HOUSE COMMITTEE ON
FINANCIAL SERVICES

THE FINANCIAL CHOICE ACT

CREATING HOPE AND OPPORTUNITY FOR INVESTORS, CONSUMERS, AND ENTREPRENEURS

A REPUBLICAN PROPOSAL TO REFORM THE FINANCIAL REGULATORY SYSTEM

APRIL 24, 2017

Outline

The Dodd-Frank Off-Ramp for Strongly Capitalized, Well-Managed Banking Organizations

<u>Executive Summary:</u>

- **Excessive regulatory complexity – embodied by the Dodd-Frank Act, the Basel capital accords, and other post-crisis regulatory initiatives – produces a less resilient financial system, cements the competitive advantages enjoyed by "too big to fail" firms, and harms economic growth.**

- **Dodd-Frank's particular brand of regulatory complexity and government micro-management has made basic financial services less accessible to small businesses and lower-income Americans, and saddled America's small and medium-sized community financial institutions with a crushing regulatory burden.**

- **The Financial CHOICE Act enhances U.S. financial market resiliency and promotes economic growth by offering well-managed, well-capitalized financial institutions – those with a simple leverage ratio of 10 percent – an "off ramp" from Dodd-Frank's suffocating regulatory complexity.**

The Problem: Excessive Regulatory Complexity and Anemic Economic Growth

In the years following the financial crisis of 2008, the size and scope of financial regulations mushroomed, as politicians in the U.S. and around the world rushed to put new rules in place, despite the absence of any evidence that it was a lack of regulatory tools – as opposed to regulatory incompetence and misguided government housing policies – that precipitated the crisis.[1]

As the dust begins to settle on the post-crisis response, however, there has been a growing recognition that financial regulation has become far too complex and too intrusive and places too much faith in the discretion and wisdom of bank regulators. In 2012, Andrew Haldane, Chief Economist of the Bank of England, gave a speech at a Federal Reserve conference in Jackson Hole, Wyoming, that has achieved notoriety among financial regulators and scholars. After observing that "no regulator had the foresight to predict the

[1] *See* Patrick McLaughlin and Robert Greene, *Did Deregulation Cause the Financial Crisis? Examining a Common Justification for Dodd-Frank*, MERCATUS CENTER, GEORGE MASON UNIVERSITY (Jul. 19, 2013), *available at* http://regdata.org/did-deregulation-cause-the-financial-crisis-examining-a-common-justification-for-dodd-frank/ ("Deregulation of the financial services sector in the years leading up to the 2008 crisis was—and still is—used to justify Dodd-Frank's substantial regulatory burdens. But financial regulation did not decrease in the decade leading up to the financial crisis—it increased…Regulatory restrictions in Title 12 of the *Code of Financial Regulation*—which regulates banking—increased by 18.2 percent while the number of restrictions in Title 17—which regulates commodity futures and securities markets—increased by 17.4 percent.").

financial crisis, although some have since exhibited supernatural powers of hindsight," Haldane delivered a warning to his regulatory brethren:

> Modern finance is complex, perhaps too complex. Regulation of modern finance is complex, almost certainly too complex. That configuration spells trouble. As you do not fight fire with fire, you do not fight complexity with complexity. Because complexity generates uncertainty, not risk, it requires a regulatory response grounded in simplicity, not complexity. Delivering that would require an about-turn from the regulatory community from the path followed for the better part of the past 50 years.[2]

For Haldane, "Exhibit A" in the trend toward excessive regulatory complexity was what he referred to as "the Tower of Basel," the global risk-based capital regime that, as discussed in more detail below, played a central role in triggering – and prolonging – the recent financial crisis. But perhaps the ultimate monument to regulatory complexity and bureaucratic hubris is the Dodd-Frank Act,[3] 2,300 pages of legislative text that have to date spawned more than 22,000 pages of new federal regulations, or the equivalent of "roughly 15 copies of 'War and Peace.'"[4]

The Democrats who drafted Dodd-Frank claimed that their reforms were narrowly targeted at the "too big to fail" institutions that were at the center of the crisis. But by layering mind-numbing amounts of complexity onto an already labyrinthine regulatory edifice, Dodd-Frank played into the hands of the largest banks, at the expense of American households and small- and medium-sized community financial institutions. Instead of ending "too big to fail," Dodd-Frank created "too small to succeed."[5]

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[2] Andrew Haldane, Chief Economist and the Executive Director of Monetary Analysis and Statistics at the Bank of England, Address at the Federal Reserve Bank of Kansas City's 366th economic policy symposium: The dog and the Frisbee (Aug. 31, 2012), (*hereinafter* Andrew Haldane, The dog and the Frisbee) *available at* http://www.bis.org/review/r120905a.pdf. *See also* John Kay, *Complexity, not size, is the real danger in banking*, FINANCIAL TIMES, (Apr. 12, 2016), *available at* www.ft.com/intl/cms/s/5c2a416e-000f-11e6-99cb-83242733f755. ("As the size of the Dodd-Frank legislation shows, we have locked ourselves into a spiral in which regulatory complexity gives rise to further organizational complexity and the construction of yet more esoteric instruments.").

[3] *See generally* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376-2223 (2010) (*hereinafter* Dodd-Frank Act).

[4] Kirsten Grind and Emily Glazer, "Inside Enforcers Shake Up Bank Culture," WALL STREET JOURNAL, (May 31, 2016) (calling Dodd-Frank "one of the most complex pieces of legislation ever"). In the words of Andrew Haldane in his "Dog and the Frisbee" speech, "once completed Dodd-Frank could comprise 30,000 pages of rulemaking. That is roughly a thousand times larger than its closest legislative cousin, Glass-Steagall. Dodd-Frank makes Glass-Steagall look like throat-clearing." *See* Patrick McLaughlin & Oliver Sherhouse, *The Dodd-Frank Wall Street Reform and Consumer Protection Act May Be the Biggest Law Ever*," MERCATUS CENTER, GEORGE MASON UNIVERSITY, (Jul. 20, 2015), *available at* http://regdata.org/the-dodd-frank-wall-street-reform-and-consumer-protection-act-may-be-the-biggest-law-ever/. (The scale of the rule-writing required by Dodd-Frank "vastly exceeds any previous regulation of financial markets, and dwarfs the regulations that accompanied all other legislation enacted during the Obama administration.")

[5] *See* Michael Rapoport, "Small Banks Look to Sell as Rules Bite," *Wall Street Journal*, April 2, 2014 (quoting Dan Baird of Capital Funding Group); Preston Ash et al., "Too Small to Succeed? – Community Banks in a New Regulatory Environment" (Federal Reserve Bank of Dallas, Financial Insights, Vol. 4, Dec. 2015), https://www.dallasfed.org/~/media/documents/outreach/fi/2015/fi1504.pdf

Indeed, the biggest Wall Street firms are the *beneficiaries* (not the victims) of Dodd-Frank, both because the law cements their status as "too big to fail" and because the massive regulatory dragnet it casts over the financial system confers an advantage on firms with the size and scale to absorb the complex new regulatory mandates. Goldman Sachs CEO Lloyd Blankfein has stated publicly that his firm "will be among the biggest beneficiaries of reform," [6] telling an investor conference in February 2015:

> More intense regulatory and technology requirements have raised the barriers to entry higher than at any other time in modern history. This is an expensive business to be in, if you don't have the market share in scale. Consider the numerous business exits that have been announced by our peers as they reassessed their competitive position and relative returns.[7]

JP Morgan Chase CEO Jamie Dimon has referred to the post-crisis regulatory regime as creating a "bigger moat" that protects his bank and other "too big to fail" firms from competition by new entrants and small firms that cannot so easily digest the costs of the Dodd-Frank regulatory requirements.[8] In 2015 testimony before the Oversight and Investigations Subcommittee, securities law expert and former University of Virginia Law School Dean Paul Mahoney rendered the following verdict: "Dodd-Frank is designed in significant part to enhance the regulatory reach of bank regulators. Inevitably, that will mean increasing the size, market share, and political clout of the largest banks."[9]

To make matters worse, banking system consolidation and crushing compliance costs caused by Dodd-Frank and Basel are not offset by tangible benefits to financial stability or access to consumer credit. Instead, excessive regulatory complexity has made the U.S. financial system less accessible and more dangerous.

The sheer weight, volume, and complexity of regulation for community financial institutions affects their ability to provide the products and services necessary to allow small businesses to grow and consumers to access credit to realize their financial and personal goals. Today's "too small to succeed" regulatory paradigm results in demonstrable economic harm on Main Street.

According to a 2015 study by researchers at Harvard University's Kennedy School of Government entitled "The State and Fate of Community Banking," the "increasingly

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[6] Joe Weisenthal, *Lloyd Blankfein: We Will Be Among the Biggest Beneficiaries of Financial Reform*, BUSINESS INSIDER, (May 5, 2010), *available at* http://www.businessinsider.com/lloyd-blankfein-we-will-be-among-the-biggest-benificaries-of-financial-reform-2010-5.

[7] *Regulation is Good for Goldman*, WALL STREET JOURNAL, (Feb. 11, 2015), (citing comments made by Mr. Blankfein at an investor conference), *available at* http://www.wsj.com/articles/regulation-is-good-for-goldman-1423700859.

[8] Joe Weisenthal, *The 4 Things That Worry Jamie Dimon…*, BUSINESS INSIDER, (Feb. 4, 2013), (citing interview by Citigroup analyst Keith Horowitz), *available at* http://www.businessinsider.com/the-four-things-that-worry-jamie-dimon-2013-2

[9] *The Dodd-Frank Act and Regulatory Overreach: Hearing Before the Subcomm. on Oversight and Investigations, H. Comm. on Fin. Services*, 114th Cong. 1st Sess. (May 13, 2015) (statement of Professor Paul G. Mahoney), *available at* http://financialservices.house.gov/uploadedfiles/hhrg-114-ba09-wstate-pmahoney-20150513.pdf.

complex and uncoordinated regulatory system [embodied by Dodd-Frank] has created an uneven regulatory playing field that is accelerating consolidation [among community financial institutions] for the wrong reasons." The study described a post-crisis competitive landscape characterized by "community banks' declining market share in several key lending markets, their decline in small business lending volume, and the disproportionate losses being realized by particularly small community banks."[10]

The "regulatory taxes" imposed by Dodd-Frank are passed along to the customer in the form of increased fees or more limited credit and product availability. Dodd-Frank policies – particularly those stemming from the Bureau of Consumer Financial Protection's top-down regulatory approach – have contributed to an array of regressive trends in access to credit for American households, including the following:

- Low-income Americans in need of basic consumer credit products find these products increasingly less available.[11]

- The availability of basic banking services has shrunk drastically since Dodd-Frank (for example, the share of banks offering free checking accounts fell from 75 percent pre-Dodd-Frank to 38 percent in 2016).[12]

- Banking fees have risen (for example, monthly service fees rose 111 percent between the enactment of Dodd-Frank and 2014).[13]

- According to an FDIC study released in 2016, 7 percent of households in the United States were unbanked in 2015, representing approximately 9 million households

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[10] Marshall Lux & Robert Greene, *The State and Fate of Community Banking*, Harvard Kennedy School of Government (Feb. 2015) (*hereinafter* Lux & Greene, *The State and Fate of Community Banking), available at* http://www.hks.harvard.edu/centers/mrcbg/publications/awp/awp37. Other research details the toll that Dodd-Frank is taking on small community financial institutions. *See, e.g.*, Preston Ash et al., *supra* note 4; Ken B. Cyree, "The Direct Costs of Bank Compliance around Crisis-Based Regulation for Small and Community Banks" (Working Paper, Presented at the Federal Reserve Bank of St. Louis, Third Annual Community Banking Research and Policy Conference, Sep. 30 - Oct. 2015), https://www.communitybanking.org/documents/Session3_Paper3_Cyree.pdf; Hester Peirce et al., "How Are Small Banks Faring under Dodd-Frank?" (The Mercatus Center at George Mason University, Working Paper No. 14-05, Feb. 2014), http://mercatus.org/sites/default/files/Peirce_SmallBankSurvey_v1.pdf.

[11] *See generally* Marshall Lux & Robert Greene, *Out of Reach: Regressive Trends in Credit Card Access* (Mossavar-Rahmani Center for Business & Government Associate Working Paper No. 54, John F. Kennedy School of Government, Harvard University, Apr. 2016) (*hereinafter* "Lux and Greene, *Out of Reach: Regressive Trends in Credit Card Access*"), https://www.hks.harvard.edu/centers/mrcbg/publications/awp/awp54.

[12] *See 2016 Bankrate checking account survey: ATM fees stay on record-setting streak*, BANKRATE, *available at* http://www.bankrate.com/banking/checking/2016-bankrate-checking-account-survey-atm-fees-stay-on-record-setting-streak/; Todd Zywicki, Opinion, Geoffrey Manne, & Julian Morris, *How to Help the Unbanked? Repeal The Durbin Amendment*, FORBES CAPITAL FLOWS (Aug. 4, 2014), *available at* http://www.forbes.com/sites/realspin/2014/08/04/how-to-help-the-unbanked-repeal-the-durbin-amendment/#43b6d8605a5f.

[13] Lux and Greene, *Out of Reach: Regressive Trends in Credit Card Access*, at 20.

(disproportionately low-income Americans).[14] An additional 19.9 percent of U.S. households, or 24.5 million households, were underbanked.[15]

- There are 50 million fewer credit cards accounts today than 2008. Between 2009 and 2012, about 30% of lower-credit borrowers (12 million people) lost access to credit cards completely, and those options that remain cost more than they did before. Those options that remain cost more, with credit card interest rates 325 basis points higher for borrowers with higher FICO scores and 360 basis points higher for borrowers with lower scores.[16]

An April 2015 study by economists at Goldman Sachs reached a similar conclusion about the "pass-through" effects of post-crisis banking regulations on small businesses that rely heavily on the community banking sector for their funding:

> The tax from increased bank regulation falls disproportionately on the smaller businesses that have few alternative sources of finance. We see this in the muted recovery in bank lending to small businesses: outstanding commercial and industrial (C&I) loans for less than $1 million are still well below the peak 2008 level and are only 10% above the trough seen in 2012. In contrast, larger C&I loans outstanding (above $1 million) are more than 25% higher than the peak in 2008. Moreover, the cost of the smallest C&I loans has risen by at least 10% from the pre-crisis average. The evidence suggests that smaller firms continue to borrow from banks – when they can get credit – because they lack effective alternative sources of finance. It also suggests that they are paying notably more for credit today; this weighs on their ability to compete with larger firms and to create new jobs.[17]

Unsurprisingly but unfortunately, Dodd-Frank has placed credit out of reach for many small businesses. Overall, bank small business loans have declined 11 percent since Dodd-Frank was enacted, in large part due to regulatory burdens on community banks. Sixty-three percent of microbusinesses and 58 percent of start-ups report unmet financing needs, according to a recent survey published by the Atlanta Fed.[18] The result is stifled American entrepreneurship and a less robust Main Street economy.

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[14] BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, REPORT ON THE ECONOMIC WELL-BEING OF U.S. HOUSEHOLDS IN 2014 (May 2015).
[15] 2015 FDIC National Survey of Unbanked and Underbanked Households (October 20, 2016).
[16] GOLDMAN SACHS GLOBAL MARKETS INSTITUTE, THE TWO-SPEED ECONOMY 13 (2015), *available at:* https://www.theclearinghouse.org/research/banking-perspectives/2017/2017-q1-banking-perspectives/two-speed-economy.
[17] *Id.* at 12.
[18] FEDERAL RESERVE BANKS OF NEW YORK, ATLANTA, BOSTON, CLEVELAND, PHILADELPHIA, RICHMOND, & ST. LOUIS, SMALL BUSINESS CREDIT SURVEY: REPORT ON EMPLOYER FIRMS, (Mar. 2016), *available at* https://www.frbatlanta.org/research/small-business/survey/2015/report-on-employer-firms.aspx?panel=1.

The Solution: A New Paradigm Offering Well-Capitalized, Well-Managed Financial Institutions Relief from Excessive Regulatory Complexity

As the enormous costs and economic harm from the Dodd-Frank Act and other post-crisis regulatory initiatives have come into sharper relief, a consensus has begun to emerge that there *has* to be a better approach to financial regulation, one that prizes simplicity over needless complexity, and market discipline over regulatory arbitrage and central planning.

A good description of this alternative approach was offered recently by former Federal Reserve Board Governor Robert Heller:

> A healthy financial sector needs a light, but firm regulatory and supervisory hand, with as few rules as possible. A few simple rules, including a strong capital base, are more important than micromanagement of the banks by the regulators. Complex regulations lead to huge compliance departments that just add a dead-weight bureaucracy to the financial system. Better to invest in higher capital levels that present a true and reliable cushion against adverse circumstances. Ever more complex regulations and a myriad of regulators and overlapping regulatory jurisdictions do not make the financial system more safe and sound.[19]

In an era where agreement on financial regulatory matters is hard to come by, support for a regulatory model in which banks operate at higher capital levels in exchange for relief from government micro-management is surprisingly broad-based.[20]

For those who view the Dodd-Frank Act as an alarming expansion of an unaccountable and uncontrollable administrative state, the appeal of such a trade-off is obvious. It shifts power away from Washington, and holds the promise of reversing the distorted incentives of a system in which taxpayers, rather than shareholders, creditors and management, are made to pay the costs when a "too big to fail" bank collapses.[21]

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[19] ROBERT HELLER, THE UNLIKELY GOVERNOR: AN AMERICAN IMMIGRANT'S JOURNEY FROM WARTIME GERMANY TO THE FEDERAL RESERVE BOARD 231 (Maybridge Press, 2015).

[20] *See* Alan Greenspan, *More capital is a less painful way to fix the banks*, FINANCIAL TIMES, (Aug. 17, 2015), *available at* http://www.ft.com/intl/cms/s/0/4d55622a-44c8-11e5-af2f-4d6e0e5eda22.html?siteedition=intl#axzz410gZ8sNQ, ("Lawmakers and regulators, given elevated capital buffers, need to be far less concerned about the quality of the banks' loan and securities portfolios since any losses would be absorbed by shareholders, not taxpayers. This would enable the Dodd-Frank Act on financial regulation of 2010 to be shelved, ending its potential to distort the markets — a potential seen in the recent decline in market liquidity and flexibility."). *See also* Frank Partnoy, *The Fed's magic tricks will not make risk disappear*, FINANCIAL TIMES, Mar. 4, 2015, *available at* https://www.ft.com/content/8fc85ac4-b5d3-11e4-a577-00144feab7de, ("Instead of encouraging big banks to play games with their accounts, regulators should offer them a simple bargain: drastically increase your capital and in return we will exempt you from the most onerous regulations."). Martin Wolf, *Financial Reform: Call to Arms*, FINANCIAL TIMES, Sept. 3, 2014, *available at* http://www.ft.com/intl/cms/s/0/152ccd58-3294-11e4-93c6-00144feabdc0.html, ("'Keep it simple, stupid' is as good a rule in regulation as it is in life. The sensible solution seems clear: force banks to fund themselves with equity to a far greater extent than they do today.")

[21] According to FDIC Vice Chairman Thomas M. Hoenig, forcing large financial firms to fund themselves with greater equity and less debt "reduces the moral hazard problem, where firms with little equity have a perverse

Under the Financial CHOICE Act, banking organizations that maintain a leverage ratio of at least 10 percent, at the time of the election, may elect to be exempted from a number of regulatory requirements, including the Basel III capital and liquidity standards and the "heightened prudential standards" applicable to larger institutions under section 165 of the Dodd-Frank Act. The CHOICE Act thus offers financial institutions of all shapes and sizes a Dodd-Frank "off-ramp" – freedom from an overly burdensome and highly intrusive regulatory regime in exchange for maintaining significantly higher capital than is required by current law and regulation.

The leverage ratio used to assess capital adequacy under the Financial CHOICE Act is more stringent than the risk-based capital regime traditionally favored by global banking regulators and embodied in the successive iterations of the Basel capital accord. Unlike Basel's risk-weighted capital requirements, a leverage ratio measures a bank's capital against its total assets, without incorporating subjective regulatory judgments about the relative riskiness of those assets.[22] Apologists for the Basel status quo can be expected to argue that by treating all assets the same for capital purposes, a leverage ratio is too blunt an instrument, because there is no "penalty" for holding risky assets if those assets are not adjusted for relative risk. Far better, they say, to trust regulators to carefully calibrate the risk weights on specific asset classes so that banks do not gorge themselves on highly speculative investments in search of higher returns.

There is just one problem with this argument: the Basel approach of setting bank capital levels according to regulatory risk-weights has been tried before – with disastrous results. In the run-up to the financial crisis, the regulators got the risk weights spectacularly wrong. For example, risk weights treated toxic mortgage-backed securities and Greek sovereign debt as risk-free loans, and thus encouraged financial firms to crowd into the riskiest of assets instead of following a prudent path of diversification. Rather than make banks safer, Basel pushed them to make loans that were bad for the economy and disastrous for the financial system.

Alex Pollock, the former president of the Chicago Federal Home Loan Bank and now a Distinguished Senior Fellow at the R Street Institute, elaborated on this troubling aspect of

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incentive to take excessive risk. The dynamic at work has been described as heads the stockholders win, tails taxpayers lose." *See* Thomas M. Hoenig, FDIC Vice Chairman, Address before the Exchequer Club of Washington, D.C.: The Leverage Ratio and Derivatives (Sept. 16, 2015) (*hereinafter* Thomas M. Hoenig, The Leverage Ratio and Derivatives), *available at* https://www.fdic.gov/news/news/speeches/spsep1615.html. *See also* ALLAN MELTZER, WHY CAPITALISM? 35 (Oxford University Press, 2012) ("Bank equity capital deters excessive risk-taking by requiring the bank to pay for its portfolio mistakes and unforeseen changes. . . .If regulators raised capital requirements, bank stockholders would bear the risk of mistakes, which would encourage prudence. Taxpayers would not pay for bankers' errors.").

[22] FDIC Vice Chairman Hoenig estimates that under the Basel regime, the largest banks' risk-weighted assets against which capital adequacy is measured represent only about 40 percent of their total assets. *See* Thomas M. Hoenig, FDIC Vice Chairman, Remarks on Bank Supervision to the Federal Reserve Bank of New York, Conference on Supervising Large Complex Financial Institutions (Mar. 18, 2016) (*hereinafter* Thomas M. Hoenig, Remarks on Bank Supervision), *available at* https://www.fdic.gov/news/news/speeches/spmar1816.html.

the Basel regime during his testimony at the Committee's July 12, 2016, hearing on the Financial CHOICE Act:

> The deepest problem with risk weightings is that they are bureaucratic, while risk is dynamic and changing. Designating an asset as low risk is likely to induce flows of increased credit which end up making it high risk. What was once a good idea becomes a "crowded trade." What was once a tail risk becomes a highly probable unhappy outcome.[23]

Basel's role in fueling the financial crisis suggests both the folly of relying upon the "expertise" of regulators to achieve financial stability and the dangers of imposing "one world view" of risk. As Peter Wallison of the American Enterprise Institute (AEI) has written, contrary to the narrative peddled by the drafters of Dodd-Frank, the financial crisis was caused not by the failure of few large financial firms, but by "the collapse in value of a single asset class – subprime, and other low-quality, residential mortgages."[24] That collapse was made far more destructive than it otherwise would have been by the fact that banks had invested hundreds of billions of dollars in mortgage-backed securities,[25] which their regulators had signaled through Basel were among the "safest" assets they could place on their balance sheets. Moving away from a highly politicized, deeply unreliable risk-based approach to measuring capital adequacy will reduce the likelihood of future crises.

By introducing an almost mind-numbing level of complexity into the calculation of bank capital, Basel has succeeded in making the largest banks almost entirely opaque to their investors, creditors, and regulators. In his influential 2012 speech, the Bank of England's Andrew Haldane noted that Basel III – global regulators' attempt to respond to the shortcomings in Basel I and II exposed by the financial crisis – numbered some 616 pages, almost double Basel II. And, according to Haldane:

> The length of the Basel rulebook, if anything, understates its complexity. The move to internal models, and from broad asset classes to individual loan exposures, has resulted in a ballooning in the number of estimated risk weights. For a large, complex bank, this has meant a rise in the number of calculations required from single figures a generation ago to several million today.[26]

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[23] One such "crowded trade" identified by Mr. Pollock involved debt and preferred stock issued by Fannie Mae and Freddie Mac in the pre-crisis period, which "were given extremely low capital risk weightings and induced an excess flow of credit [into the residential mortgage market], with disastrous consequences."

[24] Peter Wallison, *Title I and the Financial Stability Oversight Council*, *in* THE CASE AGAINST DODD-FRANK: HOW THE "CONSUMER PROTECTION" LAW ENDANGERS AMERICANS, 50 (Norbert J. Michel ed., Heritage Foundation, 2016), *available at* http://thf-reports.s3.amazonaws.com/2016/The%20Case%20Against%20Dodd-Frank.pdf.

[25] For more detailed figures *see* Zhiguo He, In Gu Khang, & Arvind Krishnamurhty, *Balance Sheet Adjustments in the 2008 Crisis* (NBER Working Paper No. 15919, Apr. 2010), *available at* http://faculty.chicagobooth.edu/zhiguo.he/research/BalanceSheetAdjustment0226.pdf.

[26] *See* Andrew Haldane, The dog and the Frisbee. Haldane further observes: "More than half of all investors do not understand or trust banks' risk weights. Their multiplicity and complexity have undermined transparency and, with it, market discipline."

A system in which banks must make "several million" individual calculations for regulators to be able to assess the strength of their capital position can only be described as "Orwellian." Worse still, Basel's complexity confers a competitive advantage on financial institutions with the scale and resources necessary to absorb the costs of that complexity and turn the regulations to their advantage (a phenomenon often referred to as "regulatory arbitrage"), which exacerbates the problem of "too big to fail."[27] Research presented at the San Francisco Fed finds that large banks "have been the primary winners from a complex risk-weighting system and have outmaneuvered the general public, which suffers from crises."[28]

Yet even more troubling than Basel's sheer complexity is the fact that it places regulators in the position of micro-managing financial institutions, serving to further politicize the allocation of credit and undermine free market capitalism. Ideally, regulators would set capital levels, and banks would decide which loans to make. A risk-based capital regime shifts the responsibility for making business decisions about lending from bankers to regulators.[29] Indeed, many believe that by giving government officials the ability to set risk weights – and thereby favor one group of assets over another – Basel has allowed government to commandeer the financial system to provide a cheaper source of funding for governments and projects favored by politicians.[30]

To this day – even after recent events in Europe underscored the considerable risks inherent in exposure to sovereign debt – Basel still generally accords those instruments a

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[27] *See* INTERNATIONAL MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT: RESTORING CONFIDENCE AND PROGRESSING ON REFORMS (Oct. 2012), *available at* http://www.imf.org/External/Pubs/FT/GFSR/2012/02/pdf/text.pdf. ("[B]ig banking groups with advantages of scale may be better able to absorb the costs of the regulations; as a result, they may become even more prominent in certain markets, making these markets more concentrated.").

[28] Gerard Caprio, Jr., *Financial Regulation After the Crisis: How Did We Get Here, and How Do We Get Out?* LSE Fin. Mark. Group Special Paper No. 226 (2013), *available at* http://www.lse.ac.uk/fmg/workingPapers/specialPapers/PDF/sp226.pdf

[29] *See* Sheila C. Bair & Ricardo Delfin, *How Efforts to Avoid Past Mistakes Created New Ones: Some Lessons from the Causes and Consequences of the Recent Financial Crisis*, *in* ACROSS THE GREAT DIVIDE: NEW PERSPECTIVES ON THE FINANCIAL CRISIS 30 (Martin Neil Baily & John B. Taylor, eds., 2014), *available at* http://www.hoover.org/sites/default/files/across-the-great-divide-ch1.pdf

[30] *See* RICHARD X. BOVE, GUARDIANS OF PROSPERITY: WHY AMERICA NEEDS BIG BANKS 129 (Portfolio Penguin, 2013), ("Outwardly, [risk weighting] would appear to make sense. In practice, it causes funds to be directed to whatever sectors of the economy the government favors and away from sectors that the government does not like. It results in differing interest rates based upon the amount of capital required. The power to make these crucial decisions is given to the banking regulators, who do so in private. Thus, one of the most important factors in moving funds through the economy is done behind closed doors by a small number of nonelected officials."). *See also* Prasad Krishnamurthy, *Rules, Standards, and Complexity in Capital Regulation*, 43 J. OF LEGAL STUDIES S291 (Jun. 2014), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2371612 ("housing policy probably drove the risk weight of 50 percent for one- to four-family residential properties. Similarly, the 100 percent weight for OECD debt and the 50 percent weight for OECD public entities were likely a result of international considerations and the Basel Committee process"). *See also* Edward J. Kane, *Bankers and Brokers First: Loose Ends in the Theory of Central Bank Policymaking*, *in* THE ROLE OF CENTRAL BANKS IN FINANCIAL STABILITY: HOW HAS IT CHANGED? (Douglas Evanoff et al., eds., 2014), *draft paper available at* https://www2.bc.edu/edward-kane/Bankers%20and%20Brokers%20First.pdf, ("For political reasons, U.S. regulators assigned unrealistically low weights to mortgage-backed securities and EU officials set zero risk weights for member-state debt.")

zero risk weight. By contrast, small business loans generally receive a 100 percent risk weight under Basel.[31] A risk-based capital regime that rewards investments in U.S. Treasuries and punishes small business lending may theoretically produce a less "risky" banking system – although as demonstrated by the foregoing discussion, that is at best a questionable proposition – but by fixing the price of public debt below that of private debt, it almost certainly results in a less dynamic economy and the creation of fewer new jobs.[32]

Another example of how risk-weighting has been used to distort the allocation of credit to benefit favored political constituencies and causes can be found in the regulations promulgated by the Federal Reserve to implement Basel for U.S.-based institutions. Those rules provide that any exposure to the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund, or the multi-lateral development banks, must be accorded a zero percent risk-weight.[33] Thus, in marketing a recent issuance of "green bonds," the World Bank touted its "0% risk-weighting under the Basel framework."[34]

Perhaps the most damning of all of the criticisms levelled at the Basel risk-based capital regime is this: being well-capitalized on a risk-weighted basis was of no value in predicting the likelihood of failure during the recent financial crisis. Remarkably, failed banks maintained the **same** risk-weighted capital ratios (on average) as did surviving banks. Banks that withstood the crisis distinguished themselves by maintaining significantly higher leverage ratios.[35] In the words of former FDIC Chairman Sheila Bair, "Extensive research conducted on banks that became troubled during the crisis demonstrated that an institution's leverage ratio is a much better predictor of financial health than its risk-based ratio."[36] In August 2016, current FDIC Vice Chairman Thomas Hoenig offered an

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[31] *See* FDIC, EXPANDED COMMUNITY BANK GUIDE TO THE NEW CAPITAL RULE FOR FDIC-SUPERVISED BANKS, *available at* https://www.fdic.gov/regulations/capital/capital/Community_Bank_Guide_Expanded.pdf

[32] *See* Thomas M. Hoenig, FDIC Vice Chairman, Speech before the International Association of Deposit Insurers, Basel, Switzerland: Basel III Capital: A Well-Intended Illusion (Apr. 9, 2013) (*hereinafter* Thomas M. Hoenig, Basel III Capital), *available at* https://www.fdic.gov/news/news/speeches/spapr0913.html, ("Basel systematically encourages investments in sectors pre-assigned lower weights – for example, mortgages, sovereign debt, and derivatives – and discourages loans to assets assigned higher weights – commercial and industrial loans. We may have inadvertently created a system that discourages the very loan growth we seek, and instead turned our financial system into one that rewards itself more than it supports economic activity.").

[33] 78 FR 62017.

[34] IFC, GREEN BONDS (Nov. 2015), *available at* http://www.ifc.org/wps/wcm/connect/353c8f004325cabfa308ef384c61d9f7/Green+Bonds+March+2014+final.pdf?MOD=AJPERES.

[35] Andrew Haldane, Chief Economist and the Executive Director of Monetary Analysis and Statistics at the Bank of England, Address at the Federal Reserve Bank of Kansas City's 366th economic policy symposium: The dog and the Frisbee (Aug. 31, 2012), *at* 29, Chart 4, *available at* http://www.bis.org/review/r120905a.pdf

[36] Letter from the Systemic Risk Council to federal banking regulators, October 15, 2013, *available at*: http://www.systemicriskcouncil.org/wp-content/uploads/2013/10/Final-SRC-Comment-Letter-re-Leverage-Ratio-10-15-13.pdf . *See also* Thomas Hogan et al., *Evaluating Risk-Based Capital Regulation*, (Mercatus Center at George Mason Univ., Working Paper No. 13-02, Jan. 2013), *available at* http://mercatus.org/sites/default/files/Hogan_EvaluatingRBC_v2_1.pdf. (finding that during the period 2001 to 2011, leverage ratios were far better predictors of bank performance than risk-weighted capital ratios, and that the "risk-based weighting system is inherently flawed and easily exploitable.")

explanation for the leverage ratio's superior performance as a barometer of financial resiliency:

> The leverage ratio has proven most reliable principally because it does not pretend to judge future trends in asset quality. It simply measures how much loss from total assets a bank can withstand before it fails. When a bank is under stress, this is all anyone cares about.[37]

The Basel Committee itself has acknowledged that risk-based capital ratios masked the true condition of many of the banks that got into trouble during the financial crisis: "An underlying feature of the financial crisis was the build-up of excessive on- and off-balance sheet leverage in the banking system. **In many cases, banks built up excessive leverage while maintaining strong risk-based capital ratios."[38]**

By relying upon a simple leverage ratio, which measures shareholder equity available to absorb losses from total balance sheet and some off-balance sheet assets, the Financial CHOICE Act substitutes simplicity and market discipline for the complexity and unfettered regulatory discretion embodied by the Basel regime. FDIC Vice Chairman Hoenig, who has spent virtually his entire career in bank supervision, has argued that a leverage ratio approach will yield a more effective, more efficient, and more cost-effective supervisory regime than one in which regulators spend endless hours calibrating risk weights and policing banks' calculations of their risk-adjusted capital ratios: "From a supervisory program perspective, moving away from risk-based capital measures toward an assessment of adequacy based on tangible equity would generate more reliable information from which to make supervisory judgments and would free up billions of dollars from supervision budgets currently spent waiting for, understanding, and implementing risk-based measures."[39]

Had the leverage ratio approach proposed by the Financial CHOICE Act been in place prior to the financial crisis – instead of Basel's risk-based capital regime – much of the economic carnage from that crisis could have been avoided, as banks would have lacked incentives to herd into risky mortgage-backed securities and sovereign debt. But as the testimony of Goldman Sachs CEO Lloyd Blankfein to the Financial Crisis Inquiry Commission suggests, neither regulators nor the large Wall Street investment banks were paying much attention to leverage in the run-up to the crisis:

> Blankfein acknowledged he didn't understand leverage as a "meaningful metric" to gauge the financial condition of his company, according to a paraphrased June 2010 interview. "Until recently, I wasn't even conscious of what our leverage was, in the sense of, the amount of our gross assets versus

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[37] Thomas M. Hoenig, Why 'Risk-Based' Capital is Far Too Risky, *Wall Street Journal*, August 11, 2016, *available at* http://www.wsj.com/articles/why-risk-based-capital-is-far-too-risky-1470957677

[38] Basel Committee on Banking Supervision, Consultative Document on Revised Basel III leverage ratio framework and disclosure requirements, (June 2013) (emphasis added).

[39] Thomas M. Hoenig, Remarks on Bank Supervision.

our equity," he said. "I always thought of it in terms of risk of the way our balance sheet was run."[40]

The regulators' misplaced faith in the risk-based capital ratios generated by Basel's complex formulas and millions of bank inputs – and their inattention to leverage – blinded them to the gathering storm in the financial sector, as FDIC Vice Chairman Hoenig explained in a 2013 speech:

> In 2007, for example, the 10 largest and most complex U.S. banking firms reported Tier 1 capital ratios that, on average, exceeded 7 percent of risk-weighted assets. Regulators deemed these largest to be well capitalized. This risk-weighted capital measure, however, mapped into an average leverage ratio of just 2.8 percent. We learned all too late that having less than 3 cents of tangible capital for every dollar of assets on the balance sheet is not enough to absorb even the smallest of financial losses, and certainly not a major shock. With the crisis, the illusion of adequate capital was discovered, after having misled shareholders, regulators, and taxpayers.[41]

There is a wide range of expert opinion – but nothing approaching consensus – on the proper level at which to set bank capital. The Basel Committee on Banking Supervision currently requires large banks to maintain a 3 percent leverage ratio.[42] The U.S. banking regulators have "gold-plated" the Basel Committee's leverage ratio and require U.S. G-SIBs to maintain a 6 percent leverage ratio.[43] While the 10 percent leverage ratio specified in the Financial CHOICE Act may therefore seem high by current standards, a survey of the historical record suggests it is far from anomalous. FDIC Vice Chairman Hoenig reports that prior to the founding of the Federal Reserve in 1913 and the creation of federal deposit insurance in 1933 (i.e., before banks benefited from a federal safety net), "the U.S. banking industry's ratio of tangible equity to assets ranged between 13 and 16 percent, regardless of bank size."[44] Research by Professor Allan Meltzer of Carnegie-Mellon University is to the same effect: "In the 1920s, capital ratios for large New York banks [engaged in both commercial and investment banking under the pre-Glass-Steagall regime then in place] ranged from 15% to 20% of assets. Stockholders took losses, but none of the major New York banks failed during the Great Depression."[45]

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[40] *Excerpts: Report on Financial Crisis*, WALL STREET JOURNAL, (Mar. 13, 2016), *available at* http://www.wsj.com/articles/excerpts-report-on-financial-crisis-1457916378.

[41] Thomas M. Hoenig, Basel III Capital: A Well-Intentioned Illusion.

[42] BASEL COMMITTEE ON BANKING SUPERVISION, BASEL III LEVERAGE RATIO FRAMEWORK AND DISCLOSURE REQUIREMENTS (Jan. 2014), *available at* http://www.bis.org/publ/bcbs270.pdf.

[43] *See* Press Release, Federal Reserve, FDIC, OCC, Agencies Adopt Enhanced Supplementary Leverage Ratio Final Rule and Issue Supplementary Leverage Ratio Notice of Proposed Rulemaking (Apr. 8, 2014), *available at* https://www.federalreserve.gov/newsevents/press/bcreg/20140408a.htm.

[44] Thomas M. Hoenig. FDIC Vice Chairman, Speech to the American Banker Regulatory Symposium, Washington, D.C.: Back to Basics: A Better Alternative to Basel Capital Rules (Sept. 14, 2012), *available at* https://www.fdic.gov/news/news/speeches/archives/2012/spsep1412_2.html.

[45] Allan H. Meltzer, *Banks Need More Capital, Not More Rules*, WALL STREET JOURNAL, (May 16, 2012), *available at* http://www.wsj.com/articles/SB10001424052702304192704577405821765336832.

Indeed, a survey of the relevant academic literature and economic research demonstrates that there is a strong theoretical and empirical basis for choosing a 10 percent leverage ratio:

- According to the FDIC, 98 percent of the insured depository institutions that entered the 2008 financial crisis with leverage ratios of 10 percent or more survived. Of the miniscule percentage that did fail, none posed a systemic risk.[46]

- After exhaustively examining loan losses and bank capital over several decades of systemic financial crises, researchers at the International Monetary Fund concluded that risk-weighted "bank capital in the 15-23 percent range could have avoided creditor losses in the vast majority of past banking crises" and that "[i]ncreases . . . beyond this are likely to provide limited benefits." The researchers pointed out that their risk-weighted 15-23% range is consistent with "9.5 percent of total leverage exposure."[47]

- William R. Cline, a senior fellow at the Peterson Institute for International Economics, similarly estimated that the optimal level of capital for reducing the probability of banking crises is "7 percent of total assets, with a more cautious alternative . . . at about 8 percent."[48]

- At a July 12, 2016, hearing on the Financial CHOICE Act, John Allison—a banking veteran with 40 years' experience who steered BB&T through the worst financial crisis since the Great Depression without a single quarterly loss—described the 10 percent leverage ratio as "kind of a rule of thumb" that "has had very good success with the industry over a long period of time."

For those who argue that the CHOICE Act's 10 percent leverage ratio is too *low*, and makes it too easy for the largest banks to qualify for the Dodd-Frank off-ramp, an analysis of the amount of new equity that those firms would be required to raise to qualify for regulatory relief is instructive. According to a report from S&P Global, the seven largest U.S. banks currently have an estimated average leverage ratio of approximately 6.9 percent.[49] In order to attain a 10 percent leverage ratio, these firms would collectively need to raise hundreds of billions of dollars in new equity – assuming asset sizes remain constant – to receive regulatory relief.

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[46] Of the insured institutions with leverage ratios of 10% or more and more than $1 billion in assets, only 13 failed. The largest of these was the Downey Savings and Loan in California, with a mere $12 billion in assets.

[47] Jihad Dagher et al., "IMF Discussion Note: Benefits and Costs of Bank Capital" (March 2016), *available at* https://www.imf.org/external/pubs/ft/sdn/2016/sdn1604.pdf.

[48] William R. Cline, "Benefits and Costs of Higher Capital Requirements for Banks" (March 2016), *available at* https://piie.com/system/files/documents/wp16-6.pdf.

[49] S&P Global, What Financial Regulations May Be Affected By The Trump Administration, and How They Can Affect Ratings, (Mar. 20, 2017) *available at*: https://www.globalcreditportal.com/ratingsdirect/renderArticle.do?articleId=1817507&SctArtId=420008&from=CM&nsl_code=LIME&sourceObjectId=10012602&sourceRevId=1&fee_ind=N&exp_date=20270320-23:00:59

On the other hand, for most community banks, which tend to operate with far less leverage than their big-bank counterparts, regulatory relief will be well within reach. This is particularly true because the Financial CHOICE Act's leverage ratio includes in its denominator, for all banks other than "traditional banking organizations"[50] and credit unions, asset-equivalents of certain off-balance sheet exposures. Since very few community or regional banks have significant off-balance sheet exposures, their leverage ratios tend to be measurably higher than those of the Wall Street banks.

Some will argue that the substantially higher capital standards contemplated by the Financial CHOICE Act will result in a sharp contraction in the supply of credit and lower economic growth, as banks shed assets rather than seek to tap the equity markets for billions of dollars in additional capital. As an initial matter, it bears repeating that the Financial CHOICE Act does not *require* anybody to raise a dime of new capital or adjust their risk profiles. Rather, it allows banks to opt in to a regime that replaces excessive regulatory complexity with market discipline, and in which equity investors stand in for taxpayers the next time a "too big to fail" firm collapses. Put another way, the Financial CHOICE Act allows banks that credibly commit to stop betting with taxpayers' money to get out from under the suffocating constraints of Dodd-Frank. But the option remains entirely with the bank.

Moreover, not everyone agrees that higher bank capital necessarily translates into less lending. In a June 15, 2015, letter to the editor of the *Wall Street Journal,* FDIC Vice Chairman Hoenig wrote: "Higher capital doesn't contribute to lower lending. The data show that the opposite is true: Banks with stronger capital positions maintain higher levels of lending over the course of economic cycles than those with less capital. Additionally, better capitalized banks compete favorably in the market and survive economic shocks without failing or requiring bailouts."[51] To support his thesis, Vice Chairman Hoenig cites evidence that "going into the crisis of 2008, banks holding an average 12 percent capital saw more modest declines in loans and a quicker recovery. In contrast, banks with capital below 8 percent, including the largest banks, experienced more dramatic declines in lending."[52]

In a recent paper prepared for the Bank of International Settlements, economists Leonardo Gambacorta and Hyun Song Shin reach a similar conclusion:

> [A] higher level of bank capital implies a substantial cost advantage for the bank as a borrower, and in turn induces the bank to increase credit at a faster pace. . . . [A] bank with a larger equity base can be expected to lend more.

[50] A traditional banking organization is defined to include a banking organization that (1) has zero trading assets and zero trading liabilities; (2) does not engage in swaps or security-based swaps, other than swaps or security-based swaps referencing interest rates or foreign exchange swaps; and (3) has a total notional exposure of swaps and security-based swaps of not more than $8,000,000,000.
[51] Thomas M. Hoenig, *The Fed, Regulation and Preventing the Fire Next Time*, WALL STREET JOURNAL, (Jun. 15, 2015), *available at* http://www.wsj.com/articles/the-fed-regulation-and-preventing-the-fire-next-time-1434308753.
[52] Thomas M. Hoenig, Remarks on Bank Supervision.

> Indeed, consistent with this reasoning, we find that banks with higher capital have higher lending growth. A 1 percentage point increase in the equity-to-total-assets ratio is associated with a higher subsequent growth rate in lending, of 0.6 percentage points per year.[53]

Arguments that higher bank capital levels are destructive to growth are based on a false premise that capital is a "set-aside," unavailable for lending or other activities. Banks do not "hold" capital – capital is a source of funds to be invested, not an asset to be held.[54] If banks really did "hold" capital, then no one would buy it – owning bank stock would be equivalent to storing cash in the vault. As FDIC Vice Chairman Hoenig explains:

> Capital is a source of funding for a bank's activities, just like deposits or borrowings. It is funding provided by the bank's owners, and it benefits the bank in important ways. Equity owners cannot withdraw funds on demand and therefore do not present a risk of unexpectedly draining the bank's liquidity. Equity owners cannot throw the bank into default if their dividend is too small. Capital reassures counterparties, helping the bank to fund itself at a reasonable cost. Ample capital gives banks the financial flexibility to take advantage of business opportunities, as we have seen since the crisis when comparing U.S. banks to their less strongly capitalized counterparts in Europe.[55]

Opponents of more stringent capital requirements argue that "equity is expensive" – that because shareholders demand a higher return on their investment than debt-holders, banks forced to raise more capital will face increased funding costs, which will in turn be passed on to customers in the form of higher fees and interest rates. But there is considerable evidence and expert opinion supporting the opposite conclusion: that banks that operate with less leverage – as measured by the tangible equity-to-total assets ratio used in the Financial CHOICE Act – face neither higher funding costs nor a reduction in their lending capacity.[56] The claim that higher bank capital erodes bank profitability and

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[53] Leonardo Gambacorta & Hyun Song Shin, *Why bank capital matters for monetary policy*, (BIS Working Paper No. 558, Monetary and Econ. Dept., Apr. 2016) (hereinafter Gambacorta & Shin, *Why bank capital matters for monetary policy*), *available at* http://www.bis.org/publ/work558.pdf.

[54] John Cochrane, *Kashkari on TBTF*, THE GRUMPY ECONOMIST (blog), (Feb. 19, 2016) (*hereinafter* John Cochrane, *Kashkari on TBTF*), *available at* http://johnhcochrane.blogspot.com/2016/02/kashkari-on-tbtf.html

[55] *See* Thomas M. Hoenig, The Leverage Ratio and Derivatives. As a general matter, European banks entered the financial crisis with less capital than U.S. firms, and were slower to raise capital coming out of the crisis (*see* DEUTSCHE BANK RESEARCH, BANK PERFORMANCE IN THE US AND EUROPE (Sept. 26, 2013), *available at* https://www.dbresearch.com/PROD/DBR_INTERNET_ENPROD/PROD0000000000320825.pdf). Some analysts have cited the restrained lending capacity of thinly capitalized European banks as one of the causes of the European economic malaise that persists some eight years after the crisis.

[56] *See* Gambacorta & Shin, *Why bank capital matters for monetary policy* ("We find that a 1 percentage point increase in the equity-to-total assets ratio is associated with a reduction of approximately 4 basis points in the overall cost of debt funding (deposits, bonds, interbank borrowing, etc."). *See also* Peter J. Wallison, *The TBTF Fix No One's Discussing: Simpler Capital Ratios*, AMERICAN BANKER, (May 11, 2016), *available at* http://www.americanbanker.com/bankthink/the-tbtf-fix-no-ones-discussing-simpler-capital-ratios-1080942-1.html, ("Data shows that investors and creditors reward a high equity-to-assets leverage ratio, probably because they have confidence that the banks' capital is real and not simply a gaming of the risk-based capital system . . . . [A] credible

suppresses lending is further belied by the fact that some of America's most successful industries – including those centered in Silicon Valley – operate with a fraction of the debt that large financial firms do, and yet manage to generate competitive risk-adjusted returns for their investors.

Even if one accepts the premise that higher bank capital levels may prompt banks to make fewer loans at the margins, it does not necessarily follow that capital standards should be eased in the name of promoting economic growth. More robust bank capital produces a more resilient banking system that is less prone to periodic crises, which in turn provides more reliable support for economic growth. Given the economic devastation caused by the last financial crisis, the role of bank capital in reducing the frequency and magnitude of such systemic events should not be understated, a point made by the Hoover Institution's John Cochrane:

> Banks produce studies claiming that higher capital requirements . . . will cause them to charge more for loans and reduce economic growth. . . . These arguments are pretty thin, because the cost of not [requiring higher capital] is immense – 10 percent or so of GDP lost for nearly a decade and counting is plausible.[57]

Indeed, one of the accelerants of the 2008-2009 financial conflagration was run-like behavior fueled by fears that large investment banks were too highly leveraged to withstand periods of extreme market stress. As Stanford economist Edward Lazear points out, this source of market instability is mitigated by a more well-capitalized banking sector: "Bank investment funded by equity avoids the danger of a run: If the value of a bank's assets falls, so too does the value of its liabilities. There is no advantage in getting to the bank before others do."[58]

Peter Wallison of AEI draws an important distinction between the collapse of the housing bubble that rocked the economy in 2008 and the bursting of other asset bubbles in the recent past that had far less destabilizing consequences:

> [L]everaged entities, funded by debt instead of equity, were especially vulnerable to the mortgage losses that exacerbated the financial crisis. Where assets are backed with equity — as is true of the mutual funds, private

leverage ratio will attract financing at lower cost, increasing return on equity."). *See also* David Miles, Jing Yang, & Gilberto Marcheggiano, *Optimal bank capital* (Bank of England, Discussion Paper No. 31, 2011) (hereinafter Miles, Yang, & Marcheggiano, *Optimal bank capital), available at* http://www.bankofengland.co.uk/monetarypolicy/Documents/externalmpc/extmpcpaper0031.pdf, ("It is absolutely NOT self-evident that requiring banks to use more equity and less debt has to substantially increase their costs of funds and mean that they need to charge substantially more on loans to service the providers of their funds.").

[57] John Cochrane, *Kashkari on TBTF*. *See also* Miles, Yang, & Marcheggiano, *Optimal bank capital* ("We conclude that even proportionally large increases in bank capital are likely to result in a small long-run impact on the borrowing costs faced by bank customers.… But substantially higher capital requirements could create very large benefits by reducing the probability of systemic banking crises.").

[58] Edward P. Lazear, *How Not to Prevent the Next Financial Meltdown*, WALL STREET JOURNAL, (Oct. 2, 2015), *available at* http://www.wsj.com/articles/how-not-to-prevent-the-next-financial-meltdown-1443827426.

> equity funds, and investment vehicles and conduits of all kinds — a sharp decline in the value of those assets, as occurred in the financial crisis, will fall on the investors in those entities rather than on the entities themselves. That will not cause a financial crisis for the same reason that the collapse of the dot-com bubble in 2001 did not cause a financial crisis, even though the losses were even greater than the losses in 2008. The losses in that event fell on an enormous pool of capital — shareholders — not on individual large firms.[59]

Banks that make the capital election available under the Financial CHOICE Act will do so only if they believe it will create more value for their customers and investors. Moreover, electing banks will not only do better for themselves, they will contribute to a less fragile financial sector and more dynamic economy. Indeed, electing banks will reduce risks to taxpayers, who serve as the real lenders of last resort under the current system. Finally, by putting more of their *own* money to work in the real economy, and wasting less on compliance with regulatory diktats from Washington, electing banks will increase productivity in an economy that continues to suffer through the slowest economic recovery in the post-World War II era.

A less leveraged, less highly concentrated banking sector, combined with a simplified regulatory scheme and a repeal of Dodd-Frank's taxpayer bailout mechanisms, will produce a financial system that is far less susceptible to destabilizing panics than the system we had prior to 2008. Investors and creditors will allocate capital and price risk based upon the state of a firm's balance sheet and the strength of its management, not their assessment of the likelihood that its failure will prompt government intervention to protect those investors and creditors. The Financial CHOICE Act's solution is not to expunge all risk from the financial system and turn banks into functional utilities. Rather, it is to confront bank management, shareholders, and creditors with the full consequences of their decisions (both good and bad), to ensure that the market rewards both effective risk management and prudent risk-taking, and to make good on Dodd-Frank's broken promise to taxpayers that they will never again be asked to pick up the tab for mistakes made on Wall Street or in Washington.

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[59] Peter J. Wallison, *Shadow banks are not a source of systemic risk*, AMERICAN BANKER, Mar. 21, 2016, *available at* https://www.aei.org/publication/shadow-banks-are-not-a-source-of-systemic-risk/. *See also* Anat Admati & Martin Hellweg, THE BANKERS' NEW CLOTHES 60 (Princeton University Press, 2013) ("[T]he $500 billion loss from subprime mortgage-related securities is dwarfed by the more than $5 trillion of losses in the value of shares on U.S. stock markets in the early 2000s, when the so-called technology bubble of the late 1990s burst.").

Bankruptcy Not Bailouts

<u>Executive Summary:</u>

- **Dodd-Frank has *not* ended "too big to fail": research by the Richmond Federal Reserve Bank shows that 62 percent of total financial system liabilities (or some $27 trillion) are either explicitly or implicitly federally guaranteed – a figure essentially unchanged since the passage of Dodd-Frank.**

- **Taxpayers remain on the hook for Wall Street risk-taking thanks to Dodd-Frank's Orderly Liquidation Authority, its failure to impose meaningful constraints on the Federal Reserve's emergency lending authority, its misguided regime for designating large financial firms as "too big to fail," and assorted other provisions backstopping the financial system.**

- **The Financial CHOICE Act ends bailouts and establishes a new chapter of the bankruptcy code that preserves the Rule of Law while enabling large, complex financial institutions to fail safely without making taxpayers foot the bill.**

The Problem: Dodd-Frank Increases the Likelihood of Taxpayer Bailouts of Large Financial Institutions

During the financial crisis of 2008 and 2009, the fear that several large, complex financial institutions might fail prompted the federal government to provide those institutions and their creditors with extraordinary taxpayer-funded assistance, both through emergency liquidity facilities administered by the Federal Reserve and other federal regulators, and the Troubled Asset Relief Program (TARP) approved by Congress in October 2008. The specter of financial firms that government officials had deemed "too big to fail" being rescued at taxpayer expense engendered profound public outrage. In the aftermath of the crisis, Congress passed and President Obama signed into law the Dodd-Frank Act, which its supporters contended would end the "too big to fail" phenomenon, and with it, the possibility of future taxpayer-funded bailouts.

The problems with a system in which government regulators deem certain financial institutions "too big to fail" are self-evident. First, "too big to fail" creates perverse incentives: if government officials and regulators in any way create the impression that some institutions are "systemically important," the inevitable conclusion that market participants will draw is that government will likely bail out its creditors in an emergency. That implicit guarantee allows the bank to borrow more cheaply than its smaller competitors. Second, the "too big to fail" doctrine makes the financial system even more fragile, which in turn makes bailouts more likely: the prospect of government bailouts makes creditors indifferent to the bets that financial institutions are making with the funds they borrow, which promotes moral hazard and further increases risk in the financial system.[60] Third, "too big to fail" violates the basic tenets of a free enterprise system. It interrupts the normal operation of markets and rewards the imprudent and reckless while punishing the prudent and productive; it undermines equal treatment and the Rule of Law by privatizing profits and socializing losses; and it undermines public faith in the economic system by failing to hold businesses and individuals accountable for the consequences of their actions.

But far from ending bailouts, the Dodd-Frank Act institutionalized them and made them a permanent feature of the regulatory toolkit, in the form of the "Orderly Liquidation Authority" set forth in Title II of the Act. The process outlined in Title II, where government officials, operating in almost total secrecy, decide which financial firms will "fail" and which of those firms' creditors will be protected from loss – and which will not – has been likened to a "Star Chamber."[61] By promoting expectations that government will come to the rescue of large financial institutions and insulate their creditors and counterparties from losses, the Dodd-Frank Act subverts market discipline and makes future bail-outs more (not less) likely.

Thus, under the Dodd-Frank regime, the largest financial institutions in America remain "too big to fail," and the size of their federally subsidized backstop has reached staggering proportions. The Federal Reserve Bank of Richmond maintains what it calls a "Bailout Barometer," which provides a running estimate of the share of financial system liabilities for which the federal government provides protection, either through explicit guarantees or through policies or past government actions that cause market participants to conclude that they will be insulated from losses.[62] The Richmond Fed estimates that the safety net covers over **$27 trillion** in private financial system liabilities, or almost **62 percent** of the total liabilities of the financial system, which is roughly equivalent to its size in 2009, just before Dodd-Frank was enacted.[63] One of the central planks of the Republican plan is scaling back the size and scope of that safety net, an objective that can be achieved by eliminating Dodd-Frank's emergency loan guarantee program and implementing the other reforms described in this section.

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[60] Jeffrey Lacker, the former President of the Richmond Federal Reserve, has described "too big to fail" as consisting of "two mutually reinforcing problems. First, creditors of some financial institutions feel protected by an implicit government commitment of support should the institution become financially troubled. Second, policymakers often feel compelled to provide support to certain financial institutions to insulate creditors from losses." Jeffrey M. Lacker, President, Federal Reserve Bank of Richmond, Ending 'Too Big to Fail' Is Going to be Hard Work, Address at the Global Society of Fellows Conference 1-2 (Apr. 9, 2013), *available at* https://www.richmondfed.org/press_room/speeches/president_jeff_lacker/2013/pdf/lacker_speech_20130409.pdf.

[61] *See e.g.* C. Boyden Gray, *Dodd-Frank, the real threat to the Constitution*, WASHINGTON POST, (Dec. 31, 2010), *available at* http://www.washingtonpost.com/wp-dyn/content/article/2010/12/30/AR2010123003482.html.

[62] *See* LIZ MARSHALL ET AL., FEDERAL RESERVE BANK OF RICHMOND, BAILOUT BAROMETER: 2014 ESTIMATE (Feb. 2016), *available at* https://www.richmondfed.org/-/media/richmondfedorg/publications/research/special_reports/safety_net/pdf/bailout_barometer_current_estimate.pdf (most recent estimate is from Dec. 31, 2015).

[63] *Id.* at 3. Making good on this guarantee would require every consumer, investor, and government in the U.S. to stop spending on what they want for more than a year, and instead spend their money on bailouts.

While America's biggest banks have, as a general matter, grown even bigger since the financial crisis, America's community financial institutions are under siege: we are losing, on average, one of them every day, as institutions exhausted by the endless regulatory onslaught from Washington either hand in their charters or agree to be acquired.[64] As Chairman Hensarling has observed, "There is something still fundamentally wrong in America when you have some institutions that are seen as too big to fail, and others [as] too small to matter."[65]

The Solution: A Six-Step Plan to End Bailouts

If we learned nothing else from the financial crisis, it is that federal subsidies of the financial sector promote moral hazard and expose taxpayers to an unacceptable risk of loss. So long as market participants perceive that regulators and politicians have the legal wherewithal to ride to their rescue in times of crisis, they will be tempted to engage in the kind of reckless behavior that makes the financial system more fragile than it otherwise would be, which in turn makes it more likely that regulators will not only face a financial crisis but will once again resort to extraordinary measures to avoid it. The solution to this problem is to make it clear to market participants in advance that they alone will bear the consequences of the risks they choose to undertake.

In order to end "too big to fail" and prevent future taxpayer bailouts of financial firms, the Financial CHOICE Act implements the following six policy changes:

1. Repealing Title II's "Orderly Liquidation Authority" (OLA)
2. Replacing OLA with a new chapter of the federal bankruptcy code designed to accommodate the failure of a large, complex financial institution;
3. Imposing new limitations on the Federal Reserve's emergency lending authority under Section 13(3) of the Federal Reserve Act;
4. Prohibiting the future use of the Exchange Stabilization Fund to bail out a financial firm or its creditors.
5. Repealing the FDIC's authority to establish a widely available program to guarantee obligations of banks during times of severe economic stress; and
6. Repealing the authority vested in the Financial Stability Oversight Council by Titles I and VIII of the Dodd-Frank Act to designate certain financial organizations as "too big to fail," and rescinding previous FSOC designations (see next chapter).

Repeal Title II's "Orderly Liquidation Authority"

Title II of the Dodd-Frank Act authorizes the FDIC to seize a firm whose imminent failure is viewed by the government as jeopardizing the U.S. financial system, and to wind it down in

[64] *See* Frank Sorrentino, *Is The Banking Industry's New Normal Hampering Economic Growth?* Opinion, FORBES, Sept. 11, 2015, *available at* http://www.forbes.com/sites/franksorrentino/2015/09/11/is-the-banking-industrys-new-normal-hampering-economic-growth/#5c61e1544210 (citing Frank Keating, CEO, American Bankers Association).
[65] Kerri Ann Panchuk, *Hensarling in the House: Rep. Jeb Hensarling pushes housing reform center stage*, HOUSING WIRE, (Sept. 4, 2013), *available at* http://financialservices.house.gov/blog/?postid=348076.

an “orderly” fashion. The Dodd-Frank Act’s drafters intended for the “Orderly Liquidation Authority” to “provide the necessary authority to liquidate failing financial companies that pose a significant risk to the financial stability of the United States in a manner that mitigates . . . [that] risk and minimizes moral hazard.”[66] The Treasury Secretary must subject a financial company to resolution under Title II after receiving a written recommendation from the FDIC and Federal Reserve and determining, in consultation with the president, that: (1) the financial company is in default or in danger of default; (2) the failure of the company and its resolution under otherwise applicable insolvency law would have serious adverse effects on the financial stability in the United States; (3) no viable private sector alternative is available to prevent the default of the company; (4) any effect of a receivership on creditors, counterparties, and shareholders would be “appropriate” given the benefits of a receivership in terms of preserving financial stability; (5) establishing a receivership would avoid or mitigate the adverse effects on stakeholders relative to not undertaking such action; (6) a federal regulatory agency has ordered the financial company to convert all of its convertible debt instruments that are subject to the regulatory order; and (7) the company is a “financial company” as defined in the Dodd-Frank Act.[67]

A resolution under Title II is funded through the “Orderly Liquidation Fund,” which is capitalized using the proceeds of obligations issued by the FDIC and purchased by the Treasury Secretary.[68] Thus, the “Orderly Liquidation Fund” can be tapped to make taxpayer-funded loans to the firm being resolved or its “covered subsidiaries,” acquire debt, purchase assets or guarantee them against loss, assume or guarantee obligations, and make payments, including payments to creditors and counterparties of the failed firm.[69] If these authorities sound familiar, it is because they are the exact same tools that the government deployed during the financial crisis to carry out multiple rescues of large financial firms, including the $43 billion in payments to the creditors and counterparties of the failed insurance company AIG, many of which were large European banks. Dodd-Frank is thus a recipe for more bailouts, as former Richmond Federal Reserve Bank President Jeffrey Lacker explained in a speech last year:

> The authors of the [Dodd-Frank] Act envisioned the [Orderly Liquidation Authority, or] OLA as a way to put an end to taxpayer-funded bailouts. However, the FDIC’s announced plans for implementation will likely encourage many creditors to expect they will benefit from the FDIC’s discretion, dampening their incentive to contain risk. If expectations of support for the creditors of financially distressed institutions are widespread, regulators will likely feel forced to provide support to these short-term creditors to avoid the turbulence of disappointing expectations.

[66] Dodd-Frank Act § 204(a).
[67] *Id*. § 203(b)(1)-(7). For broker-dealers, the SEC rather than the FDIC must vote to recommend that the Treasury Secretary subject the firm to resolution. *Id*. § 203(a)(1)(B). For insurance companies, the Director of the Treasury Department’s Federal Insurance Office, in consultation with the FDIC, must make the required recommendation. *Id*. § 203(a)(1)(C).
[68] *Id*. at § 210(n).
[69] *Id*. at § 204(d).

> Rather than ending "too big to fail," the OLA replicates the dynamic that created it.[70]

The "Orderly Liquidation Fund" can also be used to provide operating funds to a bridge financial company established by the FDIC as well as to facilitate the winding-up of the bridge entity through its merger or consolidation with another entity, the sale of its capital stock, the assumption of its liabilities or the acquisition of assets, or its termination or dissolution as provided for under the Act.[71] The FDIC must develop and secure approval of an "orderly liquidation plan" and a "mandatory repayment plan" before deploying the "Orderly Liquidation Fund" in connection with the resolution of a company.[72] If the company cannot repay the funds, the FDIC must assess creditors and large financial institutions, including financial institutions that may not have transacted any business with the failed firm.[73] Additionally, the FDIC may claw back incentive payments and other compensation made to executives that contributed to the firm's failure.[74]

Taxpayer Exposure under "Orderly Liquidation Authority"

Proponents of the "Orderly Liquidation Authority" cite the provisions described above as offering taxpayers assurances that they will never again be called upon to bail out the financial system.[75] But taxpayers have received such promises from their government before, only to find themselves holding the bag for billions of dollars in losses when disaster, whether natural or man-made, strikes. Put simply, the government's track record in managing risk and administering "insurance" programs that are required to be self-sustaining does not inspire confidence that taxpayers will always be made whole when a financial catastrophe hits and the FDIC is forced to borrow from the Treasury to staunch the bleeding. The National Flood Insurance Program owes taxpayers $24.6 billion, with no

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[70] Jeffrey M. Lacker, President, Federal Reserve Bank of Richmond, From Country Banks to SIFIs: The 100-year Quest for Financial Stability, Address at the Louisiana State University Graduate School of Banking, (May 26, 2015), available at https://www.richmondfed.org/press_room/speeches/president_jeff_lacker/2015/lacker_speech_20150526.

[71] Dodd-Frank Act § 210(h)(2)(G)(iv), (h)(9).

[72] *Id*. § 210(n)(9).

[73] *Id*. § 210(o). If assessments on claimants receiving more than the liquidation value of their claims are insufficient to repay the obligations issued by the FDIC to the Treasury Secretary, bank holding companies with greater than $50 billion in assets, and non-bank financial institutions that have been designated for "heightened prudential supervision" by the FSOC, are subject to assessments. *See id*.

[74] *Id*. § 210(s).

[75] They also cite the so-called "Boxer amendment," which provides that "no taxpayer funds shall be used to prevent the liquidation of any financial company under this title," and that "taxpayers shall bear no losses from the exercise of any authority under this title." While the Boxer Amendment may be a commendable statement of solicitude on behalf of taxpayers, the Boxer Amendment is, at best, an expression of hope that taxpayers will be made whole AFTER they have paid to bail out the creditors of large financial institutions and been exposed to the risk that they will not be repaid. Because Title II asks taxpayers to front the costs of bailing out creditors, the Boxer Amendment cannot guarantee that taxpayers will not bear some or all of the losses in connection with resolving a failed firm. The only way to effectuate the promise that the Boxer Amendment makes to taxpayers is through bankruptcy, where creditors are paid off only to the extent that the assets of the failed company permit and no taxpayer funds are available.

reasonable prospect of repayment.[76] The Pension Benefit Guaranty Corporation is running a total asset deficit of over $79 billion.[77] And the Federal Housing Administration in 2013 received an infusion of funds from the Treasury despite repeated assurances from the Obama Administration that the agency was in no danger of needing a government bailout.

Fueling the concerns about taxpayer exposure under Title II of the Dodd-Frank Act is the sheer magnitude of the amounts that the FDIC is authorized to borrow from the Treasury to carry out an "orderly liquidation." As detailed above, Title II gives the FDIC the power to lend to a failing firm; purchase its assets; guarantee its obligations; and—most importantly—pay off its creditors. To carry out these responsibilities, the FDIC can borrow up to 10 percent of the book value of the failed firm's total consolidated assets in the 30 days immediately following its appointment as receiver.[78] After those 30 days, the FDIC can borrow up to 90 percent of the fair value of the failed firm's total consolidated assets.[79]

Because the next bailout has not happened—yet—it is impossible to say just how much it will cost the American taxpayer. But just how large the exposure might be is apparent from a review of the asset sizes of the largest financial firms, which in turn demonstrates just how much the FDIC can borrow from the Treasury under Title II to resolve these firms:

Institution	**Total Assets**
JPMorgan Chase & Co.	$2.490 trillion
Bank of America Corporation	$2.189trillion
Wells Fargo & Company	$1.930 trillion
Citigroup Inc.	$1.792 trillion
Goldman Sachs Group, Inc.	$860 billion
Morgan Stanley	$815 billion[80]

Thus, to "resolve" the six largest U.S. banking organizations, the FDIC could borrow potentially over $10 trillion (depending on the fair market value of the failed firms' total consolidated assets 30 days after the FDIC has been appointed as receiver).

But even if the "Orderly Liquidation Fund" proves equal to the task of resolving a multi-trillion dollar financial institution, taxpayers are still not entirely off the hook. The healthy firms that are assessed to pay for the resolution of a failed competitor will pass the cost of

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[76] *See Flood Insurance Reform: FEMA's Perspective: Hearing Before the Subcomm. On Housing and Insurance of the H. Comm on Financial Services*, 115th Cong. (2017); *see also Opportunities and Challenges Facing the National Flood Insurance Program: Hearing Before the Subcomm. on Housing and Insurance of the H. Comm. on Financial Services*, 114th Cong. (2015) (statement of Steve Ellis, Vice President, Taxpayers for Common Sense), *available at* http://financialservices.house.gov/uploadedfiles/hhrg-114-ba04-wstate-sellis-20160112.pdf.

[77] Information current through latest GAO Report, covering FY 2016. *See* GAO, GAO-17-317, HIGH-RISK SERIES: PROGRESS ON MANY HIGH-RISK AREAS, WHILE SUBSTANTIAL EFFORTS NEEDED ON OTHERS (2017), *available at* http://www.gao.gov/assets/690/682765.pdf

[78] Dodd-Frank Act § 210(n)(6).

[79] *Id.*

[80] Holding Companies with Assets Greater Than $10 Billion, Nat'l Information Center, NATIONAL INFORMATION CENTER, FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL, https://www.ffiec.gov/nicpubweb/nicweb/HCSGreaterThan10B.aspx

those assessments on to their customers in the form of higher fees on financial products and services.[81] For this reason, Stanford University Professor John Taylor testified to the Committee that Dodd-Frank's assessment scheme "is, by definition, to me a bailout. It really doesn't matter whether the funds come directly from the taxpayers or they come indirectly from the taxpayers through an assessment of financial institutions and higher prices to consumers of financial institutions."[82]

Several commentators have noted both the unfairness and moral hazard engendered by a system in which firms that operated prudently are "taxed" to pay the cost of resolving firms whose imprudence and poor risk management prompted their failure.[83] Professors at the New York University Stern School of Business have argued that the Title II assessment regime will encourage greater risk-taking among *all* financial firms:

> [T]he *ex post* fund assessments would essentially require that prudent financial companies pay for the sins of the others. This would be bad enough . . . . But it gets worse. The Act's plan for successful financial institutions to pay the creditors of failed institutions leads to a free rider problem. This will encourage even well-managed banks to take excessive risk. The 'heads I win, tails you lose' proposition just gets passed around in the financial sector, creating an even more risky and fragile financial system, making a crisis more likely in the first instance.[84]

Witnesses who have testified before the Financial Services Committee identified another source of taxpayer exposure from the operation of Title II: the fact that firms undergoing "orderly liquidation" are not required to pay taxes on their franchise, property or income, giving them a competitive advantage and depriving the Treasury of tax revenue.[85] As Richard Fisher, former President of the Dallas Federal Reserve Bank, put it, "During the five-year resolution period, incidentally, this nationalized institution does not have to pay taxes of any kind to any government entity, and to us this looks, sounds, and tastes like a taxpayer bailout just hidden behind the opaque and very difficult language of . . . Title II."[86]

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[81] *See Who is Too Big to Fail: Does Title II of the Dodd-Frank Act Enshrine Taxpayer-Funded Bailouts?: Hearing Before the Subcomm. on Oversight and Investigations of the H. Comm. on Financial Services*, 113th Cong. 9, 17 (2013) (statement of John Taylor, Mary and Robert Raymond Professor of Economics, Stanford University).
[82] *Id*. at 9 (statement of John Taylor, Mary and Robert Raymond Professor of Economics, Stanford University).
[83] *Id*. at 29-30 (statement of David Skeel, Mary and Robert Raymond Professor of Economics, Stanford University) ("[E]ven if some of [the costs of resolution] were ultimately recovered from the industry down the road after 5 years or whatever, that is a tax of sorts . . . Effectively what we are doing is taxing a particular industry to support the resolution of the failed institution.").
[84] Viral V. Acharya et al., *Resolution Authority*, *in* REGULATING WALL STREET: THE DODD-FRANK ACT AND THE NEW ARCHITECTURE OF GLOBAL FINANCE 213, 228 (Viral V. Acharya et al. eds., 2011).
[85] *See Who is Too Big to Fail: Does Title II of the Dodd-Frank Act Enshrine Taxpayer-Funded Bailouts?: Hearing Before the Subcomm. on Oversight and Investigations of the H. Comm. on Financial Services*, 113th Cong. 7 (2013) (statement of David Skeel, Mary and Robert Raymond Professor of Economics, Stanford University); *id.* at 20 (statement of Joshua Rosner, Managing Director, Graham Fisher & Co.) (noting that the effects of lower-interest-rate borrowing and the tax exemption "would ultimately just reinforce the oligopolistic market power of that institution and the small group of institutions that are similar").
[86] *Examining How the Dodd-Frank Act Could Result in More Taxpayer-Funded Bailouts: Hearing Before the H. Comm. on Financial Services*, 113th Cong. 12 (2013) (statement of Richard Fisher). In his testimony, President

Is the FDIC up to the Job of Resolving a Large, Complex Financial Institution?

As noted above, Title II of the Dodd-Frank Act is patterned after the FDIC's long-standing authorities under the Federal Deposit Insurance Act to resolve failed depository institutions. Those who supported granting the FDIC "resolution authority" did so because they claimed that given the FDIC's knowledge and experience in resolving small banks, the FDIC could use that expertise to seamlessly resolve large, complex financial institutions. Yet the types of institutions that the FDIC is typically able to seize and reopen over the course of a weekend bear little resemblance to the trillion-dollar financial institutions with thousands of operating units around the globe that it would be called upon to resolve under the Dodd-Frank Act.[87] Witnesses at Committee hearings have also noted that the "Orderly Liquidation Authority" would most likely be invoked during a period when more than one large financial institution was under stress, and questioned the FDIC's ability to handle multiple simultaneous failures.[88]

Other critics of Title II have questioned the wisdom of entrusting the same regulators that allowed a firm to reach the point of failure with the complex task of resolving it, when an alternative venue is available in the federal bankruptcy system:

> Once a financial firm has become in need of resolution, there has already been a failure of regulation. Why the same regulators should be in charge of cleaning up the mess is something that continues to puzzle me. Certainly they deserve a say, and the special nature of financial institutions will often call for special solutions, but count me among those who remain unconvinced by the very "in-house" solution adopted by Dodd-Frank.[89]

Fisher also noted that the healthy firms subject to assessment by the FDIC to recapitalize the OLF after a failure could deduct the assessment as a business expense, further reducing revenue to the Treasury. *Id.* at 20-21.President Fisher also noted that the healthy firms subject to assessment by the FDIC to recapitalize the OLF after a failure could deduct the assessment as a business expense, further reducing revenue to the Treasury. *Id.* at 20-21.

[87] *See Who is Too Big to Fail: Does Title II of the Dodd-Frank Act Enshrine Taxpayer-Funded Bailouts?: Hearing Before the Subcomm. on Oversight and Investigations of the H. Comm. on Financial Services*, 113th Cong. 23 (2013) (statement of David Skeel) ("We have been talking about what the FDIC does with its bank resolutions, what it has done for a long time. It is very important to keep in mind the normal FDIC bank resolution looks nothing like the institutions we are talking about . . . . The small mom-and-pop institution, all of its liabilities are deposits. This is a completely different creature and this is uncharted territory."); *see also* Peter J. Wallison & David Skeel, *The Dodd Bill: Bailouts Forever*, WALL STREET JOURNAL, (updated Apr. 7, 2010), *available at* http://online.wsj.com/news/articles/SB10001424052702303493904575167571831270694 ("[I]t is wrong to think that because the FDIC can handle the closure of small banks it is equipped to take over and close a giant, nonbank financial firm like a Lehman Brothers or an AIG.").

[88] *See Who is Too Big to Fail: Does Title II of the Dodd-Frank Act Enshrine Taxpayer-Funded Bailouts?: Hearing Before the Subcomm. on Oversight and Investigations of the H. Comm. on Financial Services*, 113th Cong. 23 (2013) (statement of Joshua Rosner, Managing Director, Graham Fisher & Co.) (questioning the FDIC's ability to handle the simultaneous failure of several large institutions).

[89] Stephen J. Lubben, *The FDIC's Lehman Fantasy*, NEW YORK TIMES, DEALBOOK, *(*Apr. 29, 2011), *available at* http://dealbook.nytimes.com/2011/04/29/the-f-d-i-c-s-lehman-fantasy/?_php=true&_type=blogs&_r=0.

The FDIC's Authority under the Dodd-Frank Act to Treat "Similarly Situated" Creditors Differently is Susceptible to Misuse

Title II authorizes the FDIC to treat similarly situated creditors differently to maximize the value of the company's assets, minimize the amount of its losses, or to maintain essential operations of the company in receivership.[90] The FDIC has insisted that this authority will be used sparingly, and has, by regulation, promised not to use its discretion in a manner that would result in preferential treatment of holders of long-term senior debt, subordinated debt, or equity holders.[91] Yet witnesses have testified before the Committee that the FDIC's authority to treat similarly situated creditors differently places far too much discretion in the hands of the government to pick winners and losers in an "Orderly Liquidation" proceeding:

> I think that problem is probably the biggest issue to contend with, the ability to hand the FDIC the authority to treat similarly situated creditors differently at their whim under the guise of protecting the ability of potential counterparties to continue to serve in supporting essential functions of the institution. And so, they do have far too much discretion. It is absolute discretion[.][92]

At least one senior Democratic Member of the Financial Services Committee seems to share this concern.[93]

Create a New Section of the Bankruptcy Code for Large Financial Institutions

From the very outset of the financial reform debate in 2009, House Republicans have consistently called for large, complex financial institutions to be resolved under the Bankruptcy Code rather than through an open-ended taxpayer-funded bailout authority administered by the FDIC. While the Financial Services Committee has no jurisdiction to legislate on bankruptcy issues, the Judiciary Committee advanced legislation (H.R. 2947) through the House during the 114th Congress that creates a new subchapter of the Bankruptcy Code tailored to address the failure of a large, complex financial institution. The provisions of that bill, which passed the House by voice vote, are incorporated in the Financial CHOICE Act.

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[90] Dodd-Frank Act § 210(b)(4). This is conditioned on similarly situated creditors "receiv[ing] not less than" an amount equal to the FDIC's maximum liability to creditors of the company for which it is acting as receiver. *See id*. § 210(b)(4)(B), (d)(2), (d)(3).
[91] 12 C.F.R. § 380.27 (2016).
[92] *See Who is Too Big to Fail: Does Title II of the Dodd-Frank Act Enshrine Taxpayer-Funded Bailouts?: Hearing Before the Subcomm. on Oversight and Investigations of the H. Comm. on Financial Services*, 113th Cong. 20 (2013) (statement of Joshua Rosner, Managing Director, Graham Fisher & Co.); *see also id.* at 14-15 (statement of John Taylor) ("[I]f the bailout of certain creditors occurs at the expense of other creditors, that is also a problem because it is going against the direction of the rule of law which we have in the country.").
[93] *Id*. at 21 (statement of Rep. Brad Sherman) (asking a witness to explain why "Title II provides for an almost crony capitalism as to which creditors get paid and which don't" and further noting that "I am familiar with regular bankruptcy; you are either a secured creditor or you are an unsecured creditor. All of the unsecured creditors are equal. Apparently in this world, some animals are more equal than others").

The Republican preference for bankruptcy over bailouts is grounded in three fundamental principles:

First, the bankruptcy process is administered through the judicial system, by impartial bankruptcy judges charged by the Constitution to guarantee due process in public proceedings under well-settled rules and procedures. It is a process that is faithful to this country's belief in the Rule of Law. By contrast, the Dodd-Frank's "Orderly Liquidation Authority" places vast amounts of discretion in a handful of unelected bureaucrats to seize an institution and wind it down, paying off some creditors in full and imposing losses on others, in a process that takes place behind closed doors and that effectively cannot be challenged by the institution, its creditors, or the public.

Second, the bankruptcy process provides a certainty that the "Orderly Liquidation Authority" lacks. Management, shareholders, creditors, and—most importantly—market participants understand how the firm will be treated in bankruptcy, based upon centuries of well-settled legal precedents. Under the "Orderly Liquidation Authority," the best that anyone can do is to surmise what the FDIC *might* do. And while the FDIC has sought to provide certainty about how it might resolve a firm under Title II by issuing its "Single Point of Entry" proposal, the FDIC has been clear that the "Single Point of Entry" is a strategy that it might—or might not—follow. That lack of certainty re-creates the dangerous *ad hoc* rescue policies that were in place in the fall of 2008, and which precipitated the financial crisis. Bankruptcy provides certainty, and with it financial stability. Title II preserves the regulators' unfettered discretion, and with it, the same dangerous uncertainty that roiled financial markets and brought them down in 2008.

Indeed, the decision whether to invoke the "Orderly Liquidation Authority" in the first place – as opposed to placing a large firm in bankruptcy – is entirely within the discretion of the regulators, subject to very limited judicial review, which is itself a huge source of uncertainty. As former Comptroller of the Currency John Dugan put it, "It's hard to tell people exactly what's going to happen because we're saying, 'Well, it might be bankruptcy and it might not.'"[94] In the words of noted financial analyst Josh Rosner in testimony before the Financial Services Committee, "[i]t is very problematic if the same institution has the possibility of going through two different insolvency regimes, depending on the whim of regulators."[95]

Third, and most importantly, bankruptcy does not depend on taxpayer-provided funds to bail out, liquidate, or reorganize a failing institution. Rather than learning from the mistakes that the government made in using government funds to bail out Bear Stearns,

[94] Jesse Hamilton & Craig Torres, *Biggest Banks' Wind-Down Plans Seen Failing to Cut Risks*, BLOOMBERG, (Jun. 26, 2013) (quoting John Dugan), *available at* http://www.bloomberg.com/news/2013-06-26/biggest-banks-wind-down-plans-seen-failing-to-cut-risks.html.

[95] *See Who is Too Big to Fail: Does Title II of the Dodd-Frank Act Enshrine Taxpayer-Funded Bailouts?: Hearing Before the Subcomm. on Oversight and Investigations of the H. Comm. on Financial Services*, 113th Cong. 10 (2013) (statement of Joshua Rosner).

AIG, and host of other large financial institutions, the "Orderly Liquidation Authority" embraces that strategy and explicitly makes the taxpayer the source of funding to pay for the reorganization of a large financial institution by way of the "Orderly Liquidation Fund," a facility that exists not to "liquidate" an insolvent institution, but to reorganize it by paying off its creditors and counterparties, just as the Federal Reserve did when it bailed out AIG.

By contrast, the bankruptcy code does not provide government officials with a taxpayer-backed pot of money to wind down or reorganize a failing institution. Under the bankruptcy code, those funds come not from the government or the taxpayer but from the private sector. As a result, bankruptcy forces losses upon the creditors of "systemically important financial institutions," or SIFIs, rather than taxpayers. By committing government to bankruptcy as the method of resolving insolvent firms — rather than bailing out creditors of these firms — implicit government guarantees are ended, counter-party discipline is strengthened, and more vigilant due diligence is encouraged before a large firm becomes insolvent and bankruptcy is initiated.

Because government commits to bankruptcy rather than bailout before a large firm becomes insolvent, creditors will become more careful about extending credit to large firms, knowing that they will bear the costs of failure and therefore limiting their exposure to these firms. Moreover, large firms will likely become smaller, because the credit they obtain is now priced according to their risk of failure, rather than the implicit government guarantee backing a firm that is "too big to fail." As a result, failure — when it does happen — will be more easily contained and less destabilizing.

Apologists for Dodd-Frank's "Orderly Liquidation Authority" cite the Lehman Brothers bankruptcy as evidence that relying upon bankruptcy to resolve a large, complex financial institution is a recipe for financial chaos. But these commentators misunderstand cause and effect. Lehman's failure didn't cause the financial crisis – the government's "too big to fail" policy did. The government's ad hoc, improvised response to Lehman's failure and that of other large financial firms in 2008 caused the very panic that government officials and regulators were trying to prevent. As Stanford University economist John Taylor has explained:

> The realization by the public that the government's intervention plan had not been fully thought through, and the official story that the economy was tanking, likely led to the panic seen in the next few weeks. And this was likely amplified by the ad hoc decisions to support some financial institutions and not others and unclear, seemingly fear-based explanations of programs to address the crisis. What was the rationale for intervening with Bear Stearns, then not with Lehman, and then again with AIG? What would guide the operations of the TARP?[96]

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[96] John Taylor, "How Government Created the Financial Crisis-Research Shows the Failure to Rescue Lehman Did Not Trigger the Fall Panic, WALL STREET JOURNAL, February 9, 2009, *available at:* http://online.wsj.com/news/articles/SB123414310280561945.

In short, it wasn't letting Lehman fail that triggered the crisis. It was the massive market uncertainty created by a government "policy" – if it can even be called that – that declared an end to bailouts one day and then executed the largest bailout of a single financial institution in history (AIG) on the very next day. The crisis was brought about by the government's misguided efforts to save financial firms using taxpayer dollars—the exact same strategy that Dodd-Frank's "Orderly Liquidation Authority" codifies. Rather than stemming panics and avoiding financial crises, Title II of the Dodd-Frank Act continues the same ad hoc interventionist policies in which government officials are granted the discretion to decide which firms are "too big to fail" and which firms are not, which will result in the same sorts of panic that we saw in the fall of 2008.

By substituting bankruptcy for bailouts, the Financial CHOICE Act effectuates a reform of the financial system that begins – once and for all – to end the problem of "too big to fail." Martin Wolf, the economics editor of the *Financial Times*, explains why:

> Suppose there were no lenders of last resort, no government deposit insurance, no government regulation of financial intermediaries, and no government bailouts. Would the financial world be more or less dangerous than it is? The answer to this question is not at all obvious. . . . [I]t is far from clear that government intervention makes things any better. What is certain is that without any prospect of intervention, financial systems would look quite different: banks would be far better capitalized; maturity mismatches would be reduced, with greater reliance on securities or on long term and more illiquid deposits in banks; and deposits would be better matched by highly liquid securities. Given the frequency of banking crises, this might be a big improvement.[97]

The Financial CHOICE Act is premised upon a belief that only by credibly committing to a "no more bailouts" policy can the government lay the foundation for a resilient, stable financial system that promotes economic growth and opportunity.

Conform the Federal Reserve's 13(3) Authority to Bagehot's Dictum

During the financial crisis, the Federal Reserve resorted several times to its emergency lending authority under Section 13(3) of the Federal Reserve Act, which allows it to make emergency loans to "any individual, partnership, or corporation" under "unusual and exigent circumstances," provided the borrower "is unable to secure adequate credit accommodations from other banking institutions."[98] The Federal Reserve used this authority to bail out creditors of the investment bank Bear Stearns and insurance giant AIG in the midst of the financial crisis, and to establish a series of lending programs to support credit markets, such as the Term Securities Lending Facility, the Primary Dealer Credit Facility, the Commercial Paper Funding Facility, and the Money Market Investor Funding

[97] MARTIN WOLF, FIXING GLOBAL FINANCE 20 (2008).
[98] Federal Reserve Act § 13(3), 12 U.S.C. § 343 (2012); *id.* § 13(13), 12 U.S.C. § 347c.

Facility.[99] These programs represented an unprecedented growth in the Federal Reserve's balance sheet, and expanded the Federal Reserve's safety net far beyond the deposit-taking institutions that had been the traditional beneficiaries of that safety net to encompass non-bank institutions, such as investment banks and broker-dealers like Goldman Sachs and Merrill Lynch, and industrial companies like General Motors and General Electric.

The Fed's aggressive use of an emergency lending authority that very few Americans knew it possessed before the financial crisis began has prompted calls for that authority to be scaled back, or even eliminated. Former Philadelphia Federal Reserve Bank President Charles Plosser has said that the Federal Reserve's authority under Section 13(3) should be limited, noting that "the central bank should set boundaries and guidelines for its lending policy that it can credibly commit to follow. If the set of institutions having regular access to the Federal Reserve's credit facilities is expanded too far, it will create moral hazard and distort the market mechanism for allocating credit. This can end up undermining the very financial stability that it is supposed to promote."[100]

Richmond Federal Reserve President Jeffrey Lacker has gone a step further, suggesting in a 2015 speech that because Section 13(3) is antithetical to the goal of financial stability, it may be necessary to repeal it:

> A final step may be required before financial stability can be assured. Market participants must have well-anchored expectations that government-funded rescues will not be forthcoming. Ideally, policymakers would act in a manner that is consistent with those expectations. But in turbulent times, as we've seen, it may be tempting to act otherwise. This is a particular danger for central banks, whose independent balance sheets place their fiscal actions beyond the scope of the legislative appropriations process. Credible commitment to orderly unassisted resolutions thus may require eliminating the government's ability to provide ad hoc rescues. This would mean repealing the Federal Reserve's remaining emergency lending powers and further restraining the Fed's ability to lend to failing institutions.[101]

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[99] *See* John Weinberg, Federal Reserve Bank of Richmond, *Support for Specific Institutions: 2007-2008*, FEDERAL RESERVE HISTORY, http://www.federalreservehistory.org/Events/DetailView/56

[100] Charles I. Plosser, President, Federal Reserve Bank of Philadelphia, A Limited Central Bank, Address at the Cato Institute's 31st Annual Monetary Conference: Was the Fed a Good Idea? 11 (Nov. 14, 2013), *available at* https://www.phil.frb.org/publications/speeches/plosser/2013/11-13-13_cato-institute

[101] Jeffrey M. Lacker, President, Federal Reserve Bank of Richmond, From Country Banks to SIFIs: The 100-year Quest for Financial Stability, Address at the Louisiana State University Graduate School of Banking 6 (May 26, 2015), *available at* https://www.richmondfed.org/press_room/speeches/president_jeff_lacker/2015/lacker_speech_20150526. Mark Calabria of the Cato Institute has also argued for the elimination of the Fed's 13(3) authority. *See* Mark Calabria, *An End to Bailouts*, NATIONAL REVIEW, Jan. 28, 2013, *available at* https://www.nationalreview.com/nrd/articles/337357/end-bailouts ("The days of the Fed's picking winners and losers in our financial system should end. That will happen only with the elimination of the Fed's '13.3' powers. . . . .").

In deference to concerns about the Federal Reserve's expansive interpretation of its 13(3) emergency lending authority during the financial crisis, the Dodd-Frank Act purports to cabin that authority, but there is general consensus that the constraints imposed by the Act are illusory. Title XI of the Dodd-Frank Act requires that emergency lending programs established under Section 13(3) must have "broad-based eligibility," must be designed to provide "liquidity to the financial system" rather than to "aid a failing financial company," must be "designed to ensure . . . the security for emergency loans is sufficient to protect taxpayers from losses and that any such program is terminated in a timely and orderly fashion," and may not be made available to insolvent borrowers.[102]

While proponents of the Dodd-Frank Act claim that it limited the Federal Reserve's 13(3) emergency lending authority, others have pointed out that the changes in Dodd-Frank are largely cosmetic, and that they will not prevent the Federal Reserve from carrying out the same kinds of bailouts it did during the financial crisis.[103] The reason that the "broad-based eligibility" requirement does not end the Federal Reserve's ability to bail out individual institutions is readily apparent: the Federal Reserve could easily design a program that meets the "broad-based eligibility" requirement with a particular institution in mind.

The Dodd-Frank Act required the Federal Reserve, in consultation with the Treasury Department, to promulgate regulations implementing the new restrictions on its 13(3) authority.[104] The Fed issued those regulations in December 2015, and they became effective on January 1, 2016.[105] Unfortunately, the regulations largely avoid setting effective limitations on the Federal Reserve's emergency lending authority, and seem designed to leave the Fed maximum discretion to carry out the same kinds of bail-outs of large financial institutions that characterized its crisis response in 2008 and 2009.[106]

The Financial CHOICE Act incorporates a number of reforms to 13(3) that would significantly reduce the potential use of Section 13(3) as a bailout tool. The legislation would allow the Federal Reserve to invoke its emergency lending powers only upon a finding that "unusual and exigent circumstances exist that pose a threat to the financial stability of the United States." This amendment raises the bar from the current trigger, which permits the Fed to utilize 13(3) in "unusual and exigent circumstances," defined however the Fed sees fit. The bill also mandates that in addition to the current requirement that five of seven Fed Board Governors approve of a 13(3) facility, nine of the

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[102] Dodd-Frank Act § 1101(a).
[103] *See, e.g.*, *Examining How the Dodd-Frank Act Could Result in More Taxpayer-Funded Bailouts: Hearing Before the H. Comm. on Financial Services*, 113th Cong. 18 (2013) (statement of Jeffrey Lacker, President and Chief Executive Officer, Federal Reserve Bank of Richmond) (arguing that Section 13(3) limits are unclear, and may permit the Federal Reserve to lend to individual companies just as it did during the crisis).
[104] *See* Dodd-Frank Act § 1101(a)(6).
[105] *See* Extensions of Credit by Federal Reserve Banks, 80 Fed. Reg. 78,959 (Dec. 18, 2015) (codified at 12 C.F.R. § 20 (2016)).
[106] *See* John Carney, *How the Fed Protected Its Bailout Powers*, WALL STREET JOURNAL, (Dec. 1, 2015), *available at* http://www.wsj.com/articles/how-the-fed-protected-its-bailout-powers-1448916675 ("The Federal Reserve managed to thread the needle on its emergency lending powers, acknowledging legally mandated limits while preserving flexibility. The upshot: Banks will likely be able to rely on the Fed to provide relief in a crisis.").

twelve District Fed Bank Presidents must also approve – increasing the confidence *and* competence with which a lack of liquidity can be distinguished from a lack of solvency in times of panic. It limits eligible recipients of 13(3) assistance to financial institutions, defined as those entities that derive 85 percent or more of their annual gross revenues from activities that are "financial in nature."

The Financial CHOICE Act also restricts the use of 13(3) to those instances that meet the specific criteria of Bagehot's Dictum, named after the noted British financial journalist Walter Bagehot, which stipulates that a central bank should lend freely in a financial crisis, but only to solvent borrowers, against good collateral, and at penalty rates. The legislation codifies Bagehot's dictum through the following provisions:

> *Adequate collateral.* Directs the Federal Reserve to adopt a rule, within six months of the date of enactment, specifying the method it will use to determine the sufficiency of collateral pledged to secure 13(3) lending, including which classes of collateral it will accept, as well as a "method for obtaining independent appraisals of the collateral [the Fed] receives." In no event may the Federal Reserve accept equity securities issued by the recipient of 13(3) assistance as collateral.
>
> *Solvent borrower.* Requires that for any entity regulated by the OCC, SEC, CFTC, or FDIC, that regulator must certify in writing to the Federal Reserve that the entity is not insolvent before it can be eligible for assistance under Section 13(3).
>
> *At penalty rates.* Directs the Federal Reserve to adopt a rule, within six months of the date of enactment, establishing a minimum interest rate on the principal amount of any loan or financial assistance extended pursuant to Section 13(3). The applicable minimum interest rate shall be calculated as a trailing 90-day average of the Federal Reserve's discount rate plus a 90-day trailing average of the spread between a distressed corporate bond yield index specified by this rule and a bond yield index of debt issued by the United States specified by this rule.

Repeal Other Statutory Bail Out Mechanisms

In addition to repealing Dodd-Frank's "Orderly Liquidation Authority" and placing further constraints on the Federal Reserve's emergency lending powers, the Financial CHOICE Act bars future use of the Exchange Stabilization Fund to bail out financial institutions or their creditors, and repeals provisions of Dodd-Frank authorizing the FDIC and the Federal Reserve to guarantee bank debt during times of severe economic stress.

Exchange Stabilization Fund

In the fall of 2008, after a large money-market mutual fund "broke the buck," the Treasury Department tapped the Exchange Stabilization Fund — established in 1934 to buy and sell foreign currency to stabilize the value of the dollar relative to other currencies — to protect investors in money-market mutual funds.[107] Former Federal Reserve Vice Chairman and current Princeton University Professor Alan Blinder points out that "using the Exchange Stabilization Fund for this purpose was quite a stretch. . . . [W]ithout even a pretext of dealing in foreign exchange, the Treasury was going to use the [Exchange Stabilization Fund] to insure money funds."[108] Although Congress passed legislation in 2008 barring the Treasury Department from using the Exchange Stabilization Fund to guarantee money market mutual funds,[109] there is nothing to prevent a future Treasury Department from making creative use of the Fund to conduct other types of market interventions during a financial crisis. The Financial CHOICE Act explicitly shuts off this potential spigot for future bail-outs.

FDIC Debt Guarantees

Prior to the enactment of the Dodd-Frank Act, Section 13(c)(4)(G) of the Federal Deposit Insurance Act permitted the FDIC (with the concurrence of the Federal Reserve Board and the Treasury Secretary) to take certain extraordinary action that it would otherwise not be authorized to take (such as indemnifying uninsured creditors of an insured depository institution) if two-thirds of the members of the FDIC's Board of Directors and the Federal Reserve Board made a recommendation and the Secretary of the Treasury determined that without taking such action there would be serious adverse effects on economic conditions or financial stability. During the 2008 financial crisis, the FDIC, Federal Reserve Board, and Treasury Department relied on this authority to establish the Temporary Liquidity Guarantee Program pursuant to which the FDIC guaranteed in full all domestic noninterest bearing transaction deposits and certain debt instruments issued by certain banking organizations.

Section 1105 of the Dodd-Frank Act sought to limit this authority by authorizing the FDIC to create a widely available program to guarantee obligations of <u>solvent</u> depository institutions, bank and thrift holding companies, and their affiliates during periods of severe economic stress.[110] Such a program can only be initiated if two-thirds of the members of the FDIC Board of Directors and the Federal Reserve Board of Governors find that there has been (1) an exceptional and broad reduction in the general ability of financial market participants either to sell financial assets without an unusual and significant discount or

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[107] *See e.g.* Press Release, Treasury, Treasury Announces Guaranty Program for Money Market Funds (Sept. 9, 2008), *available at* https://www.treasury.gov/press-center/press-releases/Pages/hp1147.aspx.

[108] Alan Blinder, AFTER THE MUSIC STOPPED: THE FINANCIAL CRISIS, THE RESPONSE, AND THE WORK AHEAD 146 (2013).

[109] *See* Emergency Economic Stabilization Act of 2008 §131(b), 12 U.S.C. § 5236(b) (2012).

[110] *See* Dodd-Frank Act § 1105(a).

borrow using financial assets as collateral without an unusual and significant increase in margin, or (2) an unusual and significant reduction in the ability of financial market participants to obtain unsecured credit, and that "a failure to take action would have serious adverse effects on financial stability or economic conditions in the United States."[111] Such a guarantee program cannot go into effect unless both houses of Congress have first passed a joint resolution of approval.[112]

At the same time, Section 1106 of the Dodd-Frank Act limits Section 13(c)(4)(G) of the Federal Deposit Insurance Act by not permitting an institution that would qualify for a program established under Section 1105 (i.e., a solvent institution) to qualify for a program under Section 13(c)(4)(G) of the Federal Deposit Insurance Act. The effect of this is that the FDIC, Federal Reserve Board, and Treasury Secretary can still provide extraordinary assistance (without Congressional approval) to, for example, uninsured creditors of an insolvent institution once the FDIC has been appointed receiver. By not repealing Section 13(c)(4)(G) of the Federal Deposit Insurance Act and only making a program established pursuant to Section 1105 of the Dodd-Frank Act (which requires Congressional approval) available to solvent institutions, the drafters of the Dodd-Frank Act sought to quietly maintain an esoteric bailout authority. The Financial CHOICE Act repeals Section 1105 of the Dodd-Frank Act and Section 13(c)(4)(G) of the Federal Deposit Insurance Act, thereby significantly scaling back the scope of the federal safety net for large financial institutions and offering taxpayers greater protection.

[111] *Id.* §§ 1104, 1105(g)(3).
[112] *Id.* § 1105(d).

Repeal of the Financial Stability Oversight Council's SIFI Designation Authority

Executive Summary:

- **The Financial Stability Oversight Council's highly politicized structure and penchant for secrecy are emblematic of a "shadow regulatory system" that is both antithetical to democratic principles and harmful to the U.S. economy.**

- **The FSOC injects unprecedented levels of political risk into the financial system by equipping a council composed largely of Presidential appointees with the authority to dictate the range of acceptable activities and the size and scope of private financial firms.**

- **The FSOC's process for designating non-bank financial institutions and so-called "financial market utilities" as "systemically important," based upon vague and ill-defined standards, gives regulators broad license to concentrate more power in Washington.**

- **By repealing the FSOC's designation authority, the Financial CHOICE Act addresses one of Dodd-Frank's greatest sources of regulatory overreach, and eliminates the government's authority to anoint large financial institutions as "too big to fail."**

The Problem: The Financial Stability Oversight Council is an Amalgamation of Failed Regulators That Undermines – Rather Than Promotes – Financial Stability

Title I of the Dodd-Frank Act created the Financial Stability Oversight Council (FSOC) and charged it with identifying risks to the financial stability of the United States, promoting market discipline by eliminating the expectation of government bailouts, and responding to emerging threats to the U.S. financial system.[113] The FSOC consists of ten voting members and five nonvoting members.[114] The ten voting members are the heads of nine federal financial regulatory agencies and an independent member with insurance expertise; [115] the five nonvoting members are the directors of the Office of Financial Research (OFR) and the Federal Insurance Office, both of which were created under the Dodd-Frank Act, a state

[113] Dodd-Frank Act § 112(a)(1).
[114] Dodd-Frank Act § 111(b).
[115] These agencies are the Department of the Treasury; the Board of Governors of the Federal Reserve System (Federal Reserve Board); the Office of the Comptroller of the Currency (OCC); the Consumer Financial Protection Bureau (CFPB); the Securities and Exchange Commission (SEC); the Federal Deposit Insurance Corporation (FDIC); the Commodity Futures Trading Commission (CFTC); the Federal Housing Finance Agency (FHFA); and the National Credit Union Administration (NCUA)

insurance commissioner, a state banking supervisor, and a state securities commissioner.[116] The FSOC meets at least quarterly, subject to the call of the Chairperson, who is the Secretary of the Treasury, or to the call of a majority of the members then serving.[117]

The FSOC's Flawed Structure and Governance

Proponents of the FSOC believed that by creating a 15-member committee that brought together the heads of the major financial regulatory agencies that had missed the last crisis — along with the heads of some newly-created agencies — they had succeeded in reducing the likelihood of future crises. There is, however, a significant flaw in the FSOC theory of regulation by super-committee: simply getting regulators in a room does not make them any more expert about the subjects over which they have jurisdiction, and it certainly does not give them expertise in the subjects over which they have no jurisdiction.[118] Rather than leveraging the expertise of the regulators having primary responsibility for particular areas and institutions in the financial system, the FSOC's voting structure ensures that the FSOC Members who know little or nothing about these matters will vote on questions affecting entire industries.

The FSOC's proponents believed they were elevating expertise. Instead, by creating a multi-member panel drawn from regulators responsible for areas as diverse as housing policy and government-sponsored enterprises, federal credit unions, securities markets, consumer protection, and commercial banks, they carved up responsibility for financial regulatory policy among ten regulators—the Voting Members of the FSOC—ensuring that FSOC members would be voting on matters in which they have no discernible expertise.

Moreover, although the Dodd-Frank Act refers to the FSOC's "member agencies," the agencies themselves are not members of the FSOC. Instead, it is the heads of those agencies who comprise the FSOC's membership. As former SEC Commissioner Daniel Gallagher explains, the distinction is important:

> While the Secretary of the Treasury and the Director of the FHFA can speak in a single voice on behalf of their agencies, the Chairman of the SEC is only one of a five member, bipartisan commission, with each Commissioner having a single vote on all matters that come before the Commission. The heads of the CFTC, the FDIC, the NCUA, and the Fed are similarly situated, each leading an agency that has multiple voting members, each with an equal vote. What's more, with the exception of the Fed, the board or commission of each of those agencies is statutorily mandated to be comprised of members

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[116] *Id.*
[117] *Id.* § 111(e).
[118] In this respect, the FSOC is symptomatic of what some have identified as a larger defect in the Obama Administration's approach to governing: "If [Obama] had a weakness, some of those who watched him said, it was . . . the belief that if you could just get enough smart people in a room, they could figure out a solution to whatever the problem was and the public would accept it." DAN BALZ, COLLISION 2012: OBAMA VS. ROMNEY AND THE FUTURE OF ELECTIONS IN AMERICA 28 (2013).

> with differing political affiliations. Although the leader of each of these agencies is generally from the President's party, his or her vote counts no more than that of any other member of the commission or board.[119]

The FSOC's structure not only distorts the lines of accountability and expertise among regulators, it distorts the balance that exists within regulatory agencies and erodes their status as independent regulatory agencies. The FSOC structure gives the agency head, who is appointed by the President, the only vote on regulatory matters that the FSOC considers and denies other commissioners or board members any say on regulatory issues that are within their jurisdiction and expertise.[120]

In November 19, 2015, testimony before the Oversight and Investigations Subcommittee, Adam White, a Visiting Fellow at the Hoover Institution, explained how the FSOC's structure fosters a kind of regulatory "group-think" that stifles rather than promotes vigorous policy debates:

> In addition to removing or weakening Congress's and the courts' checks and balances against FSOC overreach, Dodd-Frank also structures the FSOC in such a way that lacks the normal "internal" checks and balances of independent regulatory commissions such as the Securities and Exchange Commission, Commodity Futures Trading Commission, and other expert regulatory agencies. Such agencies traditionally include a near-balance of members from both political parties, in order to ensure that the agency undertakes its work through deliberation, ultimately producing not just an agency decision but also (when members disagree) published opinions from dissenting members. But the FSOC offers little or no such bipartisan deliberation, because it predominantly comprises agency heads appointed by the President and serving at his pleasure. . . .[121]

By stripping expert agencies of their regulatory authority and consolidating it in a body led by a cabinet official who is beholden to the President and populated by agency heads

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[119] Daniel M. Gallagher, SEC Commissioner, Ongoing Regulatory Reform in the Global Capital Markets, Address at the Annual Conference of the Institute of International Bankers (Mar. 5, 2012), *available at* https://www.sec.gov/News/Speech/Detail/Speech/1365171490004 (emphasis omitted).

[120] This has prompted strong objections from both Republican and Democratic commissioners at the SEC, a bipartisan, five-member commission. *See* Sarah N. Lynch, *At SEC, discontent grows over closed U.S. risk council meetings*, REUTERS, (Apr. 2, 2014), *available at* http://www.reuters.com/article/2014/04/02/us-sec-risks-complaints-idUSBREA3124320140402. Democratic Commissioner Luis Aguilar noted in an April 2014 speech that he and fellow commissioners had been "cut out of" the FSOC process, and argued that "there needs to be a mechanism by which the full Commission, no not just the Chair and SEC staff, provide meaningful input and coordinate with the leadership of FSOC." *Id.* (quoting Luis Aguilar). Republican Commissioners Daniel Gallagher and Michael Piwowar have registered similar concerns; Commissioner Piwowar's request to attend meetings of the FSOC was denied. *Id.*

[121] *Oversight of the Financial Stability Oversight Council: Due Process and Transparency in Non-Bank SIFI Designations: Hearing Before the Subcomm. on Oversight and Investigations of the House Comm. on Financial Services* 114th Cong. (2015) (statement of Adam J. White), *available at* http://financialservices.house.gov/uploadedfiles/hhrg-114-ba09-wstate-awhite-20151119.pdf.

appointed by the President, the Dodd-Frank Act results in a highly politicized financial regulatory system. Not surprisingly, the FSOC's flawed structure and governance have manifested themselves in equally flawed public policy.

The FSOC's SIFI Designation Authority and "Too Big to Fail"

Of all of the FSOC's activities, none has generated more controversy than its designation of non-bank financial institutions as SIFIs, which are, by virtue of that designation, subjected to "heightened prudential standards" and supervision by the Federal Reserve. The Dodd-Frank Act authorizes the FSOC to designate a non-bank financial institution a SIFI if two-thirds of its voting members, including the Treasury Secretary, find that the firm "would pose a threat to the financial stability of the United States."[122] In making its decision, the FSOC may consider several factors, including the firm's leverage, its off-balance sheet exposures, its relationship with other financial institutions, the firm's size and "interconnectedness," the firm's reliance on short-term funding, and "any other factors the [FSOC] deems appropriate."[123] The problem is that the terms that define the FSOC's authority are so broad and so vague that they do not effectively constrain the FSOC's discretion—and neither the FSOC nor any other government agency has ever articulated a coherent standard for identifying "systemic risk" in the more than six years since Dodd-Frank was enacted.[124]

A recent staff report from the Committee established these concerns about the inconsistent and arbitrary nature of the SIFI designation process to be well-founded.[125] The Committee's staff report found that the FSOC does not follow its own rules and guidance in multiple ways. The FSOC considers non-systemic risks in its determination of whether to designate a company as systemically important. The FSOC does not determine whether material financial distress at a company will cause "impairment of financial intermediation or of financial market functioning that would be sufficiently severe to inflict significant damage on the broader economy," as required by the FSOC's rules, and instead simply assumes both impairment and significant damage on the economy. The FSOC does not follow its own requirement that evaluations of the systemic risk posed by individual firms be done in the "context of a period of overall stress in the financial services industry and in a weak macroeconomic environment," and instead the FSOC has analyzed some companies only in a normal macroeconomic environment and then declined to designate those companies.

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[122] Dodd-Frank Act § 113(c).
[123] *Id.* § 113(b)(2).
[124] As Peter Wallison of the American Enterprise Institute points out, "[i]f ever there were a candidate for a holding of unconstitutional delegation in the modern era, the grant of authority to the FSOC would be it." Peter J. Wallison, *What the FSOC's Prudential Decision Tells Us about SIFI Designations*, FINANCIAL SERVICES OUTLOOK, AMERICAN ENTERPRISE INSTITUTE Mar. 31, 2014, *available at* http://www.aei.org/outlook/economics/financial-services/banking/what-the-fsocs-prudential-decision-tells-us-about-sifi-designation/.
[125] *The Arbitrary and Inconsistent FSOC Nonbank Designations Process: Report Prepared by the Republican Staff of the Committee on Financial Services, U.S. House of Representatives*, 115th Cong., (February 2017), *available at* https://financialservices.house.gov/uploadedfiles/2017-2-28_final_fsoc_report.pdf.

The Committee's staff report also found that the FSOC performed, for some companies, an analysis of that company's vulnerability to financial distress, and declined to designate those companies. The FSOC did not perform an analysis of vulnerability to financial distress for all of the companies that it designated as SIFIs. For some companies that it declined to designate, the FSOC considered the use of collateral in certain financial transactions as a mitigating factor against designation. For companies that it designated as SIFIs, the FSOC did not consider the use of collateral in certain financial transactions to be a mitigating factor.

But there is an even more fundamental problem with the Dodd-Frank regime. Rather than mitigating risks to financial stability, the FSOC's authority to designate non-bank financial institutions for "heightened prudential supervision" undermines both financial stability and market discipline by signaling to market participants that the government considers the designated firm "too big to fail," and that they will be protected from losses if it ever gets into trouble. Jeffrey Lacker, the President of the Richmond Federal Reserve Bank, has testified that designating a firm for heightened prudential supervision encourages shareholders and creditors of the firm and of similarly situated firms to expect the government to shield them from losses during periods of distress.[126] As a result, the government might keep the distressed firm from failing to avoid the significant cost of unsettling the market's expectation that the government would support similarly situated firms.[127] Richard Fisher, the former President of the Dallas Federal Reserve Bank, has testified to the same effect:

> [B]ased on my experience working the financial markets since 1975, as soon as a financial institution is designated systemically important, as required under Title I of the Dodd-Frank Act, and becomes known by the acronym SIFI, it is viewed by the market as being the first to be saved by the first responders in a financial crisis . . . [T]he SIFIs . . . occupy a privileged position in the financial system.[128]

The Dodd-Frank Act's designation authority seeks to achieve two fundamentally irreconcilable objectives. On the one hand, the Dodd-Frank Act tries to constrain risk-taking through stricter regulation of large, complex financial institutions. But the designation of these firms undermines market discipline because it sends a clear signal that government regulators think these firms are "too big to fail"; after all, that is the reason for subjecting these firms to "heightened prudential standards."[129] Designation thus generates even greater risk-taking and moral hazard, because creditors and counterparties will not

[126] *Examining How the Dodd-Frank Act Could Result in More Taxpayer-Funded Bailouts*: *Hearing Before the H. Comm. on Financial Services*, 113th Cong. 13 (2013) (statement of Jeffrey Lacker).
[127] *See id.* at 17 (statement of Jeffrey Lacker) ("I think that discretion traps policymakers in a crisis. Expectations build up that they may use that discretion to rescue creditors and let them escape losses, and given that expectation, policymakers feel compelled to fulfill the expectation in order to avoid the disruption of markets pulling away from who they have lent to on the basis of that expected support.").
[128] *Id.* at 12 (statement of Richard Fisher).
[129] *See id.* at 13 (statement of Jeffrey Lacker).

monitor the firm as scrupulously as they otherwise would, knowing that government regulators will not allow the firm to fail, which means that they will not suffer losses.[130] Or as noted financial analyst Josh Rosner testified before the Oversight and Investigations Subcommittee, "Title I and Title II create a special class of GSE-like companies that benefit from an implied government guarantee."[131]

The FSOC's Exercise of its SIFI Designation Authority under Dodd-Frank has been Arbitrary, Capricious, and Inconsistent with Fundamental Due Process Principles

By giving the FSOC the authority to designate firms and activities for "heightened prudential supervision" using criteria that are infinitely malleable and expandable, the Dodd-Frank Act provides the government vast license to expand its own regulatory footprint. As AEI Fellow Peter Wallison has observed, it is the very nature of government bureaucracies to seek to extend their jurisdictional reach, and the elasticity of the FSOC's designation authority invites just such regulatory empire-building.[132] Mr. Wallison suggests that the tendency of government officials to push the limits of their authority, coupled with the lack of any "intelligible standard" in the Dodd-Frank Act for determining whether a firm poses a systemic threat, results in the FSOC's "making what can only be called a political or ideological decision—choosing to designate firms . . . for no other reason than it wants to increase the government's control over the financial system."[133]

To date, the FSOC has designated four nonbank financial companies for "heightened prudential supervision" by the Federal Reserve: General Electric Capital Corporation, American Insurance Group (AIG), Prudential Financial Inc., and MetLife, Inc.[134] On March 30, 2016, a federal district court rescinded the FSOC's SIFI designation of MetLife, finding that it was "arbitrary and capricious" and that the FSOC had "made critical departures"

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[130] In remarks before the International Insurance Society's annual meeting in June 2013, Thomas Leonardi, Connecticut's insurance commissioner and a member of the Treasury Department's advisory committee on insurance regulation, reflected on the potential effects of designating an insurance company for "heightened prudential supervision," noting that, "particularly on the life side, where people are buying a product for a 30- or 40-year promise, you want that financial stability; and if you say as a consumer this designation means the company has more supervision, that's a good thing. It has more capital. That's really good and, as it's potentially 'too big to fail,' so the government is not going to let this company go[.]" Gavin Souter, *Stability, Higher Costs Seen In Systemic Designation For Insurers*, BUSINESS INSURANCE (Jun. 19, 2013) (quoting Thomas Leonardi), *available at* http://www.businessinsurance.com/article/20130619/NEWS04/130619774?tags=|306|76|73.

[131] *See Who is Too Big to Fail: Does Title II of the Dodd-Frank Act Enshrine Taxpayer-Funded Bailouts?: Hearing Before the Subcomm. on Oversight and Investigations of the H. Comm. on Financial Services*, 113th Cong. 10 (2013) (statement of Joshua Rosner).

[132] Peter J. Wallison, *What the FSOC's Prudential Decision Tells Us about SIFI Designation*, FINANCIAL SERVICES OUTLOOK, AMERICAN ENTERPRISE INSTITUTE (Mar. 31 2014), *available at* http://www.aei.org/wp-content/uploads/2014/03/-what-the-fsocs-prudential-decision-tells-us-about-sifi-designation_145908427235.pdf.

[133] *Id.* at 5.

[134] *See Financial Stability Oversight Council*, U.S. DEPARTMENT OF THE TREASURY, https://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx

from its own standards for making designation determinations.[135] The government is appealing the decision.[136]

Regardless of the ultimate outcome of the MetLife litigation, the FSOC's decision to designate it as a SIFI is a veritable case study in regulatory dysfunction and governmental hubris. One member of the FSOC dissented from the designation of MetLife, and a nonvoting member voiced objections to the majority opinion. Roy Woodall—the FSOC's Independent Member Having Insurance Expertise and one of its voting members—pointed out that the majority had assumed, without justification, that MetLife would suffer a bank-style "run" of millions of insured policyholders, which was extraordinarily unlikely.[137] Mr. Woodall, whose more than 50 years of experience in the insurance industry included serving as the Kentucky Insurance Commissioner,[138] noted that the administrative record did not support a finding that MetLife's failure could disrupt the functioning of the financial system or cause a loss of confidence in similarly situated institutions. Mr. Woodall wrote that the majority who voted to designate MetLife simply did not understand the insurance industry: "The analysis relies on implausible, contrived scenarios as well as failures to appreciate fundamental aspects of insurance and annuity products, and, importantly, State insurance regulation and the framework of the McCarran-Ferguson Act."[139]

John Huff, the state insurance commissioner serving as a nonvoting FSOC member, also questioned whether the FSOC Members who voted to designate MetLife understood the state insurance regulatory regime, saying "[i]t is noteworthy that my staff sought to correct basic factual errors regarding the operation of the state regulatory system just days before the vote on the final designation of the company. Even though some errors were corrected, it is unclear whether the . . . [FSOC] ever fully considered the nature and scope of the state insurance regulatory system."[140]

As the *Wall Street Journal* has pointed out, not even Dodd-Frank's primary architects believe that companies like MetLife that are engaged in traditional insurance activities warrant designation as "SIFIs" under the statutory framework they created:

> In July Barney Frank, co-author of the law that created the council, told Congress that in general he did not believe companies "that just sell

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[135] *MetLife Inc. v. Financial Stability Oversight Council*, No. 15-0045, at *13-14 (D.D.C. Mar. 30, 2015).
[136] *See* Notice of Appeal, *MetLife Inc. v. Financial Stability Oversight Council*, No. 15-0045, at 13-14 (D.D.C. Mar. 30, 2015), filed Apr. 8, 2016.
[137] *See* FSOC, DISSENTING AND MINORITY VIEWS ON METLIFE DESIGNATION (2014) (Views of the Council's Independent Member Having Insurance Expertise), *available at* http://www.treasury.gov/initiatives/fsoc/designations/Documents/Dissenting%20and%20Minority%20Views.pdf.
[138] *See S. Roy Woodall, Jr. Biography*, U.S. DEPARTMENT OF THE TREASURY, FINANCIAL STABILITY OVERSIGHT COUNCIL, https://www.treasury.gov/initiatives/fsoc/about/council/Pages/roy_woodall.aspx.
[139] FSOC, DISSENTING AND MINORITY VIEWS ON METLIFE DESIGNATION 2 (2014) (Views of the Council's Independent Member Having Insurance Expertise), *available at* http://www.treasury.gov/initiatives/fsoc/designations/Documents/Dissenting%20and%20Minority%20Views.pdf.
[140] *Id.* at 7 (Views of Director Adam Hamm, the State Insurance Commissioner Representative). The only other member of the FSOC with insurance expertise, the Director of Treasury's Federal Insurance Office, is also a non-voting member, and did not express an opinion on MetLife's designation.

> insurance" should be designated as systemic. Remarks by former Sen. Chris Dodd during Senate floor debate in 2010 suggest that he also didn't envision this treatment for companies engaged in "traditional insurance." Yet Messrs. Dodd and Frank handed authority over this enormous industry to people who don't seem to know anything about it.[141]

Indeed, of the eight members of the FSOC who voted to designate MetLife as systemically important, none appears to have any professional background or expertise in insurance.[142] Yet the FSOC majority over-rode the consensus of the experts who best understood the insurance industry and the risks that MetLife did and did not pose to the financial system. The MetLife designation left many observers wondering why the judgment of the chairmen of the Commodity Futures Trading Commission, the National Credit Union Administration, and the Consumer Financial Protection Bureau, to take just three examples, should be substituted for that of individuals who have spent their entire careers on insurance regulatory matters. The FSOC's voting structure thus does the opposite of what its proponents wanted the FSOC to do: rather than promoting the application of policy expertise to issues of financial stability, the FSOC's voting structure subverts it.

Title VIII's Regime for Designating "Financial Market Utilities" as SIFIs

Title VII of the Dodd-Frank Act requires that certain standardized over-the-counter derivatives contracts be cleared through central clearinghouses (CCPs) in order to mitigate systemic risk. Although the proponents of this requirement believed that central clearing would promote financial stability by netting trades and centralizing the monitoring of risk, critics pointed out that CCPs instead concentrated systemic risk.[143]

This troublesome concentration of risk is compounded by the decision of Dodd-Frank's drafters to anoint CCPs as the next generation of "too big to fail" firms. Title VIII of the Dodd-Frank Act authorizes the FSOC to designate CCPs and payment systems as "systemically important financial market utilities," or FMUs, which the Dodd-Frank defines as "any person that manages or operates a multilateral system for the purpose of transferring, clearing, or settling payments, securities, or other financial transactions among financial institutions or between financial institutions and the person."[144] A

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[141] *Jack Lew's Next Conquest*, WALL STREET JOURNAL, REVIEW & OUTLOOK, (Aug. 26, 2014), *available at* http://online.wsj.com/articles/jack-lews-next-conquest-1409009217.

[142] *See generally Who is on the Council?* FINANCIAL STABILITY OVERSIGHT COUNCIL, U.S. DEPARTMENT OF THE TREASURY, https://www.treasury.gov/initiatives/fsoc/about/council/Pages/default.aspx (last visited Jun. 10, 2013).

[143] In the words of the WALL STREET JOURNAL's James Freeman, what the framers of the Dodd-Frank Act failed to grasp was that "having one or a few institutions stand behind every trade doesn't eliminate risk; it concentrates it." *See* James Freeman, *Government Warns of Systemic Risks It Created*, WALL STREET JOURNAL, (May 21, 2015), *available at* http://www.wsj.com/articles/government-warns-of-systemic-risks-it-created-1432214171.1432214171.

[144] On July 18, 2012, the FSOC designated eight companies as systemically important FMUs: The Clearing House Payments Company, L.L.C., CLS Bank International, Chicago Mercantile Exchange, Inc., The Depository Trust Company, Fixed Income Clearing Corporation, ICE Clear Credit LLC, National Securities Clearing Corporation, and The Options Clearing Corporation. *See* FSOC, APPENDIX A, DESIGNATION OF SYSTEMICALLY IMPORTANT FINANCIAL MARKET UTILITIES (Jul. 18, 2012), *available at*

clearinghouse or a payment system designated by the FSOC as an FMU faces "heightened prudential supervision" by the Federal Reserve, which may prescribe risk-management standards for such entities and participate in examinations conducted by their primary federal regulator, typically the SEC or the CFTC. *But as important, if not more, a designated FMU also gains immediate access to the Fed's discount window.*[145]

While experts disagree on whether increased reliance upon CCPs amplifies rather than mitigates systemic risk, there is broad agreement that designating these organizations as "systemically important" and granting them immediate access to the Fed discount window increases financial instability by creating the perception that they are "too big to fail." As *New York Times* columnist Gretchen Morgenson put it, "these large and systemically important financial utilities that together trade and clear trillions of dollars in transactions appear to have won the daily double—access to federal money, without the accountability."[146]

In 2013 testimony before the Financial Services Committee, former FDIC Chairman Sheila Bair warned that granting FMUs access to the discount window "not only gives these firms a real advantage over other 'non' systemic competitors, it opens up taxpayers to potential losses and creates moral hazard."[147] According to Chairman Bair, rather than making the financial system safer, Title VIII in fact makes it less stable because it "increases the likelihood of clearinghouses engaging in risky activity, adding an element of potential instability to an area where it had not previously existed."[148] Based upon her view that "FMUs will very likely become the new [Government Sponsored Enterprises], Chairman Bair has recommended that this "unwarranted expansion of the government safety net" be repealed.[149]

The idea for Fed regulation and access to the discount window originated—perhaps not surprisingly—with former Treasury Secretary Tim Geithner, who once served as the President of the Federal Reserve Bank of New York, and the Federal Reserve's general counsel, Scott Alvarez. In her book, *Bull by the Horns,* former Chairman Bair writes:

> Tim and the Fed's general counsel, Scott Alvarez, continued trying to sneak bailout language into the bill, and they succeeded in securing one loophole.

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https://www.treasury.gov/initiatives/fsoc/Documents/2012%20Appendix%20A%20Designation%20of%20Systemically%20Important%20Market%20Utilities.pdf.

[145] Authority to Designate Financial Market Utilities as Systemically Important, 76 Fed. Reg. 44763 (July 27, 2011) (to be codified at 12 CFR), *available at* http://www.treasury.gov/initiatives/fsoc/rulemaking/Documents/Final%20Rule%20on%20Authority%20to%20Designate%20Financial%20Market%20Utilities%20as%20Systemically%20Important.pdf.

[146] Gretchen Morgenson, *One Safety Net That Needs to Shrink*, NEW YORK TIMES, (Nov. 4, 2012), *available at* http://www.nytimes.com/2012/11/04/business/one-safety-net-that-needs-to-shrink.html.

[147] *Hearing on Taxpayer-Funded Bailouts under Dodd-Frank*, (prepared testimony of Sheila Bair), *available at* http://financialservices.house.gov/uploadedfiles/hhrg-113-ba00-wstate-sbair-20130626.pdf.

[148] Sheila Bair, BULL BY THE HORNS: FIGHTING TO SAVE MAIN STREET FROM WALL STREET AND WALL STREET FROM ITSELF 222 (2012).

[149] *Hearing on Taxpayer-Funded Bailouts under Dodd-Frank* (prepared testimony of Sheila Bair), *available at* http://financialservices.house.gov/uploadedfiles/hhrg-113-ba00-wstate-sbair-20130626.pdf.

> At their behest, [Senator] Dodd included in his bill a provision to let securities and derivatives clearinghouses borrow from the Fed at its discount window. We had successfully opposed that provision in the House but were becoming increasingly isolated in the Senate. Both the CFTC and SEC, initially skeptical of the provision as a potential Fed intrusion into their oversight of clearinghouses, came to support it. And the clearinghouses that they regulated were drooling at the prospect of having access to loans from the Fed.
>
> I thought it was a terrible precedent and still do. It was the first time in the history of the Fed that any entity besides an insured bank could borrow from the discount window. . . . [W]ith the bailout loophole, the market discipline that had previously kept clearinghouses tightly and prudently managed was seriously diluted. Now if the clearinghouses run out of money, they can just borrow from the Fed.[150]

The legislative history of the Dodd-Frank Act shows that at least some proponents of the Dodd-Frank Act recognized the danger of expanding the safety net to include FMUs. Even former Chairman Barney Frank saw the hazards of creating a new category of "too big to fail" institutions. During the Financial Services Committee's markup of financial reform legislation in 2009, Republicans offered an amendment to strike the FMU provision from the bill. Rather than defend the provision, Chairman Frank *supported* the Republican amendment to strike it, describing the attempt to expand the Fed's regulatory fiefdom as "an example of overreach on the part of some for the Federal Reserve." But the FMU provision reemerged in the Senate's version of the financial reform bill, ultimately making it into the Dodd-Frank conference report that was signed into law.

FSOC and the Crusade to Stamp out Risk "in the Shadows"

The FSOC views its designation authority under Titles I and VIII of Dodd-Frank as a tool for extending the "regulatory perimeter" to capture risks it says lurk in the so-called "shadow banking" system, defined loosely to include a broad range of non-bank financial intermediaries, including but not limited to broker-dealers, asset managers, and advisers to private funds, such as private equity and hedge funds. By darkly intimating that this segment of the financial services industry poses unacceptable risks to investors and financial stability, regulators seek to arrogate to themselves ever-greater power to manage the U.S. economy. Those efforts must be resisted.

The Financial CHOICE Act is premised upon a belief that firms that operate without the benefit of a federal safety net and reap the profits and suffer the losses from the risks they undertake should not be subject to the same form of intrusive prudential regulation as firms that are federally subsidized. Prudential regulation is fundamentally the regulation and suppression of risk-taking. While that approach may have some justification in the

[150] Sheila Bair, BULL BY THE HORNS: FIGHTING TO SAVE MAIN STREET FROM WALL STREET AND WALL STREET FROM ITSELF 222 (2012).

case of federally insured depository institutions whose risks are ultimately backstopped by the taxpayer, no such justification exists for firms that are not covered by that safety net.

As an initial matter, proponents of imposing a bank-centric prudential regulatory model on U.S. capital markets should be required to explain how such a regime would make the financial system any safer, given the manifest failures of U.S. regulators in the run-up to the financial crisis. The regulators, in many cases embedded in the banks that got into the most severe trouble, were unable to see the crisis coming. This included the Federal Reserve, with its stable of 300 PhD economists and vast army of bank examiners.

As noted by former SEC Commissioner Gallagher, the policymakers that pushed to regulate the capital markets like they are banks "adhere to a false narrative of the financial crisis that says capital markets regulators like the SEC failed, and the markets and market participants overseen by capital markets regulators were a major cause of the financial crisis. Forgotten, of course, are the myriad failed banks, the taxpayer dollar 'foam on the runway' that propped up too big to fail commercial banks, and – most importantly – the failed federal housing policy that actually *did* cause the financial crisis."[151]

The Dodd-Frank Act's solution to the regulatory failures exposed by the crisis was to double down by, among other measures, giving the FSOC broad license to centralize more power in the government's hands through SIFI designations. However, as demonstrated by the MetLife travesty described above, rather than use data, history, and economic analysis to support its SIFI designations, the FSOC has instead employed far-fetched, highly-speculative worst-case scenarios to justify its needless but expansive regulatory agenda. Subjecting non-bank financial companies to supervision by the Federal Reserve imposes a duplicative, costly, and ultimately ineffective layer of regulation on these institutions, given that the Federal Reserve does not have the expertise necessary to supervise non-banks. In fact, in light of the Federal Reserve's track record in the run-up to the financial crisis, it is not clear that the Federal Reserve has the expertise to supervise *banks* properly.

The bureaucratic hand-wringing over "shadow banking" reflects Washington's view that any financial firm engaged in "risky activity" must be subjected to stringent regulatory oversight if financial stability is to be preserved. As Peter Wallison of the American Enterprise Institute points out, if this view ultimately prevails, Americans will continue to suffer the consequences of the weakest recovery of the post-World War II era:

> [With respect to] worries that risks are building in shadow banking, we should hope so. Risk-taking is the source of innovation and growth. Risk-taking among the various capital markets firms — broker-dealers, mutual funds, hedge funds, private equity and others — is what has been driving the meager growth we have had since 2008. Banks, hamstrung by excessive regulation, have not been

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[151] Daniel M. Gallagher, SEC Commissioner, "Bank Regulators at the Gates: The Misguided Quest for Prduential Regulation of Asset Manager" Remarks at the 2015 Virginia Law and Business Review Symposium (Apr. 10, 2015), *available at* https://www.sec.gov/news/speech/041015-spch-cdmg.html.

> able to contribute much to the recovery, especially for small-business startups.[152]

Not just the banks have been hamstrung by the excessive regulation. As former SEC Commissioner Gallagher provided "Participants in the capital markets have not been free to regulate their own pursuits of industry and improvement and have been forced to pay far more than a pound of bread in the form of hugely burdensome regulatory costs, ultimately to the detriment of the U.S. economy."[153]

As Chairman Hensarling has pointed out, a far greater threat to financial stability and economic freedom than "shadow banking" is the "shadow **regulatory** system" embodied by the FSOC and the other vast, unaccountable bureaucracies created by the Dodd-Frank Act.

The Solution: Repeal SIFI Designation Authority and Require Greater Accountability and Transparency at the FSOC

The Financial CHOICE Act repeals the authority of the FSOC to designate non-bank financial companies as SIFIs; retroactively repeals its previous designations of certain non-bank financial companies; repeals the FSOC's related authority to designate particular financial activities for heightened prudential standards or safeguards, which includes the power to mandate that an activity be conducted in a certain way or be prohibited altogether; and repeals the FSOC's authority to break up a large financial institution if the Federal Reserve finds that the firm "poses a grave threat to the financial stability of the United States." It also repeals Title VIII of the Dodd-Frank Act, which empowers the FSOC to designate so-called "financial market utilities" as "systemically important," and gives those organizations access to the Federal Reserve discount window.

Under the Financial CHOICE Act, the FSOC would continue to serve as an inter-agency forum for (1) monitoring market developments; (2) facilitating information-sharing and regulatory coordination; (3) bringing the primary federal regulators together with the goal of identifying and mitigating risks to financial stability; and (4) reporting to Congress on those risks and making policy recommendations to address them. But the FSOC would be required to operate with a higher degree of transparency and inclusiveness than in it has the past, through the following reforms:

- The FSOC would be subject to both the "Government in the Sunshine Act" and the Federal Advisory Committee Act;
- All of the members of the commissions and boards represented on the FSOC—such as the SEC, the Federal Reserve, Federal Deposit Insurance Corporation, the Commodity Futures Trading Commission and the National Credit Union Administration—would be permitted to attend and participate in the FSOC's meetings;

[152] Peter J. Wallison, *Shadow banks are not a source of systemic risk*, FINANCIAL SERVICES OUTLOOK, AMERICAN ENTERPRISE INSTITUTE, (March 21, 2016), *available at:* https://www.aei.org/publication/shadow-banks-are-not-a-source-of-systemic-risk/.
[153] *See supra* note 151.

- Before the principal of a Commission or Board represented on the FSOC votes as an FSOC member on an issue before the FSOC, the Commission or Board would have to vote on the issue, and the principal would have to abide by the results of that vote at the FSOC meeting; and
- Members of the House Financial Services and Senate Banking Committees would be permitted to attend all FSOC meetings, whether or not the meeting is open to the public.[154]

[154] These provisions are drawn from legislation authored by former Rep. Scott Garrett (H.R. 3557)(114th Congress).

Reform the Consumer Financial Protection Bureau

Executive Summary:

- **The Consumer Financial Protection Bureau is not accountable to Congress or the American people. The Bureau's policies often harm consumers or exceed its legal authority because the Bureau is not subject to checks and balances that apply to other regulatory agencies.**

- **The Bureau symbolizes a paternalistic approach to consumer protection that empowers bureaucrats while denying consumers access to financial products and services they want and need.**

- **The Financial CHOICE Act will increase accountability by changing the Bureau's governance and funding mechanism, and promote real consumer protection by putting power where it belongs: in the hands of consumers, not Washington bureaucrats.**

The Problem: The Bureau is Both Uniquely Unaccountable and Enormously Powerful, and its Policies are Impeding Economic Opportunity

Title X of the Dodd-Frank Act established the Bureau of Consumer Financial Protection for the purpose of implementing and enforcing federal consumer financial law while ensuring that consumers have access to financial products and services, and warranting fair, transparent, and competitive markets for such services and products.[155] Under the Dodd-Frank Act, the Bureau can issue rules, examine certain institutions, and enforce consumer protection laws and regulations.

The Bureau's jurisdiction under the Dodd-Frank Act includes mortgage lenders, mortgage servicers, payday lenders, and private education lenders, as well as the power to supervise large depository institutions (such as banks) with assets of more than $10 billion and the "larger participants" of any financial market the Bureau designates through rulemaking. The Bureau is not the primary consumer protection regulator of depository institutions with less than $10 billion in assets, and the Dodd-Frank Act prohibits it from exercising supervisory or enforcement authority over a number of other businesses, including automobile dealers and merchants.[156]

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[155] Dodd-Frank Act § 1021.

[156] *See id.* §§ 1002(6), 1025, 1026,1027, 1029. Other entities exempt from the Bureau's jurisdiction are retailers, sellers of nonfinancial goods and services, real estate brokers, real estate agents, sellers of manufactured and mobile homes, income tax preparers, insurance companies, accountants, and attorneys. *Id.* § 1027.

At the head of the Bureau, the Dodd-Frank Act placed a Director who serves a five-year term and can be removed by the President only for "inefficiency, neglect of duty, or malfeasance"[157] — though this structure has since been held unconstitutional by a federal appellate court. The D.C. Circuit court's recent opinion in the case of *PHH Corporation v. CFPB* noted that the "concentration of massive, unchecked power in a single Director marks a departure from settled historical practice."[158] The D.C. Circuit held that the Bureau is "unconstitutionally structured because it is an independent agency headed by a single Director" and therefore the President must be able to remove the Director at will.[159]

The Bureau is funded out of the earnings of the Federal Reserve System.[160] In accordance with Section 1017 of the Dodd-Frank Act, in order to obtain funding, the Director need only submit a letter to the Board of Governors of the Federal Reserve each quarter certifying the amount of funds determined by the Director to be reasonably necessary for carrying out the authorities of the Bureau.[161] The Federal Reserve then transfers the stated amount to the Bureau for operations. The Bureau's funding is therefore different from that of other regulators that police markets for force and fraud, including the Federal Trade Commission, the Securities and Exchange Commission, the Consumer Product Safety Commission, and the Commodity Futures Trading Commission – all of which are funded principally through congressional appropriations.

In the next two years, the Bureau intends to issue rules governing – or to explore greater supervision of – arbitration, debt collection, small-dollar lending, overdrafts, consumer credit reporting, student loans, mortgages, debt collection-related entities, and small business lending data collection.[162] Despite its sweeping agenda, however, the Bureau is failing to protect consumer choice and financial independence.

The Bureau's Policies are Harming Consumers

The Bureau's rules and policies exemplify a "Washington-knows-best" attitude that limits the availability of useful – and safe – products and services. Experts note that Bureau regulations produce a range of harmful effects – many of which are highly regressive – on American consumers, including the following:[163]

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[157] *Id.* § 1011.
[158] *PHH Corp. v. CFPB*, No. 15-1177, at *27 (D.C. Cir. Oct. 11, 2016).
[159] *Id* at *64, *69
[160] *Id.* § 1017.
[161] *Id.* § 1017.
[162] *See* Kelly Cochran, *CFPB, Spring 2016 rulemaking agenda*, CFPB (May 18, 2016), *available at* http://www.consumerfinance.gov/about-us/blog/spring-2016-rulemaking-agenda/; *See* Policy priorities over the next two years (Feb. 25 2016), http://files.consumerfinance.gov/f/201602_cfpb_policy-priorities-over-the-next-two-years.pdf.
[163] *See e.g. Monetary Policy and the State of the Economy: Hearing Before the H. Comm. on Fin. Serv.*, 113th Cong. (2014) (statement of Abby McCloskey, Program Director of Economic Policy, AEI), *available at* http://financialservices.house.gov/uploadedfiles/hhrg-113-ba00-wstate-amccloskey-20140211.pdf. *See also* Lux and Greene, *Out of Reach: Regressive Trends in Credit Card Access*, *available at* https://www.hks.harvard.edu/centers/mrcbg/publications/awp/awp54. *See also Assessing the Effects of Consumer*

- Growing the ranks of unbanked and underbanked Americans
- Reducing the availability of credit options for low-income Americans, in turn growing the number of "credit invisible" Americans
- Increasing the price of basic banking services
- Pushing consumers into more expensive credit options
- Jeopardizing consumer privacy
- Decreasing credit availability for small businesses that rely – as many do – on personal credit products

One of the Bureau's most damaging effects on consumers and access to credit has been felt in the residential mortgage market. Indeed, rather than protecting borrowers, the litany of new mortgage lending rules stemming from the Dodd-Frank Act are excluding lower-income or marginal borrowers from the mortgage market altogether. Under the Bureau's Qualified Mortgage (QM) rule, for example, many Americans find they are no longer eligible for loans. A 2013 Federal Reserve report found that 22% of consumers who borrowed to buy a home in 2010 — one out of every five borrowers — would not have met the underwriting requirements for a "Qualified Mortgage" as required by Dodd-Frank.[164] The outlook is particularly bleak for minority borrowers: according to the Fed's analysis, roughly one-third of African-American and Hispanic home-purchase borrowers in 2010 would be unable to meet the QM underwriting requirements once the Bureau's rule is fully phased in.[165] The *Wall Street Journal* recently reported that "[i]n 2014, the number of mortgages to blacks and Hispanics combined was down 52% from 2007 across all bank and nonbank lenders, compared with a 37% drop for other racial groups combined."[166]

One lesson that should have been learned from the financial crisis is the danger of government intervention in markets for purposes of influencing mortgage credit allocation. Before the crisis, the government pushed programs to relax underwriting standards to meet affordable housing goals, with disastrous effects. Following the crisis, Democrats

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Finance Regulations, Hearing Before the S. Comm. on Bank., 114th Cong. (2016) (statement of Todd Zywicki, Professor of Law, George Mason University), *available at* http://www.banking.senate.gov/public/_cache/files/58bb96f4-8268-4ecd-95dd-5e35f8d26e4a/060C9C587736B1F08DD0A117FC3EE8B6.zywicki-testimony-4-5-16.pdf.

164 Neil Bhutta & Glenn B. Canner, Federal Reserve, *Mortgage Market Conditions and Borrower Outcomes: Evidence from the 2012 HMDA Data and Matched HMDA–Credit Record Data*, FED. RESERVE BULLETIN, (Nov. 2013), at 39-40, *available at* http://www.federalreserve.gov/pubs/bulletin/2013/pdf/2012_HMDA.pdf

165 *Id.* at 37.

166 Rachel Louise Ensign, Paul Overberg, & Anna Maria Andriotis, *Banks' Embrace of Jumbo Loans Mortgages Means Fewer Loans for Blacks, Hispanics,* WALL STREET JOURNAL, (Jun. 1, 2016), *available at* http://www.wsj.com/articles/banks-embrace-of-jumbo-mortgages-means-fewer-loans-for-blacks-hispanics-1464789752

have sought to mandate different underwriting standards and plain vanilla product requirements. Consumers are harmed in both scenarios because governments cannot ration or allocate credit as efficiently as free markets. Too much credit gave us the great recession. Too little credit keeps the dream of homeownership out of reach for too many Americans. In the words, of C.S. Lewis, it is time for the "omnipotent moral busybodies" in the federal government to learn from their mistakes.

The Bureau Demonstrates all of the Bureaucratic Pathologies One Would Expect of an Agency that was Structured to be Unaccountable to Congress and the President

Rather than faithfully executing the laws passed by Congress, the Bureau has arrogated to itself new authorities not contemplated even by the authors of Dodd-Frank. For instance, the Bureau is harming consumers by operating a "consumer complaint database" designed to catalogue and publicize consumer complaints against companies without first verifying their veracity.[167] While compiling consumer complaints is valuable for internal follow-up and investigation where warranted, publishing those complaints without verification or normalization does not permit consumers to draw conclusions about potential bad actors in the marketplace. One payments industry expert accurately described the database as a "modern-day public stockade — a list of the companies that consumers (with unverified complaints) have complained the most about."[168]

Similarly, the Bureau has in several instances offered financial advice and planning tools to guide consumers through major financial decisions without first ensuring that the tools work properly or offer meaningful advice. Other misguided and burdensome Bureau policies include: seeking to issue a rule that would limit a consumer's ability to contract to resolve disputes regarding financial products through arbitration rather than costly and protracted class-action litigation; and failing to timely address delayed loan closings and market dislocation resulting from the Bureau's TILA-RESPA Integrated Disclosure (TRID) rule.

The Bureau's short six-year history is replete with instances in which it has abused or exceeded its statutory authorities. For example, it sought to force auto-finance lenders to act as agents of the government to regulate auto dealers, which are specifically exempted from Bureau authority by Dodd-Frank.[169] The Bureau has also decided to ignore the sovereign will of 50 duly-elected state legislatures and tribal authorities by proposing a

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[167] *See The Complaint Process*, CFPB, http://www.consumerfinance.gov/complaint/process/ (last visited Jun. 14, 2016).

[168] Karen Webster, "Does The CFPB Really Help Consumers?" PYMNTS.com (Oct. 2015), *available at* http://www.pymnts.com/in-depth/2015/does-the-cfpb-really-help-consumers/.

[169] *See generally* STAFF OF H. COMM. ON FINANCIAL SERVICES, 114TH CONG., UNSAFE AT ANY BUREAUCRACY: CFPB JUNK SCIENCE AND INDIRECT AUTO LENDING (Comm. Print 2015), *available at* http://financialservices.house.gov/uploadedfiles/11-24-15_cfpb_indirect_auto_staff_report.pdf; STAFF OF H. COMM. ON FINANCIAL SERVICES, 114TH CONG., UNSAFE AT ANY BUREAUCRACY, PART II: HOW THE BUREAU OF CONSUMER FINANCIAL PROTECTION REMOVED ANTI-FRAUD SAFEGUARDS TO ACHIEVE POLITICAL GOALS (Comm. Print 2016), http://financialservices.house.gov/uploadedfiles/cfpb_indirect_auto_part_ii.pdf.

rule to regulate the small dollar, short-term credit market absent any Congressional directive or pressing need identified by the states.[170] In an initiative recently struck down by a federal district court, the Bureau attempted to collaterally regulate a college accreditation agency (which is overseen by the Department of Education) as a proxy for pursuing enforcement against for-profit institutions, despite the fact that this agency offers no consumer financial products that would properly place it within the Bureau's jurisdictional purview.[171]

Perhaps most emblematic of the Bureau's counterproductive approach to consumer financial product regulation is its opaque and iterative practice of regulation by enforcement using its "unfair, deceptive, and abusive acts or practices" (UDAAP) authority under Section 1031 of the Dodd-Frank Act.[172] Because the Bureau has declined to define what constitutes a UDAAP violation, financial firms are either cutting back product offerings to lower-income Americans or offering them only "plain vanilla" consumer financial products. As Hester Peirce of the Mercatus Center at George Mason University notes:

> A shifting standard of this sort opens the door to abuse of authority by the CFPB . . . . Consumers can expect businesses simply to avoid offering products to consumers, in fear that the CFPB enforcers will show up if the product does not work out as well as a consumer had hoped. As a result, consumers will not get the financial products that they need.[173]

This wide array of anti-consumer outcomes is the result of the Bureau's flawed structure. As consumer financial regulatory expert and George Mason University Law Professor Todd Zywicki has written:

> [I]f one were to sit down and design a policymaking agency that embodied all of the pathologies scholars of regulation have identified over the past several decades, one could hardly do better than the CFPB: an unaccountable body, headed by a single director, insulated from both removal by the President and budgetary oversight by Congress, and charged with a tunnel vision mission to pursue one narrow goal that carries the potential for substantial harm to the economy and consumers. So flawed is the CFPB's design, and so similar is it to the regulatory agencies of an earlier era, that the problems it

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[170] *See* Payday, Vehicle Title, and Certain High-Cost Installment Loans (proposed Jun. 1, 2016) (to be codified at 12 C.F.R. pt. 1041), http://files.consumerfinance.gov/f/documents/Rulemaking_Payday_Vehicle_Title_Certain_High-Cost_Installment_Loans.pdf.

[171] *See CFPB v. Accrediting Council for Independent Colleges and Schools*, No. 15-1838 (D.D.C. Apr. 21, 2016) (denying a Bureau petition for enforcement of a civil investigative demand investigating for-profit college accreditation, holding that the investigation did not entail consumer financial laws and therefore exceeded the CFPB's statutory jurisdiction).

[172] *See e.g.* S. Raman, *CFPB Defines 'Unfair,' 'Deceptive' and 'Abusive' Practices Through Enforcement Activity*, SKADDEN, ARPS, SLATE, MEAGHER & FLOM, LLP, *available at* https://www.skadden.com/insights/cfpb-defines-unfair-deceptive-and-abusive-practices-through-enforcement-activity

[173] Hester Peirce, *CFPB Knows Abuse When It Sees It*, MERCATUS CENTER: EXPERT COMMENTARY (Mar. 29, 2012), *available at* http://mercatus.org/expert_commentary/cfpb-knows-abuse-when-it-sees-it.

will manifest and the harm it will impose on the economy are entirely predictable. . . . Most tragically, unless reformed, the likely result of the CFPB in operation will be a result completely contrary to that intended by its founders: an increase in fraud against consumers, an increase in foreclosures in the event of a future housing market downturn, and an increase in cost and reduction in access to high-quality credit products for consumers.[174]

The Bureau's Overreach is History is Repeating Itself

The Bureau's history of abuse and overreach closely mirrors that which formerly plagued another independent agency that once operated with insufficient accountability: the Federal Trade Commission (FTC). Since its founding in 1914 the FTC enforced federal antitrust laws,[175] and in 1938, Congress expanded the FTC's mission to include consumer protection via a prohibition on "unfair or deceptive acts or practices."[176] The FTC interpreted its "unfair or deceptive" authority in the disjunctive for the first time in 1964,[177] when it issued its Cigarette Rule defining "unfair" acts as those that: (1) offended public policy; (2) were immoral, unethical, oppressive, or unscrupulous; or (3) caused substantial injury to consumers or competitors or other businessmen.[178] A 1972 Supreme Court opinion cited the rule approvingly, saying the FTC "considers public values beyond simply those enshrined in the letter or encompassed in the spirit of the antitrust laws,"[179] and suggesting in a footnote that the FTC's test could be read disjunctively.[180] Emboldened, the FTC quickly claimed broad power to prohibit all acts or practices that either offended public policy, or were immoral, or caused substantial injury to consumers.

Predictably, the result was a series of over-reaching rules that often had no empirical basis, based entirely upon Commissioners' personal values and that did not have to consider the ultimate costs to consumers of foregoing their ability to choose freely in the marketplace.[181] The FTC's most prominent overreach was its attempt to use its unfairness doctrine to ban all television advertising directed to children on the generalized grounds that advertising to children was "immoral, unscrupulous, and unethical."[182] The breadth of

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[174] Todd Zywicki, *The Consumer Financial Protection Bureau: Savior or Menace?*, 81 GEO. WASH. L. REV. 856 858-59 (2013).
[175] See 38 Stat. 717, codified at 15 U.S.C. 41 et seq.
[176] See 52 Stat. 111.
[177] Howard Beales, III, "*The FTC's Use of Unfairness Authority: Its Rise, Fall, and Resurrection*," available at: https://www.ftc.gov/public-statements/2003/05/ftcs-use-unfairness-authority-its-rise-fall-and-resurrection
[178] 29 Fed. Reg. 8324, 8355 (July 2, 1964).
[179] *FTC v. Sperry & Hutchinson Co*., 405 U.S. 233, 244 (1972).
[180] Id. at 244, n.5.
[181] Beales, supra. For example, the FTC's proposed Over-the-Counter Drug rulemaking would have required advertisers to use only the precise terms the FDA required on product labeling. See FTC Staff Report and Recommendations: Advertising for Over-the-Counter Drugs (May 22, 1979).
[182] See FTC Staff Report on Television Advertising to Children (1978); Notice of Proposed Rulemaking on Television Advertising to Children, 43 Fed. Reg. 17, 967 (1978). At the same time, the FTC Chairman opined that the FTC could use unfairness to regulate issues as varied as the employment of illegal aliens, tax avoidance, and pollution. See Michael Pertschuk, "*Remarks before the Annual Meeting of the Section on Antitrust and Economic Regulation of the Association of American Law Schools*," Atlanta, Georgia (Dec. 2, 1977).

the FTC's ambition outraged many in business, Congress, and the media, with the *Washington Post* calling the FTC the "National Nanny."[183]

Congress was forced to counteract the FTC's overreach by withholding the agency's funding, even shutting the FTC for several days,[184] and, after six weeks of extensive hearings, terminating the rulemaking proceeding and enacting legislation preventing the FTC from using unfairness in new rulemakings to restrict advertising.[185] So great were the concerns about the FTC's overreach that Congress did not reauthorize the FTC for fourteen years.[186] As a result of the public outcry and Congress' corrective actions, the FTC began to re-examine its "unfairness" doctrine to develop a focused, injury-based test for unfair acts and practices.[187]

Like the FTC in the 1970s, the Bureau has overreached its statutory authority and requires Congressional action to bring it in check, but unlike the FTC the Bureau currently lacks even the structural safeguards and accountability the FTC had at the time. For instance, the Bureau has been given a singular focus on consumer protection, whereas the FTC had and still has a dual statutory mandate providing some balance to its mission, and the Bureau is entirely exempt from the congressional appropriations process, whereas the FTC has always been subject to Congressional oversight through the appropriations process. Moreover, the Bureau has been granted even broader statutory authority than the FTC has ever possessed, including the authority to prohibit "abusive" as well as unfair or deceptive acts or practices. As the FTC demonstrated, unchecked independent agencies can issue tremendously harmful consumer protection rules to the exclusion of other policy considerations, such as market competition and consumer choice. And, as the FTC also demonstrated, Congressional action to reform agencies can refocus their efforts to benefit consumers and the economy. The Bureau is no exception, and Congress must again fulfil its legislative and oversight obligations to check an unaccountable rogue agency and turn it into a well-functioning consumer-protection agency.

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[183] Beales, supra, citing *Washington Post*, Mar. 1, 1978.
[184] Beales, supra.
[185] See FTC Final Staff Report and Recommendation, In the Matter of Children's Advertising 13 (Mar. 31, 1981); FTC Improvements Act, Pub. L. No. 96-252, 94 Stat. 374 (1980). These amendments also prevented the Commission for a period of three years from initiating any new rulemaking proceeding restricting commercial advertising based on unfairness, and this prohibition was continued through the FTC's appropriations legislation until 1994.
[186] Beales, supra.
[187] Id. On December 17, 1980, a unanimous FTC formally adopted the Unfairness Policy Statement, 104 F.T.C. 1073, which declared that "[un]justified consumer injury is the primary focus of the FTC Act." The Statement articulated a three-part test to determine whether the consumer injury a practice causes makes the practice unfair: the injury "must be substantial; it must not be outweighed by countervailing benefits to consumers or competition that the practice produces; and it must be an injury that consumers themselves could not reasonably have avoided." The Statement also rejected the "immoral, unscrupulous, or unethical" test, reasoning that such a test had never been relied upon as an independent basis for finding unfairness. The Statement also explained that, in most instances, the proper role of public policy is as evidence to be considered in determining the balance of costs and benefits.

The Solution: Reform the Bureau to Enhance Accountability, Expand Consumer Choices, and Promote Economic Opportunity

The Financial CHOICE Act remedies the defects in the Bureau's design in a number of ways, providing accountability to Congress and ensuring that the Bureau will benefit – rather than harm – consumers. The Act begins by renaming the Bureau to reflect its mission of protecting consumer opportunity: the Consumer Law Enforcement Agency (CLEA). For example, the Act provides accountability to the Agency's Director by making him or her removable by the President at will, and brings the Agency's structure into conformity with the Constitution. The Act additionally subjects the agency to the congressional appropriations process, providing oversight and accountability.

The Financial CHOICE Act reforms the Agency's statutory mandate to ensure that it takes into account, and seeks to promote, robust market competition, while it simultaneously re-focuses the Bureau on its responsibility to conduct robust and effective civil enforcement of consumer protection statutes. By restructuring the Agency as a civil enforcement agency, the Act ensures the Agency has the same effective tools to enforce the consumer protection statutes as those the FTC has successfully utilized for decades.

The Financial CHOICE Act also provides courts with enhanced authority to correct any erroneous interpretation made by the Agency of its own legal authority. It requires that the Bureau complete comprehensive cost-benefit analysis before adopting regulations, and affords Congress the opportunity to approve significant Agency regulations before they take effect. It repeals the CFPB's standard-less authority to deny consumers access to any financial product and service it declares "unfair, deceptive, or abusive." And, the CHOICE Act removes the Agency's ability to make rules that unilaterally expand its own authority to regulate markets Congress did not expressly authorize.

Effective consumer protection requires policing markets for fraud and deception while promoting competition and choice among financial products and services, ultimately advancing the goal of financial inclusion. By creating checks-and-balances for the Agency's operations, the Financial CHOICE Act achieves these goals and shields consumers from further harm under Dodd-Frank's command-and-control economy.

Relief from Regulatory Burden for Community Financial Institutions

Executive Summary:

- **Dodd-Frank may have been intended to rein in large, complex financial institutions, but it disproportionately burdens community financial institutions.**

- **Left unaddressed, the hundreds of new rules stemming from Dodd-Frank will only result in more rapid industry consolidation. The big banks will grow larger, while the smaller banks will become fewer.**

- **Increasing regulatory costs are inevitably passed on to customers in the form of higher prices and diminished credit availability.**

- **Addressing the weaknesses of the Dodd-Frank Act will increase consumer and small business access to credit by allowing community financial institutions to cease hiring compliance officers and resume hiring loan officers.**

The Problem: Community Financial Institutions are Suffering Under an Unprecedented Wave of Regulation Unleashed by Dodd-Frank

While sold to the American public as "Wall Street reform," the Dodd-Frank Act's most pernicious effects have been felt on Main Street, among community-based financial institutions and the customers they serve. Dodd-Frank's slew of new regulatory mandates disproportionately harms smaller institutions that lack the personnel and financial resources of larger firms, and ultimately results in a less competitive marketplace, as smaller institutions overwhelmed by the volume and complexity of regulations are forced to exit business lines or seek to merge with other institutions.[188] The end results for consumers are fewer and more expensive borrowing choices and reduced upward mobility – particularly for those economically disadvantaged groups that have historically had the most difficulty accessing credit.

Regulators have a pivotal role to play in making sure consumers or investors have all the material facts necessary to make informed decisions, but under Dodd-Frank, those same regulators are empowered to substitute their judgment for that of consumers and investors to make decisions about what financial products or services they should be able to access. The growing weight and complexity of regulation, new and existing, for community financial institutions affects their ability to provide the products and services necessary to allow small businesses to grow and consumers to realize their financial and personal goals. Faced with the avalanche of new regulatory edicts from Washington, lenders are reluctant to expand their balance sheets and small businesses are unable to access credit or forced to bear higher costs for credit. Accordingly, this affects the broader economy "because higher capital costs make small businesses [who employ half of the nation's private sector

[188] FDIC Vice Chairman (and former Kansas City Federal Reserve Bank President) Thomas Hoenig has observed that "there should be little doubt that regulatory burden contributes to the trend toward consolidation as smaller banks work to control costs and to survive within a highly regulated industry." Joe Adler, *Hoenig Casts Doubt on Reg 'Carve-Out" for Small Banks*, AM. BANKER, (June 10, 2014). Research published by the Federal Reserve Bank of Minneapolis finds a correlation between major regulatory shifts and industry consolidation, *available at* https://www.minneapolisfed.org/~/media/files/pubs/eppapers/14-1/epp_14-1.pdf

workforce and create two-thirds of new jobs] less competitive with larger firms that have access to public financing markets at historically low interest rates." [189]

Industry Consolidation and Declining Market Share at Community Financial Institutions

Dodd-Frank has accelerated the trend toward consolidation in the banking and credit union industries. According to FDIC reporting data, at year-end 2010, the year Dodd-Frank became law, there were 7,658 banks in the U.S.[190] By the fourth quarter of 2016 that number had declined to 5,980. Between the enactment of the Dodd-Frank Act and late 2014, the number of community banks (banks with less than $10 billion in assets) had declined 14 percent, almost double the rate in the period leading up to Dodd-Frank (8 percent).[191] Credit unions have also experienced a steady decline in number. According to NCUA reporting data, in 2010, there were 7,339 credit unions.[192] By the second quarter of 2016, there were only 5,887.[193]

The post-Dodd-Frank period has also seen a drastic decline in new bank start-up activity. Between 2000 and 2008, nearly 170 new banks were chartered per year. Since Dodd-Frank was enacted, less than one bank charter has been granted per year.[194] According to a March 2015 Federal Reserve Bank of Richmond study:

> [The] collapse in new bank entry has no precedent during the past 50 years, and it could have significant economic repercussions. In particular, the decline in new bank entry disproportionately decreases the number of community banks because most new banks start small. Since small banks have a comparative advantage in lending to small businesses, their declining number could affect the allocation of credit to different sectors in the economy...
>
> Banking scholars also have found that new entries are more likely when there are fewer regulatory restrictions. After the financial crisis, the number of new banking regulations increased with the passage of legislation such as

[189] Goldman Sachs Global Markets Institute, "The two-speed economy," (March 2017), available at: https://www.theclearinghouse.org/research/banking-perspectives/2017/2017-q1-banking-perspectives/two-speed-economy

[190] *See* FDIC, QUARTERLY BANKING PROFILE: FOURTH QUARTER 2010 1 (2011), *available at* https://www.fdic.gov/bank/analytical/quarterly/2011_vol5_1/FDIC_Vol5No1_Quarterly_final_v1.pdf.

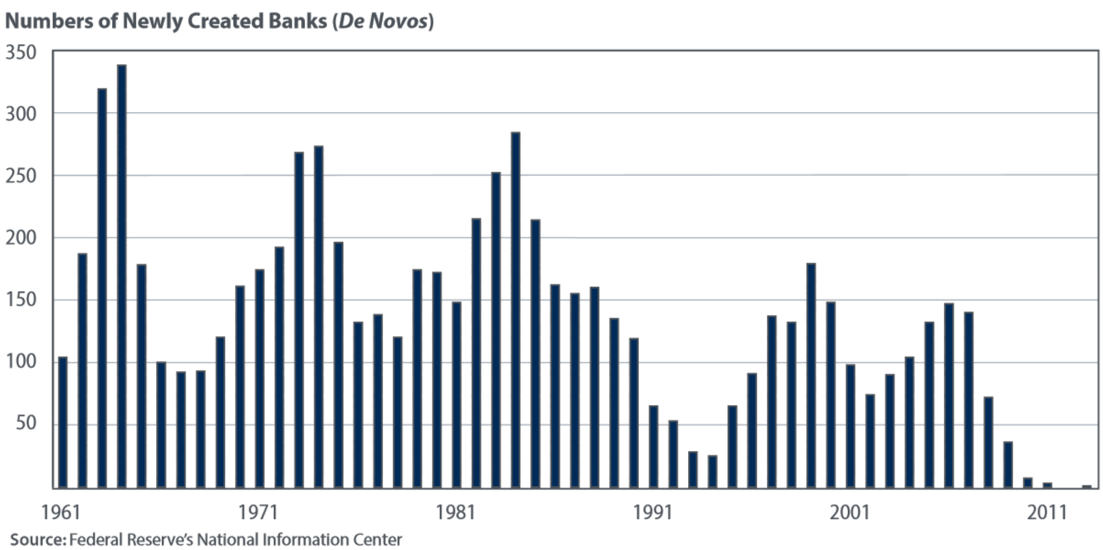
[191] FDIC data reported by the Mercatus Center http://mercatus.org/publication/small-banks-numbers-2000-2014.

[192] *See* NCUA, CALL REPORT QUARTERLY SUMMARY REPORTS (June 30, 2016), *available at* https://www.ncua.gov/analysis/Pages/call-report-data/Reports/PACA-Facts/paca-facts-2016-06.pdf.

[193] *See id*.

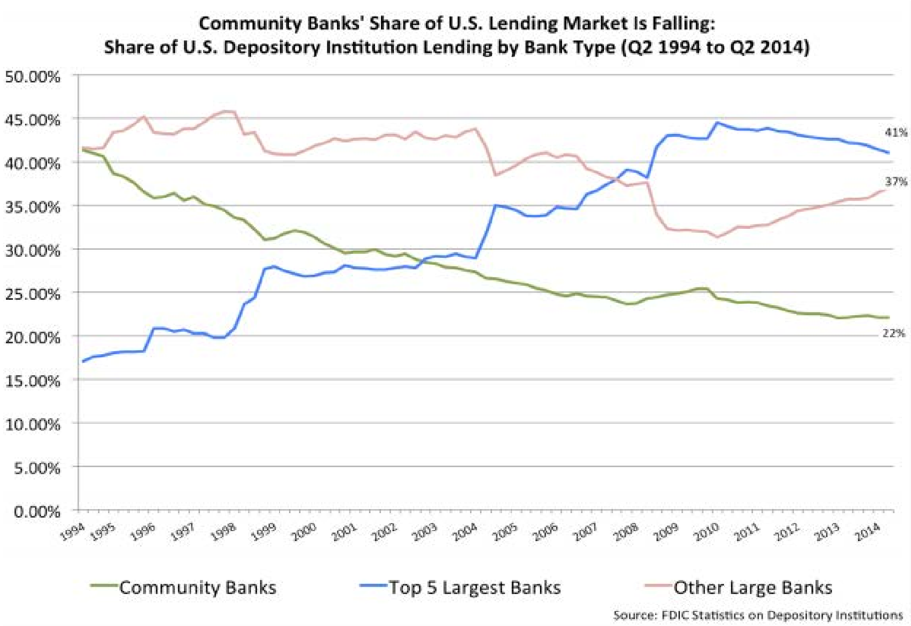
[194] ROISIN MCCORD ET AL., EXPLAINING THE DECLINE IN THE NUMBER OF BANKS SINCE THE GREAT RECESSION, FEDERAL RESERVE BANK OF RICHMOND ECONOMIC BRIEF (Mar. 2015), *available at* https://www.richmondfed.org/~/media/richmondfedorg/publications/research/economic_brief/2015/pdf/eb_15-03.pdf.

the Dodd-Frank Act. Such regulations may be particularly burdensome for small banks that are just getting started.[195]



A 2015 study by researchers at Harvard University found that since 1994, community banks' share of the U.S. lending market has fallen by approximately half – from 41 percent to 22 percent – while the top five largest banks' share has more than doubled – from 17 percent to 41 percent.[196] Lost lending market share reflects broader industry trends. Community banks' share of U.S. banking assets has decreased by more than half – from about 41 percent to 18 percent since 1994 – while the five largest banks' share of banking assets more than doubled, from roughly 18 percent to 46 percent. Prior to and during the financial crisis, community banks' share of banking assets declined 6.4 percent while the five biggest institutions' share of commercial banking assets increased 18.4 percent. Since the enactment of the Dodd-Frank Act, the decline in community banks' share of total industry assets has doubled.

[195] *Id.*
[196] http://www.hks.harvard.edu/centers/mrcbg/publications/awp/awp37.



Industry consolidation and the declining role of community banks are also reflected in data collected by the FDIC on deposit levels at U.S. banks. Data released in mid-2016 indicate that banks with more than $1 billion in assets increased total deposits by 6.7 percent over the preceding year, while depositories with less than $100 million saw their deposits shrink by 8.7 percent during the same period. The FDIC also reports that as of mid-2016, 739 banks held at least $1 billion of assets. Those institutions accounted for 12 percent of the total number of U.S. banks but they held 91 percent of all deposits across the industry.[197]

Finally, banking system consolidation can contribute to heightened financial system risk. The last crisis showed that small community financial institutions can play a unique, stabilizing role in major financial market downturns. Federal Reserve Governor Dan Tarullo remarked in 2009 that "the importance of traditional financial intermediation services, and hence of the smaller banks that typically specialize in providing those services, tends to increase during times of financial stress."[198] Unlike big banks, community banks maintained positive returns on assets (ROAs) during the crisis,[199] and a higher share of small banks, relative to large banks, achieved earnings growth during the crisis.[200] Portfolio default rates for residential mortgages issued by community banks

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[197] Kevin Wack, "Bigger Banks Are Gobbling Up a Larger Share of Deposits: FDIC," *American Banker* (Oct. 5, 2016), *available at*: http://www.americanbanker.com/news/consumer-finance/bigger-banks-are-gobbling-up-a-larger-share-of-deposits-fdic-1091749-1.html

[198] Daniel Tarullo, Governor, Board of Governors of the Federal Reserve System, Large Banks and Small Banks in an Era of Systemic Risk Regulation, Speech at the North Carolina Bankers Association Annual Convention (Jun. 15, 2009), *available at* https://www.federalreserve.gov/newsevents/speech/tarullo20090615a.htm.

[199] *See* GAO, GAO-12-881, IMPACT OF THE DODD-FRANK ACT DEPENDS LARGELY ON FUTURE RULE MAKINGS 10 (2012), *available at* http://www.gao.gov/assets/650/648210.pdf.

[200] *See* Michael Rapoport, *Small Banks Look to Sell as Rules Bite*, WALL STREET JOURNAL, at fig. 1, (Apr. 2, 2014), *available at* http://www.wsj.com/articles/SB10001424052702304157204579473912995008016.

between January 2003 and September 2012 were far lower than for the overall industry (0.20 percent vs. 1.64 percent).[201] Targeted regulatory relief for smaller financial institutions is thus not only conducive to economic growth – it improves the resiliency of U.S. lending markets.

Excessive Regulation Results in Fewer (and More Expensive) Products and Services for American Consumers

Multiple studies and surveys have documented the destructive effect of excessive regulation on the ability of community financial institutions to meet the needs of their customers. For example, a February 2017 paper by researchers at the University of Maryland examined the effects of Dodd-Frank on mortgage originations. They found that while "Dodd-Frank aimed at reducing mortgage fees and abuses against vulnerable borrowers," the lending regulations of Dodd-Frank actually "triggered a substantial redistribution of credit from the middle-class households to wealthy households."[202] They also found that while "[p]roponents of regulation aim to help vulnerable consumers," in fact the same regulators "underestimate the fact that lenders are private organizations competing in a free market, and hence they react to the incentives regulation creates based on their own objective function." Ultimately, "in the case of Dodd-Frank, middle class households did not obtain cheaper mortgages, but were cut out of the mortgage market altogether."

These findings are buttressed by a 2014 survey by the Independent Community Bankers Association (ICBA), which concluded that "regulatory burden is putting pressure on community banks' residential mortgage lending activities." According to that survey:

- 73 percent of community bank respondents said regulatory burdens are preventing them from making more residential mortgage loans.
- Significant percentages of community banks are no longer active in the residential mortgage market, are considering an exit from this line of lending or are exiting the market.
- 78 percent of respondents reported increasing the number of staff members dedicated to lending compliance over the past five years.
- 44 percent said they originated fewer first-lien residential mortgage loans in 2014 compared with the year before. [203]

Access to *non-mortgage* consumer credit has also declined sharply in the post-Dodd-Frank period. In the case of credit card lending, intrusive regulation by the CFPB, Basel III capital standards, and credit card "reforms" enacted by the Democrats in 2009 have combined to

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[201] *See*, TANYA D. MARSH & JOSEPH W. NORMAN, AMERICAN ENTERPRISE INSTITUTE, THE IMPACT OF DODD-FRANK ON COMMUNITY BANKS 24 (2013), *available at* http://www.oba.com/usr_uploads/doddfrankimpact.pdf.

[202] Francesco D'Acunto and Albert G. Rossi, *Ditching the Middle Class with Consumer Protection Regulation*, (February 2, 2017), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2833961

[203] https://www.icba.org/news-events/latest-news/2015/01/27/icba-survey-73-percent-of-community-banks-say-regulations-inhibiting-mortgage-lending

deny millions of Americans the benefits and convenience offered by these products, while hiking the costs of those who are fortunate enough to still qualify for credit. A March 2017 research paper by economists at the Goldman Sachs Global Markets Institute found that post-crisis regulations have resulted in higher prices and lower availability of credit:

> there are 50 million fewer credit card accounts in the U.S. today than at the peak in mid-2008. We estimate that between 2009 and 2012, about 30% of lower-credit borrowers (12 million people) lost access to credit cards[204]

In testimony before the Committee on February 11, 2014, Abby McCloskey, then the Director of Economic Policy at the American Enterprise Institute, offered data reflecting the loss of economic opportunity and economic security suffered by low and moderate-income Americans due to new credit card and banking regulations:

> Credit cards have become more difficult and expensive to access. From June 2010 to June 2013, credit card loans at commercial banks decreased by $40 billion. In 2012, 39 percent of low - and - middle - income households reported tighter credit conditions, such as having their credit cards canceled, limits reduced, or being denied a new card during the previous three years. Access to credit allows cash - strapped households to deal with unexpected financial emergencies and smooth consumption between paychecks.

A 2014 working paper by the Mercatus Center at George Mason University surveyed "approximately 200 banks across 41 states with less than $10 billion in assets each, serving mostly rural and small metropolitan markets."[205] The authors found that approximately 90 percent of banks responding to the survey stated that compliance costs increased since the passage of Dodd-Frank, with all but a small minority reporting increases of more than 5 percent. The Mercatus Center paper also found that:

- Small banks report having eliminated or planning to discontinue certain products and services as a result of Dodd-Frank.
- Residential mortgages, mortgage servicing, home equity lines of credit, and overdraft protection are among the most likely products and services to be cut.
- Nearly 64 percent of the banks surveyed anticipate making changes to the nature, mix, and volume of mortgage products and services as a result of new regulations.
- Roughly 10 percent anticipate discontinuing residential mortgages due to Dodd-Frank and approximately 5 percent have already done so.
- More than a quarter of respondents anticipate engaging in a merger or acquisition in the near future, which would reduce the number of small banks.[206]

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[204] See Goldman Sachs Global Markets Institute, "The two-speed economy," (March 2017), available at: https://www.theclearinghouse.org/research/banking-perspectives/2017/2017-q1-banking-perspectives/two-speed-economy

[205] Hester Peirce et al., *How Are Small Banks Faring Under Dodd-Frank?*, MERCATUS CENTER (Feb. 27, 2014), *available at* http://mercatus.org/publication/how-are-small-banks-faring-under-dodd-frank.

[206] *Id.* A survey of bank compliance officers conducted by the American Bankers Association in 2015 found that "the heightened regulatory environment led 46% of banks to pare back their offerings of loan accounts, deposit

The conclusion researchers drew from the study was that "Dodd-Frank has proved burdensome to small banks, and customers are seeing the effects of the increased regulatory burden through reduced product and service offerings as small banks rethink their lines of business and consider consolidation activity."[207] As a result, "[t]hese customers . . . may shift their patronage to larger banks that enjoy competitive advantages in managing regulatory costs but are not as conveniently located, do not provide the same level of customer service, or do not offer a regionally tailored product mix. Large banks may also not be as willing to serve the customers, such as small businesses and rural populations, which small banks typically serve."

Rather than relying upon government bureaucrats to design mortgage products, the Financial CHOICE Act seeks to better align incentives and risk by promoting portfolio lending. The CHOICE Act incorporates legislation authored by Rep. Andy Barr that has previously passed the House (H.R. 1210) creating a legal safe harbor for mortgage loans that are originated by a company and then held in portfolio on the company's balance sheet. In such circumstances, the company retains the risk of the loan for its entire term, and thus has a powerful incentive to conduct sound underwriting to determine whether the borrower has the ability to repay the loan.

The Mercatus study also explained how the Dodd-Frank Act's "one-size-fits-all" regulatory approach harms small banks and their customers:

> Regulations—such as many of those emerging from Dodd-Frank—that encourage or insist on standardization of bank products and services can be particularly harmful to small banks and their customers. Large banks find it profitable to offer standardized products. Small banks tend to serve idiosyncratic markets, and they succeed by molding their business models to the economic contours of their local communities. A large bank cannot accommodate certain types of customers with its standard products and processes. If federal banking regulations require small banks to mimic these products and processes, these customers might find that small banks cannot serve them either.

Compliance with new regulations is expensive. After a regulation has been finalized, an institution must hire lawyers to review its procedures and forms to ensure that it complies with the regulation; coordinate its compliance activities and design internal audit programs; train its employees; buy additional information technology; design, print, and mail new forms and other disclosures; monitor its employees' compliance with new rules; and make records and employees available for regulatory examinations. These expenses

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accounts, or other services." Kirsten Grind & Emily Glazer, *Nuns with Guns: The Strange Day-to-Day Struggles Between Bankers and Regulators*, WALL STREET JOURNAL, (May 30, 2016), *available at* http://www.wsj.com/articles/nuns-with-guns-the-strange-day-to-day-struggles-between-bankers-and-regulators-1464627601.

[207] *Id.*

exact a higher toll on smaller institutions than they do larger ones. Because smaller institutions do not have the same economies of scale as larger institutions, these costs can disproportionately impact a smaller institution's ability to offer competitive pricing for their services.[208]

For decades, community financial institutions have expressed concerns about rising compliance costs, claiming these costs are ballooning rapidly and threatening the economy by diminishing their ability to offer loans and discounted services to their customers. Despite these complaints, Congress has steadily increased the regulatory burdens on financial institutions over the years by enacting more laws that result in additional regulation, culminating in the enactment of the Dodd-Frank Act. Defenders of the Dodd-Frank Act have attempted to deflect criticism about its effects on community banks by pointing out that many of its provisions are intended to apply to large financial institutions, not smaller ones. The problem is that even the regulations that are meant to apply solely to large institutions end up being applied to small ones. Community bankers have reported a "trickle-down effect, in which regulation originally meant for big institutions is applied to smaller banks," often in the form of bank examiners identifying those regulations as "best practices" that should be followed by all institutions, regardless of their size.[209] Federal Reserve Board Governor Daniel Tarullo, who oversees the Fed's regulatory and supervisory initiatives, has acknowledged the validity of this concern: "Even where regulatory frameworks try to place a lesser burden on smaller banks, there may be some risk of 'supervisory trickle-down,' where supervisors informally, and perhaps not wholly intentionally, create compliance expectations for smaller banks that resemble expectations for larger institutions."[210]

The Solution: Regulatory Relief for Community Banks and Credit Unions

The Financial CHOICE Act includes a host of reforms to address the plight of consumers finding it increasingly difficult to access affordable credit and community financial institutions unable to offer the products and services that those consumers demand. The goal is to free community financial institutions from unnecessarily burdensome regulations so that they can offer customers the personalized level of service that is the hallmark of the relationship-based lending model. Among other reforms, the plan requires financial

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[208] *See* Goldman Sachs Global Markets Institute, "The two-speed economy," (April 2015), at p. 3, *available at* http://www.goldmansachs.com/our-thinking/public-policy/regulatory-reform/2-speed-economy-report.pdf. ("Regulation would typically have a disproportionate impact on the ability of small firms to compete, despite often subjecting larger firms to notable increases in direct regulatory scrutiny and higher absolute costs. The negative competitive affects for small firms arise because of the relatively fixed-cost nature of complying with regulations; large firms have a much larger volume of business over which to spread higher fixed regulatory costs than do small firms.")

[209] Jackie Stewart, "A Quarter of Small Banks Expect to Sell in 2014: KPMG," *American Banker* (Nov. 22, 2013), *available at* http://www.americanbanker.com/issues/178_225/a-quarter-of-community-banks-expect-to-sell-next-year-kpmg-1063814-1.html .

[210] Donna Borak, "Tarullo Calls for Second Look at Bank Regulations," *American Banker* (May 9, 2014), *available at* http://www.americanbanker.com/issues/179_89/feds-tarullo-calls-for-second-look-at-bank-regulations-1067371-1.html.

regulatory agencies to appropriately tailor regulations to fit an institution's business model and risk profile, thereby reducing dead-weight compliance costs and allowing banks to devote more of their operating budgets to meeting customer needs.[211] Similarly, reducing reporting burdens for highly-rated and well-managed institutions, such as by minimizing the granularity of call reports or eliminating redundancies in the data collection demands made by different regulators on the same institution, will free up resources for lending, to the benefit of consumers and the broader economy.

An important component of the regulatory relief afforded community financial institutions by the Financial CHOICE Act is greater due process protections for institutions and individuals and an enhanced ability to challenge arbitrary supervisory or enforcement actions. Specifically, the Republican plan will prohibit regulators from targeting legitimate businesses and terminating their banking relationships absent a material basis that goes beyond mere "reputational risk."[212] The legislation will also require regulators to increase transparency and reestablish due process by making final examination reports available for a depository institution's review on a timely basis, and affording the institution a right to appeal material supervisory determinations to an independent arbiter.[213]

Like community banks, America's credit unions did not cause the financial crisis, but are nonetheless caught in Dodd-Frank's regulatory cross-hairs. They, too, receive significant regulatory relief under the Financial CHOICE Act. In addition to benefiting from many of the same reforms applicable to community banks (described above), credit unions will be afforded relief unique to their charter, to require t National Credit Union Administration (NCUA), which regulates federally insured credit unions, will hold annual budget hearings that are open to the public, and to include in each annual budget a report detailing the NCUA's "overhead transfer rate."

[211] This language is based on legislation authored by Rep. Scott Tipton (H.R. 2896), which has been approved by the Financial Services Committee.
[212] This language is based on legislation authored by Rep. Blaine Luetkemeyer (H.R.766), which passed the House on February 4, 2016.
[213] This language is based on legislation authored by Rep. Lynn Westmoreland (H.R. 1941), which has previously been approved by the Financial Services Committee.

Federal Reserve Reform

Executive Summary:

- **Dodd-Frank rewarded government bureaucrats who were arguably most responsible for the financial crisis – the Federal Reserve – with expansive new regulatory powers, lending credence to the adage that at least in Washington, nothing succeeds like failure.**

- **By amassing a $4.5 trillion balance sheet and stepping well outside the bound of monetary policy to engage as a fiscal principal in in the most political of credit markets, the Fed erased the line between fiscal and monetary policy, and in doing so has undermined the important political independence of monetary policy.**

- **For far too long, the Federal Reserve has sought to shield its prudential regulatory actions behind the cloak of its monetary policy independence. The Financial CHOICE Act scales back the Fed's regulatory and supervisory powers and subjects them to greater congressional oversight and accountability.**

- **By promoting a monetary policy strategy that is both more principled and transparent. the Financial CHOICE Act finally provides a framework for monetary policy to do what it can (and only what it can) to fundamentally support a dynamic and growing economy for every American – that is, reliably produce clear price signals so that businesses and households can make better economic decisions. Leading academic and Fed economists, including several Nobel Laureates, support this important reform. However, while a decade of improvisational monetary policies consistently failed to deliver on the Fed's own benchmarks, Fed Chair Yellen continues to oppose this simple reform.**

A More Powerful Federal Reserve Must Also be More Accountable

The Federal Reserve's conduct of monetary policy and its performance as a bank regulator in the lead-up to the financial crisis have been the subject of criticism from across the ideological and political spectrum. Many economists believe that by keeping interest rates too low for too long, the Fed helped fuel a global savings glut that distorted the pricing of financial assets and helped inflate the housing bubble. And despite having teams of resident examiners embedded in the largest financial institutions and extensive statutory authorities at its disposal, the Federal Reserve failed to identify material weaknesses in these firms' operations and the risks lurking in their portfolios until it was far too late.

Yet rather than scale back the Federal Reserve's authority – which would have been a logical response to its woeful performance in the pre-crisis period – the drafters of the Dodd-Frank Act chose to double down, conferring broad new powers on the Fed to regulate virtually every corner of the financial services sector. Indeed, it is fair to say that Dodd-

Frank has made the Fed our nation's most powerful bureaucracy. The Dodd-Frank Act gives the Federal Reserve regulatory authority over non-bank financial institutions designated as "systemically important" by the FSOC, as well as all bank holding companies with assets greater than $50 billion.[214] The Federal Reserve is authorized to impose "heightened prudential standards"[215] on these firms, including capital and liquidity requirements, risk management requirements, resolution planning and credit exposure report requirements, concentration limits, stress tests, and enhanced public disclosures.[216]

The Dodd-Frank Act also entrusts the Federal Reserve with responsibility for regulating so-called financial market utilities, like clearinghouses, and payment, settlement and clearing activities deemed systemically important by the FSOC, and gives such firms access to the Federal Reserve's discount window.[217] Dodd-Frank transferred oversight of savings and loan holding companies previously exercised by the Office of Thrift Supervision to the Federal Reserve.[218] The Federal Reserve Board's Chair sits on the FSOC and participates in the deliberations on which non-bank financial firms should be designated for heightened prudential supervision.[219] Dodd-Frank authorizes the Federal Reserve, upon a vague finding that a financial institution poses a "grave threat" to financial stability, to effectively dismantle the firm.[220] The Federal Reserve also participates in the decision to place a failing firm into an "orderly liquidation" proceeding under Title II of the Dodd-Frank Act.[221]

It is hard to think of a more egregious example of Congress rewarding regulatory failure than the massive grant of authority bestowed upon the Federal Reserve in Dodd-Frank, easily the largest single expansion of the central bank's power in its one hundred year existence. Writing in *Forbes* magazine, John Carney questioned the wisdom of entrusting "heightened prudential supervision" of large non-banks to an institution whose inadequacy as a regulator helped precipitate the last financial crisis:

> At the most basic level, it's hard to see how the expansion of the scope of the Federal Reserve's authority to cover any large financial institution makes sense. The Federal Reserve was not able to prevent disaster at the firms it was already charged with overseeing. What reason is there to think it will do a better job at regulating a wider universe of firms?

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[214] *See* Dodd-Frank Act §§ 165, 113.
[215] *See id.* § 112 (a)(2)(I).
[216] *See id.* § 165; *see generally id.* tit. I, § 101-176.
[217] *See id.* §§ 803-806.
[218] *See id.* § 312.
[219] *See id.* § 111. Of the nine federal agencies represented on the FSOC, the Fed is clearly "first among equals." It is the only agency that is allowed to send three representatives – Chair Yellen, Governor Tarullo, and New York Fed President Dudley – to FSOC meetings. When SEC Commissioner Michael Piwowar asked that the SEC be afforded reciprocal treatment and that he be allowed to attend FSOC meetings, his request was denied. See Michael S. Piwowar, "Advancing and Defending the SEC's Core Mission," Speech before the U.S. Chamber of Commerce, (January 27, 2014), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370540671978
[220] *See* Dodd-Frank Act § 121.
[221] See *id.* § 203.

> More concretely, the Federal Reserve had regulators in place inside of Lehman Brothers following the collapse of Bear Stearns. These in-house regulators did not realize that Lehman's management was rebuking market demands for reduced risk and covering up its rebuke with accounting sleight-of-hand. When Lehman actually came looking for a bailout, officials were reportedly surprised at how bad things were at the firm. A similar situation unfolded at Merrill Lynch. The regulators proved inadequate to the task.[222]

Even Sen. Chris Dodd, one of Dodd-Frank's primary architects, acknowledged prior to the law's passage that in light of the Fed's dismal performance before and during the financial crisis, granting it more regulatory authority was like "a parent giving his son a bigger, faster car right after he crashed the family station wagon."[223]

Congress' decision to grant virtually unlimited regulatory authority to a single federal agency has had profound consequences for the financial system and the broader U.S. economy. As Paul Kupiec, a resident scholar at the American Enterprise Institute (AEI), observes, "Supervision and regulation are now so intrusive that it is not a stretch to say that the largest financial institutions are being run by the Fed."[224] Dr. Kupiec points out that the regulators' *de facto* management of these firms exacerbates the "too big to fail" problem that Dodd-Frank's proponents claimed to have solved: "With the Fed running . . . [too big to fail] institutions, why wouldn't a rational investor think that his or her investment is protected?"[225]

For far too long, the Federal Reserve has sought to shield its prudential regulatory actions behind the cloak of its monetary policy independence. But the case for Federal Reserve independence when setting monetary policy does not hold up when applied to the Fed's broad powers under the Dodd-Frank Act to regulate an ever-increasing share of the U.S. economy. Accordingly, the Financial CHOICE Act subjects the Federal Reserve's prudential regulatory activities – along with those of the other federal financial regulators – to the congressional appropriations process, handing the people's elected representatives an important tool with which to hold these bureaucracies accountable and achieve greater transparency in government operations. The conduct of Fed monetary policy will continue to be funded through open market operations and other sources of income, outside of the appropriations process, so as to maintain the important independence of monetary policy.

To further enhance transparency and accountability at the Federal Reserve, the Financial CHOICE Act directs the Government Accountability Office (GAO) to conduct an audit of the Fed within twelve months of the date of the bill's enactment, with a report to be delivered

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[222] John Carney, Opinion, *Chris Dodd's Incredibly Stupid Plan to Expand the Powers of the Fed*, FORBES, (Mar. 15, 2010), *available at* http://www.forbes.com/sites/streettalk/2010/03/15/chris-dodds-incredibly-stupid-plan-to-expand-the-powers-of-the-fed/#193f6ef116af.
[223] David Stout, *Senators Skeptical of Financial Regulation Plan*, NEW YORK TIMES, Jun. 18, 2009, *available at* http://www.nytimes.com/2009/06/19/business/19treasury.html.
[224] Paul Kupiec, Opinion, *Dodd-Frank doesn't end 'too big to fail,'* THE HILL, (July 30, 2014), *available at* http://thehill.com/opinion/op-ed/213871-dodd-frank-doesnt-end-too-big-to-fail.
[225] *Id.*

to Congress within 90 days of completion of the audit. Over the past eight years, the Fed has been engaged in a radical monetary policy experiment, amassing a $4.2 trillion portfolio of assets,[226] intervening to prop up select credit markets,[227] and keeping interest rates near zero.[228] It has blurred the line between fiscal and monetary policy almost beyond recognition, facilitating the Obama Administration's reckless spending, and doing so on the borrowed-time of an unsustainable national debt. In a democracy, any government agency exercising such enormous influence over the economy and the lives of individual American citizens should expect to be held accountable for its actions, and the Federal Reserve is no exception. A GAO audit of *all* aspects of Federal Reserve operations – not just those that the Fed wants us to see – is a necessary antidote to the secrecy and lack of transparency that have characterized our central bank for far too long.

The Federal Reserve's Implementation of Dodd-Frank's Living Will and Stress Testing Regimes has Been Marked by a Troubling Lack of Transparency and a Disregard for the Rule of Law

Section 165 of the Dodd-Frank Act confers a host of powerful new supervisory tools upon the Federal Reserve for overseeing the activities of bank holding companies with total consolidated assets of $50 billion or more and nonbank financial companies designated by the FSOC for heightened prudential supervision by the Federal Reserve.[229] (These institutions are frequently referred to as systemically important financial institutions or "SIFIs"). Two of these new authorities – living wills and stress tests – have been particularly controversial, both because they put government bureaucrats in the position of essentially dictating the business models and operational objectives of private businesses, and because of the lack of transparency with which the Fed has implemented its statutory powers.

Living Wills

The Dodd-Frank Act requires that SIFIs periodically submit detailed plans to the Federal Reserve and the FDIC, describing the company's strategy for rapid and orderly resolution under the Bankruptcy Code in the event of its material financial distress or failure.[230] If the Federal Reserve and FDIC conclude that a SIFI has failed to produce a "credible" plan for its orderly resolution, the agencies can take a series of punitive measures, including imposing "more stringent capital, leverage, or liquidity requirements, or restrictions on the growth,

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[226] *See System Open Market Account Holdings*, FEDERAL RESERVE BANK OF NEW YORK, http://nyapps.newyorkfed.org/markets/soma/sysopen_accholdings.html
[227] *See* Sewell Chan & Jo Craven McGinty, *Fed Documents Breadth of Emergency Measures*, NEW YORK TIMES, Dec. 1, 2010, *available at* http://www.nytimes.com/2010/12/02/business/economy/02fed.html
[228] *See* Jon Hilsenrath & Ben Lubsdorf, *Fed Raises Rates After Seven Years Near Zero, Expects 'Gradual' Tightening Path*, WALL STREET JOURNAL, (updated Dec. 16, 2015), *available at* http://www.wsj.com/articles/fed-raises-rates-after-seven-years-at-zero-expects-gradual-tightening-path-1450292616.
[229] *See* Dodd-Frank Act § 165.
[230] *See id.* § 165(d).

activities, or operations of the company, or any subsidiary thereof."[231] Failure to remedy the deficiencies identified by the regulators can ultimately result in the Federal Reserve and FDIC ordering the firm "to divest certain assets or operations."[232]

As implemented by federal regulators, the living will process has devolved into a maddeningly opaque, highly politicized, and hugely expensive exercise in command-and-control Washington regulation. A recent report by the GAO commissioned by Chairman Hensarling highlighted the lack of transparency surrounding the living wills, noting that "without greater disclosure [by the regulators], companies lack information they could use to assess and enhance their plans.[233]

The "living will" process grants the FDIC and the Federal Reserve unbridled – and unreviewable – discretion to fundamentally restructure private businesses, under a standard-less process that relies entirely upon subjective judgments made by government bureaucrats. AEI resident scholar Paul Kupiec and economist Abby McCloskey have pointed out that living wills are thus a recipe for government command-and-control of private enterprise:

> Living wills are a gateway for regulators to change the company itself. If companies' living wills are not to regulators' liking, regulators can require the institutions to restructure, raise capital, reduce leverage, divest or downsize. Thus, rejecting a living will gives regulators an opening to restructure the companies themselves . . . . This type of regulatory discretion is not uncommon in the world, but it is usually found in 'banana republics' and countries where the government runs the banking system. Such unconstrained authority opens up all sorts of avenues for partiality and government intrusion into a financial institution's operations.[234]

In testimony before the Committee on July 28, 2015, former Senate Banking Committee Chairman Phil Gramm described living wills as "a plan not of how banks will be run but how they would be liquidated if they failed. The Fed and the FDIC have almost total discretion in deciding whether the plan is acceptable and therefore whether to institute a variety of penalties, including the divestiture of assets. No other industry in the nation makes or publishes such plans, or expends management energy and board time on how to

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[231] *Id.* § 165 (d)(5)(A).
[232] *Id.* § 165(d)(5)(B).
[233] GAO, GAO-16-341, RESOLUTION PLANS: REGULATORS HAVE REFINED THEIR REVIEW PROCESSES BUT COULD IMPROVE TRANSPARENCY AND TIMELINESS (April 12, 2016), *available at:* http://www.gao.gov/products/GAO-16-341.
[234] Abby McCloskey & Paul Kupiec, *Why the 'Living Will' Process Sets Up Banks for Failure*, AMERICAN BANKER, (Aug. 11, 2014), *available at* http://www.americanbanker.com/bankthink/why-the-living-will-process-sets-banks-up-for-failure-1069285-1.html.

shut down their business. Their energy is rightly focused on how to build their business and the economy."[235]

As if to underscore Sen. Gramm's point, an April 14, 2016, article in the *American Banker* quotes Brent Hoyer, a deputy director of the FDIC's Office of Complex Financial Institutions, as saying that one of the banks involved in the most recent round of living wills administered by the regulators "met with FDIC officials on 65 occasions."[236] What Mr. Hoyer touts as evidence of the rigorous iterative nature of the living will process should give serious pause to those who worry that federal banking regulation has become overly intrusive and burdensome. It seems fair to ask whether a system in which key bank executives spend as much, if not more, of their time preparing for and attending meetings with their regulatory overlords in Washington as they do running their businesses is consistent with principles of free market capitalism.

Stress Tests

The stress tests administered by the Fed to determine the ability of U.S. banks to withstand periods of economic turmoil suffer from many of the same deficiencies as the living will process. The stress tests have become a kind of "cat-and-mouse" exercise in which Fed staff and bank compliance officers attempt to outwit one another in a game without rules or transparency. The secrecy surrounding the stress tests makes it difficult for Congress and the public to assess either the effectiveness of the Fed's regulatory oversight or the integrity of the findings yielded by the tests.

In testimony before the Committee on July 23, 2015, Columbia University Professor Charles Calomiris described the stress test process as a "Kafkaesque Kabuki drama in which regulators punish banks for failing to meet standards that are never stated (either in advance or after the fact). This makes stress tests a source of uncertainty rather than a helpful guide against unanticipated risks." Professor Calomiris went on to question how such a secretive and opaque process could be squared with basic American constitutional precepts:

> In addition to their economic costs and questionable contributions, current stress tests are also objectionable on grounds of basic adherence to the rule of law and respect for property rights. Regulators not only impose unstated quantitative standards for meeting certain stressed scenarios, they also retain the option of simply deciding that banks fail on the basis of a qualitative judgment unrelated even to their own model's criteria. It is hard to believe that the current structure of stress tests could occur in a country

[235] *The Dodd-Frank Act Five Years Later: Are We More Prosperous?: Hearing Before the Hearing Before the H. Comm. on Financial Services*, 114th Cong. (2015) (Written Testimony of Sen. Phil Gramm, Jul. 28, 2015), *available at* http://financialservices.house.gov/uploadedfiles/hhrg-114-ba00-wstate-pgramm-20150728.pdf.
[236] Lalita Clozel, *FDIC Under Fire By Own Panel of Experts*, AMERICAN BANKER, (Apr. 14, 2016), *available at:* http://www.americanbanker.com/news/law-regulation/fdic-under-fire-by-own-panel-of-experts-1080467-1.html.

like the United States, which prizes the rule of law, the protection of property rights, and adherence to due process.[237]

Chairman Gramm, testifying at a July 28, 2015, Committee hearing, echoed these concerns: "What does the stress test test? Not only does no one know, but the regulators see that as a virtue. The Fed's Vice Chairman has stated that giving banks a clear road map for compliance might make it 'easier to game the test.' But isn't the fact that compliance is easier when you know what the law says the whole point of the rule of law?"[238]

AEI resident scholar Paul Kupiec identified another potentially significant flaw in the stress testing regimen designed by the Federal Reserve, testifying on July 8, 2015, that "coordinated supervisory stress tests encourage a 'group think' approach to risk management that may increase the probability of a financial crisis." Dr. Kupiec elaborated:

> [Federal Reserve] stress test scenarios have to be specific so that banks and regulators can model the same event. Moreover, the . . . [Fed] imposes uniformity in the stress test loss rates across all designated banks by using its own stress test estimates. The . . . [Fed] acts much like a coach or a central planner and tries to ensure coherence in firms' estimates and capital plans. Unintentionally perhaps, by requiring all firms to approach the stress test problem in the same way, these tests encourage participating institutions to think and operate similarly. What happens when all the largest banks are steeled against the wrong crisis?[239]

As in so many other aspects of the Dodd-Frank regulatory architecture, then, the success or failure of stress tests in averting future financial crises depends almost entirely upon the predictive powers of the same federal bureaucrats whose shortcomings were so painfully exposed by the last crisis.

The fundamental flaws in the Fed's stress test methodology were laid bare by an October 29, 2015, report issued by the Fed's own Office of Inspector General, which examined the extent to which the model risk management practices the Fed uses in its supervisory stress testing program are "consistent with supervisory guidance on model risk management" that the Fed applies to the banking organizations it oversees. The report found significant deficiencies related to the Fed's model validation and broader governance practices. In

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[237] *The Dodd-Frank Act Five Years Later: Are We More Prosperous?: Hearing Before the Hearing Before the H. Comm. on Financial Services*, 114th Cong. (2015) (Written testimony of Charles Calomiris, "What's Wrong with Prudential Bank Regulation and How to Fix It," Jul. 23, 2015), *available at* http://financialservices.house.gov/uploadedfiles/hhrg-114-ba00-wstate-ccalomiris-20150723.pdf.

[238] *The Dodd-Frank Act Five Years Later: Are We More Prosperous?: Hearing Before the Hearing Before the H. Comm. on Financial Services*, 114th Cong. (2015) (Written Testimony of Sen. Phil Gramm, Jul. 28, 2015), *available at* http://financialservices.house.gov/uploadedfiles/hhrg-114-ba00-wstate-pgramm-20150728.pdf.

[239] *Examining the Designation and Regulation of Bank Holding Company SIFIs: Hearing Before the Subcomm. On Consumer Credit and Financial Institutions of the Hearing Before the H. Comm. on Financial Services*, 114th Cong. (2015) (Written Testimony of Paul H. Kupiec, Jul. 8, 2015), *available at* http://financialservices.house.gov/uploadedfiles/hhrg-114-ba15-wstate-pkupiec-20150708.pdf

addition, the report noted that "similar findings identified at institutions supervised by the Federal Reserve have been characterized as matters requiring immediate attention or as matters requiring attention."[240] The Federal Reserve describes "matters requiring immediate attention" as follows:

> [Matters Requiring Immediate Attention (MRIA)] arising from an examination, inspection, or any other supervisory activity are matters of significant importance and urgency that the Federal Reserve requires banking organizations to address immediately and include: (1) matters that have the potential to pose significant risk to the safety and soundness of the banking organization; (2) matters that represent significant noncompliance with applicable laws or regulations; (3) repeat criticisms that have escalated in importance due to insufficient attention or inaction by the banking organization; and (4) in the case of consumer compliance significant consumer harm. An MRIA will remain an open issue until resolution and examiners confirm the banking organization's corrective actions.[241]

The stress tests thus perfectly encapsulate the double standard that is the hallmark of the modern regulatory state: one set of rules for the bureaucratic elites and another for the entities they regulate.[242]

A recent report by the GAO commissioned by Chairman Hensarling underscored these concerns.[243] For example, the GAO found that (1) the Federal Reserve has not always followed its own guidance or principles; (2) the Federal Reserve cannot be reasonably assured that small adjustments to its stress scenario variables would produce outcomes that neither amplify nor dampen economic cycles; and (3) the Federal Reserve has limited its perspective and has not always followed its own guidance for banking institutions on model-risk management practices.

Transparency is a key feature of accountability and this limited disclosure may hinder understanding of the CCAR program and limit public and market confidence in the program and the extent to which the Federal Reserve can be held accountable for its decisions. The

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[240] *See* FEDERAL RESERVE OIG REPORT, THE BOARD IDENTIFIED AREAS OF IMPROVEMENT FOR ITS SUPERVISORY STRESS TESTING MODEL VALIDATION ACTIVITIES, AND OPPORTUNITIES EXIST FOR FURTHER ENHANCEMENT (Oct. 29, 2015), *available at* http://oig.federalreserve.gov/reports/board-supervisory-stress-testing-model-validation-oct2015.pdf.

[241] *See* FEDERAL RESERVE, SUPERVISORY CONSIDERATIONS FOR THE COMMUNICATION OF SUPERVISORY FINDINGS SR 13-13/CA 13-10, ATTACHMENT: SUPERVISORY CONSIDERATIONS FOR THE COMMUNICATION OF SUPERVISORY FINDINGS (Jun. 17, 2013), *available at* http://www.federalreserve.gov/bankinforeg/srletters/sr1313a1.pdf.

[242] The Inspector General's report prompted the WALL STREET JOURNAL to editorialize: "The Fed's stress tests theoretically judge whether the country's largest banks can withstand economic downturns. So the Fed identifying a problem with its own management of the stress tests is akin to an energy company noticing that something is not right at one of its nuclear reactors." *See The Fed is Stressed Out*, WALL STREET JOURNAL, (Nov. 27, 2015), *available at* http://www.wsj.com/articles/the-fed-is-stressed-out-1448574493.

[243] GAO, GAO-17-48, FEDERAL RESERVE: ADDITIONAL ACTIONS COULD HELP ENSURE THE ACHIEVEMENT OF STRESS TEST GOALS (November, 2016), *available at* http://www.gao.gov/assets/690/681020.pdf

Federal Reserve also has not regularly updated guidance to firms about supervisory expectations and peer practices related to the qualitative assessment. Companies that must meet these expectations annually may face challenges from the irregular timing of communications, which could limit the Federal Reserve's achievement of its CCAR goals."

Republican Reforms to the Living Will and Stress Test Processes

In an effort to inject badly needed accountability, transparency, and targeted relief into the living will and stress test processes, the Financial CHOICE Act makes a number of important reforms. For banking organizations that do *not* make a qualifying capital election and continue to submit living wills, the Financial CHOICE Act (1) provides that "living wills" can only be requested by a banking agency once every two years; (2) requires the banking agencies to provide feedback on "living wills" to banking organizations within six months of their submission; and (3) requires the banking agencies to publicly disclose their assessment frameworks.

In addition, the Financial CHOICE Act would overhaul the current regime for stress testing banks, by (1) requiring the Federal Reserve to issue regulations, after providing for notice and comment, that provide for at least three different sets of conditions under which the evaluation required by Section 165 of the Dodd-Frank Act (or under the Federal Reserve's rules implementing stress testing requirements) will be conducted, including baseline, adverse, and severely adverse, and methodologies, as well as models to estimate losses on certain assets; (2) requiring the Federal Reserve to provide copies of such regulations to the GAO and the Panel of Economic Advisors of the Congressional Budget Office before publishing such regulation; and (3) requiring the Federal Reserve to publish a summary of all stress test results. Additionally, the Financial CHOICE Act will make the company-run stress test an annual exercise, move CCAR to a biennial process, and extend the Federal Reserve's regulatory relief from CCAR's qualitative assessment to all banks. Further, the Financial CHOICE Act will provide much needed transparency to the Federal Reserve's stress tests consistent with findings in the GAO report.

Finally, to ensure that sensitive, market-moving information regarding the Federal Reserve's determinations for stress tests and living wills are not leaked,[244] the Financial CHOICE Act institutes criminal penalties for the unauthorized disclosure of such information.

The Financial CHOICE Act also seeks to end the Federal government's intrusion into the boardroom, whereby regulatory agency employees impose their will and dictate the company's activities and usurp the authority of the company's board of directors and shareholders. Since the adoption of the Dodd-Frank Act, there has been a marked increase in potentially unwarranted or improper Federal Reserve interference in the corporate affairs of publicly-traded companies, such as demanding detailed minutes and other documentation of board meetings, boards being "written up" regularly in confidential

[244] Ryan Tracy, *Regulators Set to Reject Some Big Banks' 'Living Wills'*, WALL STREET JOURNAL, (Apr. 12, 2016), https://www.wsj.com/articles/regulators-set-to-find-flaws-in-big-u-s-banks-living-wills-1460491197.

supervisory reports, and bank examiners demanding information about the lobbying efforts of member banks.[245]

All banking organizations should adopt written policies and procedures to identify and manage operational risk that is appropriate based on their size, activities, and product offerings. To require banking organizations, however, to hold operational risk capital against former activities is an inappropriate restraint and the Financial CHOICE Act limits the imposition of operational risk capital requirements to a bank's current activities and businesses and permits adjustments for operational risk mitigants.

A More Principled and Transparent Monetary Policy Would Help U.S. Households and Businesses Make Better Economic Decisions

According to Nobel Prize-winning economist Milton Friedman, "it is a matter of record that periods of relative stability in the rate of monetary growth have also been periods of relative stability in economic activity."[246] Friedman believed that when central bankers act with unlimited discretion they generally do more harm than good to the economy.

Consistent with Professor Friedman's view, the last 30 years of economic history have demonstrated that, when monetary policy follows more from a fundamentals-based strategy than unmoored improvisation, economic performance grows stronger.[247] Extrapolating from this history, Stanford University economist John Taylor thus concluded that the best way for the Fed to support a robust economy and full employment is through is principled and easy-to-communicate monetary policy strategy – one that reliably produces clear price signals so that business and households can make more productive economic decisions.[248]

Professor Allan Meltzer of Carnegie Mellon University, a prominent economic historian who has extensively studied the Fed, agrees with Professor Taylor that over the Federal Reserve's history, monetary policy has operated more effectively when it follows a simple and clearly understood strategy. Professor Meltzer argues that by following such an approach, the Fed can more effectively limit volatility in both economic growth and inflation than when the Federal Reserve appears to act subjectively or under the influence of political pressure to finance deficits.[249] The last ten years have been defined by exceptionally accommodative monetary policy. Thus far, this experiment has not produced the growth that the Federal Reserve forecast; it has, however, created an enormous amount

[245] Victoria McGrane and Jon Hilsenrath, Regulators Intensify Scrutiny of Banli Boards, Wall St. J., Mar. 30, 2015 https://www.wsj.com/articles/regulators-intensify-scrutiny-of-bank-boards-1427757247

[246] Milton Friedman, *The Role of Monetary Policy*, AM. ECON. REV., Mar. 1968, at 16.

[247] *See* John Taylor, *The Federal Reserve in a Globalized World Economy*, *in* THE FEDERAL RESERVE'S ROLE IN THE GLOBAL ECONOMY 195, (Michael Bordo & Mark Wynne eds., 2016).

[248] *See id.*

[249] *The Fed Turns 100: Lessons Learned Over a Century of Central Banking*: *Hearing Before the H. Comm. on Financial Services*, 113th Cong. 4 (2014) (statement of Allan Meltzer, Professor of Economics, Tepper School of Business, Carnegie Mellon University), *available at* http://financialservices.house.gov/uploadedfiles/113-42.pdf.

of uncertainty about the future course of monetary policy, and thus clouded the economic decision-making of households and businesses.

Dr. Charles Plosser, immediate past President of the Federal Reserve Bank of Philadelphia, has also expressed support for a transparent and reliable framework in setting monetary policy:

> One of the most important ways to support credibility and thus the effectiveness of forward guidance is to practice it as part of a systematic policy framework. I believe that indicating how the evolution of key economic variables systematically shapes current and future policy decisions is critical to such a policy framework. Indeed, a commitment to a policy framework that is systematic and rule-like provides the foundation for establishing expectations for the future path of policy and thus forward guidance. . . . The appropriate way to make policy systematic and rule-like is to make policy history dependent and base policy decisions on the state of the economy. **Doing so does not commit the policymakers to particular future values of the policy rate, but describing a reaction function explains how the policy rate will be determined by economic conditions**.[250]

In testimony before the Financial Services Committee on December 12, 2013, Dr. Douglas Holtz-Eakin, the former Director of the Congressional Budget Office, also endorsed a rules-based monetary policy:

> Certainly, I would like to see far more of a rules-based approach by the Federal Reserve. That doesn't rule out discretion, because they can pick the rule they want to operate. But if they can provide it to the Congress, and the American people will know what they are up to, they themselves have said forward guidance is crucial. **We need to know what they are going to do**. Rules provide that.[251]

A transparent and reliable monetary policy strategy would also enhance congressional oversight – and therefore public accountability – of the Federal Reserve, helping to demystify an institution that wields enormous influence over the lives of every American but about which most Americans know very little. Professor Meltzer highlighted this point in 2015 testimony before the Senate Banking Committee:

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[250] Charles Plosser, President, Federal Reserve Bank of Philadelphia, Influencing Expectations in the Conduct of Monetary Policy, Address at the Bank of Japan-Institution for Monetary and Economic Studies Conference: Monetary Policy in a Post-Financial Crisis Era 7 (May 28, 2014) (emphasis added), *available at* http://www.philadelphiafed.org/publications/speeches/plosser/2014/05-28-14-boj.cfm.

[251] *Rethinking The Federal Reserve's Many Mandates On Its 100-Year Anniversary*: *Hearing Before the H. Comm. on Financial Services*, 113th Cong. 20 (2013) (statement of Dr. Douglas Holtz-Eakin, President, American Action Forum) (emphasis added), *available at* http://financialservices.house.gov/uploadedfiles/113-56.pdf.

> Congress has to fulfill its obligation to monitor the Fed, and it cannot do that now because the Chairman of the Fed can come in here, as Alan Greenspan has said on occasion, Paul Volcker has said on occasion, and they can tell you whatever it is they wish, and it is very hard for you to contradict them. So you need a rule which says, look, you said you were going to do this, and you have not done it. That requires an answer, and that I think is one of the most important reasons why we need some kind of a rule.[252]

Monetary policy works best when the Federal Reserve can make credible commitments to the public about its future course. Requiring the Federal Reserve to systematically explain differences between actual policy decisions and prescriptions from well-known benchmarks can help households and markets set better expectations about the future path of monetary policy, and thus make better economic decisions in the present. Accordingly, the Financial CHOICE Act seeks to improve how the Fed communicates monetary policy, by requiring it to choose a monetary policy strategy, and explain to the American people how its chosen course compares to a reference policy rule.[253] Importantly, it is the Federal Reserve that selects the policy inputs that go into the formulation of its strategy, and the Fed retains the power to change or depart from its chosen strategy whenever it determines that economic circumstances warrant.[254] The requirement is simply for a more clear communication of policy and not for any particular policy.

Before assuming her current responsibilities, Fed Chair Janet Yellen was supportive of a communication strategy of referencing a benchmark model to help households and markets form better expectations about the course of monetary policy, stating in a 1996 speech that "the framework of a Taylor-type rule could help the Federal Reserve communicate to the public the rationale behind policy moves, and how those moves are consistent with its objectives."[255] But she has changed her tune considerably since becoming Fed Chair, criticizing Republican reforms to foster a more predictable monetary policy on the grounds that such reforms would both tie the Fed's hands and erode the Fed's political independence.[256]

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[252] *Federal Reserve Accountability and Reform: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 6, 114th Cong. (2015) (statement of Allan H. Meltzer University Professor of Political Economy, Tepper School of Business, Carnegie Mellon University), *available at* https://www.gpo.gov/fdsys/pkg/CHRG-114shrg93893/pdf/CHRG-114shrg93893.pdf.

[253] These provisions are drawn from the Fed Oversight Reform and Modernization Act (H.R. 3189), authored by Rep. Bill Huizenga, which passed the House on November 19, 2015.

[254] As Chairman Hensarling has noted, under the Republican plan, "[i]f the Fed wants to conduct monetary policy based upon a rousing game of rock, paper, scissors, . . . it will retain the unfettered discretion to do so," but it needs to tell the rest of us what it is doing and why. *See Monetary Policy and the State of the Economy*: *Hearing Before the H. Comm. on Financial Services*, 113th Cong. 2 (2014) (statement of Rep. Jeb Hensarling, Chairman of the House Financial Services Committee) (referring to the Federal Reserve Accountability and Transparency Act, basis for text in the CHOICE Act).

[255] Janet Yellen, Monetary policy: goals and strategy, Presentation to the National Association of Business Economists 7 (Mar. 13, 1996), *available at* https://fraser.stlouisfed.org/docs/historical/federal%20reserve%20history/bog_members_statements/yellen_19960313.pdf. In addition, note that the Fed already engages in such comparisons, but doesn't share them in a timely manner.

[256] *See e.g.* Sam Fleming, *Janet Yellen defends US central bank independence*, FINANCIAL TIMES, (Feb. 25, 2015),

Chair Yellen's critique was forcefully rebutted in a February 10, 2016, statement signed by 24 noted economists and academics, three of them Nobel Laureates:

> Having a strategy or rule does not mean that instruments of policy are fixed, but rather that they adjust in a systematic and predictable way. In no way would the legislation compromise the Fed's independence. On the contrary, publicly reporting a strategy helps prevent policy makers from bending under pressure and sacrificing independence. It strengthens independence by reducing or removing pressures from markets and governments to finance budget deficits or deviate from policies that enhance economic stability.[257]

While it is understandable that the Federal Reserve wishes to avoid greater public scrutiny of its conduct of monetary policy – which many observers have likened to performing financial alchemy – that is not how open democratic societies operate. At a time when the American people's distrust of government and cynicism about our public institutions has never been higher, asking the Federal Reserve to be accountable for its actions and operate with a modicum of transparency is most certainly not asking too much.

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available at http://www.ft.com/intl/cms/s/0/6016b23c-bd06-11e4-b523-00144feab7de.html#axzz4Bc8S4b6n.

[257] Letter from Lars Peter Hansen et al. to the H. Comm. on Financial Services (2016), *available at* http://financialservices.house.gov/uploadedfiles/020916_taylor_letter_with_signatories_.pdf. The three Nobel Laureates who signed the statement were Lars Peter Hansen and Robert Lucas of the University of Chicago and Edward Prescott of Arizona State University. Among the other signatories were two former Federal Reserve Bank Presidents, one former Treasury Secretary, and one former member of the Federal Reserve Board of Governors.

Upholding Article I: Reining in the Administrative State

Executive Summary:

- **The Constitution envisioned a system of checks and balances whereby power would be distributed among three distinct branches of government. Financial regulators instead exercise the powers of all three branches of government, aided by Dodd-Frank provisions that have largely immunized them from accountability to Congress, the President, and the courts.**

- **The Dodd-Frank Act erodes Rule of Law principles and produces unnecessarily costly regulations – which harm job creation and limit economic opportunity – by devolving enormous power to unaccountable and unelected agency bureaucrats.**

- **Only by restoring the Constitutional separation of powers and reclaiming its legislative authority can Congress restore accountability and democratic control over federal agencies and ensure the financial regulatory process is accountable, fair, and efficient.**

- **Failure to conduct economic analysis reduces the quality of regulation and creates unnecessary regulatory costs; it does a disservice to the American people. By imposing a statutory economic analysis requirement on financial regulators, the Financial CHOICE Act will yield benefits to consumers, investors, and the broader economy.**

The Problem: Financial Regulation Has Become Increasingly Untethered from Constitutional Checks and Balances

Every American schoolchild knows that the Constitution sets forth a system of checks and balances premised on the separation of powers. The Legislative branch is supposed to make the law, the Executive branch is supposed to enforce the law, and the Judicial branch is supposed to resolve any question of how to read and apply the law and act as a check on the other branches through its exercise of judicial review. George Washington, in his Farewell Address, emphasized "[t]he necessity of reciprocal checks in the exercise of political power, by dividing and distributing it into different depositories, and constituting each the guardian of the public weal against invasions by the others."[258]

[258] George Washington, President of the United States, Farewell Address, (Sept. 17, 1796).

These checks and balances are absent from modern federal agencies. Indeed, as Chief Justice Roberts observed in a 2013 opinion, quoting James Madison:

> One of the principal authors of the Constitution famously wrote that the "accumulation of all powers, legislative, executive, and judiciary, in the same hands, … may justly be pronounced the very definition of tyranny." *The Federalist* No. 47, p. 324 (J. Cooke ed. 1961) (J. Madison). Although modern administrative agencies fit most comfortably within the Executive Branch, as a practical matter they exercise legislative power, by promulgating regulations with the force of law; executive power, by policing compliance with those regulations; and judicial power, by adjudicating enforcement actions and imposing sanctions on those found to have violated their rules.[259]

Congress has been complicit in this subversion of the Framers' vision of separation of powers. Time and again, it has delegated quintessentially legislative duties to agencies of the executive branch. In doing so, it has ceded its core constitutional responsibilities to an unelected elite that has been only too happy to exercise more power over federal policy and more control over federal tax dollars.

The result is an administrative state run amok. Indeed, the growth of government regulation during the Obama administration has been unprecedented. A recent report from the Competitive Enterprise Institute estimated that the federal regulatory cost reached $1.885 trillion in 2015 alone – with the Federal Register for 2015 weighing in at over 80,000 pages.[260] And in 2016, the estimated regulatory cost for final rules was $164 billion with an additional $46 billion in estimated costs for rules proposed that year.[261] A study of 22 key industries by the Mercatus Center found that the cost of the cumulative regulatory burden on the American economy is an average reduction in GDP of 0.8 percent, leaving household incomes over $30,000 short of their potential.[262]

Nowhere has the explosive growth of the administrative state been more pronounced than in the financial arena. The Dodd-Frank Act has unleashed an onslaught of almost 400 new rules,[263] which have slowed the economy and buried small financial institutions and small businesses in an avalanche of Washington red tape. A current analysis by the American Action Forum found that compliance with the Dodd-Frank Act had cost of $36 billion and 73 million hours of paperwork – the equivalent of almost 37,000 employees working full-

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[259] *City of Arlington v. FCC*, 133 S. Ct. 1863, 1877-78 (2013) (Chief Justice Roberts, dissenting).
[260] CLYDE WAYNE CREWS, COMPETITIVE ENTERPRISE INSTITUTE, TEN THOUSAND COMMANDMENTS 2016 (2016), *available at* https://cei.org/10KC2016.
[261] Sam Batkins, *The Midnight Year in Regulation: $164 Billion in Costs, 120 Million Paperwork Hours*, AMERICAN ACTION FORUM (2016), *available at* https://www.americanactionforum.org/research/midnight-year-regulation-164-billion-costs-120-million-paperwork-hours/
[262] BENTLEY COFFEY ET AL., MERCATUS CENTER, THE CUMULATIVE COST OF REGULATIONS (2016), *available at* http://mercatus.org/publication/cumulative-cost-regulations.
[263] *See* DAVIS POLK, DODD-FRANK PROGRESS REPORT, FOURTH QUARTER 2015 REPORT 2 (2016), *available at* http://www.davispolk.com/Dodd-Frank-Rulemaking-Progress-Report/.

time on paperwork for one year.[264] These costs increase the prices of banking services, mortgages, credit cards, and other financial services that average Americans use every day.

To make matters worse, financial regulators designed by Dodd-Frank's architects to be immune from democratic accountability routinely overstep their authority with ploys like that used by the Consumer Financial Protection Bureau (CFPB) to circumvent one of the few statutory limitations on its jurisdiction by forcibly enlisting private companies to act as its agents. The CFPB wanted to force auto dealers to eliminate a variable pricing element called "dealer reserve," even though doing so would make their sales policies less competitive and more expensive.[265] But the Bureau is explicitly prohibited by the Dodd-Frank Act from regulating dealers.[266] Rather than abide by the law, the CFPB instead used enforcement actions and intimidation to force indirect auto finance companies to, in turn, force dealers to make the change in pricing policy the Bureau sought.[267]

Even more troubling, regulators have taken to dictating to institutions the types of legal businesses they may or may not serve, as most directly evidenced by the Department of Justice's (DOJ) "Operation Chokepoint."[268] This initiative restricts banks from operating accounts associated with a variety of legitimate businesses under the false cover of prosecuting fraud.[269] In essence, laws meant to protect consumers and ensure economic stability are being leveraged by partisan operatives to achieve political ends.

The unauthorized disclosure of material, non-public information, even by employees of the Federal government, deserves the immediate attention of the SEC. Federal employees are not above the law and must be held to the same standards regarding the unauthorized disclosure of material, non-public and confidential supervisory information. Any improper disclosures of stress tests or living will determinations are potentially disruptive and harmful to bank investors and the capital markets. On April 12, 2016, an improper disclosure of material, non-public and confidential supervisory information occurred at either the Federal Reserve System or the Federal Deposit Insurance Corporation.[270] A news

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[264] Sam Batkins et al., *Six Years After Dodd-Frank: Higher Costs, Uncertain Benefits*, AMERICAN ACTION FORUM, (Jul. 20, 2016), https://www.americanactionforum.org/insight/six-years-dodd-frank-higher-costs-uncertain-benefits/.

[265] *See* STAFF OF H. COMM. ON FINANCIAL SERVICES, 114TH CONG., UNSAFE AT ANY BUREAUCRACY: CFPB JUNK SCIENCE AND INDIRECT AUTO LENDING (Comm. Print 2015), *available at* http://financialservices.house.gov/uploadedfiles/11-24-15_cfpb_indirect_auto_staff_report.pdf.

[266] *See* Dodd–Frank Act § 1029.

[267] *See generally* STAFF OF H. COMM. ON FINANCIAL SERVICES, 114TH CONG., UNSAFE AT ANY BUREAUCRACY: CFPB JUNK SCIENCE AND INDIRECT AUTO LENDING (Comm. Print 2015), *available at* http://financialservices.house.gov/uploadedfiles/11-24-15_cfpb_indirect_auto_staff_report.pdf; STAFF OF H. COMM. ON FINANCIAL SERVICES, 114TH CONG., UNSAFE AT ANY BUREAUCRACY, PART II: HOW THE BUREAU OF CONSUMER FINANCIAL PROTECTION REMOVED ANTI-FRAUD SAFEGUARDS TO ACHIEVE POLITICAL GOALS (Comm. Print 2016), http://financialservices.house.gov/uploadedfiles/cfpb_indirect_auto_part_ii.pdf. Interestingly, Congressional Democrats, usually quick to rise to Dodd-Frank's defense, were oddly silent in the face of the CFPB's flouting of the statute in this instance.

[268] *See generally* STAFF OF H. COMM. ON OVERSIGHT AND GOV'T REFORM, 113TH CONG., THE DEPARTMENT OF JUSTICE'S 'OPERATION CHOKE POINT': ILLEGALLY CHOKING OFF LEGITIMATE BUSINESSES? (Comm. Print 2014), *available at* https://oversight.house.gov/wp-content/uploads/2014/05/Staff-Report-Operation-Choke-Point1.pdf.

[269] *See id.*

[270] Ryan Tracy, Regulators Set to Reject Some Big Banks' 'Living Wills,' WALL ST. J., (Apr. 12, 2016), *available*

report on that date indicated that the agencies planned to reject the revised "living wills" of at least half of the U.S. banks that resubmitted proposals as required by Section 165(d) of the Dodd-Frank Act before the formal decisions were sent to these institutions on April 13, 2016.[271] The improper disclosure of this market-sensitive information occurred one day after a report by the U.S. Government Accountability Office (GAO) commissioned by this Committee found serious deficiencies in both the transparency of the framework and criteria used by the FDIC and the Federal Reserve to evaluate the living wills and the guidance and feedback provided to the companies that have submitted living wills.[272] The Financial CHOICE Act establishes criminal penalties for the unauthorized disclosure of living will and stress test determinations and other individually identifiable information by federal officials.

Congress has the power to curb these regulatory excesses by enacting much-needed reforms. Through the provisions described below, the Financial CHOICE Act aims to restore the checks and balances the Constitution established between the branches of government.

The Solution: A Four-Step Republican Plan for Greater Regulatory Accountability and Stronger Economic Growth

Step One: Apply the REINS Act to All Financial Agencies

In an effort to stem the considerable economic damage being done by Dodd-Frank – as well as restore the proper balance of power between the executive and congressional branches of government – the Financial CHOICE Act incorporates the provisions of the Regulations from the Executive in Need of Scrutiny (REINS) Act legislation previously passed by the House (H.R. 26). The REINS Act requires Congress to pass, and the President to sign, a joint resolution of approval for all major regulations before they are effective. Major regulations are those that produce $100 million or more in impacts on the U.S. economy, spur major increases in costs or prices for consumers, or have certain other significant adverse effects on the economy. These provisions will provide much-needed congressional oversight of and accountability for the burdensome major rules that are weighing down our economy with billions of dollars in compliance costs.

Step Two: Require All Financial Regulators to Conduct Meaningful Economic Analysis before Issuing Rules

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at https://www.wsj.com/articles/regulators-set-to-find-flaws-in-big-u-s-banks-living-wills-1460491197

271 See, e.g., Elizabeth Dexheimer, U.S. Regulators Request Probes into Leak of Banks' Living Wills, BLOOMBERG, (Apr. 13, 2016), *available at* https://www.bloomberg.com/news/articles/2016-04-13/u-s-regulators-request-probes-into-leak-of-banks-living-wills

272 See U.S. Gov't Accountability Office, GA0-16-341, "Regulators Have Refined their Review Processes but Could Improve Transparency and Timeliness," (Apr. 2016), *available at*: http://www.gao.gov/assets/680/676497.pdf

A fundamental tenet of sound regulatory practice is that the benefits of a proposed regulation should, as a general matter, outweigh the costs that such regulation imposes on society. Yet the federal financial regulators have historically conducted ineffective economic analysis of proposed rules, when they conduct it at all, and have refused to change course even after a regulation has been proven to be too costly.

Indeed, among the federal financial regulatory agencies, only the SEC and the CFTC have statutory requirements to "evaluate" costs and benefits. But these requirements are porous and result in systematically insufficient analyses, which in turn exacerbate the costs of financial regulations for households and businesses. The CFTC Inspector General has found the Commission's economic analyses insufficient,[273] and former Commissioner Scott O'Malia once lamented the CFTC's failure to follow executive orders directing agencies to conduct economic analysis:

> It is my concern that the Commission's cost-benefit analysis has failed to comply with the standards for regulatory review outlined in OMB Circular A-4, Executive Order 12866, and President Obama's Executive Orders 13,563 and 13,579. . . . President Obama was very clear in his two Executive Orders that he expected the highest standards of analysis to validate the necessity of government rulemaking to ensure we don't impose undue and unfounded economic burdens on market participants and the public as a whole. I don't believe the Commission's rulemakings comply with this directive or OMB Circular A-4.[274]

Similarly, SEC analyses of costs and benefits have been demonstrably less rigorous than those conducted by other executive branch agencies, papering over significant costs and failing to consider important alternatives.[275] The GAO also has documented economic analysis shortcomings at both the SEC and CFTC.[276]

Given the lack of clear statutory mandates and agencies' failure to abide by relevant executive orders, it should perhaps come as no surprise that a Committee for Capital Markets Regulation review of 192 Dodd-Frank regulations found that 57 were issued with no economic analysis, and 85 were accompanied by non-quantitative analyses.[277] Writing in the *Wall Street Journal,* financial journalist Greg Ip noted that as a result of this failure to

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[273] *See* Hester Peirce, *Economic Analysis by Federal Financial Regulators*, 9 GEORGE MASON JO. OF LAW, ECON. & POL. 569, 588 (2013), *available at* http://jlep.net/home/wp-content/uploads/2013/10/JLEP-Issue-9.4.pdf.

[274] Letter from Scott O'Malia, Commissioner, Commodity Futures Trading Commission, to Jeffrey Zients, Acting Director, Office of Management and Budget (Feb. 23, 2012), *available at* http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/omalialetter022312.pdf.

[275] *See* Jerry Ellig & Hester Peirce, *SEC Regulatory Analysis: 'A Long Way to Go and a Short Time to Get There,'* 8:2 BROOKLYN JO. OF CORP., FIN., & COMM. LAW 361, (Spring 2014), *available at* http://ssrn.com/abstract=2485582.

[276] GAO, GAO-12-151 DODD-FRANK ACT REGULATIONS: IMPLEMENTATION COULD BENEFIT FROM ADDITIONAL ANALYSIS AND COORDINATION (Nov. 2011), *available at* http://www.gao.gov/assets/590/586210.pdf.

[277] COMMITTEE ON CAPITAL MARKETS REGULATION, A BALANCED APPROACH TO COST-BENEFIT ANALYSIS (2013), *available at* http://www.capmktsreg.org/wp-content/uploads/2013/10/A-Balanced-Approach-to-Cost-Benefit-Analysis-Reform.pdf

perform economic analysis, "no one knows the true costs or benefits of the blizzard of laws, rules and penalties imposed since the financial crisis," which is "a problem, because a proper accounting of financial regulations could show there are more effective ways to protect consumers and prevent crises."[278]

Other voices representing diverse ideological perspectives have echoed these concerns. Cass Sunstein, President Obama's former "regulatory czar," has argued that "to the extent feasible, financial regulators, no less than regulators of other kinds, should assess both costs and benefits, and they should proceed only if the benefits justify the costs."[279] In calling for economic analysis at federal financial regulators, scholars at the Mercatus Center have urged adoption of "statutory elements that track closely the directives and guidance contained in Executive Orders 12866 and 13563"[280] (standards for economic analysis at Executive branch agencies implemented by Presidents Clinton and Obama, respectively).[281]

Congressional Democrats have steadfastly opposed legislative proposals to require financial regulatory agencies to conduct cost-benefit analysis, a position that mystifies Stanford University Professor and former senior Treasury Department official John Taylor:

> [T]his discussion about cost-benefit analysis is amazing to me. It's the sort of basic thing you teach students about government policy. You have to pass a cost-benefit test. And yes, it is hard; yes, it is difficult; but why would you just abandon it? It makes no sense to me, really.[282]

Further, as SEC Acting Chairman Michael Piwowar noted, cost-benefit analysis is too narrow a lens to view the requirements of prudent rulemaking, since a study of the costs and benefits is merely a component of a rigorous economic or regulatory impact analysis. Acting Chairman Piwowar further describes that "economic analysis complements cost-benefit analysis, because it provides a more complete view of the trade-offs and consequences of alternative approaches, thereby providing the tools for 'thinking through' the cost-benefit analysis.[283]

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278 Greg Ip, "Missing in Financial Rules Debate: Hard Numbers," *Wall Street Journal*, *(*May 13, 2015), *available at* http://www.wsj.com/articles/missing-in-financial-rules-debate-hard-numbers-1431545139 .

279 Cass R. Sunstein, *Financial Regulation and Cost-Benefit Analysis*, 124 Yale L.J. F. 263 (2015), *available at* http://www.yalelawjournal.org/forum/financial-regulation-and-cost-benefit-analysis.

280 ABBY MCCLOSKEY & HESTER PEIRCE, AMERICAN ENTERPRISE INSTITUTE, HOLDING FINANCIAL REGULATORS ACCOUNTABLE: A CASE FOR ECONOMIC ANALYSIS (2014), *available at* https://www.aei.org/wp-content/uploads/2014/05/-holding-financial-regulators-accountable-a-case-for-economic-analysis_153017821758.pdf.

281 *See* Regulatory Planning and Review, Exec. Order No. 12866. *See also* Improving Regulation and Regulatory Review, Exec. Order No. 13563.

282 *Legislation to Reform the Federal Reserve on Its 100-year Anniversary: Hearing before the H. Financial Servs. Comm.*, 113th Cong. 43 (2014) (statement of John Taylor), *available at* http://financialservices.house.gov/uploadedfiles/113-89.pdf.

283 Michael S. Piwowar, SEC Commissioner, Remarks at 2016 Conference on Auditing and Capital Markets (Oct. 21, 2016), *available at* https://www.sec.gov/news/speech/piwowar-speech-conference-auditing-capital-markets-102116.html.

The Financial CHOICE Act will increase regulatory transparency and accountability in the rulemaking process by putting in place economic analysis requirements for all financial regulators. Specifically, when proposing a rule, regulators must include an assessment of the rule's need and conduct a rigorous economic analysis of its quantitative and qualitative impacts. Regulators must allow at least 90 days for notice and comment on a proposed rule and publicly release the data underlying their analyses. If the rule's costs are determined to outweigh its benefits, the regulators will be prohibited from finalizing the rule absent an express authorization from Congress.

The Financial CHOICE Act also strengthens retrospective review requirements – another regulatory best practice. Within five years of a new rule's implementation, the regulator must also complete an analysis that examines the economic impact of the rule, including its direct and indirect costs. The Financial CHOICE Act also directs regulators to conduct retrospective reviews of previous rules every five years to modify, streamline, expand, or repeal existing regulations. Finally, the legislation creates a Chief Economist Council comprised of the chief economists from each of the financial regulatory agencies, which will meet quarterly. The Council will be required to conduct a review and report on the costs and benefits of all financial regulations released in the previous year. It also will report on the cumulative effects of regulations finalized within the same timeframe.

Step Three: Fund All Financial Regulators through the Congressional Appropriations Process

To return to a Constitutional structure and create agency accountability, Congress must reclaim its "power of the purse" – one of the most potent tools the Constitution gives Congress for conducting oversight of federal agencies and implementing real reforms. This tool is needed now more than ever before. There can be no "consent of the governed" if the American people, through their democratically elected representatives, have no say in how their government spends their hard-earned dollars.

The Democrats who designed the Consumer Financial Protection Bureau intended that it be insulated not only from legislative oversight but also executive control. One of the ways they achieved this objective was to place the Bureau's budget beyond the reach of Congress and the Office of Management and Budget or any other executive branch agency. As detailed earlier in this report, the Bureau's budget is set by the Director simply sending a letter to the Federal Reserve – another independent agency that is also not subject to the congressional appropriations process – stating the amount that the CFPB intends to spend in the coming year.[284] The Fed serves purely as a rubber stamp, and neither Congress nor the President has any input into the Bureau's funding or oversight of whether that funding is spent effectively.[285]

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[284] Discussed in the section of this document titled: Reform the Consumer Financial Protection Bureau (above).

[285] *See id.* During February 10, 2016, testimony before the Financial Services Committee, Federal Reserve Board Chair Yellen appeared confused as to what role, if any, the Fed plays in the CFPB budgeting process, and was unable to state with certainty whether the Fed even has protocols in place to ensure that it does not transfer amounts

Another creature of Dodd-Frank, the FSOC, is also funded outside the appropriations process, and like the CFPB, has made the most of its lack of accountability to Congress.[286] It has stone-walled congressional oversight, waiting nearly a year in one instance to turn over responsive materials to the Financial Services Committee, and only then after the Committee issued a subpoena to its Executive Director to testify regarding the FSOC's non-compliance.[287] The FSOC operates with a level of secrecy that is extreme even by the standards of an Administration that TIME magazine once described as "the most secretive presidency in American history."[288] It conducts two-thirds of its proceedings in private executive sessions, out of public view, and releases only cursory minutes of those deliberations, leaving Congress and the public at large to guess at what goes on behind its closed doors.[289]

To reassert Congress' power of the purse, the Financial CHOICE Act calls for all of the federal financial regulatory agencies – including the CFPB and the FSOC – to be funded through the Congressional appropriations process. This will allow Congress to ensure that these agencies use their funding effectively and transparently to fulfill their missions of protecting consumers and investors.

Step Four: Statutorily Repeal the Chevron Doctrine and End the Practice of Judicial Deference to Agency Interpretations

In far too many instances in recent years, federal courts have refused to fulfill their Constitutional responsibility to interpret and apply the laws as Congress has written them, contributing to the unchecked expansion of federal agencies' powers. This trend began in earnest with the 1984 case of *Chevron v. Natural Resources Defense Council*.[290] Under the "*Chevron* doctrine" or "*Chevron* deference" established in that case, if there is ambiguity in how to interpret a statute, courts must accept an agency's interpretation of a law unless it is arbitrary or manifestly contrary to the statute.[291] In fact, the Supreme Court ruled in the

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to the Bureau exceeding the statutory formula established in Dodd-Frank. Rep. Andy Barr, *Yellen: No Fed Oversight of CFPB's $600 Million Budget*, YouTube (Feb. 10, 2016), https://www.youtube.com/watch?v=oP3Ptj8PuEI (excerpt of Federal Reserve Chair Janet Yellen's testimony before the House Financial Services Committee at a February 10, 2016, hearing entitled "Monetary Policy and the State of the Economy").

[286] *See* Dodd-Frank Act § 118; *see also id.* § 152; *id.* § 155.

[287] See Ryan Rainey, *House Panel Leans on Treasury Employees for 'Lack of Transparency,'* MORNING CONSULT, Mar. 23, 2016.

[288] *See* Denver Nicks, *Study: Obama Administration More Secretive Than Ever*, TIME, (Mar. 17, 2014), *available at* http://time.com/27443/study-obama-administration-more-secretive-than-ever/.

[289] Dennis Kelleher, the Chief Executive Officer of Better Markets, a non-profit organization that focuses on financial regulatory issues, had this to say about transparency at the FSOC: "The FSOC's proceedings make the Politburo look open by comparison . . . . No one in America even knows who they are. At the few open meetings they have, they snap their fingers and it's over, and they are all scripted. They treat their information as if it were state secrets." Susan Crabtree, *Dodd-Frank offshoot cited as too secretive*, WASHINGTON TIMES, (Feb. 17, 2013) (quoting Dennis Kelleher), *available at* http://www.washingtontimes.com/news/2013/feb/17/dodd-frank-offshoot-cited-as-too-secretive/?page=all..

[290] 467 U.S. 837 (1984).

[291] *See id.*

2013 case *City of Arlington v. FCC* that courts must even defer to an agency's interpretation of the laws that establish the agency's own jurisdiction.[292] Because of these court rulings, agencies now have virtually unfettered power to expand the scope of their own authority by regulatory fiat. And, courts also defer to agency interpretations of their own rules and regulations. The Dodd-Frank Act went still further, instructing courts to grant heightened deference to the CFPB.[293]

This is particularly problematic when agencies like the CFPB depart from decades of settled interpretation, as highlighted by the recent decision of a federal appellate court in *PHH Corporation v. CFPB*. That case challenged an order by the CFPB Director that departed from legal interpretations of a law that other regulators had adhered to for decades and applied his newly-decreed standard retroactively to justify levying an unprecedented penalty 18 times larger than what a CFPB Administrative Law Judge had previously assessed under the settled legal interpretation. On October 11, 2016, the Federal Court of Appeals for the D.C. Circuit held that the CFPB Director's statutory interpretation was incorrect as a matter of law, and that his attempt to apply that interpretation retroactively violated due process.[294]

This pattern of regulatory overreach is why Congress must eliminate the *Chevron* doctrine and hold the judicial branch to its Constitutional responsibilities. Unelected bureaucrats now decide what and who they can regulate, and how to regulate, with only the flimsiest of limitations on how far they can go in stretching and torturing the meaning of the laws written by Congress. Until both Congress and the courts uphold their end of the bargain to fulfill their Constitutional responsibilities, the administrative state will continue to grow in power and shrink in accountability, to the detriment of the American people.

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[292] *See* 133 S. Ct. 1863 (2013).
[293] Dodd-Frank Act § 1022(b)(4)(B).
[294] *PHH Corporation v. Consumer Financial Protection Bureau*, No. 15-1177, October 11, 2016 (D.C. Cir.).

Amend Dodd-Frank Title IV

Executive Summary

- **Although private equity funds did not cause nor contribute to the financial crisis, Dodd-Frank imposes burdensome requirements on advisers to private equity funds, which unnecessarily punishes their investors and impedes job creation.**

- **Title IV of the Dodd-Frank Act requires the SEC to expend scarce resources on the protection of sophisticated institutional investors and wealthy individual investors that would be better utilized protecting the millions of retail investors of more modest means who have a far greater need for the SEC's assistance.**

- **The Financial CHOICE Act amends Title IV of the Dodd-Frank Act to enhance funding opportunities for start-up companies and other job creators, and to focus government resources on protecting mom-and-pop investors instead of the wealthiest Americans.**

The purpose of the federal securities laws is to protect ordinary investors, particularly those who may lack the sophistication to knowledgeably invest in complex or esoteric securities, or who may not be wealthy enough to withstand significant losses on their investments. By contrast, investors who have significant personal wealth or expertise are considered to be sufficiently sophisticated that they do not require the same level of protection that the securities laws afford to small-dollar investors. Sophisticated investors often pool their funds in private investment vehicles to expand the reach of their portfolios beyond equity securities or mutual funds to include real estate, oil and gas partnerships, or private equity or debt offerings

Two such types of investment vehicles are private equity and venture capital funds. Both raise money from pension funds, endowments, foundations, and high net worth individuals. Private equity firms are structured as limited partnerships, but unlike hedge funds they usually employ just one main investment strategy: buying and selling other businesses. Most private equity firms provide financing and management to financially troubled existing business or to start-up businesses, or create funds to acquire ownership positions in any sized business, usually through a leveraged buyout. Venture capital firms employ similar strategies to private equity in that they provide funding and guidance – and assume the risks – to build high-growth companies capable of bringing innovations to the marketplace. However, venture capital traditionally invests in earlier stage companies, like start-ups, than private equity. Both types of investments seek to make profits for their investors by improving the operations of the companies they acquire, rearranging their capital structure, or selling the business through an initial public offering or to a larger company.

Despite these similarities, Title IV of the Dodd-Frank Act, treats advisers to venture capital and private equity firms differently and imposes new registration and reporting requirement on advisers to hedge funds and private equity funds while exempting advisers to venture capital funds and Small Business Investment Companies (SBICs). Private fund advisers with assets under management of less than $150 million qualify for a limited registration exemption if they comply with recordkeeping and reporting requirements established by the SEC.

Title IV's proponents argued that private equity poses a "systemic risk" to the U.S. financial system.[295] Yet, private equity firms by their very nature and structure are not systemically risky as they are neither highly interconnected nor highly leveraged. Because private equity funds are not a source of systemic risk, subjecting advisers to Title IV's registration and examination requirements extracts significant economic costs while doing nothing to make the financial system more stable or less risky.

Title IV of the Dodd-Frank Act requires the SEC to expend scarce resources on the protection of sophisticated institutional investors and wealthy individual investors that would be better used to protect the millions of retail investors of more modest means who have a far greater need for the SEC's assistance.[296] Currently, the SEC oversees approximately 12,000 investment advisers, of which 60 percent provide investment advice to individuals and 37 percent provide advice to private funds such as hedge funds, private equity funds, and venture capital funds. In addition, the SEC receives reports from over 3,000 exempt advisers.[297] Yet, the SEC has been able to examine approximately eleven percent of all the investment advisers under its purview.[298]

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[295] In a departure from the House-passed version of what became the Dodd-Frank Act, on March 15, 2010, former Senate Banking Committee Chairman Chris Dodd's draft legislation exempted advisers to private equity funds from the registration requirements, but required the SEC to issue final rules, within six months of enactment, to define "private equity fund" and to require such advisers to maintain records and provide annual or other reports as the SEC determines necessary or appropriate in the public interest or for the protection of investors, taking into account fund size, governance, investment strategy, risk and other factors. (*See* Dodd Draft Committee Print § 408) On May 18, 2010, Senator Jack Reed offered an amendment on the Senate floor to require the registration of advisers to private equity funds, which the Senate adopted.

[296] Even one of the primary authors of Title IV, Rep. Paul Kanjorski, questioned the rationale for dedicating SEC resources to the protection of investors in private funds, stating at a 2009 hearing: "I for one could care less about high-wealth individuals who want to contribute their money to a group of investors. If they want to take the shot of losing it, it does not really affect the rest of society." *See Perspectives on Hedge Fund Registration: Hearing Before the Subcomm. on Cap. Mark. & GSEs of the H. Comm. on Fin. Serv. Hearing*, 111th Cong. (May 7, 2009), *available at* http://archives.financialservices.house.gov/media/file/hearings/111/111-29.pdf.

[297] SEC, FY2017 BUDGET JUSTIFICATION, at 76, *available at* http://www.sec.gov/about/reports/secfy17congbudgjust.pdf.

[298] *Examining the SEC's Agenda, Operations, and FY 2018 Budget Request: Hearing Before the H. Comm. on Financial Services*, 114th Cong. 2nd Sess. (Nov. 15, 2016) (statement of Chair Mary Jo White), *available at* http://financialservices.house.gov/uploadedfiles/hhrg-114-ba00-wstate-mjwhite-20161115.pdf.

Repealing Dodd-Frank's registration requirements for private equity firms will not leave investors in those firms without protection. The SEC will still have the ability to bring enforcement actions against advisors who commit fraud in the purchase or sale of securities using its anti-fraud authority under Section 10(b) of the Securities Exchange Act of 1934[299] and Section 206 of the Investment Advisers Act.[300] Additionally, the SEC can bring actions against advisers of the exempted funds for breaches of their fiduciary duties.[301] The SEC also would still have access to records it requires.

Recent data indicate that private equity-backed companies employ over 11.3 million people nationwide in over 14,200 U.S. companies and have invested over $5 trillion in companies over ten years.[302] Because private equity does not pose any systemic risk, imposing burdensome registration and reporting requirements on private equity firms has the potential to impede job creation with no corresponding benefit to financial stability. Registration and reporting requirements can also serve as barriers to entry for new firms that lack the resources and compliance personnel to easily absorb these additional costs. Given the costs of registration and ongoing compliance, the Financial CHOICE Act strikes a better balance between key investor protections and economic opportunity by including Senator Christopher Dodd's original language to exempt advisers to private equity from registration while requiring them to maintain certain records for the SEC's inspection.

Title IV of the Dodd-Frank Act also directed the SEC to adjust the standard for calculating the net worth of an accredited investor who is a natural person by excluding the value of the investor's primary residence from the calculation, and requiring the Commission to engage in a quadrennial review of the standard to determine whether it should be further adjusted. Private placement offerings are a key source of equity capital for many small and emerging companies that generate a disproportionate share of the new jobs in our economy. Because such offerings are generally available only to accredited and other sophisticated investors, it is essential that the SEC not overly restrict the pool of accredited investors.

By expanding the definition of accredited investor to include sophisticated individuals who do not otherwise satisfy the net worth test, the Financial CHOICE Act seeks to promote capital formation and extend investment opportunity beyond a narrow class of wealthy Americans. The legislation is premised upon a belief that individual investors who have the risk appetite and ability to understand a private offering should be able to invest in it – the government should not limit the options of individual investors to only those the government deems worthy based on their income and net worth.

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[299] 15 U.S.C. § 78j–2.

[300] 15 U.S.C. § 80b–6.

[301] *See* Press Release, SEC, Biotech Venture Capitalist Stole Investor Funds for Personal Use (Mar. 30, 2016), *available at* https://www.sec.gov/news/pressrelease/2016-61.html.

[302] AMERICAN INVESTMENT COUNCIL, PRIVATE EQUITY INVESTMENT REMAINS STRONG IN 2016, *available at* http://www.investmentcouncil.org/app/uploads/2016-q4-aic-private-equity-trends-press-release-attachment-1.pdf.

Accordingly, the legislation amends the definition of accredited investor under the Securities Act of 1933 to include: (1) persons whose individual net worth, including their spouse's, exceeds $1,000,000, excluding the value of their primary residence; (2) persons with an individual income greater than $200,000, or $300,000 for joint income; (3) persons with a current securities-related license; and (4) persons who the SEC determines have demonstrable education or job experience to qualify as having professional subject-matter knowledge related to a particular investment. For the latter category, the Financial Industry Regulatory Authority (FINRA) must verify the person's education or job experience. The language is modeled on H.R. 1585, the Fair Investment Opportunities for Professional Experts Act, introduced by Rep. David Schweikert, and is constituent with recommendations of the SEC's Investor Advisor Committee and Committee on Small and Emerging Companies.[303] In the 114th Congress, the Fair Investment Opportunities for Professional Experts Act passed the House on a 347-8 vote on February 1, 2016.

[303] *See* SEC ADVISORY COMMITTEE ON SMALL AND EMERGING COMPANIES, RECOMMENDATIONS REGARDING THE ACCREDITED INVESTOR DEFINITION (from Dec. 17, 2014 and Mar. 4, 2015 meetings), *available at* http://www.sec.gov/info/smallbus/acsec.shtml. *See also* SEC INVESTOR ADVISORY COMMITTEE, RECOMMENDATION OF THE INVESTOR ADVISORY COMMITTEE, ACCREDITED INVESTOR DEFINITION (Oct. 9, 2014), *available at* http://www.sec.gov/spotlight/investor-advisory-committee-2012/investment-advisor-accredited-definition.pdf.

Repeal the Volcker Rule

Executive Summary:

- **From its inception, the Volcker Rule has been a solution in search of a problem – it seeks to address activities that had nothing to do with the financial crisis, and its practical effect has been to undermine financial stability rather than preserve it.**

- **The Volcker Rule will increase borrowing costs for businesses, lower investment returns for households, and reduce economic activity overall because it constrains market-making activity and has already reduced liquidity in key fixed-income markets, including the corporate bond market.**

- **Repeal of the Volcker Rule will promote more resilient capital markets and a more stable financial system.**

Section 619 of the Dodd-Frank Act—popularly known as the "Volcker Rule" after its chief proponent, former Federal Reserve Chairman Paul Volcker—prohibits U.S. bank holding companies and their affiliates from engaging in "proprietary trading" and from sponsoring hedge funds and private equity funds. Chairman Volcker has argued that such activities should not be conducted by firms that benefit from a federal safety net, such as deposit insurance or access to the Federal Reserve's discount window. Proponents of the Volcker Rule promised that by pushing what they describe as "risky, non-core" activities out of the banking sector, the Dodd-Frank Act would better protect taxpayers and help create a more resilient U.S. banking system.[304]

Yet even those who supported the Volcker Rule recognized that banks play an important role in financial markets by buying and selling securities on behalf of their customers, an activity that is known as "market-making." Market-making is crucial to the modern financial system, in which companies raise funds by selling equity, bonds, notes, and commercial paper. Corporations that issue debt to pay for capital investments, research and development, meet payroll, or hire new workers depend on market makers to hold down the cost of credit. Without a market maker who stands ready to buy debt securities, corporations—particularly those with small to medium-sized market capitalizations—will pay more for credit. Similarly, consumers who borrow on credit cards or to finance the purchase of a home depend on market makers to hold down the costs of credit from issuing bonds rather than by borrowing from a bank.

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[304] *Prohibiting Certain High-Risk Investment Activities by Banks and Bank Holding Companies: Hearing Before the S. Comm. on Bank.*, 111th Cong. (Feb. 2, 2010) (statement of Chairman Paul Volcker) (*hereinafter Hearing Before the S. Comm. on Bank.*, (Feb. 2, 2010)), *available at* http://www.banking.senate.gov/public/index.cfm/hearings?ID=54B42CC0-7ECD-4C0D-88C0-65F7D2002061.

Because of the key role that market-making plays in ensuring deep, liquid capital markets, the framers of the Volcker Rule sought to exempt market-making activities from the coverage of its prohibition on proprietary trading. There is just one problem: the line between impermissible "proprietary trading" and permissible "market making" is virtually impossible to draw, a hard truth that the five regulatory agencies charged with writing rules to implement the Volcker Rule came to understand as they spent over four years struggling to convert its lofty ideals into a workable regulation.

As financial regulatory experts Charles Calomiris, Robert Eisenbeis, and Robert Litan have written:

> Drawing a sharp line between permissible hedging of customer transactions and conducting trades for the banks' own accounts, however, is not easy to do and fraught with potential negative unintended consequences. Depending on how strictly regulators enforce this distinction, the Volcker Rule could significantly diminish liquidity in the trading of financial instruments, imposing a social cost on the markets that could outweigh any benefits of risk reduction it is meant to accomplish, or push substantial amounts of financial intermediation overseas. . . . To the extent that such trading has been profitable for banks, denying them the ability to pursue it could thus detract from their safety and soundness.[305]

Although it is easy to understand the "social cost" the Volcker Rule could impose on U.S. financial markets, the "benefits of risk reduction" are harder to explain, in large part because the rationale behind the Volcker Rule has never been clearly stated. Given that proprietary trading played no role in precipitating the financial crisis or making it worse, proponents of the Volcker Rule have never successfully explained how banning depository institutions from engaging in proprietary trading or investing in hedge funds and private equity makes the financial system less risky.

Even Chairman Volcker has conceded that "proprietary trading in commercial banks was . . . not central" to the crisis,[306] and he noted that the Volcker Rule would not have solved the problems posed by AIG or Lehman Brothers, neither of which was a commercial bank.[307] Former Treasury Secretary Timothy Geithner similarly observed that "if you look at this crisis, . . . most of the losses that were material for both the weak and strong institutions, did not come from those [proprietary trading] activities. They came overwhelmingly from what I think you can fairly describe as classic extensions of credit."[308] Raj Date, the former

[305] Charles W. Calomiris, Robert A. Eisenbeis, & Robert E. Litan, *Financial Crisis in the U.S. and Beyond*, in THE WORLD IN CRISIS: INSIGHTS FROM SIX SHADOW FINANCIAL REGULATORY COMMITTEES FROM AROUND THE WORLD 49 (Robert Litan ed., 2011), (*hereinafter* Charles W. Calomiris, Robert A. Eisenbeis, & Robert E. Litan, *Financial Crisis in the U.S. and Beyond*) *available at* http://finance.wharton.upenn.edu/FIC/FICPress/crisis.pdf.

[306] *Volcker: Proprietary Trading not central to crisis*, REUTERS, (Mar. 30, 2010), *available at* http://www.reuters.com/article/us-financial-regulation-volcker-idUSTRE62T56420100330.

[307] *Hearing Before the S. Comm. on Banking* (Feb. 2, 2010).

[308] *Hearing Before the Cong. Oversight Panel*, 111th Cong. (Sept. 10, 2009), *available at*

deputy director of the Consumer Financial Protection Bureau and an ardent supporter of much of the Dodd-Frank Act, described the Volcker Rule as a "solution to a non-problem" because it focuses on the "least problematic" activities undertaken by commercial banks.[309]

Calomiris, Eisenbach, and Litan have written that the Volcker Rule has "little or nothing to do with rectifying the causes of crisis," but nonetheless was "politically useful in one manner or another in attracting support for the overall bill and for punishing the large banks."[310] Similarly, Cornell University Law Professor Charles Whitehead has written that the Volcker Rule's "ultimate intention was less to cure a particular cause of the financial crisis and more to champion the populist view that commercial banking should be separated from investment banking. . . . The Volcker Rule, in effect, was motivated by a desire to return to a traditional banking model—to create a regulatory divide, much like the Glass-Steagall Act had before its repeal in 1999."[311]

In other words, the Volcker Rule is an anachronism—an effort to undo much of the financial innovation that has taken place over the past three decades. But the difficulty is that returning to the traditional banking model in which commercial banks alone are the center of financial intermediation between savers and borrowers is impossible. In 2007, Secretary Geithner, then the President of the Federal Reserve Bank of New York, noted that U.S. commercial banks accounted for only 15 percent of outstanding non-farm, non-financial debt; the rest was extended through securities markets in which companies raise funds by issuing bonds, notes, and commercial paper.[312] Peter Wallison of the American Enterprise Institute has written that the Volcker Rule is "a throwback to a world that is gone,"[313] and the financial blogger Yves Smith notes that the Volcker Rule "would work for the industry circa 1990, but looks anachronistic for the world we live in now," given that credit markets have eclipsed the traditional banking model.[314]

But even though the Obama Administration and Congressional Democrats lacked a coherent or principled basis for banning proprietary trading, even though the potential benefits were not clear and the potential costs were quite significant, and even though regulators had little or no idea how to police the line between impermissible "proprietary trading" and permissible "market making," the Volcker Rule was written into the Dodd-

https://www.gpo.gov/fdsys/pkg/CHRG-111shrg53177/html/CHRG-111shrg53177.htm.

[309] RAJ DATE, CAMBRIDGE WINTER CENTER FOR FINANCIAL INSTITUTIONS POLICY, THROUGH THE LOOKING GLASS (STEAGALL): BANKS, BROKER DEALERS, AND THE VOLCKER RULE, (Jan. 27, 2010), *available at* https://ramurapt.files.wordpress.com/2010/02/looking-glass-steagall-012710_1.pdf.

[310] Charles W. Calomiris, Robert A. Eisenbeis, & Robert E. Litan, *Financial Crisis in the U.S. and Beyond*, at 48.

[311] Charles K. Whitehead, *The Volcker Rule and Evolving Financial Markets*, HARVARD BUS. LAW REV. (Vol. 1, Jun. 1, 2011), *available at* http://www.hblr.org/wp-content/uploads/2014/09/Volcker-Rule.pdf.

[312] Timothy Geithner, President Federal Reserve Bank of New York (fmr.), Speech at the 2007 Credit Markets Symposium hosted by the Federal Reserve Bank of Richmond, Charlotte, North Carolina: Credit Markets Innovations and Their Implications (Mar. 23, 2007), *available at* https://www.newyorkfed.org/newsevents/speeches/2007/gei070323.html.

[313] Peter Wallison, *Volcker Rule is stuck in a bygone era*, AMERICAN BANKER (Nov. 10, 2011), *available at* https://www.aei.org/publication/volcker-rule-is-stuck-in-a-bygone-era/.

[314] Yves Smith, *Volcker Does Not Get It*, NAKED CAPITALISM (blog), (Jan. 31, 2010), *available at* http://www.nakedcapitalism.com/2010/01/volcker-does-not-get-it.html.

Frank Act. Congress and the Obama Administration hoped that regulators could come up with a sensible, simple way to implement the Volcker Rule. They could not. Part of the problem is a result of the statutory requirement that five regulatory agencies with disparate missions and enforcement regimes were responsible for tis drafting and enforcement, even Federal Reserve Governor Daniel Tarullo noted in his farewell remarks, "Efforts to achieve consistency in treatment across agencies have been both time-consuming and, at times, unsuccessful."[315]

The final rules implementing the Volcker Rule (as well as the Basel Capital Accord's capital and liquidity standards) make it difficult for banks to buy or sell securities for their own inventory in anticipation of client demand because managing inventory can look like "proprietary trading," subjecting the firm to regulatory sanctions and monetary penalties. The inevitable result of this uncertainty is a reduction of liquidity in crucial market sectors – including the corporate debt market – which has the perverse effect of making the financial system less resilient and more vulnerable to destabilizing events like the one that the Dodd-Frank was supposed to prevent.

The Center for Financial Stability estimated that market liquidity has declined 46 percent since its peak in March 2008,[316] and an August 2015 study by PricewaterhouseCoopers found that a "measurable reduction in financial market liquidity" had been accompanied by a 40 percent increase in bond market volatility compared to the same period in 2014.[317] Indeed, on May 20, 2015, the *Wall Street Journal* reported that what concerned financial professionals most was not Greece, the anemic U.S. recovery, the prospect of a "hard landing" in China, or the U.K.'s referendum on European Union membership, but the "lack of liquidity in the markets and what this might mean for the world economy." With banks increasingly reluctant to make markets, the following nightmare scenario presents itself: "If banks stop making markets, the risk is that this process goes into reverse: As investors discover they can't sell their assets, they may stop buying too, pushing up the cost and reducing the supply of capital to the primary market."[318]

The economic consequences of this sharp reduction in market liquidity – where market participants lose the ability to buy or sell securities quickly at a given price – are impossible to overstate. As an earlier *Wall Street Journal* article noted, "The worry is that without enough liquidity, price swings could become more severe across financial markets, raising the cost of credit on Wall Street and Main Street."[319] In addition to higher costs for

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[315] Federal Reserve Governor Daniel K. Tarullo, "Departing Thoughts," (April 5, 2017), available at: https://www.federalreserve.gov/newsevents/speech/tarullo20170404a.htm

[316] LAWRENCE GOODMAN, CENTER FOR FINANCIAL STABILITY, LIQUIDITY SHORTAGE: HOUSTON, WE HAVE A PROBLEM (Feb. 25, 2015), *available at* http://www.centerforfinancialstability.org/amfm/AMFM_022515.pdf.

[317] PRICEWATERHOUSECOOPERS, GLOBAL FINANCIAL MARKETS LIQUIDITY STUDY (Aug. 2015), *available at* http://www.pwc.com/en_GX/gx/financial-services/publications/assets/global-financial-market-liquidity-study.pdf.

[318] *Why Liquidity-Starved Markets Fear the Worst*, WALL STREET JOURNAL, (May 20, 2015) (*hereafter Why Liquidity-Starved Markets Fear the Worst*, WALL STREET JOURNAL), *available at* http://www.wsj.com/articles/why-liquidity-starved-markets-fear-the-worst-1432153849.

[319] *U.S. Watchdog Sees Risk of Repeated Liquidity Crunches*, WALL STREET JOURNAL, (Dec. 3, 2014), *available at* http://www.wsj.com/articles/u-s-watchdog-sees-risk-of-repeated-liquidity-crunches-1417554001.

corporations and consumers, the value of assets held by large pension funds, mutual funds, and insurance companies—assets which represent the savings of millions of small investors—will decline as those assets become harder to trade, making those investors worse off.

The lack of liquidity caused by misguided regulation also means that financial markets have less capacity to deal with shocks and will be more likely to seize up in a panic, just as they did in the 2008 financial crisis. Reduced liquidity in the bond markets amplifies volatility when prices begin to decline. Rather than making markets more stable, then, the new regulations have made them more brittle.

Treasury Secretary Jacob Lew and other Obama Administration officials consistently rejected the notion that the Volcker Rule and other post-crisis regulatory policies are contributing to illiquidity in the fixed-income markets.[320] This is hardly surprising: because the Volcker Rule was touted by Dodd-Frank's proponents as critical to the effort to curb Wall Street excesses and "de-risk" the financial system, any acknowledgment of its role in *fueling* systemic risk would be an admission that Dodd-Frank has failed.

But those with less of a vested interest in defending the Dodd-Frank "brand" have been more candid in their assessments of the Volcker Rule's impact on market liquidity. On December 23, 2016, the Federal Reserve released a staff working paper entitled "The Volcker Rule and Market Making in Times of Stress." The paper documents how "the illiquidity of stressed bonds has increased after the Volcker Rule," and finds that because "Volcker-affected dealers have been the main liquidity providers, the net effect is that bonds are less liquid during times of stress due to the Volcker Rule." Perhaps most troubling, the Federal Reserve staff go on to state that:

> Our results show that bond liquidity deterioration around rating downgrades has worsened following the implementation of the Volcker Rule…[W]e find that the relative deterioration in liquidity around these stress events is as high during the post-Volcker period as during the Financial Crisis. Given how badly liquidity deteriorated during the financial crisis, this finding suggests that the Volcker Rule may have serious consequences for corporate bond market functioning in stress times. [321]

Additionally, Richard G. Ketchum, then the CEO and Chairman of the Financial Industry Regulatory Authority, which oversees broker-dealers, reached a different conclusion than Secretary Lew on the impact of regulations like the Volcker Rule on liquidity, testifying as follows at a May 1, 2015, Capital Markets Subcommittee hearing:

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[320] *See The Annual Report of the Financial Stability Oversight Council: Hearing Before the H. Comm. on Fin. Serv.*, 114th Cong. (Jun. 17, 2015), *available at* http://financialservices.house.gov/calendar/eventsingle.aspx?EventID=399221.

[321] Jack Bao, Maureen O'Hara, and Alex Zhou (2016), "The Volcker Rule and Market-Making in Times of Stress," Finance and Economics Discussion Series 2016-102 (September 2016). Washington: Board of Governors of the Federal Reserve System, *available at* https://www.federalreserve.gov/econresdata/feds/2016/files/2016102pap.pdf.

> There have been dramatic changes with respect to the fixed-income market in recent years. Many of them come in the reaction of the failures and market impact coming out of the credit crisis. That has led to much higher capital requirements, the Volcker Rule that limits the ability for proprietary trading with respect to bank holding companies, a range of other issues that have all had significant impact from the standpoint of the liquidity of the fixed income market.[322]

There is considerable evidence supporting the Federal Reserve staff and Mr. Ketchum's analysis and discrediting Secretary Lew's. In June 2014, the *Financial Times* reported that U.S. banks are "pulling back" from helping funds transact in corporate bonds, citing Federal Reserve data that bank inventories have fallen almost three-quarters from their pre-crisis peak of $235 billion.[323] The article attributed this pull-back to the Volcker Rule's chilling effect on market-making and new capital requirements that make it more expensive for firms to hold these assets on their balance sheets. Similarly, a July 6, 2014, *Wall Street Journal* article noted a decrease in the average daily volume of bond trading generally over the past two years, a decline due in part to the fact that "the Volcker rule bans short-term proprietary trading, which makes bonds less likely to change hands."[324]

In February 2015, the *Financial Times* offered this assessment of the Volcker Rule's role in the reduction of liquidity in the corporate bond market:

> Although Volcker is only one ingredient, it is widely believed — even among regulators — to play a role in the dramatic decline in corporate bond liquidity since the crisis, as banks have cut their inventories. When regulators presented the final Volcker rule, they said reduced liquidity 'may be temporary' because non-banks 'may provide much of the liquidity that is lost.' That is a lot of 'mays' and does not address the question of whether relying on less-regulated entities to make markets is a good thing.[325]

The *Wall Street Journal* reported on May 20, 2015, that "[b]anks have become so reluctant to make markets that it has become hard to execute large trades even in the vast foreign-exchange and government markets without moving prices, raising fears that investors will take unexpectedly large losses when they try to sell."[326]

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[322] *Oversight of the Financial Industry Regulatory Authority: Hearing Before the Subcomm. on Cap.Mark and GSEs of the H. Comm. on Fin. Serv.*, 114th Cong. (May 1, 2015), *available at* http://financialservices.house.gov/uploadedfiles/114-20.pdf.
[323] *Fed looks at exit fees on bond funds*, FINANCIAL TIMES, (Jun. 16, 2014), *available at* http://www.ft.com/intl/cms/s/0/290ed010-f567-11e3-91a8-00144feabdc0.html?siteedition=intl#axzz3502N0WDL.
[324] *The Bond Market Is a Drag These Days*, WALL STREET JOURNAL, (Jul. 6, 2014), *available at* http://online.wsj.com/articles/heard-on-the-street-the-bond-market-is-a-drag-these-days-1404682515.
[325] *Volcker Rule To Usher In 50 Trades Of Gray*, FINANCIAL TIMES, (Feb. 23, 2015), *available at* http://www.ft.com/intl/cms/s/0/5fa489f4-bb3b-11e4-b95c-00144feab7de.html#axzz3TLhahRJl.
[326] *Why Liquidity-Starved Markets Fear the Worst*, WALL STREET JOURNAL.

Evidence of the Volcker Rule's ill effects and profound unintended consequences have continued to mount throughout 2016 and early 2017:

- Former Treasury Secretary Hank Paulson commented to CNBC on September 27, 2016, that "the Volcker Rule solved a problem that was not a problem. We have much less liquidity in the markets. It has become much harder for financial institutions to provide liquidity."[327]

- On September 16, 2016, Douglas Cifu, CEO of Virtu, one of the world's largest electronic market-makers, announced that his firm would no longer invest in certain bond exchange traded funds (ETFs) because the underlying securities had become too hard to trade.[328] Virtu's stance gives the lie to assurances that federal regulators have offered that even if dealer banks had to reduce their market-making activity and their inventories because of the Volcker Rule, other sources of liquidity would step in to fill the void.

- On October 7, 2016, the value of the British pound plummeted from $1.26 to $1.18 in a matter of minutes during trading in Asia, with some electronic platforms recording trades below $1.15. The *Wall Street Journal* attributed this extreme volatility, in part, to a lack of currency traders in the foreign exchange markets:

> One reason the pound fell so sharply . . . is because Wall Street foreign-exchange desks have slimmed down in response to post-crisis financial regulations meant to limit risk taking. Those rules forced banks to rein in a service known as market-making, by which they facilitate trading by agreeing to buy and sell currencies. The number of foreign-exchange traders at 12 global banks fell 23% to 1,477 in the first half of the year from 1,916 in 2010, according to Coalition, a London consulting firm. The top five banks also accounted for just 44.7% of the market's volume, down from 61% in 2014, according to a Euromoney survey.[329]

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[327] Bush Treasury chief: Regulators too focused on Wall Street banks (Sept. 27, 2016), *available at* http://thehill.com/policy/finance/298048-bush-treasury-chief-regulators-too-focused-on-wall-street-banks

[328] Annie Massa, "One of the Largest Electronic Traders Won't Touch Some Bond ETFs," Bloomberg (Sept. 16, 2016), *available at* http://www.bloomberg.com/news/articles/2016-09-16/one-of-the-largest-electronic-traders-won-t-touch-some-bond-etfs

[329] *Currency Swings Worsen as Wall Street Steps Back*, WALL STREET JOURNAL, (Oct. 10, 2016), *available at*: http://www.wsj.com/articles/currency-swings-worsen-as-wall-street-steps-back-1476047787. CFTC Commissioner Christopher Giancarlo also attributed the action in the British pound and several other recent "flash crashes" to the lack of liquidity produced by the Volcker Rule and other post-crisis regulatory initiatives: "Last Friday, the British pound suddenly crashed six percent against the U.S. dollar in volatile trading. The abrupt 'flash crash' of the world's fourth-most-traded currency was exacerbated by a lack of tradeable market liquidity. There have been at least twelve major flash crashes since the passage of the Dodd-Frank Act." http://www.derivationslaw.com/2016/10/cftc-commissioner-giancarlo-sounds-alarm-flash-crashes-dodd-frank-bank-capital-constraints/?utm_source=Mondaq&utm_medium=syndication&utm_campaign=View-Original

- On June 2, 2016, Steve Schwarzman, the Chairman & CEO of the large private equity firm Blackstone Group, offered one of the most pointed critiques of the Volcker Rule at an industry conference:

> What's happening during that period is the junk bond market just went on sabbatical when illiquid. So, for all of you Dodd-Frank lovers, here's what happens when you have a commitment to regulation and reform, and you don't quite understand all of the implications. So, when they passed the Volcker rule, there were 25 firms making markets in junk bonds. Guess how many there are now. Five. That's 25 to 5. Triumph? You decide. Okay. So what happens when things get difficult, that market now just locks up. That is not healthy for the capital markets. And this is happening all over. It's when you get almost all the market makers out of doing market making, right? So, it affects the treasury market. It affects all markets, and liquidity is coming down because we mandated that to make the world safer. This does not make the world safer by the way. This is not encouraging the world to be safe because when people need to sell, and there isn't liquidity, what happens? They sell something anyhow, and so you develop these odd outcomes, right?[330]

- On December 23, 2016, the Federal Reserve staff working paper entitled "The Volcker Rule and Market Making in Times of Stress" documents that the Volcker Rule's "requirements have the potential to impact the behavior of dealers covered by the rule and lead to less liquid markets. Ambiguity as to what is legal market making and what is prohibited proprietary trading may exacerbate the problem by pushing dealers toward more conservative trading strategies." The Fed researchers conclude:

> Our main finding is that the Volcker Rule has a deleterious effect on corporate bond liquidity and dealers subject to the Rule become less willing to provide liquidity during stress times. While dealers not affected by the Volcker Rule have stepped in to provide liquidity, we find that the net effect is a less liquid corporate bond market. We also rule out that the effects are due to the implementation of Basel III in conjunction with CCAR requirements. [331]

- In a January 7, 2017 speech, Federal Reserve Board Governor Jerome Powell parted company with Chair Yellen and other Fed officials who have defended the Volcker Rule when he observed that "some regulations, particularly the Volcker Rule, have discouraged banks from holding and making markets in [corporate] debt."[332]

[330] Rachel Butt, "Billionaire Steve Schwarzman Just Went Off on the Dodd-Frank Act," Business Insider, (June 2, 2016), *available at:* http://www.businessinsider.com/steve-schwarzman-dodd-frank-act-2016-6

[331] Jack Bao, Maureen O'Hara, and Alex Zhou (2016), "The Volcker Rule and Market-Making in Times of Stress," Finance and Economics Discussion Series 2016-102 (September 2016). Washington: Board of Governors of the Federal Reserve System, *available at* https://www.federalreserve.gov/econresdata/feds/2016/files/2016102pap.pdf.

[332] Jerome H. Powell, "Low Interest Rates and the Financial System," Remarks at the 77th Annual Meeting of the

According to Governor Powell, the Volcker Rule "forces you to look into the mind and heart of every trader and of every trade. If that's the test you set for yourself, you're going to wind up with tremendous expense and burden and quite marginal benefit." Powell urged Congress to "take another look" at the Volcker Rule.

- In a February 2017 paper published by the Harvard Business School, former Federal Reserve Board Governor and Obama Administration official Jeremy Stein wrote that:

> There are reasons to be skeptical about the usefulness of the Volcker Rule. By discouraging "speculation" at broker-dealer banks, the rule may dissuade dealers from providing liquidity during a market correction. Most fundamentally, market-making and proprietary trading are almost impossible to distinguish in practice, making the rule difficult to enforce, while at the same time creating large compliance and supervisory costs…Thus, on balance, we believe that the Volcker Rule should be repealed.[333]

- During former Federal Reserve Governor Daniel Tarullo's April 5, 2017, farewell remarks, he correctly noted,

> the Volcker rule is too complicated. Achieving compliance under the current approach would consume too many supervisory, as well as bank, resources relative to the implementation and oversight of other prudential standards. And although the evidence is still more anecdotal than systematic, it may be having a deleterious effect on market making, particularly for some less liquid issues.[334]

- In an April 7, 2017, speech, the New York Federal Reserve Bank President and Chief Executive Officer, William Dudley, commented "the line between market-making and proprietary trading is not always clear-cut, which makes regulation in this space difficult," and "that it may be worth considering giving greater discretion to trading desks that facilitate client business to intervene when markets are illiquid and volatile."[335]

American Finance Association, (Jan. 7, 2017), *available at* https://www.federalreserve.gov/newsevents/speech/powell20170107a.pdf

[333] JEREMY STEIN ET AL, HARVARD BUSINESS SCHOOL: PROJECT ON BEHAVIORAL FINANCE AND FINANCIAL SYSTEM, THE FINANCIAL REGULATORY REFORM AGENDA IN 2017 (FEB. 2017), *available at* http://www.hbs.edu/faculty/initiatives/behavioral-finance-and-financial-stability/Documents/2017-09%20The%20Financial%20Regulatory%20Reform%20Agenda%20in%202017.pdf.

[334] Federal Reserve Governor Daniel K. Tarullo, "Departing Thoughts," (April 5, 2017), *available at* https://www.federalreserve.gov/newsevents/speech/tarullo20170404a.htm

[335] William C. Dudley, President and CEO, New York Federal Reserve Bank, "Principles for Financial Regulatory Reform," (April 7, 2016), *available at* https://www.newyorkfed.org/newsevents/speeches/2017/dud170407

- On April 19, 2017, Tobias Adrian, the new Director of the International Monetary Fund's monetary and capital markets department, provided another critique of the both the Volcker Rule's complexities and its impact on financial markets

> It is a rule that's very difficult to enforce, because it's very difficult to distinguish between what are proprietary trades and what are client trades. So it's not clear how effective it is," and It's important for the regulatory community to evaluate trade-offs, because regulations make the system safer. But they can also impact the ability of institutions to supply credit, to make markets, and that trade-off has to be carefully considered.[336]

Finally, while the Volcker Rule is generally thought to only affect the operations of the largest Wall Street banks, its reach is actually far more extensive. Because of the Volcker Rule's complexity, even those community banks that do not conduct any proprietary trading have nonetheless had to incur large costs simply proving what the regulators already know – that they are *not* engaged in activities covered by the rule. For instance, community banks must review their investment portfolios to determine whether they are purchasing or selling any securities for a "trading account," a term that can be defined by the Volcker Rule under any one of three different tests, one of which requires the bank to divine the intent underlying each transaction. Community banks must also perform due diligence to determine whether each security in their portfolios qualifies for an exemption from the rule. Repealing the Volcker Rule will therefore have the salutary consequence of removing one more unnecessary regulatory burden inflicted on community financial institutions by the Dodd-Frank Act.

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[336] Andrew Mayeda, "IMF Calls Volcker Rule Hard to Enforce and Threat to Liquidity," Bloomberg, (April 20, 2017), *available at* https://www.bloomberg.com/news/articles/2017-04-20/imf-calls-volcker-rule-hard-to-enforce-and-threat-to-liquidity

Repeal the Durbin Amendment

Executive Summary:

- **The Durbin Amendment, which was inserted into the Dodd-Frank Act without adequate congressional deliberation, is a price-fixing scheme that picks winners and losers in the marketplace.**

- **The Durbin Amendment has resulted in the elimination of free checking accounts at banks, pushing vulnerable Americans out of the mainstream banking system, while providing no discernible benefit to retail consumers.**

Background on Debit Interchange Fees

When a customer uses a credit or debit card to pay for goods or services at a merchant, the merchant's bank pays the customer's bank an "interchange fee" for purchases that use a card network such as Visa and MasterCard. These fees are set by the credit card networks, and are the biggest part of the fees that merchants pay for the privilege of accepting credit cards.[337] Interchange fees have a complex pricing structure, and those fees are set according to the card brand, the type of credit or debit card, the type and size of the accepting merchant, and the type of transaction.[338] Interchange fees are typically a flat fee plus a percentage of the total purchase price.[339]

To accept certain cards, a retailer must transact with a bank that has access to card networks.[340] The merchant and the bank negotiate the fee that the merchant pays for the privilege of accepting cards; the card networks are not involved in these negotiations. Most experts believe these arrangements are freely and fairly negotiated because many banks offer access to card networks and they compete against each other for customers on price and services. These experts point to the frequent renegotiation of short-term contracts between merchants and banks as evidence that this market is competitive.

Through these negotiations, merchants are frequently able to obtain discounts on the fees they pay. These discounts are typically structured in one of two ways: (1) a blended rate that is a fixed percentage of the sale, or (2) an "interchange plus" rate that is composed of the interchange fee, the card network fee, and a fixed percentage of the sale. Small merchants typically pay the blended rate, whereas medium and large-size merchants negotiate for an "interchange plus" rate.

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[337] See Robin A. Prager et al., *Interchange Fees and Payment Card Networks: Economics, Industry Developments, and Policy Issues* 12 (Finance and Economics Discussion Series No. 2009-23, 2009), *available at* https://www.federalreserve.gov/pubs/feds/2009/200923/200923pap.pdf.
[338] *See id.* at 25.
[339] *See id.* at 12.
[340] *Cf. id.* at 13.

Many large retail "big box" merchants can negotiate the fees they pay because they control large transaction volumes; other merchants refuse to accept credit cards to avoid paying the fees; still other merchants believe they cannot refuse to accept the major network-branded cards, because they are ubiquitous and preferred by their customers. Merchants have complained that the interchange fees they pay are set at levels that are far higher than the banks' costs for processing these transactions. Merchants claim that if fees were set at competitive rates, consumers would benefit from lower prices.

The banking industry counters that consumers do not benefit from lower interchange fees, both because merchants do not pass savings on to consumers in the form of lower prices and because bank profits from interchange fees subsidize the costs – and thereby lower the prices – of other financial products and services that consumers rely upon. Capping interchange fees thus forces banks to raise prices for other goods and services and restrict choices for bank customers.

The Durbin Amendment

During the Senate's consideration of financial regulatory reform legislation, Senator Richard Durbin (D-IL) offered an amendment to cap interchange fees on debit card transactions.[341] Senator Durbin's amendment passed by a vote of 64-33 and ultimately became Section 1075 of the Dodd-Frank Act.[342] The amendment was not considered by the House prior to final passage of the Dodd-Frank Act, and was never the subject of a hearing in the Financial Services Committee.

The Durbin Amendment is based on the false premise that interchange fees are the result of a monopoly that requires government intervention; rather than permit market participants to negotiate interchange fees, it instead directs the Federal Reserve to cap interchange fees for debit cards at a level that is "reasonable and proportional to the cost incurred by the issuer with respect to the transaction."[343] This mandate is unworkable because the terms "reasonable and proportional" are vague, and the mandate is unnecessary because there is no monopoly, given the many card networks that exist alongside and compete with Visa and MasterCard. The mandate is also misguided because it inserts Congress and federal agencies between private parties engaged in a dispute over the contractual amounts that should be paid for services. The only branch of government that arguably has a legitimate role to play in this circumstance is the judiciary, which is authorized to resolve contractual disputes between parties based on federal law, precedent, and the particular facts of the case.

Section 1075 also appears to prohibit the Federal Reserve from considering the networks' large fixed costs—such as those associated with setting up and operating the network—

[341] *See* 156 CONG. REC. S3651-52 (2010) (introducing amendment SA 3989 to S. 3217).
[342] *See id*; Roll Call Vote No. 149, 156 CONG. REC. S3705 (2010).
[343] Dodd-Frank Act § 1075(a)(2).

instead directing the Federal Reserve to set fees exclusively in relation to the marginal costs of individual transactions, which would grossly underestimate the total costs that the networks have incurred to set up networks capable of processing millions of transactions at low cost per transaction.[344]

On June 29, 2011, the Federal Reserve issued its final rule implementing the Durbin Amendment,[345] capping interchange fees at 21 cents, plus 5 basis points of the transaction value to adjust for fraud losses.[346] The Federal Reserve's rule also permits certain issuers to collect an additional one cent per transaction "fraud prevention adjustment."[347] These limits apply only to interchange fees on debit cards issued by banks that have more than $10 billion in assets.[348]

The Effect of the Durbin Amendment

The Durbin amendment has had the effect on debit card pricing that its proponents intended. According to the Federal Reserve, the average interchange fee for covered issuers per debit card transaction was 24 cents in the fourth quarter of 2011, immediately after the adoption of the restrictions, which is a 45 percent decrease from 2009, when the average interchange fee was 43 cents.[349] This amounts to a government-mandated wealth transfer, and the evidence strongly suggests that financial products and services have become less available and more expensive as a result.

A January 2014 Moebs Services survey of 2,890 financial institutions, including large and small banks and credit unions, found that "overall, about 41% of U.S. financial institutions aren't offering unconditional free checking accounts this year [2014], up eight percentage points from a year earlier [2013]."[350] A *Wall Street Journal* report on the survey noted that "the last time free checking was harder to come by was in 2002," and "the trend marks the steepest annual drop in the percentage of banks and other financial institutions offering free checking since 2010, and follows a trend of less-generous deposit accounts since the recession."[351] The article also cited the imposition of higher minimum balance requirements and new account maintenance fees at several large U.S. banks.[352]

Notably the Moebs Services survey referenced in the preceding paragraph included small banks, which are technically exempt from the Durbin Amendment if they hold less than $10

[344] *See id.*, § 1075 (a)(4), (5).
[345] Debit Card Interchange Fees and Routing, 76 Fed. Reg. 43,394, 49,467 (Jun. 29, 2011) (codified at 12 C.F.R. pt. 235).
[346] Debit Card Interchange Fees and Routing, 12 C.F.R. § 235.3(b) (2016).
[347] *Id.* § 235.4(a).
[348] *Id.* § 235.5(a).
[349] *See* FEDERAL RESERVE, AVERAGE DEBIT CARD INTERCHANGE FEE BY PAYMENT CARD NETWORK (May 1, 2012), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20120501a.htm. By contrast, the average interchange fee for exempt issuers in 2011 Q4 was the same as it had been in 2009: 43 cents.
[350] Annamarie Andriotis & Saabira Chaudhuri, *Free Checking Is Disappearing Perk*, WALL STREET JOURNAL, (Feb. 6, 2014), *available at* http://www.wsj.com/articles/SB10001424052702304450904579365251142904312.
[351] *Id.*
[352] *Id.*

billion in assets.[353] But as basic economic theory would predict, implementing price caps for major market participants will distort the market in its entirety. In an Independent Community Bankers of America survey of community banks to determine the impact of the Durbin Amendment, 61 percent reported that they were considering imposing monthly fees for all checking customers, and 93 percent said they would have to charge customers for services they now provide for free.[354] In a 2014 survey of small banks (with less than $10 billion in assets), approximately half reported being impacted by the Durbin Amendment.[355] Contrary to proponents' claims, the Durbin Amendment exemption fails to exempt.

In March 2014, researchers at the Federal Reserve and the Office of Financial Research issued a report on "Bank Profitability and Debit Card Interchange Regulation: Bank Responses to the Durbin Amendment."[356] The report found that subsequent to implementation of the Durbin Amendment, interchange revenue had dropped and banks were only able to recoup 30 percent of lost revenue from higher fees on deposit accounts.[357] This report also showed that banks affected by the Durbin Amendment raised deposit fees 3 to 5 percent.[358]

Before Dodd-Frank became law, just over 75 percent of banks offered free checking.[359] By 2015, just 37 percent of banks offered free checking.[360] Research finds that the Durbin Amendment has contributed to this drop, as well as a 165 percent increase in the average minimum balance for noninterest checking accounts, which along with other Durbin-related fee increases, has driven up the number of unbanked Americans.[361] An October 2014 report in *The Economist* cited estimates that the Durbin Amendment has resulted "in the transfer of between $1 billion and $3 billion annually from poor households to big retailers and their shareholders."[362]

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[353] *See* Dodd-Frank Act § 1075(a)(6).
[354] *See* Comment Letter from Karen M. Thomas, Senior Executive Vice President, Independent Community Bankers of America, to the Board of Governors of the Federal Reserve System 22-23 (Feb. 22, 2011), *available at* http://www.federalreserve.gov/SECRS/2011/March/20110303/R-1404/R-1404_022211_67952_575354719897_1.pdf.
[355] Hester Peirce et al., *How Are Small Banks Faring Under Dodd-Frank?* 41 (Mercatus Center Working Paper No. 14-05, 2014), *available at* http://mercatus.org/sites/default/files/Peirce_SmallBankSurvey_v1.pdf.
[356] BENJAMIN KAY, MARK D. MANUSZAK, & CINDY M. VOJTECH, BANK PROFITABILITY AND DEBIT CARD INTERCHANGE REGULATION: BANK RESPONSES TO THE DURBIN AMENDMENT (March 2014), *available at* http://www.bostonfed.org/payments2014/papers/Cindy_M_Vojtech.pdf.
[357] *Id. at 5.*
[358] *Id.* at 17.
[359] Todd Zywicki, Opinion, Geoffrey Manne, & Julian Morris, *How to Help the Unbanked? Repeal The Durbin Amendment*, FORBES CAPITAL FLOWS (Aug. 4, 2014), *available at* http://www.forbes.com/sites/realspin/2014/08/04/how-to-help-the-unbanked-repeal-the-durbin-amendment/#43b6d8605a5f.
[360] Claes Bell, *Another record-setting year for checking account fees* 2, BANKRATE, (Oct. 5, 2015), *available at* http://www.bankrate.com/finance/checking/record-setting-year-for-checking-account-fees-2.aspx
[361] Lux and Greene, *Out of Reach: Regressive Trends in Credit Card Access, available at* https://www.hks.harvard.edu/centers/mrcbg/publications/awp/awp54
[362] *Plastic Stochastic: Capping fees on card transactions has not worked out as planned*, THE ECONOMIST (Oct. 4, 2014), *available at* http://www.economist.com/news/finance-and-economics/21621882-capping-fees-card-transactions-has-not-worked-out-planned-plastic-stochastic

Also worth noting is an October 23, 2013, University of Chicago working paper entitled "The Impact of the U.S. Debit Card Interchange Fee Regulation on Consumer Welfare: An Event Study Analysis."[363] The paper questions whether consumers gained more from cost savings passed on by merchants, in the form of higher prices and better services, than they lost from cost increases passed on by banks, in the form of higher prices or less services.[364] The authors concluded that "consumers lost more on the bank side than they gained on the merchant side. Our estimate is that, based on the expectations of investors, the present discounted value of the losses for consumers as a result of the implementation of the Durbin Amendment is between $22 and $25 billion."[365]

The Financial CHOICE Act would repeal the Durbin amendment, and thereby bring an end to a misguided government experiment in price-fixing that has done consumers more harm than good. It is time for Congress to get out of the business of rationing consumer access to the mainstream banking system.

[363] David S. Evans, Howard Chang , & Steven Joyce, *The Impact of the U.S. Debit Card Interchange Fee Regulation on Consumer Welfare: An Event Study Analysis* (Coase-Sandor Institute for Law and Economics Working Paper No. 658, 2d Series, 2013), *available at* http://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?article=1651&context=law_and_economics
[364] *Id.* at 1.
[365] *Id.*

Eliminate the Office of Financial Research

Executive Summary:

- **By driving regulators towards a homogenized assessment of financial system threats, the OFR contributes to a "one-world view" of risk that has had such disastrous consequences in Basel and other regulatory contexts. Eliminating the OFR would actually *improve* risk management by encouraging diverse perceptions of risk and risk management strategies.**
- **There are countless other federal agencies – most notably the Federal Reserve, which maintains a "Division of Financial Stability" and employs over 300 PhD economists – that perform market surveillance and collect and analyze data for purposes of identifying threats to financial stability. Eliminating the OFR will result in one less redundant federal bureaucracy.**

Title I of the Dodd-Frank Act created the Office of Financial Research (OFR) within the Treasury Department to support the work of the FSOC, by collecting and analyzing data on systemic risk in financial markets.[366] The OFR is headed by an independent director who is appointed by the President to serve a six-year term, subject to the advice and consent of the Senate.[367] Dodd-Frank gives the Director "sole discretion" for determining how to carry out his Dodd-Frank authorities.[368] The OFR has broad powers to compel the production of data by participants in the financial markets, including by issuing subpoenas. The OFR has the authority to demand "all data necessary" from financial companies and can compel financial companies to produce sensitive, non-public information such as information about individual loans.[369]

Congress's oversight over the OFR is limited by its inability to exercise the "power of the purse." Like the FSOC and the Consumer Financial Protection Bureau (CFPB), the OFR sets its own budget and funds itself outside of the Congressional appropriations process, through assessments on bank holding companies that have total consolidated assets of $50 billion or more and nonbank financial companies that the FSOC has designated for supervision by the Federal Reserve.[370] And as in the case of the FSOC and the CFPB, insulation from the Congressional appropriations process appears to have bred a host of bureaucratic pathologies at the OFR. A November 2016, article in the *American Banker* painted a picture of a highly dysfunctional agency culture and a hostile work environment

[366] *See* Dodd–Frank Act §§ 151-156.
[367] *See* id. § 152(b)(1).
[368] Id. § 152(b)(5).
[369] *Id.* § 154(b)(1).
[370] *Id.* § 154(b)(1).

for minorities. The article cited survey data reflecting low employee morale and a lack of confidence among employees in the OFR's leadership.[371]

The OFR's capacity for carrying out the responsibilities conferred upon it by the Dodd-Frank Act was called into serious question by its September 2013 report on the asset management industry—a collection of firms that facilitate the investment activities of individuals and institutions, often by acting as the investor's agent—which it prepared at the FSOC's request.[372] The report concluded that the asset management industry could pose a systemic risk to the financial system because of the "extensive connections" between asset managers and other market participants as well as because of fire sales by asset management firms that could flood the market for a particular asset and thereby depress the asset's price.[373]

The OFR's analysis of the asset management industry was roundly dismissed by a broad range of commentators as superficial and analytically unsound. The SEC, which is the primary regulator of asset managers, was so troubled by the quality of the report that it took the extraordinary step of soliciting public comment on it.[374] A bipartisan group of senators wrote a letter stating that they were "concerned that the people involved in the study lack a fundamental understanding of the fund industry itself."[375] Even Barney Frank—the primary House author of the Dodd-Frank Act and the former Chairman of the House Financial Services Committee—criticized the OFR's conclusions. As the *Wall Street Journal* noted, "Mr. Frank said he did not favor designating such large asset managers as BlackRock or Fidelity as 'systemically important' and that this was not the intent of his law."[376]

The non-profit group Better Markets, usually an advocate for heavier government intervention in financial markets, wrote in its comment letter to the SEC that "the [OFR] Report adopts an arbitrary analytical framework; it provides little empirical support; it ignores or minimizes the significance of relevant factors; and it conveys its findings in such vague and amorphous terms that it proves to be of little value and is in fact misleading.[377]

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[371] Victoria Finkle, *Low Morale, Racial Bias Claims Beset* Another *Dodd-Frank Agency*, AMERICAN BANKER, Nov. 21, 2016, *available at* http://www.americanbanker.com/news/law-regulation/low-morale-racial-bias-claims-beset-another-dodd-frank-agency-1092530-1.html

[372] OFR, ASSET MANAGEMENT AND FINANCIAL STABILITY (2013), *available at* https://financialresearch.gov/reports/files/ofr_asset_management_and_financial_stability.pdf

[373] *Id. at* 21-23 (2013).

[374] *See* Andrew Ackerman & Ryan Tracy, *SEC Fights Turf War Over Asset Managers*, WALL STREET JOURNAL, updated Jan. 28, 2014, *available at* http://www.wsj.com/articles/SB10001424052702303277704579349162124450516?cb=logged0.6339490402797565

[375] Emily Stephenson & Sarah N. Lynch, *U.S. Senators Slam Study on Systemic Risks Posed by Asset Managers*, REUTERS, Jan. 24, 2014, *available at* http://www.reuters.com/article/2014/01/24/financial-regulation-asset-idUSL2N0KY19A20140124.

[376] *Barney Frank vs. Dodd-Frank*, WALL STREET JOURNAL: REVIEW & OUTLOOK, Dec. 8, 2013, *available at* http://online.wsj.com/news/articles/SB10001424052702304465604579220052504852822.

[377] Comment Letter from Dennis Kelleher et al., to Elizabeth Murphy, Secretary, Securities Exchange Commission (Nov. 1, 2013), *available at* http://www.sec.gov/comments/am-1/am1-24.pdf.

The Dean of Columbia University's business school, the Chairman of the Brookings Institution, and the head of Harvard Law School's program on international financial institutions wrote that the OFR's report "presents an inaccurate and incomplete picture of the asset management market and the risks it poses to the financial system."[378] And University of Michigan Law Professor Michael Barr, a former senior Treasury official and one of the primary architects of the Dodd-Frank Act, drily noted in testimony before the Committee that the OFR's asset management report "was not something I would hang my hat on."[379]

Even if the OFR were capable of producing credible analyses of systemic risk issues – which the asset management report suggests it is not – its elimination would be justified by the need to streamline government operations and reduce the duplication of effort among multiple federal regulators. Research by the Republican staff of the Financial Services Committee suggests that there are as many as **20** other federal divisions, sections, departments, centers, committees, offices, and bureaus that will remain in place after OFR is eliminated that are capable of collecting or analyzing data that can be used by policymakers to assess risks to the financial system and the broader economy. Several of these entities have missions and capabilities that are virtually indistinguishable from OFR's.

For example, the Federal Reserve, whose workforce includes over 300 PhD economists,[380] features a Division of Financial Stability,[381] where the it "conducts an active research and analysis program, and it monitors financial institutions, markets and infrastructure to assess the resilience of the financial system and identify potential risks vulnerabilities."[382] Within this division, the Financial and Macroeconomic Stability Studies section specifically researches "linkages between financial stability and macroeconomic performance, including the effects of the distress of financial institutions."[383] A May 2016 *Reuters* article reported that Ms. Orice Williams Brown, managing director of financial markets and community investment at the GAO, "noted that the Office of Financial Research and a

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[378] Comment Letter from R. Glenn Hubbard, et al., to Elizabeth Murphy, Secretary, Securities and Exchange Commission (Nov. 1, 2013), https://www.sec.gov/comments/am-1/am1-9.pdf.
[379] *Examining the Dangers of the FSOC's Designation Process and its Impact on the U.S. Financial System: Hearing Before the H. Comm. on Financial Services*, 113th Cong. (2014), *available at* http://financialservices.house.gov/uploadedfiles/113-79.pdf.
[380] *See The Economists*, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, https://www.federalreserve.gov/econresdata/theeconomists.htm; *Macroeconomics*, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, https://www.federalreserve.gov/econresdata/macroeconomics-c.htm
[381] Formerly the Office of Financial Policy and Research, renamed and redesignated as a division of the Federal Reserve Board on May 11, 2016. *See* Press Release, Board of Governors of the Federal Reserve System (May 11, 2016), https://www.federalreserve.gov/newsevents/press/other/20160511a.htm.
[382] See Federal Reserve Board announces Office of Financial Policy and Research has been designated a division of the Board and renamed Division of Financial Stability (May 11, 2016), *available at*: https://www.federalreserve.gov/newsevents/pressreleases/other20160511a.htm
[383] *Financial and Macroeconomic Stability Studies*, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, https://www.federalreserve.gov/econresdata/fspr-fms-staff.htm

special research division of the Federal Reserve are at times analyzing the same topic without appropriate coordination."[384]
The Treasury Department, where OFR is housed, already has an Office of Economic Policy, which is "responsible for analyzing and reporting on current and prospective economic developments in the U.S. and world economies and . . . developments in the financial markets,"[385] and includes a Deputy Assistant Secretary for Macroeconomic Analysis with a dedicated staff of economists.[386] And the FDIC maintains a Center for Financial Research, which includes a risk measurement research program.[387] As this small sample indicates, eliminating the OFR will in no way leave federal regulators with a shortage of information, data, or insight into systemic risk and financial stability. Rather, it will streamline government by removing a redundant (and largely ineffectual) layer of bureaucracy.

More broadly, elimination of the OFR would actually *improve* risk management by encouraging diverse perceptions of risk and risk management strategies. It is simply naïve to believe that more data and papers by one more government agency will improve policy-makers' ability to preemptively detect and mitigate tail-end risk events that drive financial crises. In his critique of the OFR, Nassim N. Taleb, Distinguished Professor of Risk Engineering at NYU and author of *The Black Swan,* accurately notes:

> Had the last crisis been predictable, or the risks been measurable, then central banks with access to all manner of information, and thousands of PhDs on their staff, would have been able to see it. Their models failed in 2007-2008 (as well as in previous crises). The same applies to the thousands of regulators we have worldwide.[388]

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[384] Lauren Tara Lacapra & Lisa Lambert, *US Watchdog Probes Financial Regulatory System*, REUTERS, May 18, 2016, *available at* http://www.reuters.com/article/us-finance-summit-gao-idUSKCN0Y931W. This needless duplication of effort could impede the ability of regulators to successfully implement policies aimed at curbing the risk of financial downturns. For one thing, "it is not clear what happens when differences in opinion arise between OFR and the various financial regulators," notes a 2014 Milken Institute study. James R. Barth et al., *Misdiagnosis: Incomplete Cures of Financial Regulatory Failures*, MILKEN INSTITUTE: VIEWPOINTS 8 (Oct. 2014), *available at* http://assets1b.milkeninstitute.org/assets/Publication/Viewpoint/PDF/Misdiagnosis-incomplete-cures-of-financial-regulatory-failures-Barth-Caprio-Levine2.pdf. Further complicating matters, "the mission and staffing of OFR implies that it cannot be expected to identify and provide in-depth understanding of emerging market trends that may pose risks," according to Larry Wall of the Atlanta Fed. Larry D. Wall, *Stricter Microprudential Supervision Versus Macroprudential Supervision* 19-20 (Working Paper, Federal Reserve Bank of Atlanta, 2014), https://www.frbatlanta.org/-/media/Documents/news/conferences/2014/cenfis-nonbank-financial-firms/Wall-Stricter-Micro-vs-Macroprudential-Supervision.pdf.

[385] *Economic Policy*, DEPARTMENT OF THE TREASURY, https://www.treasury.gov/about/organizational-structure/offices/Pages/Economic-Policy.aspx

[386] *History of the Office of Economic Policy*, DEPARTMENT OF THE TREASURY, https://www.treasury.gov/about/organizational-structure/offices/Documents/History%20of%20Economic%20Policy.pdf

[387] *Research Programs, Center for Financial Research*, FDIC, https://www.fdic.gov/bank/analytical/cfr/research.html

[388] *Oversight of the Office of Financial Research and the Financial Stability Oversight Council: Hearing Before the Subcomm. On Oversight and Investigations of the H. Comm. on Financial Services*, 112th Cong. 84 (2011) (statement of Nassim N. Taleb, Distinguished Professor of Risk Engineering, NYU-Polytechnic Institute).

The OFR is emblematic of the trend toward a homogenized, "one-world" view of risk management that also informs the work of the Basel Committee on Banking Supervision, as well as many other post-crisis regulatory initiatives. American taxpayers would be better served by a regime in which financial firms are free to view various financial risks differently rather than taking their cues from government risk managers. Diversification of risk management strategies is critical to fostering a resilient financial system. As Professor Taleb notes, "risks need to be handled by the entities themselves, in an organic way, paying for their mistakes as they go. It is far more effective to make bankers accountable for their mistakes than try the central risk manager version of [the] Soviet-style central planner, putting hope ahead of empirical reality."[389]

Therefore, the Financial CHOICE Act eliminates the OFR.

[389] *Id.* at 83.

SEC Enforcement Issues

<u>Executive Summary:</u>

- **Because both Wall Street and Washington must be held accountable if future financial melt-downs are to be averted, the Financial CHOICE Act increases penalties for violations of the securities laws for individuals and entities, but couples those increases with important reforms to the SEC's enforcement program designed to promote the Rule of Law and ensure due process.**

- **The vigorous enforcement of the federal securities laws is paramount and the SEC must have the tools it needs to deter and punish wrongdoing and, whenever possible, to make defrauded investors whole. But the SEC must strike the right balance between deterring and punishing securities fraud and protecting shareholders from paying unnecessarily for the sins of rogue corporate officers and employees, who have rarely been the subject of disciplinary action or financial penalties in post-crisis enforcement actions. By requiring the SEC to incorporate economic analysis in its deliberations on enforcement matters, the Financial CHOICE Act will help ensure that shareholder interests are recognized and protected to a greater extent than is currently the case.**

- **All individuals who are either under investigation by the SEC or appear before the SEC in administrative proceedings must have a full and complete opportunity to defend themselves. The Financial CHOICE Act's provisions affording defendants in SEC administrative proceedings a right of removal to federal court will help ensure that those defendants receive due process, and eliminate the unfair "home court advantage" that the SEC has sought to gain by steering cases to its in-house administrative law judges.**

The SEC's Enforcement Division

Although the SEC was created in 1934, its Division of Enforcement (Enforcement Division) was not established until 1972.[390] The Enforcement Division investigates potential violations of the federal securities laws and prosecutes these cases in the federal courts or in administrative proceedings before the SEC's own administrative law judges (ALJs). The

[390] Prior to 1972, the SEC's enforcement function was administered by its individual operating divisions. *See* SEC, ABOUT THE DIVISION OF ENFORCEMENT, *available at* https://www.sec.gov/divisions/enforce/about.htm.

SEC is a civil enforcement agency—it cannot bring criminal charges itself, although it can refer cases for criminal prosecution to the Justice Department. The Enforcement Division has broad authority to subpoena documents and testimony from individuals and entities suspected of violating the federal securities laws, or who may have information relevant to a fraud investigation. The SEC brought a record 868 enforcement actions in FY 2016 and obtained over $4 billion in disgorgement and civil penalties resulting from those actions.[391]

Penalty Authority

The SEC's enforcement program historically has been remedial, rather than punitive, in seeking to enforce violations of federal securities laws through non-monetary remedies such as injunctive relief and disgorgement of ill-gotten gains. This view changed in the 1980s as Congress began providing the SEC with enhanced enforcement authorities, including expanded remedial powers and new penalty authority in statutes such as the Insider Trading Sanctions Act of 1984, the Insider Trading and Securities Fraud Enforcement Act of 1988, and the Securities and Enforcement Remedies and Penny Stock Reform Act of 1990. These laws established criminal penalties enforced by the Department of Justice, and authorized the SEC to seek civil monetary penalties, bar directors and officers for violations of antifraud provisions, and issue administrative cease-and-desist orders, temporary restraining orders, and orders for disgorgement.[392] Congress subsequently updated these authorities in other laws including the Sarbanes-Oxley Act and the Dodd-Frank Act.

Many of the civil monetary penalties administered by the SEC are based on a three-tiered structure, in which the severity of the penalty increases according to the gravity of the offense. For each tier, the maximum penalty cannot be greater than either the gross pecuniary gain or the maximum statutory amount.[393] While Congress established the maximum penalty levels for various violations of federal securities laws, those amounts are increased for inflation at least once every four years under the Federal Civil Penalties Inflation Adjustment Act.[394] As such, the SEC has continually increased the maximum statutory amounts consistent with inflation.[395]

However, the SEC expressed concerns that the current statutory authorities limit their ability to pursue penalties and influence the structure of settlement agreements.[396] To address these concerns, the Financial CHOICE Act significantly increases the SEC's civil penalty authority, as well as criminal sanctions under the federal securities laws, for the

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[391] *See* SEC Press Release, SEC Announces Enforcement Results for FY 2016 (Oct. 11, 2016), *available at* https://www.sec.gov/news/pressrelease/2016-212.html

[392] *See* Paul S. Atkins & Bradley J. Bondi, *Evaluating the Mission: A Critical Relief of the History and Evolution of the SEC Enforcement Program*, 13 Fordham J. of Corp. and Fin. L. (2008), *available at* http://ir.lawnet.fordham.edu/cgi/viewcontent.cgi?article=1013&context=jcfl.

[393] *Id.* at 392.

[394] *See* 28 U.S.C § 2461.

[395] *See* 17 C.F.R. §§ 201.1001- 201.1005.

[396] *See e.g.* Letter from SEC Chairman Mary Schapiro to Sen. Jack Reed re: SEC Penalty Authority (Nov. 28, 2011) *available at* http://www.davispolk.com/files/uploads/IMG/Mary-Schapiro--Letter-to-Senator-Jack-Reed.pdf.

most serious offenses. It increases the first and second tier penalties, and nearly doubles the penalty amounts for third-tier offenses – those involving substantial losses for the victim or substantial pecuniary gain for the offender – for both individuals and corporations.

Additionally, the Financial CHOICE Act establishes a new fourth tier for recidivist offenders that allows for damages that are triple otherwise maximum monetary penalties. It also significantly increases the criminal penalties for individuals for insider trading and other corrupt practices. Overall, the Republican approach allows the SEC Enforcement Division and the Department of Justice to pursue the worst offenders with stronger penalty authority than was provided for in the Dodd-Frank Act, which will have a deterrent effect on corporate executives considering stepping over the line.

Enforcement Authorities

As noted, the SEC possesses a wide array of enforcement tools to supplement and effectuate its penalty authority. However, there have been increasing concerns regarding the SEC's use of this authority in its enforcement of the federal securities laws.

Over the past seven years, the SEC has increasingly turned to its own ALJs—rather than the federal courts—to adjudicate enforcement actions. This shift from litigation in federal court to administrative proceedings occurred largely as a result of Section 929P of the Dodd-Frank Act, which expanded the SEC's authority to obtain civil penalties in administrative proceedings against *any* person or entity. SEC administrative proceedings are quasi-judicial proceedings in which ALJs appointed by the SEC adjudicate enforcement actions under SEC rules. While the SEC has publicly supported administrative proceedings as a more efficient way to resolve enforcement matters, critics have noted that administrative proceedings confer several advantages on the SEC and may deprive defendants of their due process rights:

> Unlike in federal court cases seeking penalties, in which, following the opportunity to take full discovery (including depositions of all the key individuals), a defendant has a right to a jury trial presided over by a neutral federal judge, administrative proceedings are before an administrative law judge, a commission employee, who renders an initial decision that is subject to an appeal to his or her employer, the commission (which itself brought the administrative complaint), with an unfavorable commission decision being subject to appeal to a U.S. Court of Appeals.[397]

The SEC's "home court" advantage in administrative proceedings has been manifest in its win-loss record compared to cases it brings in the federal courts. During FY 2014, the SEC's Enforcement Division won all six of its litigated administrative proceedings,

[397] Elaine Greenberg, James A. Meyers, Michelle van Oppen, & Danielle P. Van Wert, *SEC Reloads its Quiver with Administrative Proceedings*, LAW 360, (Dec. 23, 2014), *available at* http://www.law360.com/articles/604814/sec-reloads-its-quiver-with-administrative-proceedings.

compared to only 11 of its 18 cases brought in federal court.[398] The Enforcement Division's broad prosecutorial discretion, coupled with Section 929P's enhanced authority to obtain penalties in administrative proceedings, has created a strong incentive for the SEC to bring cases in an administrative forum that have historically been brought in the federal courts instead.[399] SEC Acting Chairman Michael Piwowar observed in a 2015 speech that the Enforcement Division's avoidance of federal court "has the appearance of the Commission looking to improve its chances of success by moving cases to its in-house administrative system."[400]

In December 2016, the U.S. Court of Appeals for the Tenth Circuit dealt the SEC's in-house tribunals a serious blow, ruling that the SEC's process for hiring ALJs violates the Appointments Clause of the U.S. Constitution, because the judges are "inferior officers" within the meaning of that clause and must therefore be appointed directly by the SEC Commissioners.[401] The Tenth Circuit's opinion conflicts with an earlier decision by the U.S. Court of Appeals for the D.C. Circuit, which held in August 2016 that ALJs needn't be appointed directly because their decisions are reviewable by the SEC Commissioners.

The SEC's recent penchant for imposing civil penalties on corporations that violate the federal securities laws instead of bringing enforcement actions against individual offenders also has raised concerns among SEC commissioners and other commentators that innocent shareholders are being penalized while the culpable corporate officers escape liability. As a result of this policy, even though the SEC is collecting larger penalties from public companies, those penalties may not be having the intended effect. Corporate employees tempted to cut legal corners or engage in malfeasance will think twice if they know they are likely to pay a price for their wrongdoing. If it is far more likely that the costs will instead be imposed on the company or its shareholders, that deterrent effect is undermined. As Acting Chairman Piwowar explained at the 2017 "SEC Speaks" Conference:

> A financial reporting fraud by the managers of a large company may result in the loss of billions of dollars of market capitalization when the fraud is discovered by the market. This may have widespread direct or indirect effects on millions of shareholders, the value of whose investment plummets.

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[398] *See* Peter K.M. Chan, Kate M. Emminger, Christian J. Mixter, & Susan D. Resley, *There's No Place Like Home: SEC Increasingly Uses Administrative Proceedings*, NATIONAL LAW REVIEW, Dec. 22, 2014, *available at* http://www.natlawreview.com/article/there-s-no-place-home-sec-increasingly-uses-administrative-proceedings. S*ee also* Jean Eaglesham, *SEC Is Steering More Trials to Judges It Appoints*, WALL STREET JOURNAL, Oct. 21, 2015, *available at* http://www.wsj.com/articles/sec-is-steering-more-trials-to-judges-it-appoints-1413849590 ("The agency won nine of 10 contested administrative proceedings in the 12-month period through September 2013 and seven out of seven in the 12 months through September 2012, according to SEC data. The SEC won 75% and 67%, respectively, of its trials in federal court in those years.").

[399] *See* Jed S. Rakoff, U.S. District Judge for the Southern District of New York, Remarks at the PLI Securities Regulation Institute Keynote Address (Nov. 5, 2014).

[400] Remarks by Commissioner Michael S. Piwowar at the "SEC Speaks" Conference 2015: A Fair, Orderly, and Efficient SEC, (Feb. 20, 2015), *available at* http://www.sec.gov/news/speech/022015-spchcmsp.html#.VOtB0fnF8kg.

[401] See *Bandimere v. United States Securities and Exchange Commission*, 10th Circuit Court of Appeals, No. 15-9586, (December 27, 2016), *available at*: https://www.ca10.uscourts.gov/opinions/15/15-9586.pdf

> It is entirely appropriate to discipline and punish corporate malefactors who violate our laws, but, when we speak of penalizing a corporation, we must also remember the innocent investors who are so often the primary victims of the fraud. Ultimately, *who* is actually penalized by our penalties?[402]

Critics also have noted that the Enforcement Division has broad discretion to set the amount of civil penalties and that there are no binding rules or guidelines requiring the SEC to consider the best interests of shareholders in deciding whether to approve a civil penalty proposed by the Division. At the 2015 edition of the "SEC Speaks" conference, Acting Chairman Piwowar commented that the imposition of corporate penalties and the issuance of waivers "would benefit from the consistent application of public stated guidelines or factors."[403]

Yet there are circumstances in which civil money penalties against corporations are clearly warranted. For example, penalties against regulated entities (which submit to substantive and comprehensive regulation by the SEC) or corporations where the shareholders receive a direct benefit from the fraud (for example, bribery of a foreign official to secure lucrative business in violation of the Foreign Corrupt Practices Act) may deter and punish fraudulent conduct without further harming shareholders.

Another concern is the SEC's system for automatic disqualifications, in which individuals and other entities found to have committed certain bad acts, or deemed to have done so through the operation of a legal settlement with the federal government, are barred from engaging in certain activities or from relying on exemptions that otherwise would be available to them.[404] The SEC has the discretion to waive the disqualification based in its review of the facts and circumstances. While this may seem like a reasonable approach, it has resulted in a system that often conflates the disqualifications with the SEC's current remedial and punitive enforcement authorities, which was not Congress's original intent in establishing the enhanced enforcement authorities.[405] These disqualifications were never

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[402] Remarks by Acting Chairman Michael S. Piwowar at the "SEC Speaks" Conference 2017: Remembering the Forgotten Investor, (Feb. 24, 2017), *available at* https://www.sec.gov/news/speech/piwowar-remembering-the-forgotten-investor.html

[403] Remarks by Commissioner Michael S. Piwowar at the "SEC Speaks" Conference 2015: A Fair, Orderly, and Efficient SEC, (Feb. 20, 2015), *available at* http://www.sec.gov/news/speech/022015-spchcmsp.html#.VOtB0fnF8kg.

[404] *See* Daniel M. Gallagher, SEC Commissioner, Remarks at the 37th Annual Conference on Securities Regulation and Business Law: Why is the SEC Wavering on Waivers? (Feb. 13, 2015), *available at* https://www.sec.gov/news/speech/021315-spc-cdmg.html.

[405] *See Id.* ("Clear evidence that automatic disqualifications are not appropriate as enforcement sanctions can be found in the fact that Congress chose not to incorporate them into the Securities Law Enforcement Remedies Act of 1990, the statute most relevant to the Commission's sanctioning authority… The Act provided the SEC broad penalty authority and added a number of additional remedial enforcement tools, including the authority to impose administrative cease-and-desist orders and officer and director bars. Noticeably absent from the Remedies Act, however, were any amendments to the then-existing disqualification provisions. If Congress believed that these provisions should be part of the Commission's sanctioning authority, it stands to reason that they would have included these disqualification provisions in the new, stand-alone, sanctioning provisions of the securities laws. Yet the words 'disqualification' and 'waiver' do not appear in the Remedies Act, and there is nothing in the agency or legislative record suggesting that automatic securities law disqualifications should be used as enforcement

meant to be enforcement enhancements and even SEC Chair Mary Jo White has acknowledged that the actions subject to automatic disqualifications "very often…involve a relatively limited number of a firm's employees or a specific business line, and [are] wholly unrelated to the activities that would be the subject of the disqualification."[406] When the actions of individuals, corporations, or other entities warrant putting them out of business to protect investors, the SEC has sufficient authority to do so.

Finally, there has been increasing concern with the SEC's growing practice of "rulemaking by enforcement." In settlements, the Enforcement Division has mandated that settling defendants agree to "undertakings," or remedial measures. These "undertakings" effectively have the force of new regulations because they put other market participants on notice that similar activities, even if not inconsistent with current regulations, could result in SEC enforcement actions. These undertakings essentially amount to new compliance obligations imposed on corporations and individuals outside of the predictable regulatory process and the mandates of the Administrative Procedure Act, including the right of public notice and comment. As a result, rulemaking by enforcement has the potential to create greater uncertainty for market participants and deprive companies and individuals of essential due process protections.

These issues and others related to the SEC's sprawling enforcement program raise a number of important questions – not all of which can be resolved within the scope of the Financial CHOICE Act. In the past, the SEC has taken it upon itself to engage in a review of its policies and procedures. In 1972, then-SEC Chairman William Casey announced the creation of an advisory committee to "review and evaluate the Commission's enforcement policies and practices and to make such recommendations as they deemed appropriate."[407] While the official name of the committee was the "Advisory Committee on Enforcement and Practices," but it is best known as the "Wells Committee," after its chairman, John Wells.[408]

It has been 45 years since the Wells Committee engaged in a holistic review of the SEC's enforcement program and the significant changes – in terms of the SEC's mission, its authorities, and the markets and its participants – necessitate another introspective to modernize the SEC's Enforcement program and policies. As former SEC Chairman Paul Atkins articulated in his call for such a committee:

> Chairman Casey wanted to ensure that the SEC properly allocated resources, balanced regulation and enforcement, and protected the rights of defendants and others with whom the agency interacted. In the [45] years since the Wells Committee set out its recommendations, financial markets have

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sanctions.")

406 Mary Jo White, SEC Chairman, Remarks at the Corporate Counsel Institute, Georgetown University in Washington, DC: Understanding Disqualifications, Exemptions and Waivers Under the Federal Securities Laws (Mar. 12, 2015), *available at* https://www.sec.gov/news/speech/031215-spch-cmjw.html.

407 *See* Paul S. Atkins & Bradley J. Bondi, *Evaluating the Mission: A Critical Relief of the History and Evolution of the SEC Enforcement Program*, 13 Fordham J. of Corp. and Fin. L. (2008), *available at* http://ir.lawnet.fordham.edu/cgi/viewcontent.cgi?article=1013&context=jcfl.

408 *Id.*

> changed tremendously, and corporate scandals have rocked both Wall Street and Main Street…It is time for the Commission to convene a new advisory committee, in a spirit similar to that of the Wells Committee, to conduct an independent review of the SEC's enforcement program and to recommend any needed changes to modernize enforcement practices.[409]

The Financial CHOICE Act will require that the SEC Chairman convene a new Committee, with the same mission as the original Wells Committee, to holistically review the Enforcement program to ensure it comports with both with the SEC's mission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation and our constitutional due process rights.

Overall, Republicans support the vigorous enforcement of the federal securities laws and believe that the SEC must have the tools it needs to deter and punish wrongdoing and, whenever possible, to make defrauded investors whole. But the SEC must strike the right balance between deterring and punishing securities fraud and protecting shareholders ultimately responsible for paying large civil penalties for violations they did not commit and that may further harm a public company.

To help the SEC and the Enforcement Division strike this balance, the Financial CHOICE Act requires the SEC to implement policies consistent with the principles of predictability, fairness, and transparency. For example, to better protect innocent shareholders from further monetary harm, the legislation requires the SEC, when issuing a civil penalty against an issuer, to include findings, supported by the SEC Chief Economist, whether the alleged violations resulted in direct economic benefit to the issuer and the penalties do not harm the issuer's shareholders.

The Financial CHOICE Act addresses constitutional concerns with the SEC's enforcement program by giving respondents in SEC administrative proceedings the right to remove their enforcement action to federal court to ensure that the respondents' due process rights are protected. It also requires the SEC to allow respondents to appear before the Commission prior to the initiation of a formal enforcement action, and establishes an Enforcement Ombudsman to review complaints about the Enforcement program. Further, the SEC will be required to approve and publish an Enforcement Manual to ensure transparency and uniform application of its procedures. It comports certain private claims under the Investment Company Act with prior securities litigation reform efforts. Finally, the Financial CHOICE Act eliminates the system of automatic disqualifications and makes such disqualifications subject to the Commission's discretion, thereby ensuring that the worst offenders can be barred from certain business activities and, if necessary, the industry.

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[409] Commissioner Paul S. Atkins, Remarks Before the Exechequer Club of Washington, D.C., Jul. 16, 2008, *available at* https://www.sec.gov/news/speech/2008/spch071608psa.htm.

Sarbanes-Oxley Act and the PCAOB

In the wake of a series of corporate accounting scandals and frauds in 2001 and 2002 involving publicly traded companies like Enron, WorldCom, Tyco, Global Crossing and Adelphia, President George W. Bush signed into law the Sarbanes-Oxley Act of 2002.[410] The Sarbanes-Oxley Act established the Public Company Accounting Oversight Board (PCAOB),[411] which is supervised by the SEC. The PCAOB is a private, nonprofit corporation charged with overseeing the auditors of public companies. The PCAOB's mission is to protect investors and the public interest by promoting informative, fair, and independent audit reports. Among the PCAOB's responsibilities are periodically inspecting audit firms and promulgating and enforcing auditing standards. The PCAOB has five members, who are appointed to staggered five-year terms by the SEC, after consultation with the Federal Reserve Board Chairman and the Secretary of the Treasury. The SEC's oversight authority over the PCAOB includes the ability to approve the PCAOB's rules, standards, and budget.

The Sarbanes-Oxley Act restricts accounting firms from performing a number of other services for the companies they audit. The Sarbanes-Oxley Act also contained sweeping reforms for issuers of publicly traded securities, auditors, corporate board members, and attorneys. It implemented measures intended to deter and punish corporate and accounting fraud and corruption, threatening severe penalties for wrongdoers.

"Sunlight is said to be the best of disinfectants," wrote U.S. Supreme Court Justice Louis Brandeis in 1913. But in creating the PCOAB, Congress did not adhere to Justice Brandeis's famous axiom. The Sarbanes-Oxley Act omits Congress from the class of entities that can receive confidential information from the PCAOB, which creates statutory ambiguity and could allow the PCAOB to deny congressional requests for information.[412] To ensure that the PCAOB follows its congressionally mandated mission, Congress must have full and complete access to PCAOB documents. The Financial CHOICE Act will ensure that the PCAOB cannot deny Congress access to information.

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[410] *See* generally Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (*hereinafter* Sarbanes-Oxley Act).
[411] Sarbanes-Oxley Act § 101-109.
[412] *See* Sarbanes-Oxley Act Section 105(b)(5)(B)

Reforms to Title IX of Dodd-Frank

Executive Summary:

- **Title IX of the Dodd-Frank Act is an almost perfect embodiment of the adage coined by former Obama chief of staff Rahm Emanuel in the early days of the Administration: "Never let a good crisis go to waste." It consists of a grab bag of items culled from the wish list of congressional Democrats and their political allies that in most instances have nothing to do with addressing the causes of the financial crisis.**

- **The Dodd-Frank Act represented a missed opportunity to streamline and rationalize the SEC's balkanized and overly bureaucratic structure. The Financial CHOICE Act includes organizational changes and other reforms of the SEC that will make for a more nimble, less sclerotic agency better-suited to fulfilling its statutory mission.**

- **Imposing the DOL's severely flawed fiduciary duty rule on broker-dealers will raise costs and reduce access to investment advice for retail investors, costing Americans billions of dollars in lost retirement savings.**

Driven by a belief that the financial crisis resulted from a lack of regulation, the drafters of the Dodd-Frank Act promised that by increasing government oversight and control over the economy to an unprecedented degree, they would head off future financial crises. This "command-and-control" philosophy is evidenced by numerous mandates included in Title IX of the Act,[413] which empowered the SEC to promulgate an array of new federal regulations that had little or nothing to with the financial crisis. Title IX contains ten subtitles and more than 100 provisions on topics that range from investor protection, civil enforcement remedies and penalties, fiduciary duty, securities arbitration, the SEC's operations/structure/funding/authority, corporate governance, whistleblowers, compensation practices, credit rating agencies, asset-backed securities and risk retention, the Sarbanes-Oxley Act and the PCAOB, municipal securities, municipal advisers, and the Municipal Securities Rulemaking Board and the powers and authorities of Inspectors General. The Financial CHOICE Act repeals the most egregious examples of government overreach in Title IX, modifies several other provisions, and leaves others intact.

SEC Structure and Organization

The Dodd-Frank Act included several provisions intended to restructure the SEC so that the agency could better meet its statutory mission of protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation. However, many of these provisions only compound bureaucratic complexity and inefficiencies at the SEC. For

[413] Dodd-Frank Act § 901-991.

example, Dodd-Frank mandated more direct reports to the SEC Chair by agency officials, placing more demands on the occupant of that office at a time when her time and attention are better spent focusing on the SEC's mission-critical functions.

Section 967 of the Dodd-Frank Act directed the SEC to hire an independent consultant "of high caliber and with expertise in organizational restructuring and the operations of the capital markets to examine the internal operations, structure, funding and the need for comprehensive reform of the SEC." To effectuate this directive, the SEC retained and paid $4.85 million to the Boston Consulting Group (BCG),[414] which issued a report on its findings in March 2011.[415] The BCG study contained numerous recommendations focused on four key themes to optimize the operational capacity of the SEC: (1) reprioritize regulatory activities; (2) reshape the organization; (3) invest in enabling infrastructure; and (4) enhance the self-regulatory organization (SRO) engagement model.[416] To advance these priorities, the BCG recommended numerous changes, including that the SEC evaluate the importance of its activities across the agency, rank the importance of those activities, and allocate its resources accordingly.[417] BCG also recommended that the SEC seek flexibility from Congress regarding certain mandated Dodd-Frank offices so as to avoid unnecessary duplication.[418] Overall, the BCG report found that the recommended initiatives and organizational redesign would yield efficiencies and enhance the SEC's capabilities, while saving the SEC approximately $50 million.[419]

While the SEC established a process for assessing and making internal recommendations based on the BCG report, the SEC ultimately did not act on many of the recommendations. The SEC stood up the three Dodd-Frank-mandated offices without seeking flexibility from Congress to eliminate duplication and avoid unnecessary strains on the Chair's resources. It failed to change the SEC's structural organization to increase efficiencies and enhance its capabilities. And it neglected to adequately reprioritize its regulatory activities through a rigorous assessment of all its divisions and offices to better focus on mission-critical activities.

The Financial CHOICE Act will address these shortcomings by requiring the SEC to implement the BCG report's recommendations and submit legislative proposals to Congress for additional authority or flexibility. It will also update the structure of several SEC divisions and offices, including the Investor Advisory Committee, the Office of Credit Ratings, the Office of Municipal Securities, and the Ombudsman, to establish a more efficient structure that eliminates unnecessary reports to the Chair and is in line with the Commission's tripartite mission.

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[414] Sarah N. Lynch, *Analysis: Critics Question Cost As Consultants Nip And Tuck SEC*, REUTERS, Feb. 29, 2012, *available at* http://www.reuters.com/article/us-sec-consultants-idUSTRE81S28Q20120229.
[415] BOSTON CONSULTING GROUP, U.S. SECURITIES AND EXCHANGE COMMISSION ORGANIZATIONAL STUDY AND REFORM (2011) *available at* https://www.sec.gov/news/studies/2011/967study.pdf.
[416] *Id.* at 5-8.
[417] *Id.* at 79
[418] *Id.* at 98.
[419] *Id.* at 8.

The Dodd-Frank Act's authorization of the SEC lapsed at the end of FY 2015. The Financial CHOICE Act reauthorizes the SEC for a period of five years, subject to appropriations. Additionally, the CHOICE Act eliminates the SEC Reserve Fund, created by Section 991 of Dodd-Frank, which provides the SEC up to $100 million annually to spend at its discretion. The Reserve Fund spending is an addition to the SEC's ability to carry over unspent appropriations from year to year. Finally, the legislation will reinstate the SEC's authority to collect registration fees, as well as transaction fees, under the federal securities laws to offset the cost of its annual appropriation.

Investor Protections

Title IX also included numerous provisions touted as enhancing investor protections. Yet if implemented in their current form, these provisions would in fact limit investor access and choice and increase investor costs. The Financial CHOICE Act will amend and eliminate provisions that restrict financial opportunity and investment options for hardworking Americans. Most notably, the legislation will amend Section 913, which authorized, but did not require, the SEC to establish a uniform standard of care for broker-dealers and investment advisers, and also required the SEC to study and issue a report on the issue.

The SEC's study, released in 2011, recommended the imposition of a uniform fiduciary standard for broker-dealers and investment advisers.[420] As then-SEC Commissioners Kathy Casey and Troy Paredes pointed out at the time, the study declined to identify whether investors were being harmed or disadvantaged under one standard of care compared to the other, and therefore lacked a basis for concluding that a uniform standard would improve investor protection. Commissioners Casey and Paredes also questioned the costs that new standards of care would impose on market participants and investors, and noted that the SEC staff study did not account for the potential overall cost of the recommended changes to broker-dealers, investment advisers, and retail investors.[421]

While the Department of Labor recently finalized its rules to amend the definition of "investment advice" to expand the class of financial professionals subject to fiduciary duties covered by the Employee Retirement Income Security Act of 1974 (ERISA),[422] the SEC is the agency that Congress designated to oversee and regulate the conduct of persons providing investment advice and effecting securities transactions in the United States. If changes are necessary to the delivery of financial advice, the capital markets regulatory authorities should undertake the action necessary to address any perceived inadequacies

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[420] SEC, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS, (2011), *available at* https://www.sec.gov/news/studies/2011/913studyfinal.pdf.

[421] Commissioners Kathleen L. Casey & Troy A. Paredes, Statement Regarding Study On Investment Advisers And Broker-Dealers (Jan. 21, 2011), *available at* https://www.sec.gov/news/speech/2011/spch012211klctap.htm.

[422] Definition of the Term "Fiduciary"; Conflict of Interest Rule-Retirement Advice; Best Interest Contract Exemption (Prohibited Transaction Exemption 2016-01); Class Exemption for Principal Transactions in Certain Assets Between Investment Advice Fiduciaries and Employee Benefit Plans and IRAs (Prohibited Transaction Exemption 2016-02); Prohibited Transaction Exemptions 75-1, 77-4, 80-83, 83-1, 84-24, and 86-128, 82 Fed. Reg. 12319 (Mar. 2, 2017), *available at* https://www.federalregister.gov/documents/2017/03/02/2017-04096/definition-of-the-term-fiduciary-conflict-of-interest-rule-retirement-investment-advice-best.

to protect investors with smaller account balances, including workers saving for retirement. But it should be done only after rigorous analysis on the need for the rule, its impact on investor access to financial advice, and the costs and benefits to investors.

The Financial CHOICE Act repeals the DOL's fiduciary rule and requires the SEC, before promulgating any such rule, to report to the House Committee on Financial Services and the Senate Committee on Banking, Housing, and Urban Affairs on whether (i) retail customers are being harmed because broker-dealers are held to a different standard of conduct from that of investment advisers; (ii) alternative remedies will reduce any confusion and harm to retail investors due to the different standard of conduct; (iii) adoption of a uniform fiduciary standard would adversely impact the commissions of broker-dealers or the availability of certain financial products and transactions; and (iv) the adoption of a uniform fiduciary standard would adversely impact retail investors' access to personalized and cost-effective investment advice or recommendations about securities. Additionally, the SEC's chief economist is required to support any conclusion in the report with economic analysis.[423] Finally, it requires the DOL, if it promulgates a fiduciary rule under ERISA, to substantially conform it to the SEC's standards.

Another Dodd-Frank Act provision that holds the potential for investor harm is Section 921, which authorized the SEC to prohibit or restrict the use of pre-dispute arbitration if it found it to be in the public interest and necessary for the protection of investors. While the SEC has not taken any action under Section 921, using this authority to eliminate arbitration would harm – rather than protect – investors. Such regulatory attempts to prohibit or restrict arbitration would likely leave investors worse off, while significantly benefitting trial lawyers who stand to gain from increased litigation and class action lawsuits. Therefore, the Financial CHOICE Act eliminates the SEC's authority to prohibit or restrict arbitration agreements.

Asset-Backed Securities

Many post mortems of the financial crisis posit that a perceived misalignment of incentives in the originate-to-distribute model led to the proliferation of poorly underwritten mortgages, which triggered the housing market collapse. But the mulita-trillion dollar asset-backed securities (ABS) market is much broader than residential mortgages, covering securities backed by everything from auto loans, business loans, credit cards, and equipment leases to commercial real estate. Many of these instruments performed well during the crisis, while others did not. Unfortunately, the Dodd-Frank Act essentially treats all of these categories of ABS as subprime residential mortgages. By failing to differentiate among types of borrowers, collateral, maturities, and investors, Dodd-Frank's "one size fits all" approach hampers market efficiency and harms those borrowers that rely on the ABS market.

[423] These provisions are drawn from legislation authored by Rep. Ann Wagner (H.R. 1090), which passed the House on October 27, 2015.

Ultimately, the Dodd-Frank Act will increase costs for the businesses and consumers that rely on the ABS market for credit. For instance, a business that takes out a loan that becomes part of a collateralized loan obligation (CLO) will find it more difficult and costly to refinance or roll over that loan if the CLO market shrinks because the Dodd-Frank Act's risk retention requirements reduces market capacity. In fact, CLO issuance declined over 20 percent once CLOs were required to comply with risk retention.[424] To avoid that result, the Financial CHOICE Act eliminates the risk retention requirements for asset-backed securities other than residential mortgages.

Credit Rating Agencies

Title IX included several reforms geared toward credit rating agencies—also known as Nationally Recognized Statistical Rating Organizations (NRSROs)—which came in for heavy criticism for the role that their failures played in precipitating and accelerating the financial crisis.[425] However, several of the Dodd-Frank Act's reforms carry unintended consequences for the capital markets and actually create new barriers to entry, thereby further entrenching a rating agency oligopoly that has not served investors or the economy well.

In the years leading up to the crisis, the government adopted a series of policies that had the effect of conferring a "Good Housekeeping" seal of approval on the rating agencies and their products, including designating certain agencies as "nationally recognized" and hard-wiring references to their ratings into numerous Federal statutes and regulations. These regulatory privileges and the perception that the government had placed its imprimatur on the rating agencies' assessments bred a sense of complacency among investors that contributed to a mispricing of risk and a collapse of market confidence when ratings of certain asset-backed securities were called into question during the subprime melt-down of 2007 and 2008.[426]

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[424] *The Impact of the Dodd-Frank Act and Basel III on the Fixed Income Market and Securitizations: Hearing Before the Subcomm. on Capital Markets and Government Sponsored Enterprises of the H. Fin. Services Committee*, 114th Cong. (2016) (Statement of Meredith Coffee, Executive Vice President of the Loan Syndications and Trading Association).

[425] In its final report, the Financial Crisis Inquiry Commission concluded that "the failures of credit rating agencies were essential cogs in the wheel of financial destruction. The three credit rating agencies were key enablers of the financial meltdown. The mortgage-related securities at the heart of the crisis could not have been marketed and sold without their seal of approval." NCCFEC, FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES (2011), *available at* http://fcic.law.stanford.edu/report.

[426] The financial crisis was not the first time that the rating agencies' flawed risk analyses figured prominently in massive losses to investors. For example, the major NRSROs produced misleadingly positive credit ratings for Mercury Financial in 1997, Enron in 2001, WorldCom in 2002, and Parmalat in 2003 in the lead-up to their respective demises – despite clear red flags – thus driving misperceptions of risk that hurt the retirement savings of millions of Americans. *See* Lawrence J. White, *Credit-Rating Agencies and the Financial Crisis: Less Regulation of CRAs is a Better Response*, 25 J. OF INT'L BANKING L. & REG. 170 (forthcoming), *available at* http://www.stern.nyu.edu/sites/default/files/assets/documents/con_039549.pdf; *Credit Rating Agencies: Three is no crowd*, THE ECONOMIST, (2005), http://www.economist.com/node/3789445; Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L. Q. 619, 666-667, 667n.221 (1999),, *available at* http://openscholarship.wustl.edu/cgi/viewcontent.cgi?article=1481&context=law_lawreview ; Claire A. Hill, *Why Did Anyone Listen to the Rating Agencies After Enron?* 4 J. OF BUS. & TECH L. 283 (2009),

As economist Lawrence J. White notes:

> There is little question that the three major credit rating agencies were central parties in the subprime mortgage lending boom. Subprime lending was fueled importantly by the ability of the mortgage originators to sell their loans to "packagers" (or securitizers), who pooled the loans into securities and sold the securities to institutional investors, or who combined the securities with other debt instruments into yet-more-complicated securities, . . . that were sold to institutional investors. And crucial to the ability of these packagers to sell the securities was the process of obtaining favorable ratings on the securities.[427]

In other words, the major NRSROs – aided by regulatory barriers to competition – actively helped create an asset bubble, thus causing financial market risk to blossom with a stamped regulatory seal of approval. Fanning these flames were statutory provisions and federal regulations that effectively relieved institutional investors of the responsibility for performing independent credit risk analysis so long as the asset in which they were investing carried the requisite rating.[428] As Mark Calabria of the Cato Institute has pointed out, this overreliance on ratings caused investors to adopt a homogenized view of risk and crowd into the same asset classes, which had disastrous consequences when markets began to seize up:

> One contributor to [asset] fire sales is that banking regulation, including an overreliance on ratings, encourages uniformity in bank balance sheets. If everyone is required to hold only AAA and searches for yield within AAA, then everyone ends up with similar balance sheets, Unfortunately, when many are forced to sell, they end up selling similar assets, resulting in fire-sale prices. When banks sold [mortgage-backed securities] to increase their capital levels, they found fewer buyers among their industry, since other banks were subjected to the same regulatory constraints.[429]

To cure this problem and encourage investors to perform their own due diligence rather than blindly relying on ratings, House Republicans introduced legislation in 2009 to remove references to credit ratings from all federal statutes and regulations.[430] This proposal was ultimately incorporated in large measure in the Dodd-Frank Act as Sections

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available at http://scholarship.law.umn.edu/cgi/viewcontent.cgi?article=1083&context=faculty_articles.

[427] Lawrence J. White, *Credit-Rating Agencies and the Financial Crisis: Less Regulation of CRAs is a Better Response*, 25 J. OF INT'L BANKING L. & REG. 170 (forthcoming), at 13.

[428] *See* Hester Peirce, *Let the Markets Fix the Ratings Agencies*, REAL CLEAR MARKETS, Sept. 10, 2014, http://www.realclearmarkets.com/articles/2014/09/10/let_the_markets_fix_the_ratings_agencies_101270.html (Institutional investors "care more about getting the desired credit rating than getting an independent third party's actual assessment of the credit risk").

[429] Mark Calabria, *Best Rx For Rating Agencies: Competition, Not Regulation*, INVESTOR'S BUSINESS DAILY, January 8, 2016.

[430] See Title VI of the Consumer Protection and Regulatory Enhancement Act, H.R. 3310, 111th Congress, (as introduced Jul. 23, 2009).

939 and 939A, which repealed statutory references to credit ratings and directed federal regulators to review their regulations to identify any such references and remove them.[431] In place of these references, each agency was instructed to establish standards of credit-worthiness that are appropriate for the purposes of the regulations.[432] According to former SEC Commissioner Daniel Gallagher, Section 939A's mandate that federal agencies remove references to credit ratings from their rulebooks "may well be the clearest, most direct mandate we at the SEC have been given [by Dodd-Frank]. It has the virtue of being responsive to one of the core problems underlying the financial crisis — over reliance on credit ratings by investors and regulators during a time when the rating agencies were falling down on the job."[433]

Unfortunately, much of the good done by Section 939A would be undone if the SEC were to move forward with implementation of Section 939F of the Dodd-Frank Act, commonly known as the "Franken Amendment." Section 939F directed the SEC to study the credit rating process for structured finance products and the conflicts associated with the "issuer-pay" and the "subscriber-pay" models, as well as the feasibility of establishing a system in which a public or private utility or a self-regulatory organization assigns NRSROs to rate structured finance products, rather than permitting issuers to choose the NRSRO that will rate their products.[434] The creation of a government-appointed board to assign ratings to NRSROs will encourage over-reliance on credit ratings by investors – who will reasonably conclude that the ratings bear a governmental imprimatur – and work at cross-purposes with Section 939A's emphasis on market discipline and investor due diligence.[435] The Financial CHOICE Act therefore repeals the Franken Amendment.

While the avowed intent of the Dodd-Frank Act's authors was to reduce the influence of the rating agencies and force fundamental changes in their business model, more than six years after the law was enacted, little has changed. The Dodd-Frank Act's vast array of new regulatory requirements, legal liability, and associated compliance costs have erected barriers to entry and made it difficult for smaller, and often more innovative, rating agencies to compete against the "big three" (Moody's, S&P, and Fitch). Indeed, in terms of total bond ratings, the "big three" now enjoy an almost 96 percent market share, suggesting that the rating agency oligopoly that the Dodd-Frank Act sought to dismantle is more entrenched than ever.[436] In addition to repealing Section 939F, the Financial CHOICE Act

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[431] Dodd-Frank Act §§ 939, 939A.

[432] *Id.* § 939A; *see*; SEC STAFF, REPORT ON REVIEW OF RELIANCE ON CREDIT RATINGS AS REQUIRED BY SECTION 939A(C) OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT (2011), *available at* http://www.sec.gov/news/studies/2011/939astudy.pdf; *see also* Alex J. Pollock, *An Easy Fix to Dodd-Frank's Credit Ratings Rule*, AMERICAN BANKER, Nov. 5, 2013, *available at* http://www.americanbanker.com/bankthink/an-easy-fix-to-dodd-franks-credit-ratings-rule-1063396-1.html.

[433] Daniel M. Gallagher, SEC Commissioner, SEC Priorities in Perspective, Address at the SIFMA Regional Conference (Sept. 24, 2012), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1365171491262 .

[434] Dodd-Frank Act § 939F.

[435] *See* HESTER PEIRCE & JAMES BROUGHEL, DODD-FRANK: WHAT IT DOES AND WHY IT'S FLAWED 103 (2012), *available at* http://mercatus.org/sites/default/files/dodd-frank-FINAL.pdf ("A system in which a governmental or quasi-governmental entity doles out work to different credit rating agencies would likely lower the quality of NRSROs and increase the public perception that the SEC approves their work.").

[436] *See* Securities and Exchange Commission Annual Report on Nationally Recognized Statistical Rating

attempts to eliminate barriers to entry and foster greater competition by making other reforms, including providing the SEC with clear exemptive authority to facilitate a more competitive and efficient marketplace for credit ratings. Additionally, it eliminates or modifies several of the more burdensome or unnecessary requirements imposed on NRSROs by the Dodd-Frank Act, such as the requirement that the board, instead of a chief credit officer, be responsible for approving ratings methodologies and limitations on communication of material information to ensure the accuracy of ratings.

Relief for Smaller Issuers

Another Republican proposal that was ultimately incorporated in the Dodd-Frank Act is Section 989G, which made permanent the exemption for non-accelerated filers to comply with an outside auditor's attestation of a company's internal financial controls mandated by Section 404(b) of the Sarbanes-Oxley Act. However, the arbitrary threshold of $75 million in market capitalization still captures thousands of small companies grappling with the burdensome costs of 404(b) compliance. A 2011 SEC study found that Section 404(b) compliance can cost over $1 million annually, a staggering sum for a start-up or other small business that has not yet begun generating meaningful revenues.[437] The Financial CHOICE Act increases the exemption to issuers with a market capitalization of up to $500 million and extends the exemption to depository institutions with less than $1 billion in assets.

Corporate Governance and Executive Compensation

Title IX of the Dodd-Frank Act represents a broad expansion of the federal government's reach into the corporate boardroom, including on corporate governance matters that have traditionally been the province of state law. Nowhere is this interventionist approach on greater display than in the area of executive compensation. Popular outrage over instances of lavish pay packages for Wall Street traders whose bad bets helped spark the financial crisis provided the impetus for broad new government mandates that may have made for good politics, but have resulted in highly questionable public policy. Two of the most misguided Dodd-Frank provisions – relating to incentive-based compensation and pay ratio disclosures – are repealed by the Financial CHOICE Act.

Dodd-Frank's Restrictions on Incentive-Based Compensation

Section 956 of the Dodd-Frank Act directs the federal banking agencies, the SEC, the FHFA, and the NCUA to write new rules to prohibit incentive-based compensation structures that encourage "inappropriate risks" at financial institutions with greater than $1 billion in assets Under Section 956, covered financial institutions include banks, broker-dealers, investment advisers, Fannie Mae and Freddie Mac, and possibly a wide array of other

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Organizations 12 (2015), *available at* https://www.sec.gov/ocr/reportspubs/annual-reports/2015-annual-report-on-nrsros.pdf.

[437] SEC STAFF, STUDY AND RECOMMENDATIONS ON SECTION 404(B) OF THE SARBANES-OXLEY ACT OF 2002 FOR ISSUERS WITH PUBLIC FLOAT BETWEEN $75 AND $250 MILLION (2011) *available at* https://www.sec.gov/news/studies/2011/404bfloat-study.pdf.

companies, such as insurance subsidiaries of a covered institution. Earlier this year, almost six years after Dodd-Frank was enacted, the regulators issued a 700-page revised proposed rule on incentive-based compensation for public comment.[438]

Only in Washington does the idea of giving government bureaucrats – some of whom have never worked in the private sector – the authority to dictate "incentive-based compensation" standards at private companies make any sense at all. Worse yet, the specific statutory directive on compensation is, like much else in the Dodd-Frank Act, riddled with vague and open-ended terms that essentially give regulators unbridled discretion to design compensation packages. The regulators are instructed "to prohibit any types of incentive-based payment arrangement, or any feature of any such arrangement, that the regulators determine encourages **inappropriate risks** by covered institutions (1) by providing an executive officer, employee, director or principal shareholder of the covered financial institution with **excessive compensation, fees, or benefits**; or (2) that could lead to **material financial loss** to the covered financial institution." What standards the regulators are to apply in defining such purely subjective terms as "inappropriate risks," "excessive compensation," and "material financial loss" is left unstated.

Government attempts to artificially lower the compensation of employees in one industry will inevitably drive talented people to seek employment in other industries where no such restrictions apply. While the Democrats who drafted Dodd-Frank undoubtedly view that as a positive result – and an appropriate use of government power – it is neither. Far from mitigating systemic risk, driving talented professionals out of the financial services sector only increases the likelihood of a future financial crisis. The Financial CHOICE Act repeals this intrusive provision.

Dodd-Frank's Pay Ratio Disclosure

Section 953(b) of the Dodd-Frank Act requires all publicly traded companies, save for Emerging Growth Companies, to calculate and disclose for certain SEC filings the median annual total compensation of all employees excluding the Chief Executive Officer (CEO), disclose the annual total compensation of the CEO, and calculate and disclose a ratio comparing those two numbers. The SEC issued final rules implementing the pay ratio disclosure in August 2015.[439] Proponents of this new requirement cite statistics suggesting that the ratio of CEO salaries to the pay of the average worker at large U.S. companies has increased exponentially over the past several decades. Critics of the provision point out that it does little, if anything, to promote the SEC's investor protection mission, and that addressing income inequality is not within the SEC's purview.

In dissenting from the SEC's initial proposal implementing Section 953(b), then-Commissioner Daniel Gallagher noted that the proposal "continues a trend of politically

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[438] *See* Press Release, *FHFA*, Agencies Invite Comment on Proposed Rule to Prohibit Incentive-Based Pay that Encourages Inappropriate Risk-Taking in Financial Institutions (May 16, 2016), *available at* http://www.fhfa.gov/Media/PublicAffairs/Pages/Agencies-Propose-Rules-to-Prohibit-Incentive-Based-Pay.aspx.
[439] *See* 17 C.F.R. § 229 (2016); 17 C.F.R. § 249 (2016).

motivated new disclosure requirements that impose unnecessary compliance costs on U.S. issuers, reducing their international competitiveness while providing no benefits to investors and political benefits to special interest groups."[440] Former Commissioner Gallagher has also described the pay ratio rule as "social policy masquerading as disclosure requirements," which has the effect of encouraging companies to remain private.[441]

Even if ameliorating income inequality *were* a legitimate purpose of the securities laws, it is far from clear that the pay ratio disclosure advances that objective. Companies seeking to avoid public opprobrium for purportedly excessive CEO pay now have an incentive to goose their pay ratio by shedding their lowest-paid employees and replacing them with contractors and temporary workers provided by staffing companies, which are explicitly not included in the required calculation. This potential harm to rank-and-file employees prompted the *Wall Street Journal* editorial board to describe the pay-ratio rule as "the perfect progressive policy. Possibly wasteful and irrelevant, but to the extent it affects the behavior of corporate executives, it provides an incentive not to hire the people its sponsors claim to be helping."[442]

The drafters of the Dodd-Frank Act also believed that disclosing the ratio of CEO pay to the median pay of other corporate employees would allow investors and other stakeholders to draw meaningful comparisons among corporate compensation policies. But this, too, appears to be misguided, as Thaya Knight of the Cato Institute pointed out in a *Wall Street Journal* op-ed critical of the pay-ratio rule:

> It will be difficult to compare two companies' ratios, because the calculations will vary widely by industry and business model. A technology company that employs many highly educated, and therefore highly compensated, engineers will tend to have a low number. A retail giant, which employs thousands of part-time cashiers, will tend to have a high number. The difference between the two simply reflects the difference in market wages between a software engineer and a cashier.[443]

Or, to take another example, a Wall Street investment bank, where pay is generally high, will compare favorably to a retailer with predominantly low-paid staff and a modestly compensated CEO.

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[440] SEC, COMMISSIONER DANIEL M. GALLAGHER, DISSENTING STATEMENT CONCERNING THE PROPOSAL OF RULES TO IMPLEMENT THE SECTION 953(B) PAY RATIO DISCLOSURE PROVISION OF THE DODD-FRANK ACT, (2013), *available at* https://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370542558873.

[441] Daniel M. Gallagher, SEC, Commissioner, Dodd-Frank at Five: A Capital Markets Swan Song, Speech before the U.S. Chamber of Commerce (Aug. 4, 2015), *available at* http://www.sec.gov/news/speech/dodd-frank-at-five.html

[442] *The Warren Commission*, WALL STREET JOURNAL: REVIEW AND OUTLOOK, Aug. 5, 2015, *available* at http://www.wsj.com/articles/the-warren-commission-1438814488.

[443] Thaya Knight, Opinion, *A Misbegotten Political Jab at CEO Pay*, WALL STREET JOURNAL, Aug. 10, 2015, *available at* http://www.wsj.com/articles/a-misbegotten-political-jab-at-ceo-pay-1439249624.

The Center on Executive Compensation has conducted research suggesting that shareholders do not need, nor want, the data required to be compiled under the SEC's pay-ratio rule:

> [O]nly a small segment of shareholders, primarily unions and social activists, are likely to use the pay ratio to drive their own political agendas Shareholders generally have decisively rejected all efforts to require various companies to disclose a pay ratio through the shareholder proposal process. According to Center data, since 2010 there have been only 15 separate shareholder proposals – out of thousands of proposals submitted – requesting that companies voluntarily adopt a pay ratio or similar disclosure. These proposals averaged 93% shareholder *opposition* with no single proposal receiving over 10% support.[444]

Because Section 953(b)'s pay ratio disclosures do not provide useful information about a company's operations, performance, or pay practices, such disclosures will be immaterial and, at worst, confusing to investors seeking to make informed investment decisions. Complying with the pay ratio rule will also impose significant costs and burdens on U.S. companies already laboring under a record-breaking amount of government red tape. For example, total costs for the private sector to comply with the pay ratio rule are estimated to be as high as $710 million every year.[445] According to the National Association of Manufacturers, to comply with the pay ratio rule it will "require a substantial diversion of company resources from productive investment to compliance activities. Manufacturers also have significant concerns about the impact of the cost burden of this requirement on competitiveness."[446] By hindering the ability of U.S. businesses to grow, compete, and create jobs, the pay ratio rule will directly undermine the SEC's mandate to ensure efficient capital markets and facilitate capital formation.[447]

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[444] *See* Press Release, Center on Executive Compensation, "Center on Executive Compensation Strongly Opposes Final Pay Ratio Rule: Overly Burdensome and Politically-Motivated Requirement will Provide No Meaningful Data to Investors," (Aug. 5, 2015), *available at* http://www.execcomp.org/Docs/c15-37_Center%20PR-Pay%20Ratio%20Final%20Rule%20August%202015.pdf.

[445] *See* IKE BRANNON, U.S. CHAMBER OF COMMERCE, CENTER FOR CAPITAL MARKETS COMPETITIVENESS, THE EGREGIOUS COSTS OF THE SEC'S PAY-RATIO DISCLOSURE REGULATION (May 2014), *available at* https://www.uschamber.com/sites/default/files/documents/files/Egregious-Cost-of-Pay-Ratio-5.14.pdf.

[446] Letter from National Association of Manufacturers to SEC (Dec. 2, 2013), *available at* https://www.sec.gov/comments/s7-07-13/s70713-509.pdf. *See also* Letter from Dover Corp. to SEC (Nov. 26, 2013), available at https://www.sec.gov/comments/s7-07-13/s70713-440.pdf, ("[A]ny amount spent on collecting data, calculating the ratio and preparing the necessary disclosures would be better spent on investments in new markets, products and equipment for the benefit of ... shareholders.").

[447] *See* Michael S. Piwowar, SEC Commissioner, Statement at Open Meeting Regarding Municipal Advisors and Pay Ratio Disclosure (Sep. 18, 2013), *available at* https://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370542565153, ("I am not only unable to support the pay ratio disclosure proposal, I object to the Commission even considering it. The Commission should not be spending any of its limited resources on any rulemaking that unambiguously harms investors, negatively affects competition, promotes inefficiencies, and restricts capital formation.").

On February 6, 2017, Acting SEC Chairman Michael Piwowar announced that he was seeking 45-days of public input on any "unexpected challenges that issuers have experienced as they prepare for compliance" with the SEC's final rule to implement Section 953(b) and whether the SEC need to grant additional guidance or relief from the compliance date. He also noted that, "some issuers have begun to encounter unanticipated compliance difficulties that may hinder them in meeting the reporting deadline," and that he directed SEC Staff the "to reconsider the implementation of the rule based on the submission of public comments.[448]

The Piwowar "call for evidence" did provide the SEC with helpful evidence about the pay ratio rule's consequences and costs. For example, Quest Diagnostics noted in its letter to the SEC "we have found that the costs associated with compliance are potentially significant, uncertain and difficult to quantify," and "are likely to need to add staff as a result of the Rule."[449] Another public company, SteinMart, estimated in its February 21, 2017, letter to the SEC that it was considering the use of an "outside specialist" to perform the work because of the complexity of the undertaking tom comply with the rule at a cost of $25,000 annually. The company also estimated that "over 200 hours of management time will be spent to obtain data, analyze information, and review disclosures in order to comply with the pay ratio rule."[450] Finally, the Society for Corporate Governance informed the SEC on March 24, 2017, that cumulative costs to comply with Section 953(b) "across the Society's 998 public members would range between $99 million to $548 million per year on an ongoing basis."[451] The Financial CHOICE Act repeals this costly, burdensome, special interest, name-and-shame provision.

Corporate Governance

While corporate governance has traditionally been regulated at the state level under state corporation laws, the Dodd-Frank Act and prior federal statutes have imposed significant changes at the federal level on how corporations govern themselves. In the U.S. system of corporate governance, oversight of and responsibility for the corporation are primarily the responsibility of the corporation's board of directors, who are elected by the corporation's shareholders. The board of directors has fiduciary duties to the company and its shareholders, including the obligation to increase the value of the corporation over the long-term.

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[448] *See* SEC Release, "Reconsideration of Pay Ratio Rule Implementation," Acting Chairman Michael S. Piwowar, (Feb. 6, 2017), *available at*: https://www.sec.gov/news/statement/reconsideration-of-pay-ratio-rule-implementation.html

[449] *See* letter from Jeffrey S. Shuman, Senior Vice President, Chief Human Resources Officer, Quest Diagnostics, to the SEC (March 24, 2017), *available at*: https://www.sec.gov/comments/pay-ratio-statement/cll3-1666293-148965.pdf

[450] *See* letter from Gregory Kleffner, Executive Vice President & Chief Financial Officer, SteinMart, to the SEC (February 21, 2017), *available at*: https://www.sec.gov/comments/pay-ratio-statement/cll3-1591357-132280.pdf

[451] *See* Letter from Society of Corporate Secretaries & Government Professionals to the SEC, (March 24, 2017); *available at* https://www.sec.gov/comments/pay-ratio-statement/cll3-1664965-148929.pdf

Modern corporations are subject to numerous pressures and continuous scrutiny from the corporation's many stakeholders, which include its shareholders, management, employees, customers, suppliers, special interest groups, communities, politicians, and regulators. These stakeholders have a broad array of interests in the corporation's operation and success. Although boards are expected to consider these diverse and sometimes conflicting interests of the corporation's stakeholders, the board's primary obligation is to ensure that the corporation creates long-term value for the corporation's shareholders.

Over time, the board's ability to focus on shareholder value has been inhibited by the proliferation of shareholder proposals for public companies annual meetings. Section 14 and Rule 14a-8 under the Securities Exchange Act of 1934 govern the submission of shareholder proposals. The Rule allows any shareholder who holds $2,000 or 1 percent worth of a company's stock – for a period of one year – to submit a non-binding shareholder proposal on any subject matter that they please. To put this into perspective, the largest publicly traded company in the United States by market capitalization is Apple, with a current market cap of roughly $750 billion. Rule 14a-8 currently would allow a shareholder who owns .000000003 worth of the stock (or roughly 14 shares of Apple) to offer a proposal, and force Apple (and all other shareholders) to pay for the dissemination of that proposal.

Due in part to the extremely low bar for qualification to submit a proposal, as well as the SEC's increasing tendency to err on the side of proponents in allowing these proposals access to the corporate proxy, the shareholder proposal process has become one of the favorite vehicles for special interest activists to advance their social, environmental, or political agendas. Proponents largely include activist public pension funds, social, or environmentally-focused funds, as well as so-called "gadfly" investors who own miniscule amounts of a company's stock, often times just so they are able to submit proposals year after year. A few examples of some of the proposals that proponents have put forward in recent years for consideration by their fellow shareholders:

- 2007 proposal that the Board of Directors of YUM! Brands provide additional information to shareholders regarding fish sustainability practices at their Long John Silver's franchise. (received 6.25% shareholder support)
- 2013 proposal from shareholder of Choice Hotels asking company to determine how much water flows through every shower head in every hotel that Choice owns.[452]
- 2013 proposal from shareholder of Goldman Sachs recommending that Goldman Sachs – the company itself – should run for political office.[453]

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[452] *See e.g.* John Engler, *How Gadflys Shareholders Keep CEOs Distracted*, WALL STREET JOURNAL: COMMENTARY, May 26, 2016, *available at*: http://www.wsj.com/articles/how-gadfly-shareholders-keep-ceos-distracted-1464300425)

[453] *See* Letter from SEC to Goldman Sachs (Feb. 19, 2013), *available at* https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2013/johnharrington021913-14a8.pdf.

Despite the increasing number of proposals at public companies, shareholder support for environmental, social, or political issues remains stubbornly low. According to Proxy Monitor, in the decade they have been tracking proposals at Fortune 250 companies, *not a single environmental-related shareholder proposal has received the majority support of shareholders over board opposition*.[454] Proposals related to political spending disclosure have not fared much better - only *one* proposal in that timeframe has received majority support, and in 2016 such proposals averaged only 23% support from shareholders.[455]

As explained by former Commissioner Gallagher:

> the SEC's shareholder proposal rule, Rule 14a-8, is being abused by special interest groups to advance idiosyncratic goals that may directly conflict with the interests of most shareholders. A proponent, often with little to no skin in the game, can force a company to include in its proxy a proposal, which can touch on any of a wide range of issues, including immaterial social and political matters. Or, the company can expend substantial corporate resources seeking exclusion of the proposal.[456]

In addition to low thresholds for the initial submission of a proposal, shareholders are allowed to *resubmit* their proposal in subsequent years, even if they receive extremely low levels of support. Current regulations allow a company to exclude a resubmitted proposal from its proxy only if it failed to receive the support of 3% of shareholders the last time it was voted on; 6% if it has been voted on twice in the last five years; and 10% if it was voted on three or more times in the last five years. Thus, in many cases shareholder proposals that have been opposed by over 90% of shareholders on multiple occasions are allowed to be resubmitted, forcing companies to spend time and money in deciding how to deal with them.

The increasing use of the shareholder proposal system to embarrass companies or to advance idiosyncratic agendas – while the vast majority of shareholders vote in opposition to them – shows that this system is broken and in need of reform. The resounding message from a majority of shareholders is that they care about the companies they invest in generating a decent return, and have no interest in becoming involved in the pet issues of others. Despite the fact that the majority of shareholders oppose the activist shareholder proposals, because of the current regulatory regime, public companies must dedicate time, and money to defend against them. We want our companies to better use their resources to grow, and create more jobs – not fight politically motivated activist shareholders.

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[454] James R. Copland and Margaret M. O'Keefe, "An Annual Report on Corporate Governance and Shareholder Activism," Manhattan Institute Proxy Monitor; at page 16, *available at* http://www.proxymonitor.org/pdf/pmr_13.pdfhttp://www.proxymonitor.org/pdf/pmr_13.pdf .

[455] Id.

[456] Daniel M. Gallagher, SEC, Commissioner, Activism, Short-Termism, and the SEC: Remarks at the 21st Annual Stanford Directors' College (Jun. 23, 2015), *available at* https://www.sec.gov/news/speech/activism-short-termism-and-the-sec.html#_edn12.

The Financial CHOICE Act will modernize, and right size, the federal government's role in shareholder proposals with an emphasis on allowing corporate boards to responsibly guide the companies focused on maximizing shareholder value. Specifically, it will remove the dollar threshold, leaving in place a percentage of ownership threshold and extending the holding period to three years. This critical modernization of the SEC rule will ensure that shareholders with sufficient skin in the game, and interest in the long-term value of the company have access to the corporate proxy, and eliminate the ability for gadflies to abuse the system. Additionally, it will update the resubmission thresholds consistent with the SEC's 1997 proposal.

Capital Formation

<u>Executive Summary:</u>

- **Small companies that are at the forefront of technological innovation and job creation face significant obstacles in obtaining funding in the capital markets. These obstacles are often attributable to the proportionately larger burden that securities regulations—written for large public companies—place on small companies when they seek to go public.**

- **Over the last 35 years, the SEC has established several offices and committees to promote small business capital formation, but it has largely failed to adopt any of the recommendations made by these panels. At a time when the American people continue to struggle with the slowest, weakest recovery of the post-war era, the SEC's inattention to these issues is unacceptable. If the SEC will not make capital formation a priority, it is incumbent upon Congress to do it for them.**

- **The best way to protect investors is to foster competitive markets that encourage innovation, expand the investment opportunities available to all investors, and promote a regulatory regime that acknowledges the differences between small, private and start-up companies and well-established public companies. The Financial CHOICE Act contains a host of provisions designed to advance these objectives.**

Congress entrusted the SEC with a three-part statutory mission in overseeing the U.S. capital markets: to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. Unfortunately, the Dodd-Frank Act's answer to the financial crisis was to burden the SEC with myriad responsibilities, many of which were unrelated to its statutory mission. Former SEC Commissioner Daniel Gallagher has pointed out that these additional Dodd-Frank-imposed mandates prevent the SEC from engaging in "basic 'blocking and tackling,' the fundamentals of our regulatory mission stemming from our threefold statutory mission."[457] Because these extraneous responsibilities make it harder for the SEC to meet its statutory responsibilities, Congress has the responsibility to either amend or repeal the provisions in the Dodd-Frank Act that not only divert the SEC from its statutory mission but also force the SEC to expend valuable resources on activities that do not benefit capital markets or investors.

[457] Daniel M. Gallagher, SEC Commissioner, "A Renewed Focus on SEC Priorities", Remarks at the AICPA/SIFMA Financial Management Society Conference on the Securities Industry (Oct. 25, 2013), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370540102737.

Since 2010, the SEC has devoted thousands of man-hours and millions of dollars to finish rules mandated by the Dodd-Frank Act that neither address the causes of the financial crises nor advance the SEC's statutory mission.[458] For example, rather than devote time and resources to rules that would protect investors or facilitate capital formation, the SEC has instead focused its efforts on rules to require public companies to make confusing and immaterial disclosures relating to, for example, conflict minerals, resource extraction, and CEO pay ratios. The Dodd-Frank Act has accelerated a troubling trend in which the securities laws have been hijacked by those more interested in scoring political points than enhancing capital markets or investor protection.

Although small companies are at the forefront of technological innovation and job creation, they frequently face obstacles in obtaining funding in the capital markets. These obstacles are often attributable to the proportionately larger burden that securities regulations—written for large public companies—place on small companies when they seek to go public. The Jumpstart Our Business Startups Act—popularly known as the JOBS Act—makes it easier for smaller companies to access capital markets. Signed into law on April 5, 2012, the bipartisan JOBS Act consists of six bills that originated in the Financial Services Committee that help small companies obtain access to capital markets by lifting the burden of certain securities regulations.[459]

By helping small companies obtain funding, the JOBS Act facilitates economic growth and job creation. It does this by encouraging the SEC to expand its mission beyond its traditional approach to securities regulation. Acting SEC Chairman Michael Piwowar described the changes the JOBS Act makes to the SEC's mission this way: "The JOBS Act requires the Commission to think of capital formation and investor protection in fundamentally different ways than we have in the past. The crowdfunding provision of the JOBS Act forces us to think outside of our historical securities regulation box and to create a different paradigm than the one we have used for the past eight decades."[460]

Even President Obama called the law a "game changer" for entrepreneurs and capital formation. Yet since the enactment of the JOBS Act, the SEC has continued to give short shrift to that part of its statutory mission that relates to capital formation. For example, the JOBS Act mandated that the SEC complete the rules to implement the law's crowdfunding title within nine months from the date of enactment (January 2013). Regrettably, the SEC took an additional 34 months to propose and ultimately approve the crowdfunding rules to allow small businesses and startups to raise capital over the Internet from individual investors. [461]

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[458] *See e.g.* Andrew Ackerman, *CEO-Pay Rule Is 7,196 Hours in the Making*, WALL STREET JOURNAL: MONEYBEAT, Dec. 17, 2014, *available at* http://blogs.wsj.com/moneybeat/2014/12/17/ceo-pay-rule-is-7196-hours-in-the-making/.
[459] Jumpstart Our Business Startups Act, Pub. L. 112-106, 126 Stat 306 (2012).
[460] SEC Commissioner Michael S. Piwowar, "Statement at Open Meeting Regarding Crowdfunding" (Oct. 23, 2013), *available at* https://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370542558708.
[461] 17 CFR § 200, 227, 232, 239, 240, 249, 269, 274 (2016).

The SEC also has failed to follow up the JOBS Act with a post-JOBS Act agenda to expand access to capital for entrepreneurs and start-up ventures. This is not surprising considering the SEC's historical failures to prioritize this aspect of its mission in the absence of specific congressional directives. In 1980, Congress, as part of the Small Business Investment Incentive Act, instructed the SEC to conduct an annual government-business forum to review the current status of problems and programs relating to small business capital formation.[462] In accordance with this requirement, since 1982, the SEC has annually convened its "Government-Business Forum on Small Business Capital Formation," and solicited recommendations for promoting small-business capital formation.

A major purpose of the Forum is to provide a platform to identify unnecessary impediments to small business capital formation and find ways to eliminate or reduce them. Each Forum seeks to develop recommendations for government and private action to improve the environment for small business capital formation. But the SEC rarely, if ever, acts on any of the recommendations made by the Forum's participants, which include small business executives, venture capitalists, government officials, trade association representatives, lawyers, accountants, academics and small business advocates. For example, the crowdfunding and Regulation A+ provisions of the JOBS Act mirrored the Forum's recommendations to the SEC, which the SEC had previously ignored.

Despite the SEC's failure to implement most of the JOBS Act in a timely manner, the parts of the Act that were self-effectuating have helped small businesses and emerging growth companies (EGCs) gain access to the capital markets at a lower cost. The data show:

- EGCs accounted for over 90 percent of the initial public offerings (IPOs) in 2016 and 2015.[463]

- Approximately 83 percent of all publicly filed IPO registration statements and approximately 87 percent of the IPOs that have gone effective since April 2012 were filed by EGCs.[464]

- The IPO "on-ramp" provisions of the JOBS Act have been particularly helpful to small companies. Confidential submissions of IPO registration statements for JOBS Act companies have quickly become standard practice, with 88 percent of EGCs confidentially submitting at least one draft registration statement before public filing. EGCs have also taken advantage of reduced disclosure requirements for

[462] *See* Government-Business Forum on Small Business Capital Formation, *available at* https://www.sec.gov/info/smallbus/sbforum.shtml
[463] *See* ERNST & YOUNG, UPDATE ON EMERGING GROWTH COMPANIES AND THE JOBS ACT (2016), *available at* http://www.ey.com/Publication/vwLUAssets/ey-update-on-emerging-growth-companies-and-the-jobs-act-november-2016/$FILE/ey-update-on-emerging-growth-companies-and-the-jobs-act-november-2016.pdf.
[464] *See id.*

executive compensation under the JOBS Act and many EGCs have elected to provide audited financials for two years rather than three years.[465]

With the recent slowdown in IPOs in 2016, more companies have been raising capital through the JOBS Act's updates in private securities offerings. For example, since the SEC adopted Regulation A+ in 2015, there have been 147 Regulation A+ offerings filed with the SEC by companies seeking to raise over $2.6 billion in capital.[466] Additionally, since the crowdfunding rule went into effect in May 2016, there have been 163 crowdfunding offerings raising a total of $18 million.[467]

Even with these important advances, many small companies still cannot access the capital they need to grow their businesses and create jobs. According to one survey, 57 percent of respondents believe the current business financing environment is restricting growth opportunities while 49 percent of respondents believe it is restricting their ability to hire.[468] While the JOBS Act has made it easier for these companies to go public, the JOBS Act alone was not enough to entirely overcome the capital formation obstacles these companies face in trying to go public.

The drafters of the Dodd-Frank Act failed to understand that the best way to protect investors is to foster competitive markets that reward productive innovation, expand the opportunities available to all investors, and develop a regulatory regime that acknowledges the differences between small, private and start-up companies and well-established public companies. Real investor protection puts power where it belongs: in the hands of investors, not Washington bureaucrats. Investors are not protected when regulators churn out volumes of complex and burdensome regulations that:

- eliminate sources of capital and increase compliance costs for small and emerging companies seeking to grow and create jobs;

- increase the cost and reduce the availability of investment products and investment advice for low-balance customers who need these products and services to save for retirement, buy a home, or pay for a child's education;

- prevent investors from taking informed risks in the securities markets to generate returns; and

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[465] *See id.*

[466] ANZELA KNYAZEVA, REGULATION A+: WHAT DO WE KNOW SO FAR? (2016), *available at* https://www.sec.gov/files/Knyazeva_RegulationA%20.pdf.

[467] VLADIMIR IVANOV AND ANZELA KNYAZEVA, U.S. SECURITIES-BASED CROWDFUNDING UNDER TITLE III OF THE JOBS ACT (2016), *available at* https://www.sec.gov/dera/staff-papers/white-papers/RegCF_WhitePaper.pdf.

[468] CRAIG R. EVERETT, PEPPERDINE UNIVERSITY PRIVATE CAPITAL ACCESS INDEX SURVEY RESPONSES FOURTH QUARTER 2016 (2016), *available at* https://bschool.pepperdine.edu/about/people/faculty/appliedresearch/research/pcmsurvey/content/q4-2016-pca-trends.pdf.

- reduce liquidity—the ability easily to buy and sell securities without impacting price—in U.S. capital markets.

The Financial CHOICE Act includes numerous provisions – many of them strongly bipartisan – to further capital formation. Specifically, the legislation will modernize the regulatory regime for business development companies (BDCs) to allow them to amplify financing for small and medium-size businesses at a time when these companies are struggling to access capital to support growth and job creation.[469] It will facilitate the creation of venture exchanges to encourage smaller companies to access capital in the public markets, with the potential to create millions of jobs.[470] It will expand provisions of the JOBS Act helping companies offer securities in a public offering. It will eliminate onerous and unnecessary regulatory burdens on smaller public and private companies that are restricting their ability to access capital to grow and create jobs. And it will require the SEC to consider the recommendations of its Forum on Small Business Capital Formation, and outline what, if any, action the SEC intends to take to implement those recommendations, thereby ensuring the SEC no longer neglects its statutory mission.[471]

[469] This language is based on legislation authored by former Rep. Mick Mulvaney (H.R. 3868), which was approved by the Financial Services Committee in the 114th Congress.
[470] This language is based on legislation authored by former Rep. Scott Garrett (H.R. 4638), which was approved by the Financial Services Committee in the 114th Congress.
[471] This language is based on legislation authored by Rep. Bruce Poliquin (H.R. 1312), which passed the House on March 9, 2017.

Repeal Specialized Public Company Disclosures for Conflict Minerals, Extractive Industries, and Mine Safety

Executive Summary:

- **Title XV of the Dodd-Frank Act imposes a number of overly burdensome disclosure requirements related to conflict minerals, extractive industries, and mine safety that bear no rational relationship to the SEC's statutory mission to protect investors, maintain fair, orderly, and efficient markets, and promote capital formation. The Financial CHOICE Act repeals those requirements.**

- **There is overwhelming evidence that Dodd-Frank's conflict minerals disclosure requirement has done far more harm than good to its intended beneficiaries – the citizens of the Democratic Republic of Congo and neighboring Central African countries.**

- **Former SEC Chair Mary Jo White, an Obama appointee, has conceded the Commission is not the appropriate agency to carry out humanitarian policy. The provisions of Title XV of the Dodd-Frank Act are a prime example of the increasing use of the federal securities laws as a cudgel to force public companies to disclose extraneous political, social, and environmental matters in their periodic filings.**

Former SEC Commissioner Daniel Gallagher noted that because of Dodd-Frank, "…the SEC became the implementing tool for the long pent-up dreams of liberal policymakers and special interest groups. Indeed, Dodd-Frank stands as the only piece of major securities legislation in U.S. history that was rammed through Congress without bipartisan support." [472] As a result, the Dodd-Frank Act was able to include a "Miscellaneous" Title, or basically a title that allowed partisan provisions to be included without any legislative record, or proof that the requirements addressed any issues related to the financial crisis.

Sections 1502, 1503, and 1504 of the Dodd-Frank Act present new challenges to the SEC, which is ill-equipped to handle rulemaking requirements that fall outside of its statutory mission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. In the words of former SEC Chair Mary Jo White: "Seeking to improve safety in mines for workers or to end horrible human rights atrocities in the Democratic Republic of the Congo are compelling objectives, which, as a citizen, I wholeheartedly share. But, as the Chair of the SEC, I must question, as a policy matter, using the federal securities laws and the SEC's powers of mandatory disclosure to accomplish these goals."[473]

[472] Daniel M. Gallagher, "Dodd-Frank at Five: A Capital markets Swan Song" (Aug. 4, 2015), U.S. Chamber of Commerce, *available at* https://www.sec.gov/news/speech/dodd-frank-at-five.html.
[473] Mary Jo White, The Importance of Independence, 14th Annual A.A. Sommer, Jr. Corporate Securities and Financial Law Lecture, Fordham Law School (Oct. 13, 2013), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370539864016.

Chair White's words are echoed in the revised rule the SEC issued to implement Section 1504, following the judicial rejection of its first attempt: "The use of securities law disclosure requirements to advance foreign policy objectives is uncommon, and therefore foreign policy is not a topic we routinely address in our rulemaking."[474] Writing in the *Fordham Law Review*, Karen Woody, Assistant Professor of Law at Indiana University, argues that the mission creep imposed by foreign policy-related disclosure requirements threatens the SEC's effectiveness. Section 1502, she writes, "flies in the face of the SEC's mandate. . . Furthermore, requiring the SEC to enforce these disclosure requirements stretches thin an already overburdened agency and demands that it oversee diplomatic and humanitarian regulations for which it lacks the institutional competence."[475]

Section 1502 of the Dodd-Frank Act requires public companies to disclose whether they source "conflict minerals" – tin, tungsten, tantalum, and gold – from the Democratic Republic of Congo (DRC) and its nine neighboring countries. These minerals are used in countless products, from cell phones to apparel, and mining proceeds have been blamed for financing rebels in eastern Congo.

As an initial matter, Dodd-Frank's conflict minerals provisions are explicitly designed to achieve foreign policy objectives, and bear no relation to the underlying purpose of the securities laws, which is to protect investors by providing them with information that is material to their investment decisions, and promote the formation of capital. Indeed, by imposing enormous compliance costs on public companies, Section 1502 impedes the ability of those firms to innovate, grow, and create jobs, while at the same time lowering the returns they can offer their investors. In its economic analysis of the final rule implementing Section 1502, the SEC estimated the initial cost of compliance as "between approximately $3 billion to $4 billion, while the annual cost of ongoing compliance will be between $207 million and $609 million."[476]

Since the SEC issued its disclosure rule in August 2012, the courts have highlighted the unconstitutionality of certain requirements. In April 2014, a panel of the U.S. Court of Appeals for the D.C. Circuit ruled that forcing companies to describe the conflict-free status of their products violated their First Amendment rights. This decision was upheld by the same three-judge panel in August 2015, with the court also noting that the SEC had failed to demonstrate that its rulemaking would alleviate the humanitarian crisis in the DRC.[477] The SEC and Amnesty International requested an *en banc* rehearing before the full D.C. Circuit, but this petition was denied. The Justice Department later declined to seek Supreme Court review of the decision.[478]

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[474] Disclosure of Payments by Resource Extraction Issuers, 80 Fed. Reg. 80,057, 80,063 (proposed Dec. 23, 2015).

[475] Karen E. Woody, *Conflict Minerals Legislation: The SEC's New Role as Diplomatic and Humanitarian Watchdog*, 81 FORDHAM L. REV.1315 (2013), *available at* http://ir.lawnet.fordham.edu/cgi/viewcontent.cgi?article=4849&context=flr.

[476] Conflict Minerals, 77 F.R. 56274, 56334 (Sept. 12, 2012) (amending 170 C.F.R. §§ 240, 249b).

[477] *National Association of Manufacturers v. SEC*, 800 F.3d 518, 526 (D.C. Cir. 2015).

[478] *See* Letter from Attorney General Loretta Lynch to Speaker Paul Ryan (Mar. 4, 2016) (headed "re: *National Association of Manufacturers v. Securities and Exchange Commission*, 800 F.3d 518 (D.C. Cir. 2015)"), *available at* https://www.justice.gov/oip/foia-library/osg-530d-letters/3-4-2016.pdf/download.

Section 1502's constitutional and procedural deficiencies have been compounded by the damage it has done to the citizens of Central Africa, the very region it purports to help. Critics, many from the region itself, argue that Section 1502 has led to a *de facto* embargo on the region's minerals, further impoverishing Africans while leaving local militias unaffected. In one letter to the SEC, leaders from three Congolese mining cooperatives wrote, "We the local population in the areas that will be the most effected [sic] by your proposed legislation Dodd-Frank Bill, have not been consulted. . . ." Noting that the SEC's rule would lead to a boycott of their minerals, the Congolese went on to plead, "we cannot continue to suffer any longer. Do we now have to choose between dying by a bullet or starving to death?"[479]

A *New York Times* investigation in 2011 painted an even bleaker picture of what locals refer to as the "Loi Obama" (the Obama Law – Dodd-Frank), noting that "the Dodd-Frank law has had unintended and devastating consequences," and "has brought about a de facto embargo on the minerals mined in the region." The author explains that

> Villagers who relied on their mining income to buy food when harvests failed are beginning to go hungry. . . . Meanwhile, [Dodd-Frank] is benefiting some of the very people it was meant to single out. The chief beneficiary is Gen. Bosco Ntaganda, who is nicknamed The Terminator and is sought by the International Criminal Court. Ostensibly a member of the Congolese Army, he is in fact a freelance killer with his own ethnic Tutsi militia, which provides "security" to traders smuggling minerals across the border to neighboring Rwanda.[480]

Another letter signed by more than 70 researchers and Africa observers, many from Congo itself, echoed the charge that the Congolese had been excluded from policymaking that profoundly affected their livelihoods. "As a result," the signatories concluded, "the conflict minerals movement has yet to lead to meaningful improvement on the ground, and has had a number of unintended and damaging consequences."[481] Indeed, a recent study found that "instead of reducing violence, the evidence indicates the [Dodd-Frank conflict minerals regime] increased the incidents in which armed groups looted civilians and committed violence against them."[482]

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[479] Letter from Axel Mutia et al. to the SEC (Mar. 1, 2011) (headed "Submission to the United States Securities and Exchange Commission on the Regulatory Initiatives Under the Dodd-Frank Act"), *available at* https://www.sec.gov/comments/s7-40-10/s74010-179.pdf.

[480] David Aronson, "How Congress Devastated Congo" *The New York Times* (Aug. 7, 2011), http://www.nytimes.com/2011/08/08/opinion/how-congress-devastated-congo.html?_r=1.

[481] Open Letter from Aloys Tegera et al. to Conflict Minerals Stakeholders, *available at* https://ethuin.files.wordpress.com/2014/10/09092014-open-letter-final-and-list-doc.pdf.

[482] Dominic Parker and Bryan Vadheim, *Resource Cursed or Policy Cursed? U.S. Regulation of Conflict Minerals and the Rise of Violence in the Congo*, J. OF THE ASS'N. OF ENVIRONMENTAL & RESOURCE ECONOMISTS (Jun. 3, 2016) (forthcoming article), *available at* http://aae.wisc.edu/dparker5/papers/ParkerVadheimJAERE.pdf.

In addition to the harm inflicted on Africans, research has shown that the SEC's rule has not illuminated companies' sourcing of conflict minerals to any meaningful degree. According to the GAO, initial company disclosures revealed little: 67 percent of companies reported not being able to determine their minerals' country of origin, and another 3 percent did not provide a clear determination. No company in GAO's sample could determine whether its minerals financed armed groups.[483] GAO confirmed these findings the following year, with 67 percent of companies still unable to confirm the source of their conflict minerals, and 97 percent reporting that they could not determine whether those minerals benefitted armed groups in the DRC.[484]

Professor Jeff Schwartz of the University of Utah Law School has come to similar conclusions, having reviewed 1,300 inaugural filings under Section 1502. He writes, "The overall picture is not pretty. I argue that the filings do not contain sufficient information about conflict-mineral supply chains for the legislation to work as intended, and that this is the result of shortcomings in the original law, in the SEC rules that followed, and in the corporate compliance effort."[485]

Even the U.S. government has found tracing minerals to armed groups to be an impossible task: in a 2014 analysis mandated by Dodd-Frank, the Commerce Department reported it was unable to determine whether smelters drew on minerals that benefited armed groups. "We do not have the ability to distinguish such facilities," Commerce stated.[486]

Another politically motivated disclosure requirement that is inconsistent with the SEC's core mission can be found at Section 1504 of Dodd-Frank, which requires public companies to disclose their payments to governments, including companies owned by a foreign government, made for the purpose of the commercial development of oil, natural gas, or minerals. As SEC Acting-Chairman Michael Piwowar stated during the re-proposal of the SEC's resource extraction rule in 2015, "Disclosure of resource extraction payments neither reforms Wall Street nor provides consumer protection and it is wholly unrelated, and largely contrary, to the Commission's core mission."[487] The SEC's initial rule was vacated

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[483] GAO, GAO-15-561, SEC CONFLICT MINERALS RULE: INITIAL DISCLOSURES INDICATE MOST COMPANIES WERE UNABLE TO DETERMINE THE SOURCE OF THEIR CONFLICT MINERALS (2015), *available at* http://www.gao.gov/products/GAO-15-561.

[484] GAO, GAO-16-805, SEC CONFLICT MINERALS RULE: COMPANIES FACE CONTINUING CHALLENGES IN DETERMINING WHETHER THEIR CONFLICT MINERALS BENEFIT ARMED GROUPS (2016), *available at* http://www.gao.gov/products/GAO-16-805.

[485] Jeff Schwartz, *The Conflict Minerals Experiment*, HARVARD BUSINESS LAW REVIEW (forthcoming 2015) (included as testimony to House Committee on Financial Services Hearing titled "Dodd-Frank Five Years Later: What Have We Learned from Conflict Minerals Reporting"), *available at* http://financialservices.house.gov/uploadedfiles/hhrg-114-ba19-wstate-jschwartz-20151117.pdf.).

[486] DEPARTMENT OF COMMERCE, DEPARTMENT OF COMMERCE REPORTING REQUIREMENTS UNDER SECTION 1502(D)(3)(C) OF THE DODD-FRANK ACT: WORLDWIDE CONFLICT MINERAL PROCESSING FACILITIES, (2014). This report was issued nearly two years late due to the difficulties in tracking down processing facilities in eastern Congo. *See* Emily Chasan, *Conflict Minerals Too Hard to Track*, *Commerce Department* Says, WALL STREET JOURNAL, Sept. 5, 2014, *available at* http://blogs.wsj.com/cfo/2014/09/05/conflict-minerals-too-hard-to-track-commerce-department-says/.

[487] *See* SEC Commissioner Michael S. Piwowar, Dissenting Statement at Open Meeting on Resource Extraction (Dec. 11, 2015) *available at*: https://www.sec.gov/news/statement/piwowar-dissenting-statement-at-open-meeting-

by a federal district court in Washington, and the Commission itself has noted that Section 1504 is one of only three rulemaking provisions in the entirety of U.S. securities law (anther being Section 1502) "that appear[s] designed primarily to advance U.S. foreign policy objectives," not investor protection or capital formation.[488] In its economic analysis of the rule implementing Section 1504, the SEC estimated the ongoing compliance costs of the rule would be in the range of $96 million to $591 million annually.

On February 1 and 3, 2017, the House and Senate respectively, passed joint resolutions of disapproval to nullify the SEC's July 27, 2016 final rule titled "Disclosure of Payments by Resource Extraction Issuers." On February 14, 2017, President Trump signed joint resolution into law.[489]Despite Congress overturning the flawed rule in 2017 through the Congressional Review Act, Section 1504 remains law and requires the SEC to move forward with this politically motivated rulemaking.[490]

Finally, Section 1503 of Dodd-Frank directed the SEC to promulgate rules requiring that mining companies disclose certain safety information in their quarterly and annual reports. In finalizing the rule in December 2011, the SEC required mining companies to disclose information about mine safety and health, including significant violations, orders, and citations, the dollar value of assessments, and mining-related fatalities. Much of this information is already reported to the Mine Safety and Health Administration,[491] and adding this duplicative disclosure regime is estimated to increase compliance costs by well over $1 million annually, according to the SEC itself.[492]

That core mission of the SEC is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. The politically motivated provisions in the Title XV "Miscellaneous" do nothing to fulfill the SEC's statutory mandate. The Financial CHOICE Act repeals these harmful and counterproductive provisions of the Dodd-Frank Act that are "more directed at exerting societal pressure on companies to change behavior, rather than to disclose information that primarily informs investment decisions."[493]

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resource-extraction.html.

[488] Extraction Issuers Proposed Rule, 80 Federal Register (December 23, 2015) pp. 80057 – 80111. https://www.sec.gov/rules/proposed/2015/34-76620.pdf.

[489] Public Law No. 115-4, *available at*: https://www.gpo.gov/fdsys/pkg/PLAW-115publ4/pdf/PLAW-115publ4.pdf

[490] *See* Pub. L. No. 115-4 (2017).

[491] David R. Burton, *How Dodd-Frank Mandated Disclosures Harm, Rather than Protect, Investors, Issue Brief #4526 on Regulation*, HERITAGE, Mar. 10, 2016, *available at* http://www.heritage.org/research/reports/2016/03/how-doddfrank-mandated-disclosures-harm-rather-than-protect-investors.

[492] Mine Safety Disclosure, 76 Fed. Reg. 81,762 (Dec. 28, 2011).

[493] White, The Importance of Independence, (2013).

Improving Insurance Regulation by Reforming Dodd-Frank Title V

Executive Summary:

- **The Dodd-Frank Act created new, overlapping and conflicting federal insurance positions between the FIO Director and the FSOC Independent Member with Insurance Expertise that have produced fragmentation, not consolidation, within our financial system.**

- **Consolidating federal insurance positions into one advocate will give a unified voice and seat at the table for the U.S. insurance industry at the domestic and international levels, while preserving our traditional state-based system of insurance regulation.**

The Dodd-Frank Act made two notable changes to the role the federal government plays in the insurance industry. First, in Title V, the Dodd-Frank Act created a new Federal Insurance Office (FIO) within the Treasury Department to provide the federal government with information and expertise on insurance matters.[494] Though by design FIO has no supervisory or regulatory authority, the Dodd-Frank Act charges the FIO with several mandates, including: (1) monitoring all aspects of the insurance industry; (2) recommending which insurance companies be designated for heightened prudential standards and supervision; (3) assisting in administering the Terrorism Risk Insurance Program; (4) coordinating federal involvement and policymaking on international insurance matters and in negotiations of international insurance agreements; and (5) consulting with state insurance regulators on matters of national or international importance.[495] The Dodd-Frank Act also charged the FIO Director with producing several one-time and annual reports on matters relating to the insurance industry.[496]

The FIO Director is a non-voting member of the FSOC, the 15-member inter-agency group comprising federal and state regulators and other financial regulatory experts that Dodd-Frank charges with identifying risks to the financial stability of the United States and promoting market discipline.[497] The Dodd-Frank Act mandates that one of the FSOC's members – this one with voting powers – be an Independent Member with Insurance Expertise, with no other federal supervisory or regulatory duties.[498] The Independent Member is the sole source of expertise among the FSOC's ten voting members.[499]

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[494] *See* Dodd-Frank Act § 502.
[495] *See id.* § 502(a).
[496] *See id.* § 502(a).
[497] *See id.* § 111(b)(1).
[498] *See id.*
[499] *See* FSOC, DISSENTING AND MINORITY VIEWS ON PRUDENTIAL DESIGNATION (2014) (Views of the Council's Independent Member Having Insurance Expertise), *available at* http://www.treasury.gov/initiatives/fsoc/designations/Documents/Dissenting%20and%20Minority%20Views.pdf.

This fragmented approach – featuring one insurance bureaucrat who monitors the insurance industry, advises federal officials, and participates in international insurance negotiations but cannot vote on FSOC macroprudential matters, and another insurance bureaucrat who *does* vote on FSOC macroprudential matters but has no other substantive policy responsibilities – has proved unwieldy. In theory, on matters relating to an insurance company, other FSOC voting members might be expected to defer to the professional judgment of the FSOC's dedicated insurance expert in evaluating the potential systemic risk posed by an insurer. But in practice, the opposite has occurred. For example, when the FSOC voted in 2013 to designate the insurance conglomerate Prudential Financial as "systemically important," the Independent Member with Insurance Expertise strongly dissented, but only one of the eight other voting members that day sided with him.[500] This scenario repeated itself in the 2014 designation of MetLife, when the Independent Member with Insurance Expertise filed the lone dissent to the FSOC's determination.

Similarly, FIO has been criticized by some for not using its position to champion the best interests of the U.S. domestic insurance industry in insurance matters and in negotiations of international insurance agreements. Other critics have lamented that FIO lacks a unified voice in speaking with state regulators on matters of national or international importance, further fragmenting our unique system of domestic insurance regulation.

To address these overlapping and conflicting authorities, the Financial CHOICE Act consolidates the federal insurance bureaucracy by merging and reforming FIO and the Independent Member with Insurance Expertise into one unified Independent Insurance Advocate (IIA). Appointed by the President, subject to the advice and consent of the Senate, for a six-year term, the IIA will be housed as an independent Office of the Independent Insurance Advocate within the Treasury Department.

The IIA will replace the Independent Member with Insurance Expertise as the voting FSOC member and will coordinate federal efforts on the prudential aspects of international insurance matters, including representing the U.S. in the International Association of Insurance Supervisors (IAIS) and assisting in the negotiations of covered agreements. Also the IIA will consult with state insurance regulators regarding insurance matters of national importance and prudential insurance matters of international importance and will assist Treasury in administering TRIA.

To promote accountability and transparency in the new office, the IIA will be required to testify before Congress twice a year on the activities and objectives of the Office, any actions taken by the Office pursuant to covered agreements, the state of the insurance industry, and the scope of global insurance and reinsurance markets and the role such markets play in supporting insurance in the U.S.

[500] *See* FSOC, RESOLUTION APPROVING FINAL DETERMINATION REGARDING PRUDENTIAL FINANCIAL, INC. 10, 12 (2013) (Views of the Acting Director of the Federal Housing Finance Agency) (Views of the Independent Member Having Insurance Expertise), *available at* https://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/September%2019%202013%20Notational%20Vote.pdf.