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Disciplinary Note

## **JUSTICE, MARKET FAILURES, AND GOVERNMENT AGENCY RULEMAKING**

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Law is the chief institution through which second-order justice is administered. We live in a liberal society where everything is permitted unless specifically prohibited. But Scripture tells us that we are fallen creatures. Lawmaking, therefore, must play a critical role in shaping second-order justice, in Wolterstorff's terms, and it is important to ensure that our government makes laws that are just and righteous, as we strive toward first-order justice.

### **Administrative Rulemaking**

One area of my research is looking into the mechanisms of administrative rulemaking. Administrative rulemaking is the process by which government agencies adopt rules that have the force of law. In the U.S. we typically think of lawmaking as an act of Congress, carried out by elected officials in their representative capacity. But in today's administrative state in the U.S., and in many other democratic societies and advanced economies, many rules that have far-reaching economic and social impacts—including efficiency and distributive consequences—are adopted at the agency level by appointed officials or civil servants. This is considered constitutional as long as each agency acts within its lawfully delegated authority from Congress.

The basic rulemaking process in the U.S. is governed by the Administrative Procedure Act of 1946. The most common process includes (i) an agency's issuance of a notice of proposed rulemaking, (ii) a 30-day period during which the general public can submit comments and views on the proposed rule, and (iii) the agency's adoption of the final rule after giving a careful consideration of the submitted comments and views. Once a rule is adopted, those citizens or interest groups who desire to challenge the rule can seek judicial review and have the court examine whether the agency followed a proper procedure and acted within its statutory authority in adopting the rule.

### **Market Failure as an Obstacle to First-Order Justice**

The traditional basis for government regulation is a market failure. In economic terms, a market failure is a situation in

which the allocation of goods and services by an unregulated market fails to achieve efficiency. Typical examples include natural monopoly, public goods, information asymmetry, and externalities. For economists, the main problem with a market failure is that society is leaving money on the table, and valuable resources or opportunities are being wasted due to transaction costs.

Under Wolterstorff's framework, however, a market failure can also be seen as hindering first-order justice in the economy. Market participants often fail to practice first-order justice because their incentives are misaligned or because they lack information. As a result, agency rules that can effectively address market failures, coupled with enforcement actions, can help, guide, or compel individuals and institutions to render to others what is due to them. Accordingly, improving the government's process of administrative rulemaking can lead to a better administration of second-order justice and render greater first-order justice in our economy.

## How Second-Order Justice Can Be Thwarted

My [research agenda](#) seeks to broadly identify innovative mechanisms by which we can promote more transparent, empirically-informed, and fair rulemaking in a world where agencies often have to operate on the basis of less than perfect information. Innovation is necessary in this area because, in practice, there are a number of ways in which administrative rulemaking may be misguided.

First, a well-intentioned agency head can design and adopt a rule based on incomplete or biased information. In such instances, an agency may have correctly identified the relevant market failure, but it may end up adopting a rule that comes short of addressing it appropriately.

Second, a well-intentioned agency head can face opposition by powerful and well-funded interest groups that may have their own agenda. Those groups can seek judicial review of an agency's rule once it is adopted. In some instances, an agency can lose the legal challenge and the reviewing court may vacate what could have been an efficient rule. This can happen, for example, if the court finds that the agency did not sufficiently analyze the rule's benefits and its costs on the economy.

Third, an agency head herself may strive to adopt a rule that will have a very particular political outcome. In so doing, she may turn a blind eye to how the rule may bring about other consequences. In such instances, a rule adopted by the agency can have a mix of good and bad effects. It may also come with significant distribution concerns. In all these instances, second-order justice is thwarted, and unfair outcomes may result.

## Justice in SEC Rulemaking

My special interest lies at the intersection of securities regulation (a body of law that regulates the market for capital) and administrative law (a body of law that regulates the administration of government agencies). Between 2007 and 2012, I had the privilege of working at the U.S. Securities and Exchange Commission (SEC). The SEC is a federal government agency whose mission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. The agency routinely adopts corporate disclosure rules to provide greater transparency for investors and brings

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enforcement actions against those who violate the law.

During my first three years at the agency, I was an Economic Fellow and helped the Commission analyze the costs and benefits of various rules the agency sought to adopt. One challenge facing a regulatory agency, such as the SEC, is that it must at times adopt a rule to address a clear market failure, but without a large amount of relevant data. Without data, quantifying benefits and costs will be nearly impossible and the agency will have to resort to qualitative reasoning to justify its rule. During the last two years, I worked as an attorney advisor in the Division of Economic and Risk Analysis and worked closely with the Office of the General Counsel when the Commission had to defend its rules from legal challenges by various petitioners who argued that the agency's economic analysis was faulty or otherwise insufficient.

Throughout my time at the SEC, I was preoccupied with the administrative rulemaking process. The basic process posed two difficulties. First, it was easy for powerful interest groups, intent on opposing a proposed rule, to hijack the process by submitting voluminous technical comments with a vast lot of information that may be one-sided. Second, there was insufficient transparency in the way the agency staff or the commenters communicated their own reservations, uncertainties, or risks about a rule. I began thinking about ways to make modest and implementable reforms to address these difficulties—including *ex post* and *ex ante* mechanisms to bring more data to the process and analytical frameworks for considering the economic and distributive effects of a rule in a more comprehensive manner.

Eventually, I joined legal academia with the hope that my research in this area could contribute to promoting more transparent and productive regulatory dialogues in rulemaking and lead to agency rules that are both efficient and effective. There is much work to be done in this area. In an increasingly complex world, challenges to designing an optimal rule will be formidable. But these are challenges, I believe, worth tackling.

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## Further Reading

Lee, Yoon-Ho. 2013. "An Options-Approach to Agency Rulemaking," 65 *Administrative Law Review* 881-941 (discussing the advantage of a real-option approach to agency rulemaking in the presence of uncertainty)

Lee, Yoon-Ho. 2015. "The Efficiency Criterion for Securities Regulation: Investor Welfare or Total Surplus?" 57 *Arizona Law Review* 85-128 (discussing the significance of articulating a clear cost-benefit analysis framework in agency rulemaking).

Lee, Yoon-Ho. 2015. "SEC Rules, Stakeholder Interests, and Cost-Benefit Analysis," 10 *Capital Markets Law Journal* 311-28 (comparing and contrasting two different frameworks of cost-benefit analysis in the context of SEC rules).

Lee, Yoon-Ho. 2016. "Beyond Agency Core Mission," 68 *Administrative Law Review* 551-603 (discussing the necessity of departing from the core-mission model).

Lee, Yoon-Ho. 2019. "Incorporating Market Reactions into Agency Rulemaking," 54 *Wake Forest Law Review* 1361-98 (suggesting ways to incorporate stock market reactions into the administrative rulemaking process).

Lee, Yoon-Ho. 2021. "A Model of Stock-Market-Based Rulemaking," 23 *American Law & Economics Review* 1-55 (presenting a game-theoretic model of stock-market-based rulemaking).

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