured as traditional final rules subject to all of the notice-and-comment requirements. See Regulatory Actions, SEC, http://www.sec.gov/rules.shtml, archived at http://perma.cc/AU28-UYWJ (follow “Interim Final Temporary Rules”; then follow each year tab from 2007–2011 to establish number of interim temporary rules) (last visited Dec. 26, 2013).

With that caveat regarding interim rules out of the way, consider the results of the search. The search yielded thirty-four hits. Of these, only four were structured as multi-stage rules for the purpose of experimentation. See Delegation of Authority to the Director of [the SEC’s] Division of Enforcement, 75 Fed. Reg. 49,820 (Aug. 16, 2010) (codified at 17 C.F.R. pt. 200); Regulation SHO and Rule 10a-1, 72 Fed. Reg. 36,348 (July 3, 2007) (codified at 17 C.F.R. pts. 240, 242); Short Sales, 69 Fed. Reg. 48,008 (Aug. 6, 2004) (codified at 17 C.F.R. pts. 240–42); Broker-Dealer Exemption From Sending Certain Financial Information to Customers, 68 Fed. Reg. 46,446 (Aug. 6, 2003) (codified at 17 C.F.R. pt. 240). Two of these four rules each pertained to the experiment regarding the uptick rule discussed further below. Thus, the search generated only three distinct examples of experimental rules.

Three other rules pertained to a 2007 interim final temporary rule. See Principal Trades with Certain Advisory Clients, 72 Fed. Reg. 55,022 (Sep. 28, 2007) (codified at 17 C.F.R. pt. 275) (adopting a temporary rule in order to transition to an unexpected interpretation of the Investment Advisors Act by the D.C. Circuit in Financial Planning Ass’n v. SEC, 482 F.3d 481 (D.C. Cir. 2007)). These three rules extended the sunset provision of that interim temporary rule. See Principal Trades with Certain Advisory Clients, 75 Fed. Reg. 82,236 (Dec. 30, 2010) (codified at 17 C.F.R. pt. 275); Principal Trades with Certain Advisory Clients, 75 Fed. Reg. 742 (Jan. 6, 2010) (codified at 17 C.F.R. pt. 275); Principal Trades with Certain Advisory Clients, 74 Fed. Reg. 69,009 (Dec. 30, 2009) (codified at 17 C.F.R. pt. 275). As explained above, the search was intended to omit these “good cause” exemptions to the notice-and-comment process precisely because they are fairly narrow exceptions to the SEC’s general approach to rulemaking. Thus, this Article omitted them from the list of “experimental rules.”

that were extremely uncertain. The first dealt with an internal issue regarding who should bring enforcement actions within the SEC. The second dealt with the regulation of short sales. And the third was concerned with the rules requiring broker-dealers to deliver information to their clients.

Still, these were hardly the only rules that the SEC promulgated during the first decade of the new millennium that could have benefited from experimentation. In fact, participants in the notice-and-comment process recognized this fact on certain occasions. In five cases, a sufficient number of commenters had requested experimental rules such that the SEC had to explain in the final rule release why the Commission was instead adopting a single-stage rule. Moreover, this does not reflect calls made by outside commentators for the use of experimental rules for particular policies.

The remaining rules dealt with experimentations being run by entities other than the SEC, including self-regulatory organizations (like the New York Stock Exchange) and industry participants, or were otherwise irrelevant.

---

122 Delegation of Authority to the Director of [the SEC’s] Division of Enforcement, 75 Fed. Reg. at 49,820 (establishing a true experimental rule that was adopted with a one-year sunset—but interestingly deals purely with the SEC’s internal procedure, in this case with respect to enforcement).

123 Amendments to Regulation SHO, 73 Fed. Reg. 61,706, 61,706 (Oct. 17, 2008) (codified at 17 C.F.R. pt. 242) (addressing abusive “naked” short selling in all equity securities by requiring that participants of a clearing agency registered with the Commission deliver securities by settlement date, or, if the participants have not delivered shares by settlement date, immediately purchase or borrow securities to close out the fail to deliver position by no later than the beginning of regular trading hours on the settlement day following the day the participant incurred the fail to deliver position). The most significant example of experimentation at the SEC has been with respect to the uptick rule for short sales. In 2004, the SEC established a true experimental rule—what they called a pilot program—with a one-year sunset that was intended to test the effectiveness of the uptick rule by eliminating its application to a subset of publicly traded companies. Short Sales, 69 Fed. Reg. at 48,008; see also Regulation SHO and Rule 10a-1, 72 Fed. Reg. at 36,349 & n.14 (providing background on this pilot program). After the conclusion of the experimental period, the SEC decided to eliminate the rule on a permanent basis. Regulation SHO and Rule 10a-1, 72 Fed. Reg. at 36,349. When the financial crisis hit, the SEC came under attack from a number of different camps for having contributed to market volatility by eliminating the uptick rule. See Amendments to Regulation SHO, 75 Fed. Reg. at 11,233. Consequently, the SEC reinstated the uptick rule, this time adding a circuit breaker, which in effect means that the uptick rule does not apply unless the stock price has dropped more than ten percent in one day. Id. at 11,232. Interestingly, there were requests for an experimental rule with respect to the circuit breaker, but the SEC rejected this request. Id. at 11,278.

124 Broker-Dealer Exemption from Sending Certain Financial Information to Customers, 68 Fed. Reg. at 46,446. The Broker-Dealer exemption adopted amendments to a rule under the Securities Exchange Act of 1934 that required a broker-dealer to send detailed balance sheets to customers twice a year. Id. The SEC rule provided a conditional exemption that permitted a broker-dealer to send only summary information as long as it also provided customers with other avenues to receive detailed balance sheet information. Id. The amendment aimed to reduce the cost of doing business for a broker-dealer while at the same time providing customers of the broker-dealer with easy access to the essential information they would need to evaluate the financial soundness of the broker-dealer. See id.

125 See infra note 126 and accompanying text.

126 See Facilitating Shareholder Director Nominations, 75 Fed. Reg. at 56,687 & n.169 (identifying two different commentators—Theragenics, a publicly traded company, and Alston & Bird, a law firm—who proposed adopting proxy access on a pilot basis); Amendments to Regulation SHO, 75 Fed. Reg. at 11,232, 11,278 (adopting a short sale-related circuit breaker that, if triggered, would impose a restriction on the prices at which securities may be sold short); Amendments to Rules for
The fact that the SEC promulgated so few experimental rules is surprising. What is even more surprising, however, is the number of policies with uncertain payoffs—that could have benefited from experimentation—that the SEC instead adopted on a permanent basis without experimentation.

Nor does this scarcity of experimental rules seem to be limited to the SEC. For example, during the same decade-long period ending on December 31, 2011, the Commodity Futures Trading Commission promulgated 259 rules, yet only two of these (0.8%) were structured as experimental rules. The results are similar at the Federal Trade Commission (0.8%), the National Transportation Safety Board (none) and the Federal Energy Regulatory Commission (none).

Indeed, this scarcity of experimental rules is what one might expect based on the dominant descriptive (and normative) model of regulatory design. This model, often referred to as “minimalism,” favors static efficiency—maximizing efficiency in the present without regard for future periods. This minimalism model, therefore, tends to ignore the learning benefits that arise from multi-stage decision making.

To be sure, this is not to say that agencies never engage in experimentation. In fact, some regulatory regimes are designed specifically to take advantage of the learning benefits associated with multi-stage decision mak-

---

Nationally Recognized Statistical Rating Organizations, 74 Fed. Reg. at 6,462 (identifying several nationally recognized statistical rating organizations that had requested that one aspect of the proposed rule be adopted on a pilot basis); Standards Relating to Listed Company Audit Committees, 68 Fed. Reg. at 18,788, 18,795 & n.86, 18,804 (proposing an exemption from certain requirements for audit committees for boards of auditors or statutory auditors of foreign private issuers that fulfilled the remaining requirements of the rule; provided that those boards operate under legal or listing provisions intended to provide oversight of outside auditors that is independent of management, that membership on the board excludes executive officers of the issuer, and that certain other requirements were met); Customer Margin Rules Relating to Security Futures, 67 Fed. Reg. at 53,146, 53,147 (establishing a joint rule with the CFTC, in which the SEC rejected requests to experiment with the margin rules through an experimental rule).

127 See Bigger Mess, supra note 63 (quoting Wharton accounting professor Wayne R. Guay as advocating a sunset provision); Ribstein, supra note 63.


129 During this period, there were no experimental rules promulgated by the NTSB.

130 During this period, there were no experimental rules promulgated by the FERC, although there were final rules that were adopted on a permanent basis following the termination of an earlier experimental rule. See Promotion of a More Efficient Capacity Release Market, 73 Fed. Reg. 37,058, 37,059 (June 30, 2008) (codified at 18 C.F.R. pt. 284). There is also one example of the FERC rejecting commenters’ requests to structure a policy as an experimental rule. See Frequency Regulation Compensation in the Organized Wholesale Power Markets, 76 Fed. Reg. 67,260, 67,272 (Oct. 31, 2011) (codified at 18 C.F.R. pt. 35).

131 See Sabel & Simon, supra note 4, at 56.

132 See id. at 60–61 (“In practice, the minimalists seem to deploy a static conception of efficiency that risks slighting [the capacity for learning and innovation].”).
These regimes include the Nuclear Regulatory Commission, which monitors data generated by nuclear power plants to constantly inform the agency’s understanding of potential hazards.134 Similarly, federal and state food regulators are able to assess and update their strategies in light of a constant stream of data on food-borne illnesses, which is generated by a network coordinated by the Centers for Disease Control and Prevention.135 Additionally, the Clean Water Act requires states to adopt and revise water quality standards at least once every three years to take into account the latest learning on the matter.136 More generally, experimentation seems to be embedded in certain regulatory cultures, particularly those that appear to be more closely related to science, as is the case with the Federal Communications Commission (FCC) and the Environmental Protection Agency (EPA).137

Nevertheless, many other agencies, including the SEC, obviously fall into the minimalist paradigm, in which the benefits of multi-stage decision making are forgone in favor of a static, single-stage decision regarding the optimal policy—a decision often made under uncertain conditions.138 Though, as already

133 Id. at 55–56.
134 See id. at 84–85.
135 See id. at 85–86.
137 The same search conducted for these two agencies yields many more cases of experimental rulemaking; 78 out of 1813 final rules promulgated by the FCC and 513 out of more than 3000 final rules promulgated by the EPA. Note, however, that these results were not individually analyzed to determine whether the rules should be classified as “experimental rules” for the purposes of this Article; therefore, these numbers should be viewed as upper-bounds only.
138 See supra notes 119–132 and accompanying text. One might plausibly argue that the reason that we do not see much experimentation at the federal level is because of federalism concerns. Under notions of federalism, it was believed that the states were the actors intended to engage in experimentation, not necessarily the federal government. See New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting) (“It is one of the happy incidents of the federal system that a single courageous state may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country.”). Rules are tested at the state level, incubated at the state level, and then adopted at the federal level only if they are successful. So, maybe the failure to identify experimentation at the federal level does not mean that there is a lack of experimentation in government but rather that what experimentation does exist is instead focused at the state level, where it belongs, and that federal rules are permanent because they reflect these rules that have already been subject to experimentation by the states. A moment’s reflection, however, reveals several problems with this argument.

First, although states can and do act as laboratories of experimentation, legal fields that have been preempted by the federal government simply cannot be tested at the state level. See Rice v. Santa Fe Elevator Corp., 331 U.S. 218, 230 (1947) (noting that federal law “may touch a field in which the federal interest is so dominant that the federal system will be assumed to preclude enforcement of state laws on the same subject”). And even if there is not complete preemption, as in the case of state and federal securities laws, states cannot experiment with the federal overlay. See id. at 230–31 (establishing that federal law may choose to selectively preempt in such a way that allows states to continue to regulate, as long as such state regulation does not “collide” with the federal regulations). So, for example, a state could not decide to create a new exemption from the federal securities laws for companies that are residents of that state. Preemption therefore hinders the ability of states to experiment.

Second, there might be pathologies in the market for law that prevents states from engaging in experimentation. For example, in corporate law, there is a debate as to whether the competition among
demonstrated, in the face of such uncertainty, a single-stage decision-making process is unlikely to be the optimal strategy. But this raises an important question: if experimental rules are so potentially valuable, why don’t agencies, like the SEC, make greater use of them? As Part II argues, the likely reason is that experimental rules are disfavored in the political economy.

II. THE POLITICAL ECONOMY OF EXPERIMENTAL RULES

Part II looks to public choice theory to help explain the dearth of experimental rulemaking at many federal agencies. Section A of this Part discusses public choice theory generally. Section B then establishes how an understanding of public choice theory helps to explain why experimental rules are disfavored in the political economy. Finally, Section C uses a model to further illuminate why experimental rules are disfavored in the political economy.

A. The Theory: A Public Choice Understanding of the “Political Economy” for Regulation

Public choice theory views the production of regulation through an economic lens. According to the theory, regulation is a product that is exchanged in a market in which government is the supplier and certain firms within the regulated industry are the consumers. The key to this “political...
The "economy" model is the insight that regulation can actually benefit at least certain regulated firms by raising their rivals’ costs by a greater amount than their own. This is referred to as “cost predation.” For example, although mandatory disclosure rules under the federal securities laws might increase the compliance costs of all public companies, these costs will fall disproportionately on small, upstart firms with more prospects than revenues rather than large, established firms. Consequently, these large established firms might actually demand more, rather than less, regulation, which will make it harder for their rival upstarts to compete in the industry. Because regulation might actually benefit a certain cross section of the regulated industry, those beneficiaries will find it in their interest to compensate regulators in exchange for regulation. This compensation will typically take the form of promises of future, post-government employment in a particular industry or other types of career support.

Regulators, however, are not limited to acting as simple brokers in this political economy, handing out rents in the form of regulation to certain well-organized interest groups. Regulators can also extract rents for themselves through a form of political extortion. They do this by threatening to regulate where regulation would not benefit a certain group of firms. Alternatively, they engage in political extortion by threatening to deregulate where regulation benefits a certain group of firms. For example, just as large, well-established firms might compensate regulators for increased disclosure rules in an effort to increase their rivals’ costs, they might also be willing to compensate regulators for their agreement not to scale back the disclosure laws, which would result in the loss of their cost advantage over their competitors.

---

147 This is an example of Ricardian rent creation. McC Chesney, supra note 15, at 14.
148 Id.
150 See Easterbrook & Fischel, supra note 59, at 277–78; Macey, supra note 149, at 914–15.
151 See Levine, supra note 15, at 273; Macey, supra note 149, at 914–15.
152 See Levine, supra note 15, at 273; supra note 16 and accompanying text.
153 See Kysar, supra note 6, at 1051.
157 In reality, the bargain over regulation does not boil down to a stark, binary choice between regulation or no regulation, but rather is best characterized by a continuum between these two extremes. Thus, in a sense, every regulatory bargain will involve both rent creation through cost predation (where regulators create rents by adopting regulation that benefits certain interest groups) and rent extraction through political extortion (where regulators exercise forbearance in rent creation).
B. The Intuition: An Explanation for the Dearth of Experimental Rules

Both of these public choice accounts—the “cost predation” account and the “political extortion” account\(^\text{158}\)—play an important role in understanding why experimental rules might be disfavored in the political economy. Consider an interest group that has the organization to obtain a given policy in exchange for promises of future career support for regulators. This policy could be adopted in one of two forms: it could be adopted on a permanent basis; or it could be adopted on a short-term, experimental basis with the goal of reconsidering the desirability of adopting the policy on a permanent basis after the expiration of the sunset period.

There are two reasons to believe that the supporters of this hypothetical policy might “pay” the regulator less for the policy if it is adopted as an experimental rule rather than a non-experimental, permanent one. First, the experimental rule is more likely to be temporary than the permanent rule because the policy’s readoption after expiration of the sunset is contingent on the results of the experiment.\(^\text{159}\) If the experiment generates data that suggests that the policy is not cost-effective, then the regulator will be less likely to readopt the policy after the sunset’s expiration; or if the rule is adopted, a court will be more likely to vacate it because the conclusion that the rule is cost-effective in light of the evidence to the contrary would have difficulty surviving arbitrary and capricious review.\(^\text{160}\) Thus, if the policy will increase the costs of the interest group’s rivals (as under the cost predation account), it will do so for a shorter time under the experimental rule than under the permanent rule.

The second reason that the supporters of this hypothetical policy might value experimental rules less is that an experimental rule is a more effective vehicle for political extortion than a permanent rule.\(^\text{161}\) Regulators can always threaten to repeal rules or regulations that benefit certain interest groups in an effort to extract payments from those groups in exchange for the regulators’ forbearance.\(^\text{162}\) This is true regardless of the type of rule at issue. But the amount of rents that a regulator can extract from this political extortion does depend on whether the rule is experimental (and therefore expires automatically on its own terms) or not.\(^\text{163}\) This is because the greater the costs that the agency must incur to repeal a given rule, the less credible the threat is, and therefore, the smaller the rents are that the agency can extract as a result of

\(^{158}\) See McChesney, supra note 15, at 14, 20.

\(^{159}\) See Gersen, supra note 4, at 285 (observing that “holding the substance of legislation constant, a temporary measure actually produces less benefit to an interest than does otherwise equivalent permanent legislation” because the temporary measure will be of shorter duration).

\(^{160}\) Recall that this is why arbitrary and capricious review has the potential of reinforcing learning, as discussed previously. See supra notes 10, 89–93 and accompanying text.

\(^{161}\) See Kysar, supra note 6, at 1051–52.


\(^{163}\) See Kysar, supra note 6, at 1051–52.
these threats. To repeal a permanent rule, a regulator would have to follow the costly procedures imposed by the Administrative Procedure Act, which, in the case of the repeal of formal rules, would require a formal notice-and-comment rulemaking. \(^{164}\) These costs will clearly be greater than the costs of allowing an experimental rule to expire automatically on its own terms. \(^{165}\)

**C. The Model: The Higher “Cost” of Experimental Rules**

This intuition that interest groups might be willing to pay less for experimental rules than for permanent rules is captured in a more concrete manner in Figure 1 below. To understand this figure, imagine a hypothetical agency policy that can be structured in one of two ways. First, it could be structured as an experimental rule, meaning that it is adopted on a trial basis and sunsets after some relatively modest amount of time, say two years. After this “experimental period,” the agency can decide whether to extend the rule indefinitely or reject it in favor of another rule. Alternatively, that same policy could be structured as a permanent, single-stage rule with no automatic expiration. In each case, the rule is challenged in court shortly after its adoption on the ground that the agency’s decision to promulgate the rule was “arbitrary and capricious.” For simplicity of explication, assume that the statute of limitations for challenging an agency rule is also two years, the same as the initial stage of the experimental rule. \(^{166}\)

---

\(^{164}\) See, e.g., KOCH, supra note 71, § 4:22 (explaining that “the effort to repeal or modify [a] rule must be through a process having equal status with the original rule”); see also Nat’l Family Planning & Reprod. Health Ass’n v. Sullivan, 979 F.2d 227, 234 (D.C. Cir. 1992) (holding that an agency cannot alter, without notice-and-comment, a legislative rule, “unless such a change can be legitimately characterized as merely a permissible interpretation of the regulation, consistent with its language and original purpose”).

\(^{165}\) Kysar, supra note 6, at 1051–52 (“It is much easier to let a sunset expire than to repeal or amend legislation.”).

\(^{166}\) In reality, the statute of limitations for such actions is six years. See 28 U.S.C. § 2401(a) (2006).
For interest groups that favor this policy, the expected value of these two alternative rules might be thought of as consisting of four different components. The first component (Term 1) is the value of the policy during the first two years of its life, which in the hypothetical corresponds to the initial (pre-sunset) stage of the experimental rule. The value of the policy ($V_1$) for the duration of this two-year period must be discounted by the probability that the rule will survive arbitrary and capricious review ($P(A_1)$), which by hypothesis takes place shortly after the rule’s adoption. Term 1 in each equation is equal because the standard of review is the same regardless of whether the policy is structured as an experimental or a single-stage rule.

The second component of the expected value equation (Term 2) consists of the value of the policy ($V_2$) following this initial two-year period. This value must also be discounted, but the discount rate will differ depending on the type of rule in question. With respect to the permanent, single-stage rule, the value of the policy after the initial two-year period will be discounted by the probability that the court affirms the rule during the initial two-year period. After all, if the rule is not affirmed during the initial two-year period, then that is the end of the rule.

The case of the multi-stage rule is a bit more complicated. In order for there to be a post-experimental period at all in that case (i.e., a period lasting longer than the initial two-year period), the agency must extend the rule on a permanent basis after it sunsets, and the extended rule must overcome yet another round of judicial review because the extension of the rule will be a separate agency action subject to judicial review. In other words, the principal difference between a single-stage rule and a multi-stage rule (that is readopted following the experimental period) is that the multi-stage rule will need to survive judicial review twice, once prior to the expiration of the experimental period and a second time after the rule is readopted. Thus, $V_2$ must be discounted by the probability that the extended rule will survive a second arbitrary and capricious review ($P(A_2)$).

---

167 In the hypothetical, no legal challenges could be brought with respect to the single-stage rule after this initial two-year period since that is the length of the statute of limitations. See supra note 166. In reality, this assumption probably does not matter since a rule will only be challenged once and this challenge will almost always occur within the first year or within the first couple of months of the rule’s adoption.

168 One might object that Equation (1) does not reflect the probability that the agency will extend the rule on a permanent basis. This might be a concern if the political dynamic were to change between the start and end of the experimental period so that it no longer favored the interest groups responsible for the rule’s adoption in the first place. But assuming that the political dynamic is relatively stable (and the experimental period will typically not be long—in the hypothetical, it is only two years), the agency will adopt the rule on a permanent basis as long as those interest groups are willing to pay the extortion costs, which are reflected in Term 3.

169 This informal model assumes that the dominant interest group that favors the policy in question can get the agency to readopt the policy on a permanent basis after the experimental rule expires simply by paying off the agency. Under this assumption, the only reason that a multi-stage experi-
if the multi-stage rule is not affirmed during the experimental period (the initial two-year period in the case of the single-stage rule), then there will be no post-experimental period. Thus, as in the case of the single-stage rule, $V_2$ in equation (1) must also be discounted by $P(A_1)$. Thus, Term 2 in equation (1) will be less than Term 2 in equation (2), as evidenced in the chart by the less-than symbol.

The third component of the expected value equation (Term 3) must capture the likelihood that the rule’s backers will have to pay extortion rents in the event that the agency decides to threaten to repeal the rule (in the case of the single-stage rule) or to allow it to expire without extension (in the case of the multi-stage rule). These extortion rents ($V_E$) are going to be greater for the multi-stage rule ($V_E(1)$) than for the single-stage rule ($V_E(2)$) because, as previously discussed, it is more credible for an agency to threaten to allow the rule to expire automatically than it is for an agency to threaten to repeal the rule pursuant to the complicated procedures set forth in the APA. And of course, ($V_E$) must also be discounted by the probability that the rule will survive arbitrary and capricious review in the first instance $P(A_1)$. Thus, Term 3 in equation (1) is going to be greater than Term 3 in equation (2), as evidenced in the chart by the greater-than symbol.

In comparing the two equations in Figure 1, and ignoring the cost term (Term 4), which will be discussed momentarily, it should be clear now how the expected value of the multi-stage rule might be less than the expected value of the single-stage counterpart. This observation, however, only gets part of the way toward determining the total rents available under each type of rule. After all, just because the demand side might be willing to pay less for one product than it will pay for an alternative does not mean that the supply-side’s revenues will fall if it provides that product over the alternative. Think of this in terms of butter and margarine. For example, just because consumers are willing to pay less for margarine does not mean that firms will obtain less revenue if they produce margarine instead of butter. Whether they will depends on the difference in quantity demanded for the two goods. If the quantity demanded for the lesser priced margarine is sufficiently greater than the quantity demanded for

---

mental rule might be more temporary than a single-stage rule is because a court might vacate the multi-stage rule after it has been readopted on a permanent basis following the experiment. There is also the possibility, however, that the agency will simply refuse to readopt the policy on a permanent basis because it cannot justify the policy in light of the data generated by the experiment. This is another reason why the multi-stage rule might be more temporary than a single-stage rule. Nevertheless, it doesn’t affect the ultimate point being made here: a permanent rule that first passes through an experimental period must survive two rounds of judicial review rather than the single round that a permanent rule is subject to when adopted as a single-stage rule at the outset. And therefore, as explained in Part III, one attempt at subsidizing experimental rules might be to lessen the costs related to the judicial review of experimental rules.

170 See supra notes 19, 161–165 and accompanying text.
butter to more than offset the difference in price, then a firm’s revenues will actually be greater if it produces the less expensive product.

Similarly, the determination of total rents available under the two different types of rules will depend not only on the price of regulation (reflected in Figure 1) but also on the demand for the different rules. For example, it is possible that experimental rules are like the cheaper, but more popular margarine—the cheaper price brings in new interest groups that would not otherwise participate in the political economy, thereby increasing the value that agencies can extract from the production of these rents.171 This is unlikely, however, because interest groups are relatively entrenched at particular agencies.172

Comparatively, in markets where the medium of exchange is cash, different consumer groups can easily enter and exit the market in response to changes in prices. Such is not the case in the market for regulation. In that market, the medium of exchange is not cash, but rather “career support.”173 At the agency level, this career support typically comes in the form of informal and formal promises of employment after the regulator leaves the agency.174 These types of promises require established relationships, which take time to build and nurture. This entrenched nature of the consumer group in the market for regulation means that the demand for experimental rules (or more particularly, the number of consumers who are willing to pay for such rules) is more or less the same as the demand for single-stage rules.

Consider then how these various elements of the political economy of experimental rules fit together. Interest groups in the market for regulation will typically pay more for single-stage rules than they will for multi-stage rules. Moreover, because the number of consumers willing to pay for regulation is more or less the same regardless of the rule in question, there will be higher rents associated with single-stage rules than with multi-stage rules.175 Thus, the political economy will tend to favor single-stage rules.176

171 Professor Gersen raises this possibility with respect to temporary legislation. See Gersen, supra note 4, at 285.
172 Cf. Mark J. Roe, Delaware’s Politics, 118 HARV. L. REV. 2491, 2500–04 (2005) (arguing that there are fewer interests involved in the production of corporate law in Delaware than there are in Washington D.C., and there is little chance of interests migrating to Delaware that are not already there). This stability of the interests that manage to capture an agency is implicit in the observation that interest groups are more likely to capture a single agency than multiple ones. See HULT, supra note 20, at 8; O’Connell, supra note 20, at 1677; supra note 20 and accompanying text.
173 See supra note 152 and accompanying text.
174 See supra notes 16, 152 and accompanying text.
175 An increase in demand in response to a decrease in price occurs not just because new consumers enter the market in response to the price decrease, but because the pre-existing consumers buy more of the cheaper product. Thus, one might argue that just because interest groups are fairly entrenched in a particular agency culture, and therefore the lower priced experimental rules are unlikely to attract new interest groups, total revenue may nevertheless stay the same or increase if current interest groups purchase more experimental rules than they do permanent rules. Although this makes perfect sense when describing firms, it makes less sense when describing government entities that are subject to a fixed budget that is not a function of the amount of revenues generated by the political
Of course, the analysis thus far has considered only the relative benefits of experimental and permanent rules; the price interest groups are willing to pay for regulatory rents (and the value regulators receive in exchange for such rents) is going to be a function not only of benefits but of costs as well. The transaction cost element (Term 4) of this political economy analysis, however, is considerably more indeterminate than the revenue element (Terms 1–3), an observation that is reflected in Figure 1 by the inclusion of both inequality and equality signs.

The transaction costs associated with the adoption of a formal agency rule consist primarily of the costs that interest groups must incur to participate in the notice-and-comment period. For an interest group that desires the adoption of a particular policy that will endure for the relative long term, an experimental rule might on the one hand seem particularly attractive from a cost perspective. After all, the costs associated with the initial adoption of an experimental rule ($C_{E1}$) are likely to be less than the costs associated with the initial adoption of a permanent rule ($C_P$), because there is relatively less at stake with a rule that will automatically terminate, and therefore, less of a need to invest effort in its adoption.

176 Note that this conclusion is largely consistent with the public choice literature on the durability of laws. See, e.g., William M. Landes & Richard A. Posner, The Independent Judiciary in an Interest-Group Perspective, 18 J.L. & ECON. 875, 878–79 (1975); Jonathan R. Macey, Winstar, Bureaucracy and Public Choice, 6 S. CT. ECON. REV. 173, 180 (1998); Robert D. Tollison, Public Choice and Legislation, 74 VA. L. REV. 339, 344 (1988). Recently, Professor Gersen has mounted an important challenge to this literature. See Gersen, supra note 4, at 280–81. Professor Gersen’s argument has both a theoretical and empirical component. Id. As a theoretical matter, Gersen argues that long-term legislation, for example legislation lacking an automatic expiration, can be prematurely terminated by future lawmakers who decide to repeal the law. Id. Although this is certainly true, it is undoubtedly less costly from the standpoint of a lawmaker to terminate a law with a sunset provision by allowing it to terminate automatically than it is to formally repeal a law that does not contain a sunset provision. Professor Gersen’s empirical point is that the durability of legislation is heterogeneous. Id. at 280. Although this might be true with respect to federal statutes, as shown in Part I, it is not the case with respect to rules adopted by federal agencies, which are very rarely made to terminate automatically.

177 Professor Gersen divides these costs into both enactment costs and maintenance costs. Gersen, supra note 4, at 263. This Article focuses on enactment costs because, except for the difference in extortion costs, which are a type of maintenance cost, maintenance costs should be relatively equal for experimental and non-experimental rules alike. And the difference in extortion costs is already captured by Term 3.

178 See id. at 264; Kysar, supra note 6, at 1021.
On the other hand, in order for that same policy to endure for the long run, if it is structured as an experimental rule, the interest group in question would also need to incur costs \((C_{E2})\) to persuade the agency to readopt the rule after it sunsets. Clearly, this cost is not present when the policy is structured as a permanent rule. Moreover, this cost of readoption after the sunset period \((C_{E2})\) will likely be a function of the data generated during the experimental period. If the data favors the desired policy, then \(C_{E2}\) will be relatively less (because it will require less effort to persuade the agency to readopt) and vice versa. Thus, the costs of structuring the policy as an experimental rule will sometimes be greater than structuring that same policy as a permanent rule. Other times, the opposite will be true.

The indeterminacy of this comparative cost analysis, however, has no effect on this Article’s ultimate conclusions. This Article has argued thus far that there are real social benefits that arise from experimental rules, but that as an empirical matter, they appear to be disfavored in the political economy. 179 They may be disfavored for a combination of revenue and cost factors. This Article has shown how the “revenues” generated from experimental rules are likely to be less than for permanent rules. 180 Of course, if experimental rules were commonly adopted by agencies, then one would have to conclude that these smaller revenues are offset by the cost considerations. In reality, however, experimental rules are actually quite rare, which points to one of two conclusions about the cost structure of these rules: either experimental rules are simply more costly than permanent rules or, if they are not more costly, then the amount of costs saved through the use of experimental rules must be less than the amount of revenues lost through these rules’ use. Ultimately, however, drawing a definitive conclusion about the comparative costs of these two rule types is unnecessary to evaluate how the political economy can be harnessed in an attempt to nudge agencies toward greater experimentation.

179 Some might argue that competition in the political economy will actually lead to socially optimal outcomes, and therefore, if legislators and regulators do not rely on experimental rules, then it must be because they are not socially optimal. See, e.g., Gary S. Becker, *A Theory of Competition Among Pressure Groups for Political Influence*, 98 Q.J. ECON. 371, 394–96 (1983) (arguing that competition amongst pressure groups for political influence is reflected in government outcomes that correct market failures); Gary S. Becker, *Public Policies, Pressure Groups, and Dead Weight Costs*, 28 J. PUB. ECON. 329, 329–30 (1985) (arguing that pressure groups influence political outcomes as they “jockey for power”); see also DONALD A. WITTMAN, THE MYTH OF DEMOCRATIC FAILURE: WHY POLITICAL INSTITUTIONS ARE EFFICIENT 2 (1995) (arguing that all democratic markets—including political markets—are organized to promote wealth-maximizing outcomes, are highly competitive, and reward efficient behavior); Tyler Cowen et al., *Rent Seeking Can Promote the Provision of Public Goods*, 6 ECON. & POL. 131, 131–32 (1994) (arguing that rent-seeking can increase political effort, thereby increasing social welfare). The dominant theory, however, is that rent-seeking does not necessarily result in optimal social outcomes. See, e.g., Elhauge, *supra* note 94, at 34, 58.

180 See *supra* notes 20, 166–176 and accompanying text.
III. ENCOURAGING POLICY EXPERIMENTATION

This Part proposes that applying a deferential standard of judicial review to experimental rules would increase the value of experimental rules in the political economy and thereby encourage agencies to increase their usage of such rules. Section A of this Part first proposes a deferential judicial review for experimental rules. Section A then proceeds to demonstrate how this deferential judicial review would permit courts to consider only the procedural requirements of hard look review in the pre-sunset phase. Section B then anticipates and addresses three preliminary objections to this new deferential standard of judicial review for experimental rules. Section C uses Business Roundtable v. SEC, a 2011 U.S. Court of Appeals for the D.C. Circuit decision, to illustrate how deferential judicial review would operate. Section D then discusses the benefits of applying a principle of deference. Finally, Section E briefly addresses potential costs to a principle of deference, but concludes that these potential costs are greatly outweighed by the benefits discussed in Section D.

A. A Proposal for More Deferential Judicial Review for Experimental Rules

Part II’s public choice analysis suggests that the value of experimental rules in the political economy turns in part on two factors: the standard of review applied to final agency rules and the fact that any long-term policy that goes through an experimentation process would have to survive two separate instances of judicial review. As such, alteration of the judicial standard of review could serve as a lever for nudging interests toward greater reliance on experimental rules. To that end, this Article proposes that courts apply a more deferential standard of review to experimental rules than they apply to their non-experimental counterparts. I call this the “principle of deference” to experimental rules. The intended effect of this principle of deference is to make

---

181 See infra notes 182–269 and accompanying text.
182 See infra notes 187–189 and accompanying text.
183 See infra notes 190–196 and accompanying text.
184 See infra notes 197–246 and accompanying text.
185 See infra notes 247–269 and accompanying text.
186 See infra notes 247–269 and accompanying text.
187 See supra notes 141–180 and accompanying text.
188 Other scholars have argued that courts should be more deferential to experimental approaches to lawmaking as a matter of doctrine and theory. See, e.g., Abramowicz et al., supra note 4, at 981–82 (contending that randomized experimentation in agency policy making should warrant more deferential judicial review, as courts should recognize the “unique value” in randomized experimentation); Michael C. Dorf & Charles F. Sabel, A Constitution of Democratic Experimentalism, 98 COLUM. L. REV. 267, 395–98 (1998) (arguing for deferential judicial review of experimental regulatory approaches that would focus on whether an agency undertook the effort to “generate rolling best-practices standards”). This Article’s contribution is in developing the argument for, and the outlines
experimental rules relatively more valuable to interest groups than single-stage rules, thereby nudging rulemakers toward policy experimentation.\textsuperscript{189}

Although there are many different ways of operationalizing this principle of deference in order to encourage the increased use of experimental rules, this Article proposes a standard of review for experimental rules that incorporates only the procedural element of hard look review. Recall that under hard look review, courts are to ensure that agencies follow a prescribed procedure: they must take into account only those factors that the organic statute identifies as being relevant to the particular rulemaking in question.\textsuperscript{190} But hard look review also incorporates a substantive element.\textsuperscript{191} Courts review the agency’s explanations and conclusions to ensure that they are reasonable.\textsuperscript{192} In other words, to survive hard look review, the agency “must articulate a ‘satisfactory’ explanation for its actions that does not ‘run counter to the evidence before the agency’ and that demonstrates a ‘rational connection between the facts found and the choice made.’”\textsuperscript{193}

This Article’s proposed standard of review for experimental rules would require the procedural element of hard look review but would not incorporate the substantive element. Thus, for an experimental rule to survive judicial review, the agency would have to show only that it took into account the relevant factors in promulgating the rule. A reviewing court would otherwise defer to the agency’s predictions or conclusions regarding the costs and benefits of the rule, as well as to the inferences the agency draws from any extant data that it considers. By incorporating the procedural but not the substantive element of hard look review, this proposed standard would result in greater deference to agencies with respect to experimental rules, thereby achieving the goal of nudging the political economy toward experimentation. Moreover, it would do so without completely eliminating the requirement that agencies engage in rea-

\textsuperscript{189} Note that this Article makes no assumption about the normative desirability of interest group legislation; it does not argue that agency rules are deficient because they are the product of interest group activity and therefore we need a policy response. Rather, this Article argues that agency rules in many cases are deficient because they are not structured as experimental rules, and in thinking about how to encourage the use of experimental rules, we need to understand, as a descriptive matter, how such rules are valued by interest groups in the political economy. In other words, this Article uses public choice not to generate normative force for a particular policy goal, but rather as a way of understanding the proper means to accomplish a particular policy goal (increased use of experimental rules) that derives its normative force from something other than public choice theory (in particular, the benefits of experimentation). Thus, critiques of attempts to use public choice theory alone to generate normative results are inapplicable to this Article’s argument. See Elhauge, supra note 94, at 58.

\textsuperscript{190} See supra notes 89–90 and accompanying text.

\textsuperscript{191} See supra notes 89, 91 and accompanying text.

\textsuperscript{192} See supra notes 92–93 and accompanying text.

soned decision making, which would arguably be the result of a more deferential standard like rational basis review.

To be sure, this Article is not the first to propose a more deferential standard of review with respect to agency rules. These prior proposals, however, were intended not to spur experimentation, but simply to avoid the “ossification” of agency rules by what is perceived as a standard of judicial review that is too stringent. By contrast, the position taken in this Article is that traditional hard look review is necessary to reinforce the learning created by experimentation, but only after the agency has had the opportunity to experiment. For that reason, traditional substantive hard look review should be relaxed during the initial, experimental stage of an experimental rule (i.e., before the sunset), then rigorously applied after the experimental period has expired (i.e., after the sunset) when the agency must make a more permanent decision in light of the evidence generated by the experiment.

B. Three Preliminary Objections

Before considering how this principle of deference for experimental rules might apply in practice, first consider three preliminary objections, all of which are concerned with ways in which this bifurcated approach to judicial review of agency rules might lend itself to exploitation by the agency.

The first objection is that an agency might choose to implement a policy through an experimental rule instead of a permanent one, not because the policy issue in question is particularly uncertain (and therefore could benefit from experimentation) but rather because the agency simply wants to reap the benefits of a higher level of judicial deference. One way of addressing this issue would be to involve the courts in deciding the reasonableness of an agency’s decision to experiment with respect to a given policy. Such review of experimental reasonableness would likely have to be carefully limited so that it did not defeat the purpose of the principle of deference, which after all is to create a more deferential standard of review for experimental rules in order to encourage their use. For example, the court might have to determine that there is reason to believe that the available evidence regarding a particular policy would likely be improved through experimentation. As long as the court determined that this threshold standard of experimental reasonableness was met, the predictions and conclusions underlying the agency’s experimental rule would then merit application of the principle of deference.

---

194 See, e.g., McGarity, supra note 25, at 1436; Pierce, supra note 25, at 8, 22.
195 McGarity, supra note 25, at 1436, 1451; Pierce, supra note 25, at 24–25; see also Abramowicz, et al., supra note 4, at 981–82 (suggesting that agency experiments should receive greater deference, not in order to foster greater experimentation but as a matter of policy and doctrine).
196 See supra notes 89–93 and accompanying text.
Of course, this concern about agencies adopting experimental rules in order to avoid heightened judicial scrutiny might not be much of a concern at all if the agency was required to adopt a permanent rule once the experiment had run its course and the agency was limited as to the permissible duration of an experimental rule. In that case, maybe the experiment would not have been necessary, but it might be a small price to pay for greater experimentation in general, including for policies that could truly benefit from the experiment.

Such an observation raises the second way in which the principle of deference might be exploited by agencies. Once a given experimental rule expires, an agency might readopt precisely the same rule (or a slightly modified version of that rule)—once again on an experimental basis, and possibly successively thereafter. In doing so, the agency would avoid ever having to submit to the higher level of scrutiny—hard look review—that applies to permanent rules. This problem, however, hardly seems intractable, particularly if limits on experimentation were put in place. For example, we might impose a rule on agencies requiring that an experiment be substantially different from a prior experiment and subject that determination to judicial review.

The third way that agencies might exploit the differential treatment that experimental rules would receive under this proposed principle of deference would be by adopting experimental periods for their rules that are unnecessarily long in light of the requirements of the experiment. By doing so, an agency would reap the benefits of deference for a longer period than is necessary to generate sufficient experimental data. Although a legitimate concern, this is also manageable through a cap on the length of the sunset period. For example, it might be established that the sunset period cannot last for more than three years. If the agency desired a longer sunset period, it would need to justify that extended period to a court at the expiration of the three years.

C. Applying the Principle of Deference: Business Roundtable v. SEC

To see how this proposed principle of deference would work in practice, consider a recent high-profile case involving an SEC rule. In 2011, in Business Roundtable v. SEC, the D.C. Circuit vacated the SEC’s proxy access rule.197 The proxy access rule was intended to give shareholders of public companies greater power to nominate members of the company’s board of directors.198 The modern proxy access rule199 was at least eight years in the making.200

197 647 F.3d 1144, 1156 (D.C. Cir. 2011).
199 Proxy access had been considered before, both in 1942 and then again in 1977. See Security and Exchange Commission Proxy Rules: Hearings on H.R. 1493, H.R. 1821, and H.R. 2019 Before the H. Comm. on Interstate and Foreign Commerce, 78th Cong. 17–19 (1943) (statement of Ganson Purcell, Chairman, Securities and Exchange Commission) (testifying that the SEC solicited comments on staff proposal); SEC & EXCH. COMM’N, DIV. OF CORPORATE FIN., STAFF REPORT: REVIEW OF THE PROXY
When it was finally adopted, the rule was immediately challenged in the courts by the Business Roundtable, an interest group representing large companies.\textsuperscript{201} The D.C. Circuit vacated the proxy access rule in part because of problems with the SEC’s predictions and conclusions regarding the costs and benefits of the rule, which of course were highly uncertain given the nature of the rule.\textsuperscript{202} In particular, the court reasoned that the SEC “neglected to support its predictive judgments” and “failed adequately to quantify the [sic] certain costs or to explain why those costs could not be quantified.”\textsuperscript{203} Specifically, the SEC concluded that the proxy access rule would increase shareholder value,\textsuperscript{204} that the costs of the rule would be limited,\textsuperscript{205} that the rule would not be co-opted by special interests,\textsuperscript{206} and that the rule would generate proxy challenges that would not otherwise have taken place in the rule’s absence.\textsuperscript{207} The court found fault with each one of these predictions and conclusions on the basis that they
were not supported by sufficient evidence.\textsuperscript{208} To be sure, the court was almost certainly correct about the lack of evidence, but the problem is that there was not overwhelming evidence that cut in the other direction (i.e., against the SEC’s conclusions) either.

Consider, for example, the evidence regarding the effect of the proxy access rule on shareholder value.\textsuperscript{209} This evidence mainly consisted of four groups of studies.\textsuperscript{210} First, there were five studies that examined the shareholder wealth effects of traditional proxy contests—that is to say, situations where shareholders pay to publish and distribute their own proxy containing a list of their own nominees to the board of directors.\textsuperscript{211} Second, there was one study that looked at corporate governance at thirty-seven firms during the financial crisis.\textsuperscript{212} Third, there were two studies that looked at the effect on firm value of shareholder-nominated members (or otherwise independent members) of the board of directors.\textsuperscript{213} Finally, there were two studies that sought to measure the effect of the announcement of the SEC’s proxy access rule on the share price of a sample of firms.\textsuperscript{214}

\textsuperscript{208} See \textit{Bus. Roundtable}, 647 F.3d at 1149–54.
\textsuperscript{209} See \textit{Facilitating Shareholder Director Nominations}, 75 Fed. Reg. at 56,761–62; \textit{infra} notes 210–226 and accompanying text.
\textsuperscript{210} See \textit{infra} notes 211–226 and accompanying text.
\textsuperscript{212} See \textit{id.} at 56,760 n.912, 56,762 n.924 (citing Brian R. Cheffins, \textit{Did Corporate Governance “Fail” During the 2008 Stock Market Meltdown?}, \textit{The Case of the S&P 500}, 65 BUS. LAW. 1 (2009)).
The first group of evidence contained studies that had examined the shareholder wealth effects of traditional proxy contests.\textsuperscript{215} With respect to this first group, the SEC discounted three of the studies—in one case because of its small sample size of only thirty-two firms,\textsuperscript{216} in another case because of the authors’ own acknowledgment that the results were ambiguous,\textsuperscript{217} and in the third case because a subsequent study demonstrated a flaw in the data collection of the prior study that, when corrected, reversed that study’s results.\textsuperscript{218} The two remaining studies in the group, which the SEC relied on, consisted of one study that demonstrated positive shareholder wealth effects from proxy contests and another that was a survey piece that concluded that the “[t]he latest evidence suggests that proxy fights provide a degree of managerial disciplining and enhance shareholder value.”\textsuperscript{219}

The second group of evidence consisted of a single study of the quality of the corporate governance at thirty-seven firms during the financial crisis.\textsuperscript{220} The author concluded that because these firms involved extremely active boards that replaced their CEOs at a greater than average rate, corporate governance functioned tolerably well in these companies during the financial crisis, and therefore, there was no immediate need for reform.\textsuperscript{221} The SEC discounted this study in light of its small sample size and short timeframe, which was limited only to 2008.\textsuperscript{222}

The third group of evidence consisted of mainly two studies demonstrating that public companies with boards consisting of a minority of shareholder nominated (or otherwise independent) directors tended to have greater equity value than their peers.\textsuperscript{223} The SEC relied on these studies.\textsuperscript{224}

Finally, the last group of evidence consisted of two event studies that sought to measure the stock price reactions of public firms to the SEC’s announcement that it was considering a proxy access rule.\textsuperscript{225} The SEC discounted these studies on the ground that, as is common in criticisms of such event stud-

\begin{thebibliography}{99}
\item \textsuperscript{215} See \textit{supra} note 211 and accompanying text.
\item \textsuperscript{216} See \textit{Facilitating Shareholder Director Nominations}, 75 Fed. Reg. at 56,762 n.926 (citing Borstadt & Zwirlein, \textit{supra} note 211).
\item \textsuperscript{217} See id. at 56,763 n.927 (citing Beltratti & Stulz, \textit{supra} note 211).
\item \textsuperscript{218} See id. at 56,762 n.926 (citing Ikenberry & Lakonishok, \textit{supra} note 211 and noting that the source was later criticized as being flawed by Mulherin & Poulsen, \textit{supra} note 211).
\item \textsuperscript{219} See id. at 56,763 n.926 (quoting Becht et al., \textit{supra} note 211, at 68).
\item \textsuperscript{220} See id. at 56,762 n.924 (citing Cheffins, \textit{supra} note 212).
\item \textsuperscript{221} See Cheffins, \textit{supra} note 212, at 1.
\item \textsuperscript{222} See \textit{Facilitating Shareholder Director Nominations}, 75 Fed. Reg. at 56,763 n.928 (concluding that “the relatively short timeframe and small number of companies examined in [the] Cheffins . . . study alone justify some caution in attempting to draw any sharp inferences from the study”).
\item \textsuperscript{223} See id. at 56,762 & nn.921–23 (citing Cotter et al., \textit{supra} note 213; Cer\textit{\textit{n}}ich, et al., \textit{supra} note 213).
\item \textsuperscript{224} See id. at 56,762.
\item \textsuperscript{225} See id. at 57,763 n.928 (citing Akyol et al., \textit{supra} note 214; Larcker et al., \textit{supra} note 214).
\end{thebibliography}
ies, their results were particularly sensitive to the particular dates selected by the researchers.226

A review of this evidence suggests that it was anything but conclusive as to whether the proxy access rule would lead to an increase in shareholder value.227 In fact, the D.C. Circuit acknowledged that the evidence was “admittedly (at best) mixed.”228 Consistent with substantive hard look review, the D.C. Circuit weighed in on the reasonableness of the agency’s findings in light of the mixed evidence and ultimately disagreed with the SEC’s conclusions.229

Consider now, by contrast, how differently this analysis would have played out under the principle of deference proposed by this Article. Assume the SEC had instead structured the proxy access rule as an experimental rule, in which case it would automatically expire after a few years with the goal of generating data during that initial experimental period to bring to bear on the

---

226 See id. at 57,763 & n.928 (citing Akyol et al., supra note 214; Larcker et al., supra note 214).
227 In fact, an even stronger claim for experimentation in the case of proxy access could be made on the basis that not only was the evidence not conclusive, but it was not even the correct type of evidence for assessing the normative desirability of proxy access. See, e.g., Grant M. Hayden & Matthew T. Bodie, The Bizarre Law & Economics of Business Roundtable v. SEC, 38 J. CORP. L. 101, 120–25 (2012). After all, the primary type of evidence brought to bear on the SEC’s proposed proxy access rule was evidence based on proxy fights, in which shareholder dissidents incur significant costs to nominate and elect their own slate of directors to the board. See supra notes 211, 215–219 and accompanying text. Yet, because proxy fights are so costly, a shareholder dissident will be careful to wage one only if he is fairly certain of a successful outcome. The fact that shareholders would not have been required to have this sort of “skin in the game” to use the SEC’s proxy access rule therefore suggests that the results of proxy fights are not particularly predictive of the results of proxy access. This observation takes on even greater importance in light of the fact that most of the positive stock returns associated with proxy fight event studies are limited to those proxy fights for control of the company. Yet the SEC explicitly barred the use of its proxy access rule for the purpose of gaining control, which suggests another reason to be skeptical of the predictive power of the proxy fight evidence. I thank Professor Roberta Romano for pointing these observations out to me.
228 See Bus. Roundtable, 647 F.3d at 1151.
229 See id. (“[W]e think the Commission has not sufficiently supported its conclusion that increasing the potential for election of directors nominated by shareholders will result in improved board and company performance and shareholder value.”). In one sense, therefore, this Article agrees with Professor James Cox who, in a recent article criticized the Business Roundtable court’s willingness to engage in substantive review of the SEC’s policy conclusions. See Cox & Baucom, supra note 4, at 1813, 1824. After all, part of this Article’s argument in favor of the principle of deference is that substantive review of agency conclusions is inappropriate, particularly in highly uncertain policy areas like that of proxy access. The heart of Professor Cox’s critique, however, is that the D.C. Circuit misinterpreted the federal securities laws, which, as he quite rightly points out, require only that the SEC consider certain factors (including, in addition to investor protection, efficiency, competition and capital formation), not that they draw any conclusions regarding a rule’s propensity (or failure) to further such goals. See id. at 1837. But as this Article tries (hopefully with some success) to make clear here, the problem is unfortunately much more fundamental than that and derives not from a misinterpretation of a single statute but rather from the D.C. Circuit’s general approach to judicial review of agency actions under the APA. In other words, substantive hard look review is likely to be inappropriate whenever policy uncertainty is high, which will often include securities regulation, but is certainly not limited to that context. See supra notes 190–193 and accompanying text. And substantive hard look review will apply regardless of the precise wording of the organic statute regarding relevant factors for the rulemaking. See supra notes 190–193 and accompanying text.
decision whether to adopt the rule on a more permanent basis. Consistent with this Article’s proposal, the initial adoption of that experimental rule would be subject to judicial deference.\textsuperscript{230} Thus, the court would ask whether the SEC considered relevant factors in drawing its conclusions regarding proxy access, but would refrain from determining for itself the reasonableness of that conclusion. By doing this, the court would be applying only the procedural component of hard look review at the experimental rule phase.\textsuperscript{231} In this case, application of that principle would clearly result in deference to the SEC’s prediction that the proxy access rule would increase shareholder value.

A similar conclusion would follow from application of the principle of deference to the SEC’s other conclusions with respect to the proxy access rule. Consider, for example, the SEC’s conclusion that the costs of the proxy access rule would be limited.\textsuperscript{232} This question turned at least in part on the extent to which the issuers would oppose proxy challenges brought pursuant to the proxy access rule.\textsuperscript{233} The only evidence presented on this issue was from the U.S. Chamber of Commerce, which provided examples of the costs of recent proxy contests at large companies.\textsuperscript{234} In response, the SEC concluded that in at least some cases, directors’ fiduciary duties would limit costly opposition campaigns if the directors determined that these campaigns are not cost-effective.\textsuperscript{235} Nevertheless, the court concluded that the SEC’s prediction was based on insufficient evidence.\textsuperscript{236}

The SEC’s conclusion regarding whether the rule would be co-opted by special interests was similarly devoid of evidentiary support.\textsuperscript{237} Of course, neither was there evidentiary support for the alternative proposition. Nevertheless, the court thought there was still “good reason to believe” that the rule would be abused by special interests.\textsuperscript{238} Without the chance to test the rule, however, it was impossible to determine who was right.

\textsuperscript{230} Note that before applying the principle of deference, the court might first be required to determine whether it was reasonable for the SEC to engage in experimentation with respect to proxy access in the first place, which might require the court to determine whether there is a reason to believe that the available data for or against proxy access would likely be improved through experimentation. As explained previously in Section B of this Part, that limited question might be necessary to avoid agencies using experimental rules to avoid judicial scrutiny.

\textsuperscript{231} See \textit{Bus. Roundtable}, 647 F.3d at 1148.


\textsuperscript{233} See \textit{id.} (“We understand that company boards may be motivated by the issues at stake to expend significant resources to challenge shareholder director nominees, elect their own nominees, or solicit votes against a shareholder proposal.”).

\textsuperscript{234} See \textit{id.} at 56,770 & n.1003.

\textsuperscript{235} See \textit{id.} at 56,770.

\textsuperscript{236} \textit{Bus. Roundtable}, 647 F.3d at 1150 (“We agree with the petitioners that the Commission’s prediction directors might choose not to oppose shareholder nominees had no basis beyond mere speculation.”).

\textsuperscript{237} See \textit{Facilitating Shareholder Director Nominations}, 75 Fed. Reg. at 56,706.

\textsuperscript{238} \textit{Bus. Roundtable}, 647 F.3d at 1152.
Finally, there was little evidence to shed light on the SEC’s core theory behind the proxy access rule, which was that it would lower the costs of waging a proxy battle because shareholders could simply include their nominees in the company’s proxy materials instead of having to go to the expense of publishing and mailing their own.\footnote{See Facilitating Shareholder Director Nominations, 75 Fed. Reg. at 56,753.} These lower costs would therefore induce proxy contests that would not otherwise have been waged.\footnote{See id. at 56,772.} The court, however, saw no evidence that the rule would not simply provide a way for those who would otherwise have brought a traditional proxy contest anyway to bring it with lower costs.\footnote{See Bus. Roundtable, 647 F.3d at 1153.} In other words, the court faulted the SEC for not taking into account the possibility that the rule would not actually create any new proxy challenges. Yet, without testing the rule, there was really no way to predict such an outcome.

Under the principle of deference proposed by this Article, as long as an agency makes a prediction about the costs and benefits of a rule—as the SEC did in Business Roundtable—the agency is shielded from the court’s more searching substantive review. By eliminating substantive review during the experimental phase, this proposal removes the risk that the court will make an error in determining whether the agency’s policy conclusions were reasonable. Under this Article’s proposed rule, therefore, none of the D.C. Circuit’s objections regarding the uncertainty of the proxy access rule would have been valid, provided of course that the SEC had adopted the proxy access as an experimental rule.\footnote{See id. at 56,772.}

To be sure, if applied to Business Roundtable, this proposed principle of deference may not have led to a different outcome in the case. The court identified additional defects that were not tied to the uncertainty of the proxy rule.\footnote{See Bus. Roundtable, 647 F.3d at 1151, 1153–54.} For example, the court pointed out that the SEC had been inconsistent in its calculations of the costs and benefits of the rule.\footnote{See id. at 1151.} The court determined that the Commission had been opportunistic in the way it framed the costs and benefits of the rule, including that the Commission had discounted the costs (but not the benefits) of the rule as an artifact of the right to elect directors under state law.\footnote{See id. at 1153–54.} It is true that the court identified yet another ground—that the Commission had failed to consider how pension funds would use the rule, including responding to comments that they would use the rule to the detriment of shareholders generally.\footnote{See id. at 1151–52.} The court, however, ultimately acknowledged that the Commission had indeed considered this factor, and therefore it seems that in the final analysis, the court was really saying that it just disagreed with the Commission’s conclusion on this issue.\footnote{See id.} Thus, this ground for vacating the rule would be yet another substantive consideration that would be off limits under this Article’s proposed principle of deference.
ence principles outlined here, the court would have had to vacate the proxy access rule on these other grounds alone, and could not have relied on the other deficiencies that seemed to be a function of the uncertainty of the proxy access rule.246

D. The Benefits of the Principle of Deference

Although this Article’s proposed principle of deference would represent a significant departure from the current approach to judicial review of agency action, it would not be unprecedented; nor would it undermine the original purposes of hard look review.247

First, the principle of deference would not be unprecedented. It was not that long ago that arbitrary and capricious review was typically treated as the same thing as “rational basis review, and was therefore even more deferential than the procedural hard look review for experimental rules proposed by this Article.248 In fact, it was only in the 1970s when the D.C. Circuit began suggesting that the “arbitrary and capricious” standard required the court to ensure that the agency engaged in “reasoned decision-making,” which engendered a debate over whether this requirement demanded a review of the procedures followed by the agency or also of the substance of the agency’s decision.249 This debate was largely put to rest, at least as a descriptive matter, with the U.S. Supreme Court’s 1983 decision in *Motor Vehicle Manufacturers Ass’n v. State Farm Mutual Automobile Insurance Co.*250 Of course, the principle of deference would be unprecedented in that neither the courts nor the APA distinguishes between experimental and non-experimental rules with respect to standards of review.251 The text of the APA, however, also fails to support a more searching form of arbitrary and capricious review for purposes of policing interest group legislation, and yet the D.C. Circuit and the Supreme Court have taken precisely this position with respect to review of final agency action.252 For that reason, it does not appear to be that much of a stretch for the D.C. Circuit to reason that the justification underlying hard look review simply does not apply to experimental rules, at least with respect to the period prior to the sunset.

---

246 Even though the court relied on other arguments as well for vacating the rule, it would probably be less likely to vacate the rule armed with fewer grounds for finding it deficient.
247 See infra notes 248–256 and accompanying text.
248 See GARY LAWSON, FEDERAL ADMINISTRATIVE LAW 700 (6th ed. 2013) (describing this pre-hard look review as affording agencies an “extraordinary level of deference”).
249 The origins of this debate are typically traced to the concurring opinions of Chief Judge David Bazelon and Judge Harold Leventhal in the 1976 D.C. Circuit case of *Ethyl Corp. v. EPA*. See 541 F.2d 1, 66–68 (D.C. Cir. 1976) (Bazelon, C.J., concurring); id. at 68–69 (Leventhal, J., concurring).
250 See 463 U.S. 29 (1983); supra note 89 and accompanying text.
252 See supra notes 89–93 and accompanying text.
Nor would this Article’s proposed principle of deference undermine the original purposes of hard look review. Hard look review was developed by the D.C. Circuit, and later ratified by the Supreme Court, as a judicial remedy for what was perceived at the time as the emerging problem of agency capture.253 If agencies were required to demonstrate that they “had responded to significant points made during the public comment period, had examined all relevant factors, and had considered significant alternatives to the course of action ultimately chosen,”254 the reasoning went, then it would be more difficult for agencies to be captured by interest groups.255 This reasoning is perfectly plausible, perhaps even wise, except with respect to rules with extremely uncertain payoffs. In the case of extreme uncertainty, when the evidence points in different directions, there will be greater disagreement with respect to whether the agency satisfied substantive hard look review, and therefore, a greater likelihood of a court making one of two types of errors: either affirming a suboptimal rule or vacating an optimal one.256

The principle of deference might be viewed as a way of mediating between those who criticize substantive hard look review on the basis of the reviewing court’s lack of expertise257 and the supporters of substantive hard look review who highlight its potential for encouraging agencies to engage in a more comprehensive or deliberative decision-making process.258 On the one

253 See Kathryn A. Watts, Proposing a Place for Politics in Arbitrary and Capricious Review, 119 YALE L.J. 2, 15–23 (2009) (recounting the history of hard look review); see State Farm, 463 U.S. at 42–44; supra note 89 and accompanying text.
254 See Garland, supra note 90, at 526–27.
255 See Watts, supra note 253, at 32–35.
256 See, e.g., Seidenfeld, supra note 89, at 492 (“From the agency’s perspective, hard look review has become an icy stare that freezes action; no matter how much care the agency believes it has given to a decision, the agency faces uncertainty about whether the reviewing court will find that the agency performed its decisionmaking task adequately.”).
257 See Frank B. Cross, Pragmatic Pathologies of Judicial Review of Administrative Rulemaking, 78 N.C. L. REV. 1013, 1054–55 (2000) (arguing that “quality rulemaking is undermined” by the judiciary’s lack of expertise); McGarity, supra note 25, at 1452 (observing that there are “clear limits to judicial competence in the area of highly scientific and technical rulemaking”); Richard J. Pierce, Jr., Seven Ways to Deossify Agency Rulemaking, 47 ADMIN. L. REV. 59, 69–70 (1995) (identifying how the judiciary’s lack of expertise can frustrate agency action); Martin Shapiro, Administrative Discretion: The Next Stage, 92 YALE L.J. 1487, 1507 (1983) (“Courts cannot take a hard look at materials they cannot understand nor be partners to technocrats in a realm in which only technocrats speak the language.”).
258 See Colin S. Diver, Policymaking Paradigms in Administrative Law, 95 HARV. L. REV. 393, 409–21 (1981); Jim Rossi, Redeeming Judicial Review: The Hard Look Doctrine and Federal Regulatory Efforts to Restructure the Electric Utility Industry, 1994 WIS. L. REV. 763, 811, 818–20; Mark Seidenfeld, A Civic Republican Justification for the Bureaucratic State, 105 HARV. L. REV. 1511, 1570 (1992); Seidenfeld, supra note 89, at 514 (“In short, hard look review performs a valuable function by encouraging agencies to think through the full implications of their policies.”); Cass R. Sunstein, On the Costs and Benefits of Aggressive Judicial Review of Agency Action, 1989 DUKE L.J. 522, 527–29 (“It is also possible to show that aggressive judicial review has often provided significant benefits both in bringing about desirable regulatory initiatives and in preventing unreasonable or unlawful regulation.”).
hand, the principle of deference acknowledges the potential of substantive hard look review to result in judicial error (either because courts affirm sub-optimal policies or vacate optimal ones). Consequently, it relaxes this standard when the payoffs of the rule are particularly uncertain, and therefore the likelihood of judicial error is particularly high. On the other hand, however, the principle of deference also recognizes substantive hard look review’s potential for improving agency decision making through learning. Accordingly, the principle of deference would result in the application of rigorous substantive hard look review, but only after the agency has eliminated uncertainty through the experiment.

To illustrate, consider yet again the issue of proxy access and the *Business Roundtable* case. In *Business Roundtable*, there was very little evidence regarding the central policy goals of the proxy access rule. What little evidence did exist, the court itself acknowledged was ambiguous. This rule was seemingly a prime candidate for experimentation. Yet, because of the political economy’s preference for single-stage rules, the proxy access rule was not adopted as an experimental rule, and the SEC consequently lost out on the opportunity for learning. To be sure, the court ultimately vacated the rule; but it just as easily could have affirmed it. This is the problem with hard look review of rules that implement policies with extremely uncertain payoffs—there will be considerable disagreement, even among courts, regarding the correct outcome of the case. Moreover, if the court in *Business Roundtable* had affirmed the rule, and the rule had ended up being sub-optimal for all of the reasons offered by the rule’s opponents, then the court would have been entrenching a sub-optimal policy in a permanent rule. This is what one might call the first-

---

259 Pierce, supra note 257, at 68–70. Pierce stated:

> When an agency attempts to make major policy decisions through rulemaking in an area affected by factual and scientific uncertainty . . . . It cannot hope to predict the precise scope or intensity of that review process. . . . [P]redicting the outcome of the review proceeding is best accomplished by flipping a coin. . . . [Reviewing courts] are easily led to believe that . . . an inherent uncertainty with respect to a factual or scientific predicate for a rule could be eliminated if the agency just thought about it a little more.

Id.

260 See supra notes 88–100 and accompanying text.

261 647 F.3d 1144.

262 See id. at 1151 (characterizing the empirical evidence as “(at best) mixed”).


264 See supra notes 61–62 and accompanying text.
order problem of experimental rules: the political economy’s favored treatment of permanent rules (combined with the increased probability of judicial error in conducting hard look review) increases the likelihood that sub-optimal rules will become entrenched.

Business Roundtable, however, also suggests that even if the relevant parties had overcome the political economy dynamics and formulated the proxy access rule as an experimental rule, the SEC still would have lost out on the opportunity for learning because the court vacated the rule. This is what one might call the second-order problem of experimental rules: regardless of whether experimental rules are used, the increased probability of judicial error in conducting hard look review under conditions of extreme uncertainty result in vacating those rules before any data can be gathered to test their underlying theories.265

The principle of deference addresses both of these problems.266 It solves the first-order problem because it encourages experimental policy making by making experimental rules relatively more valuable in the political economy.267 Recall that, everything else being equal, interest groups will value single-stage rules more than they will multi-stage rules more than they will multi-stage rules for two reasons.268 First, a multi-stage rule is more likely to be temporary because a permanent rule that must

265 McGarity, supra note 25, at 1452–53 (“[S]trict substantive judicial review can hamper innovation and experimentation. Agencies will be disinclined to experiment when they know that the effort may wind up being thrown back at them by unsympathetic judges.”).

266 Several scholars have recently observed that dividing regulation up in stages might make for better policies, particularly in cases where uncertainty is high, like financial regulation and SEC rule-making. See Cox & Baucom, supra note 4, at 1842–44; Romano, supra note 87, at 88, 95–107; Whitehead, supra note 4, at 1274, 1295. Although this Article obviously agrees with this observation as a general matter, what this Article argues for is something more specific—that without changing the way courts review final agency actions, such staged rules (or what this Article refers to as experimental rules) are neither politically feasible nor maximally beneficial. They are not politically feasible because they are disfavored in the political economy for the reasons developed in Part II. See supra notes 141–180 and accompanying text. And they are not maximally beneficial because substantive hard look review, if applied equally to experimental rules as to their non-experimental counterparts, is likely to short circuit experimentation. After all, as discussed in greater detail below, if the proxy access rule in Business Roundtable had been structured as an experimental rule, the result (vacating of the rule) would likely have been the same, and the experiment would have been prematurely terminated because of substantive hard look review. Thus, any attempt to encourage the use of experimental rules must confront these two issues, which is the purpose behind this Article’s proposed principle of deference.

267 By contrast, one commentator has proposed that the SEC’s cost-benefit analysis be exempt from judicial review altogether. Bruce R. Kraus, Challenge to SEC Rule-Making, PENSIONS & INVESTMENTS (Dec. 12, 2011), http://www.pionline.com/article/20111212/PRINTSUB/312129993, archived at http://perma.cc/M6MF-CX84. But the problem with that approach is that it fails to address the concern over the entrenchment of sub-optimal rules. Even if executive agencies enjoy this type of exemption from judicial review, the fact that their analyses must pass muster with the Office of Information and Regulatory Affairs (OIRA) mitigates this concern. And because the SEC does not have to undergo OIRA review, exempting SEC cost-benefit analyses from judicial review would leave their analyses completely unchecked.

268 See supra notes 158–165, 175–176 and accompanying text.
first pass through an experimental period must undergo two rounds of judicial review instead of a single round when the permanent rule is adopted at the outset. Second, multi-stage rules have a greater potential for rent extortion and therefore must be discounted by a greater amount than single-stage rules. These inequalities are reflected in Term 2 and Term 3, respectively, of both Figure 1 and Figure 2.

Where the principle of deference makes a difference is in Term 1. Recall that this term of the expected value equation captures the value of the policy during the “experimental period,” which is the period that begins with adoption and ends when the sunset expires (in the case of the multi-stage rule) and when the sunset would have expired (in the case of the single-stage rule) if the single-stage rule had been instead structured as an experimental rule. This value is discounted by the probability that a court will not vacate the rule under arbitrary and capricious review. As reflected in Figure 1, Term 1 is the same regardless of whether the policy is structured as an experimental rule or a multi-stage rule. After all, under current law, judicial review of whether a rule is arbitrary and capricious under the APA is the same regardless of whether it is an experimental rule or a permanent rule. The principle of deference changes this equality. As reflected in Figure 2, under the principle of deference, the value of the rule during the experimental period (Term 1) is greater for the experimental rule than it is for the single-stage rule. This is because the principle of deference makes it more likely that an experimental rule will survive judicial review. By making experimental rules relatively more valuable on an expected value basis, the principle of deference increases the amount of rents that interest groups may obtain (and value that agencies may receive in exchange) in the political economy and therefore nudges the parties toward experimental rules.

Figure 2: Comparing the Expected Value of Multi-Stage and Single-Stage Rules Under the Principle of Deference

<table>
<thead>
<tr>
<th>Term</th>
<th>Multi-Stage Rule: ( E(V) = P(A_1) \times V_1 + P(A_1) \times P(A_2) \times V_2 - P(A_1) \times V_{E(1)} - C_E )</th>
<th>Single-Stage Rule: ( E(V) = P(A_1) \times V_1 + P(A_1) \times V_2 - P(A_1) \times V_{E(2)} - C_P )</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Term 1</td>
<td>Term 2</td>
</tr>
<tr>
<td>2</td>
<td>Term 3</td>
<td>Term 4</td>
</tr>
</tbody>
</table>

Again, the principle of deference solves both of the problems associated with experimental rules. The principle of deference addresses the first-order problem of experimental rules—that the bias in favor of single-stage rules, combined with the increased probability of judicial error in conducting hard
look review under conditions of extreme uncertainty, will lead to sub-optimal policies becoming entrenched. The principle of deference also solves the second-order problem, which is that the court will mistakenly vacate an experimental rule before its sunset, thereby short-circuiting the experiment.

There is a certain irony in the Business Roundtable court’s objections over the quality or quantity of the evidence on which the SEC premised its predictions and conclusions regarding the proxy access rule. After all, by finding that the decision-making process was inadequate for these reasons, the court effectively locked into place the inadequate store of data and prevented the SEC from running an experiment that would help it determine whether the rule was in fact a game changer or not. Thus, an additional benefit of the principle of deference is that it would unlock a yet unexplored vein of potential value associated with experimental rules by allowing for greater experimentation. Had the SEC structured the proxy access rule as a multi-stage rule (and had the court applied the principle of deference in the way this Article suggests), it is likely that the rule would have been upheld—at least until the sunset expired.\(^{269}\) At that point in time, several years of data would help determine whether the rule was the panacea advocated for by its supporters or the pernicious source of inefficiencies, as characterized by its opponents. In the absence of the principle of deference, however, the only result is speculation about whether the SEC’s predictions were correct.

E. The Cost of the Principle of Deference

The most significant cost associated with increased deference toward experimental rules is that this proposal will necessarily increase the rents available to interest groups and rent-seeking costs spent to obtain such rents. Of course, such a result represents a deadweight loss for the economy. And indeed, it would do precisely that. In fact, the whole purpose of increased deference toward experimental rules is to increase the value of experimental rules to interest groups, which has the effect of also increasing the costs that such groups are willing to incur in order to obtain those regulatory rents. The result is a nudge in favor of experimentation, but also a nudge in favor of rent-seeking, which represents a real deadweight loss. This cost becomes all the more acute when one considers that there is no guarantee that the principle of deference will actually result in the greater use of experimental rules, in which case rent-seeking costs would increase without an accompanying increase in associated benefits.

\(^{269}\) As this Article previously suggested, this outcome is not guaranteed because there were additional grounds upon which the court justified its decision to vacate the rule, and those additional deficiencies would not be remedied by the principle of deference. Nevertheless, it is possible, if not likely, that the court would have at the very least refused to vacate the rule altogether based merely on a few deficiencies in the SEC’s procedure.
Although these objections are certainly valid, they are ultimately unpersuasive to the extent that they are intended to defeat the principle of deference. The principle of deference may not actually result in greater use of experimental rules, but there is a good chance that it would, and the potential benefits are significant. Generalizing from the SEC example, recall that agencies are in many cases adopting highly uncertain policies in the form of single-stage rules, which is actually inferior from a welfare perspective to not only experimentation but to the status quo as well. Thus, perhaps we need to take a page from the literature on experimentation itself and actually treat the principle of deference as an experiment. If it is unsuccessful, then it is certainly reversible. On the other hand, if it is successful, improved agency policy will result. Either way, the experiment will have been well worth it.

CONCLUSION

There is a growing recognition that experimentation, or staged decision making, holds out the potential for dramatically improving the quality of legislative output. Rules that are adopted for the express purpose of generating experimental data and that automatically terminate at the conclusion of the policy experiment—what this Article calls “experimental rules”—are the obvious legal vehicle for carrying out this aspiration of legislative experimentalism. Yet, in the one context where experimental rules are likely to be the most effective—the federal agency context—these rules are, for the most part, extraordinarily rare. This Article argues that both the source of this problem and the potential solution lie in public choice theory. The political economy appears to disfavor experimental rules either because they are more temporary and therefore less valuable to interest groups, or because they are more costly to adopt. This public choice equation could change, however, if courts were to apply greater deference to experimental rules than they do to non-experimental rules. By effectively guaranteeing that an experimental rule would survive judicial review—at least prior to the sunset period when the experiment is running its course—interest groups could be nudged toward this type of rule, thereby encouraging agencies to engage in greater experimentation. The effect would be laws with more predictability and therefore a greater likelihood of success. And of course, there is always the possibility, however remote, that experimental rules could produce the legislative equivalent of the light bulb.