



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

JUNE 23, 2016

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

Executive Summary:

- 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, by saddling 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

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), <http://www.dallasfed.org/assets/documents/banking/firm/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

And 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 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 and 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

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-beneficiaries-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 or 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 pre-Dodd-Frank to 37 percent in 2015).¹²
- Banking fees have risen (for example, monthly service fees have grown 111 percent since Dodd-Frank).¹³
- The share of unbanked Americans (disproportionately low-income Americans¹⁴) has grown to 9.6 million from 9.1 million before Dodd-Frank.¹⁵
- There are 15 percent fewer credit card accounts now than in 2008, and on average, credit card interest rates are 200 basis points higher.¹⁶

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 *Bankrate 2015 Checking Survey*, BANKRATE, available at <http://www.bankrate.com/finance/checking/record-setting-year-for-checking-account-fees-2.aspx>; 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.

¹⁴ BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, REPORT ON THE ECONOMIC WELL-BEING OF U.S. HOUSEHOLDS IN 2014 (May 2015).

¹⁵ See Lux & Greene, *Out of Reach: Regressive Trends in Credit Card Access*, at 20 (figures are from 2009 and 2013, respectively).

¹⁶ GOLDMAN SACHS GLOBAL MARKETS INSTITUTE, THE TWO-SPEED ECONOMY 13 (2015), available at

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.

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

<http://www.goldmansachs.com/our-thinking/public-policy/regulatory-reform/2-speed-economy-report.pdf>.

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>.

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

Under the Financial CHOICE Act, banking organizations that maintain a leverage ratio of at least 10 percent and have a composite CAMELS rating of 1 or 2, 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 Republican plan 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.

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 <http://www.ft.com/intl/cms/s/0/8fc85ac4-b5d3-11e4-a577-00144feab7de.html#axzz3dKFC9OKf>, (“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 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.”).

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, treating toxic mortgage-backed securities and Greek sovereign debt as essentially risk-free, which encouraged financial firms to crowd into these assets and caused risk to be highly correlated among institutions and across geographical borders. Thus, rather than containing risk, Basel helped concentrate it. Rather than making banks safer, the Basel rules made them more fragile.

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."²³ 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,²⁴ 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

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>.

²³ 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>.

²⁴ For more detailed figures see Zhiguo He, In Gu Khang, & Arvind Krishnamurthy, *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>.

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.²⁵

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.”²⁶ 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.”²⁷

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.²⁸ 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.²⁹

²⁵ 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.”

²⁶ 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.”).

²⁷ 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>.

²⁸ 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 Bailly & John B. Taylor, eds., 2014), available at <http://www.hoover.org/sites/default/files/across-the-great-divide-ch1.pdf>.

²⁹ 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

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 zero risk weight. By contrast, small business loans generally receive a 100 percent risk weight under Basel.³⁰ 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.³¹

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.³² Thus, in marketing a recent issuance of “green bonds,” the World Bank touted its “0% risk-weighting under the Basel framework.”³³

By relying upon a simple leverage ratio, which measures funds available to absorb loss against 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 Thomas 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

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.”).

³⁰ 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.

³¹ 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.”).

³² 78 FR 62017.

³³ IFC, GREEN BONDS (Nov. 2015), available at <http://www.ifc.org/wps/wcm/connect/353c8f004325cabfa308ef384c61d9f7/Green+Bonds+March+2014+final.pdf?MOD=AJPERES>.

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."³⁴

Had the leverage ratio approach proposed by House Republicans been in place prior to the financial crisis – instead of Basel's risk-based capital regime – much of the economic carnage from that crisis might 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 our equity," he said. "I always thought of it in terms of risk of the way our balance sheet was run."³⁵

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.³⁶

Hoenig's claim that risk-based capital measures provided only "the illusion of adequate capital" is consistent with Andrew Haldane's study of failures during the crisis. Remarkably, failed banks maintained the *same* risk-weighted capital ratios (on average) as

³⁴ Thomas M. Hoenig, Remarks on Bank Supervision.

³⁵ *Excerpts: Report on Financial Crisis*, WALL STREET JOURNAL, Mar. 13, 2016, available at <http://www.wsj.com/articles/excerpts-report-on-financial-crisis-1457916378>.

³⁶ Thomas M. Hoenig, Basel III Capital: A Well-Intentioned Illusion.

did surviving banks. In other words, being well-capitalized on a risk-weighted basis was of no value in predicting the likelihood of failure. Banks that survived instead distinguished themselves by maintaining significantly higher *leverage* ratios.³⁷ Indeed, Haldane's research suggests that no major global bank with a 10 percent leverage ratio or better failed during the most recent financial crisis.³⁸ Haldane's thesis finds support in a Mercatus Center-published analysis of bank performance between 2001 and 2011, which concludes that leverage ratios are far better indicators of bank performance than risk-weighted capital ratios, and that the "risk-based weighting system is inherently flawed and easily exploitable."³⁹

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.⁴⁰ 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.⁴¹ A banking organization that elects to maintain a 10 percent leverage ratio under the Republican plan will thus be significantly better capitalized than any U.S. or global regulator currently requires.

While a 10 percent leverage ratio may 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."⁴² 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."⁴³

For those who claim that the Republican plan is instead too *generous* in its treatment of big banks, a survey of the amount of new equity that those firms would be required to raise to qualify for regulatory relief is instructive. According to SEC filings, the eight largest U.S.

³⁷ Andrew Haldane, *The Dog and the Frisbee* at 29, Chart 4.

³⁸ *Id.*, at 32, Chart 5.

³⁹ Thomas Hogan et al., *Evaluating Risk-Based Capital Regulation*, (Mercatus Cent. at George Mason Univ., Working Paper No. 13-02, Jan. 2013), available at http://mercatus.org/sites/default/files/Hogan_EvaluatingRBC_v2_1.pdf.

⁴⁰ BASEL COMMITTEE ON BANKING SUPERVISION, *BASEL III LEVERAGE RATIO FRAMEWORK AND DISCLOSURE REQUIREMENTS* (Jan. 2014), available at <http://www.bis.org/publ/bcbs270.pdf>.

⁴¹ 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>.

⁴² 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.

⁴³ Allan H. Meltzer, *Banks Need More Capital, Not More Rules*, WALL STREET JOURNAL, May 16, 2012, available at <http://www.wsj.com/articles/SB10001424052702304192704577405821765336832>.

banks currently have an estimated average leverage ratio of approximately 6.6 percent.⁴⁴ 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.

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 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 Republican plan 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 Republican plan 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.”⁴⁵ 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.”⁴⁶

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

⁴⁴ Company SEC filings available at: <https://www.sec.gov/edgar/searchedgar/companysearch.html>.

⁴⁵ 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>.

⁴⁶ Thomas M. Hoenig, Remarks on Bank Supervision.

pace. . . . [A] bank with a larger equity base can be expected to lend more. 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.⁴⁷

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.⁴⁸ 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.⁴⁹

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.⁵⁰ The claim that higher bank capital erodes bank profitability and

⁴⁷ 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>

⁴⁸ 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>.

⁴⁹ 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/PROD000000000320825.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.

⁵⁰ 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>,

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 University of Chicago economist 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.⁵¹

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.”⁵²

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.

(“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 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.”).

⁵¹ 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.”).

⁵² 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>.

Where assets are backed with equity — as is true of the mutual funds, private 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.⁵³

Banks that make this capital election 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 Republican 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.

⁵³ 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

Executive Summary:

- **Dodd-Frank has *not* ended “too big to fail”:** research by the Richmond Federal Reserve Bank shows that 60 percent of total financial system liabilities (or some \$26 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 in 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.⁵⁴ 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.”⁵⁵ 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.⁵⁶ The Richmond Fed estimates that the financial safety net covers some **\$26 trillion** in liabilities, or **60 percent** of the total liabilities of the financial system, which is roughly equivalent to its size in 2009, just before Dodd-Frank was enacted.⁵⁷ 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.

⁵⁴ Jeffrey Lacker, the 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.

⁵⁵ 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>.

⁵⁶ 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, 2014).

⁵⁷ *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.⁵⁸ 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."⁵⁹

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

⁵⁸ 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).

⁵⁹ 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.”⁶⁰ 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.⁶¹

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.⁶² 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.⁶³ 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 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.

⁶⁰ Dodd-Frank Act § 204(a).

⁶¹ *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).

⁶² *Id.* at § 210(n).

⁶³ *Id.* at § 204(d).

Rather than ending “too big to fail,” the OLA replicates the dynamic that created it.⁶⁴

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.⁶⁵ 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.⁶⁶ 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.⁶⁷ Additionally, the FDIC may claw back incentive payments and other compensation made to executives that contributed to the firm’s failure.⁶⁸

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.⁶⁹ 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 \$23 billion, with no

⁶⁴ 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.

⁶⁵ Dodd-Frank Act § 210(h)(2)(G)(iv), (h)(9).

⁶⁶ *Id.* § 210(n)(9).

⁶⁷ *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.*

⁶⁸ *Id.* § 210(s).

⁶⁹ 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.⁷⁰ The Pension Benefit Guaranty Corporation is running a total asset deficit of approximately \$61 billion.⁷¹ And the Federal Housing Administration recently 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.⁷² After those 30 days, the FDIC can borrow up to 90 percent of the fair value of the failed firm’s total consolidated assets.⁷³

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.	\$2.352 trillion
Bank of America Corporation	\$2.147 trillion
Wells Fargo & Company	\$1.788 trillion
Citigroup Inc.	\$1.731 trillion
Goldman Sachs Group, Inc.	\$861 billion
Morgan Stanley	\$787 billion ⁷⁴

Thus, to “resolve” JP Morgan Chase, the FDIC could borrow up to 90% of JP Morgan Chase’s total assets, which is \$2.1 trillion. To resolve Bank of America, the FDIC could borrow up to \$1.9 trillion. To resolve Wells Fargo, \$1.6 trillion.

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

⁷⁰ See *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>.

⁷¹ Information current through latest GAO Report, covering FY 2014. See GAO, GAO-15-290, HIGH-RISK SERIES: AN UPDATE 335 (2015).

⁷² Dodd-Frank Act § 210(n)(6).

⁷³ *Id.*

⁷⁴ *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> (figures listed in this report reflect asset values as of Dec. 31, 2015).

those assessments on to their customers in the form of higher fees on financial products and services.⁷⁵ 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."⁷⁶

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.⁷⁷ 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.⁷⁸

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.⁷⁹ 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."⁸⁰

⁷⁵ 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).

⁷⁶ *Id.* at 9 (statement of John Taylor, Mary and Robert Raymond Professor of Economics, Stanford University).

⁷⁷ *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.").

⁷⁸ 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).

⁷⁹ 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").

⁸⁰ *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.⁸¹ 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.⁸²

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.⁸³

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.

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. 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.").

⁸² 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).

⁸³ 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.⁸⁴ 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.⁸⁵ 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[.]⁸⁶

At least one senior Democratic Member of the Financial Services Committee seems to share this concern.⁸⁷

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 earlier this year 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.

⁸⁴ 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).

⁸⁵ 12 C.F.R. § 380.27 (2016).

⁸⁶ *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.").

⁸⁷ *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.'"⁸⁸ 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."⁸⁹

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, AIG, and host of other large financial institutions, the "Orderly Liquidation Authority"

⁸⁸ 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>.

⁸⁹ 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).

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 institution, but to reorganize an insolvent institution 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-provided 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, no matter how significant or broad the losses that would be suffered by these creditors — 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?⁹⁰

⁹⁰ 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.⁹¹

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."⁹² 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

⁹¹ MARTIN WOLF, *FIXING GLOBAL FINANCE* 20 (2008).

⁹² Federal Reserve Act § 13(3), 12 U.S.C. § 343 (2012); *id.* § 13(13), 12 U.S.C. § 347c.

Facility.⁹³ 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."⁹⁴

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.⁹⁵

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

⁹³ See John Weinberg, Federal Reserve Bank of Richmond, *Support for Specific Institutions: 2007-2998*, FEDERAL RESERVE HISTORY, <http://www.federalreservehistory.org/Events/DetailView/56> (last visited Jun. 10, 2016).

⁹⁴ 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-institu.

⁹⁵ 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...").

cabin that authority, but there is general consensus that the constraints imposed by the Act are largely 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.⁹⁶

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.⁹⁷ 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.⁹⁸ The Fed issued those regulations in December 2015, and they became effective on January 1, 2016.⁹⁹ Unfortunately, the regulations largely avoid setting effective constraints 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 2009.¹⁰⁰

The Financial CHOICE Act incorporates a number of reforms to 13(3) authored by Rep. Bill Huizenga that have previously passed the House (H.R. 3189) and 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 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

⁹⁶ Dodd-Frank Act § 1101(a).

⁹⁷ 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).

⁹⁸ See Dodd-Frank Act § 1101(a)(6).

⁹⁹ See *Extensions of Credit by Federal Reserve Banks*, 80 Fed. Reg. 78,959 (Dec. 18, 2015) (codified at 12 C.F.R. § 20 (2016)).

¹⁰⁰ 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.”).

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.”

Finally, the Financial CHOICE Act 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 Dodd-Frank’s Other Bail-Out Authorities

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.¹⁰¹ 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.”¹⁰² Although Congress passed legislation in 2008 barring the Treasury Department from using the Exchange Stabilization Fund to guarantee money market mutual funds,¹⁰³ 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

Title XI of the Dodd-Frank Act authorizes the FDIC to create a widely available program to guarantee obligations of solvent depository institutions, bank and thrift holding companies, and their affiliates during periods of severe economic stress.¹⁰⁴ Such a program can only be initiated upon a 2/3rds vote of the FDIC Board of Directors and the Federal Reserve Board of Governors finding 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 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.”¹⁰⁵ Such a guarantee program cannot go into effect unless both houses of Congress have first passed a joint resolution of approval.¹⁰⁶

The Financial CHOICE Act would eliminate this emergency loan guarantee facility, which, like so much else in Dodd-Frank, is both an invitation to moral hazard and a massive expansion of the federal safety net benefiting financial institutions, at the potential expense of taxpayers.

¹⁰¹ 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>.

¹⁰² Alan Blinder, AFTER THE MUSIC STOPPED: THE FINANCIAL CRISIS, THE RESPONSE, AND THE WORK AHEAD 146 (2013).

¹⁰³ See Emergency Economic Stabilization Act of 2008 §131(b), 12 U.S.C. § 5236(b) (2012).

¹⁰⁴ See Dodd-Frank Act § 1105(a).

¹⁰⁵ *Id.* §§ 1104, 1105(g)(3).

¹⁰⁶ *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.¹⁰⁷ The FSOC consists of ten voting members and five nonvoting members.¹⁰⁸ The ten voting members are the heads of nine federal financial regulatory agencies and an independent member with insurance expertise;¹⁰⁹ 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 insurance commissioner, a state banking supervisor, and a state securities

¹⁰⁷ Dodd-Frank Act § 112(a)(1).

¹⁰⁸ Dodd-Frank Act § 111(b).

¹⁰⁹ 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).

commissioner.¹¹⁰ 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.¹¹¹

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.¹¹² 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 with differing political affiliations. Although the leader of each of these

¹¹⁰ *Id.*

¹¹¹ *Id.* § 111(e).

¹¹² 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).

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.¹¹³

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.¹¹⁴

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. . . .¹¹⁵

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 appointed by the President, the Dodd-Frank Act results in a highly politicized financial

¹¹³ 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).

¹¹⁴ 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.*

¹¹⁵ *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>.

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."¹¹⁶ 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."¹¹⁷ 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 almost six years since Dodd-Frank was enacted.¹¹⁸

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.¹¹⁹ 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.¹²⁰ Richard Fisher, the former President of the Dallas Federal Reserve Bank, has testified to the same effect:

¹¹⁶ Dodd-Frank Act § 113(c).

¹¹⁷ *Id.* § 113(b)(2).

¹¹⁸ 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/>.

¹¹⁹ *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).

¹²⁰ *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.").

[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.¹²¹

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."¹²² Designation thus generates even greater risk-taking and moral hazard, because creditors and counterparties will not 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.¹²³ 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."¹²⁴

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.¹²⁵ Mr. Wallison

¹²¹ *Id.* at 12 (statement of Richard Fisher).

¹²² *See id.* at 13 (statement of Jeffrey Lacker).

¹²³ 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>.

¹²⁴ *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).

¹²⁵ Peter J. Wallison, *What the FSOC's Prudential Decision Tells Us about SIFI Designation*, FINANCIAL SERVICES OUTLOOK, AMERICAN ENTERPRISE INSTITUTE 5, 7, 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.

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.”¹²⁶

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.¹²⁷ 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” from its own standards for making designation determinations.¹²⁸ The government is appealing the decision.¹²⁹

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.¹³⁰ Mr. Woodall, whose more than 50 years of experience in the insurance industry included serving as the Kentucky Insurance Commissioner,¹³¹ 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.”¹³²

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

¹²⁶ *Id.* at 5.

¹²⁷ See *Financial Stability Oversight Council*, U.S. DEPARTMENT OF THE TREASURY, <https://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx> (last visited Jun. 8, 2016).

¹²⁸ *MetLife Inc. v. Financial Stability Oversight Council*, No. 15-0045, at *13-14 (D.D.C. Mar. 30, 2015).

¹²⁹ 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.

¹³⁰ 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>.

¹³¹ 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.

¹³² 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>.

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.”¹³³

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 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.¹³⁴

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.¹³⁵ 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.¹³⁶

¹³³ *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.

¹³⁴ *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>.

¹³⁵ 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).

¹³⁶ 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,

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."¹³⁷ A 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 Securities and Exchange Commission or the Commodity Futures Trading Commission. *But as important, if not more, a designated FMU also gains immediate access to the Fed's discount window.*¹³⁸

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."¹³⁹

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."¹⁴⁰ 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."¹⁴¹ Based upon her view that

available at <http://www.wsj.com/articles/government-warns-of-systemic-risks-it-created-1432214171>.

¹³⁷ 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 <https://www.treasury.gov/initiatives/fsoc/Documents/2012%20Appendix%20A%20Designation%20of%20Systemically%20Important%20Market%20Utilities.pdf>.

¹³⁸ 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>.

¹³⁹ 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>.

¹⁴⁰ *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>.

¹⁴¹ Sheila Bair, BULL BY THE HORNS: FIGHTING TO SAVE MAIN STREET FROM WALL STREET AND WALL STREET FROM ITSELF 222 (2012).

“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.¹⁴²

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*, 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. 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.¹⁴³

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.

¹⁴² *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>.

¹⁴³ Sheila Bair, *BULL BY THE HORNS: FIGHTING TO SAVE MAIN STREET FROM WALL STREET AND WALL STREET FROM ITSELF 222* (2012).

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 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 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.

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 able to contribute much to the recovery, especially for small-business startups.¹⁴⁴

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 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, the Commodity Futures Trading Commission and the National Credit Union Administration—would be permitted to attend and participate in the FSOC’s meetings;
- 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

¹⁴⁴ 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/>.

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.¹⁴⁵

¹⁴⁵ These provisions are drawn from legislation authored by Rep. Scott Garrett (H.R. 3557).

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 CFPB 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.¹⁴⁶ To fulfill its statutory mandate, the Bureau can issue rules, examine certain institutions, and enforce consumer protection laws and regulations.

The Bureau's jurisdiction includes large depository institutions (such as banks) with assets of more than \$10 billion, mortgage lenders, mortgage servicers, payday lenders, and private education lenders. 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.¹⁴⁷

The Bureau is funded out of the earnings of the Federal Reserve System and is helmed by a sole Director who serves a five-year term.¹⁴⁸ 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

¹⁴⁶ Dodd-Frank Act § 1021.

¹⁴⁷ 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.

¹⁴⁸ *Id.* § 1017.

by the Director to be reasonably necessary for carrying out the authorities of the Bureau.¹⁴⁹ 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.¹⁵⁰ Despite its sweeping agenda, however, the Bureau is failing to protect consumer choice and financial independence.

The CFPB's Policies are Harming Consumers

The CFPB's rules and policies exemplify a “Washington-knows-best” attitude that limits the availability of useful – and safe – products and services. Experts note that CFPB regulations produce a range of harmful effects – many of which are highly regressive – on American consumers, including the following:¹⁵¹

- 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-

¹⁴⁹ *Id.* § 1017.

¹⁵⁰ See Kelly Cochran, *CFPB, Spring 2016 rulemaking agenda*, CFPB (May 18, 2016)

<http://www.consumerfinance.gov/about-us/blog/spring-2016-rulemaking-agenda/>; **POLICY PRIORITIES OVER THE NEXT TWO YEARS**, CFPB (Feb. 25 2016), http://files.consumerfinance.gov/f/201602_cfpb_policy-priorities-over-the-next-two-years.pdf.

¹⁵¹ 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 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>.

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.¹⁵² The outlook is particularly bleak for minority borrowers: according to the Fed's analysis, roughly one-third of African-American and Hispanic borrowers will be unable to meet the QM underwriting requirements once the Bureau's rule is fully phased in.¹⁵³ 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.”¹⁵⁴

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 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 CFPB is Demonstrating 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 even contemplated 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.¹⁵⁵ Without additional verification or normalization of the Bureau's database of complaints, consumers are unable to draw conclusions about potential bad actors in the marketplace. One payments industry expert accurately described the database as a

¹⁵² 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.

¹⁵³ *Id.* at 37.

¹⁵⁴ 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>.

¹⁵⁵ See *The Complaint Process*, CFPB, <http://www.consumerfinance.gov/complaint/process/> (last visited Jun. 14, 2016).

“modern-day public stockade — a list of the companies that consumers (with unverified complaints) have complained the most about.”¹⁵⁶

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 mounting consumer concerns about market dislocation and delayed closings 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.¹⁵⁷ The Bureau has also decided to ignore the sovereign will of 50 duly-elected state legislatures and tribal authorities by proposing a rule to regulate the small dollar, short-term credit market absent any Congressional directive or pressing need identified by the states.¹⁵⁸ In an initiative recently struck down by a federal district court, the Bureau attempted to collaterally regulate 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.¹⁵⁹

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.¹⁶⁰ Because the Bureau has declined to define what constitutes a UDAAP violation, financial firms are either cutting back product

¹⁵⁶ 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/>.

¹⁵⁷ 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.

¹⁵⁸ 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.

¹⁵⁹ 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).

¹⁶⁰ See e.g. S. Raman, *CFPB Defines 'Unfair,' 'Deceptive' and 'Abusive' Practices Through Enforcement Activity*, SKADDEN, ARPS, SLATE, MEAGHER & FLOM, LLP, <https://www.skadden.com/insights/cfpb-defines-unfair-deceptive-and-abusive-practices-through-enforcement-activity> (last accessed Jun. 13, 2010).

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.¹⁶¹

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 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.¹⁶²

The Solution: Reform the CFPB 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. For example, the Act replaces the Bureau’s sole Director with a multi-member, bipartisan commission similar to those of other consumer or investor protection agencies. The Act additionally subjects the Bureau to the congressional appropriations process and reforms the Bureau’s statutory mandate to ensure that it takes into account, and seeks to promote, robust market competition.

¹⁶¹ Hester Peirce, *CFPB Knows Abuse When It Sees It*, MERCATUS CENTER: EXPERT COMMENTARY (Mar. 29, 2012), http://mercatus.org/expert_commentary/cfpb-knows-abuse-when-it-sees-it.

¹⁶² Todd Zywicki, *The Consumer Financial Protection Bureau: Savior or Menace?* 81 GEO. WASH. L. REV. 856 858-59 (2013).

The Financial CHOICE Act also provides courts with enhanced authority to correct any erroneous interpretation made by the Bureau 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 Bureau 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 "abusive."

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 bill 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.

Effective consumer protection requires providing Americans with the information they need to make informed decisions, policing markets for fraud and deception, and promoting competition and choice among financial products and services, which ultimately advances the goal of financial inclusion. By creating checks-and-balances for the Bureau'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.¹⁶³ 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

¹⁶³ 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. https://www.minneapolisfed.org/~media/files/pubs/eppapers/14-1/epp_14-1.pdf.

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 job creators are deferring plans to purchase inventory and add new employees, choosing to hoard cash instead.¹⁶⁴

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 7,657 banks in the U.S.¹⁶⁵ By the end of 2015 that number had declined to 6,182.¹⁶⁶ 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).¹⁶⁷ Credit unions have also experienced a steady decline in number. According to NCUA reporting data, in 2010, there were 7,339 credit unions.¹⁶⁸ At year-end 2015, there were only 6,021.¹⁶⁹

The high attrition rate among incumbent banks has been coupled with an almost total absence of de novo bank chartering activity. In the 15 years leading up to Dodd-Frank's enactment, an average of 140 new commercial banks and 15 new savings banks were chartered each year.¹⁷⁰ But since Dodd-Frank's enactment, the number of new bank charters can be counted on the fingers of one hand, a phenomenon that is at least partly attributable to a hostile regulatory environment.¹⁷¹

Industry consolidation has been accompanied by a marked decline in community banks' share of industry assets. A study by researchers at Harvard University's Kennedy School of

¹⁶⁴ See e.g. Richard Finger, Opinion, *Banks Are Not Lending Like They Should, And With Good Reason*, FORBES May 30, 2013, available at <http://www.forbes.com/sites/richardfinger/2013/05/30/banks-are-not-lending-like-they-should-and-with-good-reason/#4ce5324c44b1>; Paul Sperry, Opinion, *Dodd-Frank Rules Will Crush Employment, Banks Warn*, INVESTORS BUSINESS DAILY, Dec. 5, 2011, available at <http://www.investors.com/politics/policy-analysis/dodd-frank-bank-regulations-cost-jobs/>.

¹⁶⁵ 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.

¹⁶⁶ See FDIC, QUARTERLY BANKING PROFILE: FOURTH QUARTER 2015 4, available at <https://www.fdic.gov/bank/analytical/qbp/2015dec/qbp.pdf>.

¹⁶⁷ FDIC data reported by the Mercatus Center <http://mercatus.org/publication/small-banks-numbers-2000-2014>.

¹⁶⁸ See NCUA, PACA FACTS DATA, FEDERALLY INSURED CREDIT UNIONS 1 (Dec. 31, 2010), available at <https://www.ncua.gov/DataApps/Documents/CRS201012.pdf>.

¹⁶⁹ See *id.*

¹⁷⁰ Average new charters between 1995 and 2009 calculated using FDIC annual financial data. See FDIC, COMMERCIAL BANK REPORTS, TABLE CB02, CHANGES IN NUMBER OF INSTITUTIONS, FDIC-INSURED COMMERCIAL BANKS, US AND OTHER AREAS, YEAR-TO-DATE ACTIVITY, 1934 - 2014 (accessed June 2016), available at <https://www5.fdic.gov/hsob/SelectRpt.asp?EntryTyp=10&Header=1>. See also FDIC, SAVINGS INSTITUTION REPORTS, TABLE SI02, CHANGES IN NUMBER OF INSTITUTIONS, FDIC-INSURED SAVINGS INSTITUTIONS, US AND OTHER AREAS, YEAR-TO-DATE ACTIVITY, 1984 - 2014 (accessed June 2016), available at <https://www5.fdic.gov/hsob/SelectRpt.asp?EntryTyp=20&Header=1>.

¹⁷¹ ROISIN MCCORD ET AL., EXPLAINING THE DECLINE IN THE NUMBER OF BANKS SINCE THE GREAT RECESSION, FEDERAL RESERVE BANK OF RICHMOND ECONOMIC BRIEF (Mar. 2105), available at https://www.richmondfed.org/~media/richmondfedorg/publications/research/economic_brief/2015/pdf/eb_15-03.pdf.

Government – also discussed in the first chapter – found that since the enactment of the Dodd-Frank Act in mid-2010, banks with less than \$10 billion in assets have seen their market share decline by 12 percent, a rate double the 6 percent decline of the four pre-Dodd-Frank years.¹⁷²

Other 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. 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.”¹⁷³ 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 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.”¹⁷⁴ 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.¹⁷⁵

As noted earlier in this paper, 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 Tarullo remarked in 2009 that “the importance of traditional financial intermediation services, and hence of the smaller banks that typically specialize in

¹⁷² Marshall Lux & Robert Greene, *The State and Fate of Community Banking* 3 (M-RCBG Associate Working Paper Series No. 37, February 2015), at 3
https://www.hks.harvard.edu/content/download/74695/1687293/version/1/file/Final_State_and_Fate_Lux_Greene.pdf.

¹⁷³ Hester Peirce et al., *How Are Small Banks Faring Under Dodd-Frank?*, MERCATUS CENTER (Feb. 27, 2014), <http://mercatus.org/publication/how-are-small-banks-faring-under-dodd-frank>.

¹⁷⁴ *Id.*

¹⁷⁵ *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 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>.

providing those services, tends to increase during times of financial stress.”¹⁷⁶ Unlike big banks, community banks maintained positive returns on assets (ROAs) during the crisis,¹⁷⁷ and a higher share of small banks, relative to large banks, achieved earnings growth during the crisis.¹⁷⁸ Portfolio default rates for residential mortgages issued by community banks between January 2003 and September 2012 were far lower than for the overall industry (0.20 percent vs. 1.64 percent).¹⁷⁹ Targeted regulatory relief for smaller financial institutions is thus not only conducive to economic growth – it improves the resiliency of U.S. lending markets.

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 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.¹⁸⁰ 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.”¹⁸¹ The legislation will also require regulators to increase transparency and reestablish due process by making final examination reports available for

¹⁷⁶ 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>.

¹⁷⁷ 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>.

¹⁷⁸ 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>.

¹⁷⁹ 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.

¹⁸⁰ This language is based on legislation authored by Rep. Scott Tipton (H.R. 2896), which has been approved by the Financial Services Committee.

¹⁸¹ This language is based on legislation authored by Rep. Blaine Luetkemeyer (H.R.766), which passed the House on February 4, 2016.

a depository institution's review on a timely basis, and affording the institution a right to appeal material supervisory determinations to an independent arbiter.¹⁸²

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, including but not limited to the following:

- The National Credit Union Administration (NCUA), which regulates federally insured credit unions, will be required to 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";
- Well-managed, well-capitalized credit unions will benefit from a less frequent examination cycle; and
- A new Credit Union Advisory Council will advise the NCUA Board on the "big picture" of regulatory impact across Federal law and regulation

¹⁸² 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 the governmental entity 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 engaging in credit allocation on a grand scale, the Fed has blurred the line between fiscal and monetary policy beyond recognition, and in doing so has undermined its political independence.**
- **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 more predictable, rules-based monetary policy, the Financial CHOICE Act provides a stronger foundation for economic growth than the Fed’s improvisational approach of recent years, the results of which have been underwhelming to say the least. Although Fed Chair Yellen has opposed these modest reforms, they are supported by a long list of leading economists, including three recent Nobel Laureates.**

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 authorities 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.¹⁸³ The Federal Reserve is authorized to impose “heightened prudential standards”¹⁸⁴ 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.¹⁸⁵

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.¹⁸⁶ Dodd-Frank transferred oversight of savings and loan holding companies previously exercised by the Office of Thrift Supervision to the Federal Reserve.¹⁸⁷ The Federal Reserve Board Chairman sits on the FSOC and participates in the deliberations on which non-bank financial firms should be designated for heightened prudential supervision.¹⁸⁸ 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.¹⁸⁹ 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.¹⁹⁰

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?

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-

¹⁸³ See Dodd-Frank Act §§ 165, 113.

¹⁸⁴ See *id.* § 112 (a)(2)(I).

¹⁸⁵ See *id.* § 165; see generally *id.* tit. I, § 101-176.

¹⁸⁶ See *id.* §§ 803-806.

¹⁸⁷ See *id.* § 312.

¹⁸⁸ 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>.

¹⁸⁹ See Dodd-Frank Act § 121.

¹⁹⁰ See *id.* § 203.

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.¹⁹¹

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."¹⁹²

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."¹⁹³ 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?"¹⁹⁴

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.

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 to Congress within 90 days of completion of the audit. Over the past eight years, the Fed has been engaged in a radical experiment in monetary policy, amassing a \$4.2 trillion portfolio of assets,¹⁹⁵ intervening to prop up select credit markets,¹⁹⁶ and keeping interest

¹⁹¹ 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>.

¹⁹² 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>.

¹⁹³ 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>.

¹⁹⁴ *Id.*

¹⁹⁵ See *System Open Market Account Holdings*, FEDERAL RESERVE BANK OF NEW YORK,

rates near zero.¹⁹⁷ It has blurred the line between fiscal and monetary policy almost beyond recognition, facilitating the Obama Administration’s reckless spending and accumulation of more 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.¹⁹⁸ (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.¹⁹⁹ 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, activities, or operations of the company, or any subsidiary thereof.”²⁰⁰ 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.”²⁰¹

http://nyapps.newyorkfed.org/markets/soma/sysopen_accholdings.html (last visited Jun. 14, 2016).

¹⁹⁶ 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>.

¹⁹⁷ 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>.

¹⁹⁸ See Dodd-Frank Act § 165.

¹⁹⁹ See *id.* § 165(d).

²⁰⁰ *Id.* § 165 (d)(5)(A).

²⁰¹ *Id.* § 165(d)(5)(B).

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.”²⁰²

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.²⁰³

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 shut down their business. Their energy is rightly focused on how to build their business and the economy.”²⁰⁴

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

²⁰² 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>.

²⁰³ 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>.

²⁰⁴ *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>.

administered by the regulators “met with FDIC officials on 65 occasions.”²⁰⁵ 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 like the United States, which prizes the rule of law, the protection of property rights, and adherence to due process.²⁰⁶

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

²⁰⁵ 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>.

²⁰⁶ *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>.

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?”²⁰⁷

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 steered against the wrong crisis?²⁰⁸

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 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.”²⁰⁹ The Federal Reserve describes “matters requiring immediate attention” as follows:

²⁰⁷ *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/hrg-114-ba00-wstate-pgramm-20150728.pdf>.

²⁰⁸ *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/hrg-114-ba15-wstate-pkupiec-20150708.pdf>.

²⁰⁹ 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>.

[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.²¹⁰

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.²¹¹

Republican Reforms to the Living Will and Stress Test Processes

In an effort to inject badly needed transparency into the living will and stress test processes, the Financial CHOICE Act (1) requires banking organizations that currently submit living wills to continue to submit living wills until they make an effective capital election and (2) permits the banking agencies to conduct stress tests (but not limit capital distributions) of a banking organization that has made a qualifying capital election. 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 banking agencies to provide feedback on “living wills” to banking organizations within six months of their submission; and (3) requires 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 banking agencies 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 banking agencies’ rules implementing stress testing requirements will be conducted, including baseline, adverse, and severely adverse, and methodologies, including models to estimate losses on certain assets; (2) requiring the banking agencies to provide copies of such regulations to the GAO and the Panel of Economic Advisors of the Congressional Budget

²¹⁰ 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/bankinfo/reg/srletters/sr1313a1.pdf>.

²¹¹ 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>.

Office before publishing such regulation; and (3) requiring the banking agencies to publish a summary of all stress test results.

A More Rules-Based Monetary Policy Would Increase Transparency and 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.”²¹² 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 has been based more on a disciplined strategy and less on improvisation, the economy has performed better.²¹³ Extrapolating from this history, Stanford University economist John Taylor has concluded that the best way for the Fed to help the economy is by adopting a transparent, rules-based policy strategy that will provide predictability for U.S. businesses and investors.²¹⁴

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 simple and clearly understood rules. 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.²¹⁵ The last ten years have been defined by exceptionally accommodative monetary policy. Thus far, this monetary experiment has not produced the growth that the Federal Reserve forecast; it has, however, created an enormous amount of uncertainty about the future course of monetary policy.

Dr. Charles Plosser, immediate past President of the Federal Reserve Bank of Philadelphia, has also expressed support for a rules-based 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

²¹² Milton Friedman, *The Role of Monetary Policy*, AM. ECON. REV., Mar. 1968, at 16.

²¹³ 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).

²¹⁴ See *id.*

²¹⁵ *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>.

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.**²¹⁶

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.²¹⁷

A rules-based monetary policy 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:

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.²¹⁸

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

²¹⁶ 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>.

²¹⁷ *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>.

²¹⁸ *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>.

differences between actual policy decisions and prescriptions from a well-known benchmark 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 generate a monetary policy rule and explain to the American people how its chosen course compares to a standard reference rule specified in the statute.²¹⁹ Importantly, it is the Federal Reserve that selects the policy inputs that go into the formulation of its rule, and the Fed retains the power to change or depart from its chosen strategy whenever it determines that economic circumstances warrant.²²⁰

Before assuming her current responsibilities, Chair 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.”²²¹ But she has changed her tune considerably since becoming Fed Chair, criticizing Republican reforms to foster a more predictable rules-based monetary policy on the grounds that such reforms would both tie the Fed’s hands and erode the Fed’s political independence.²²²

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.²²³

²¹⁹ 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.

²²⁰ 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).

²²¹ 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.

²²² See e.g. Sam Fleming, *Janet Yellen defends US central bank independence*, FINANCIAL TIMES, Feb. 25, 2015, available at <http://www.ft.com/intl/cms/s/0/6016b23c-bd06-11e4-b523-00144feab7de.html#axzz4Bc8S4b6n>.

²²³ Letter from Lars Peter Hansen et al. to the H. Comm. on Financial Services (2016), available at

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.

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 cost-benefit analysis reduces the quality of regulation and creates unnecessary regulatory costs; it does a disservice to the American people. By imposing a statutory cost-benefit 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.”²²⁴

These checks and balances are absent from modern federal agencies. Indeed, as Chief Justice Roberts observed, 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

²²⁴ George Washington, President of the United States, Farewell Address, (Sept. 17, 1796).

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.²²⁵

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.²²⁶ Also, over 60 federal agencies have almost 3,300 regulations currently in development.²²⁷ And in 2016, the estimated regulatory cost for final rules is already nearing \$63 billion with an additional \$16.4 billion in estimated costs for rules proposed this year.²²⁸ 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.²²⁹

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,²³⁰ which have slowed the economy and buried small financial institutions and small businesses in an avalanche of Washington red tape. A 2015 study by the American Action Forum found that compliance with the Dodd-Frank Act had cost of \$24 billion and 61 million hours of paperwork – the equivalent of 30,370 employees working full-time on paperwork for one year.²³¹ These costs increase the prices of banking services, mortgages, credit cards, and other financial services that average Americans use every day.

²²⁵ *City of Arlington v. FCC*, 133 S. Ct. 1863, 1877-78 (2013) (Chief Justice Roberts, dissenting).

²²⁶ CLYDE WAYNE CREWS, COMPETITIVE ENTERPRISE INSTITUTE, TEN THOUSAND COMMANDMENTS 2016 (2016), available at <https://cei.org/10KC2016>.

²²⁷ *See id.*

²²⁸ Sam Batkins, *\$927 Million In Costs*, AMERICAN ACTION FORUM: WEEK IN REGULATION (2016), available at <http://www.americanactionforum.org/week-in-regulation/927-million-costs/>.

²²⁹ BENTLEY COFFEY ET AL., MERCATUS CENTER, THE CUMULATIVE COST OF REGULATIONS (2016), available at <http://mercatus.org/publication/cumulative-cost-regulations>.

²³⁰ *See* DAVIS POLK, DODD-FRANK PROGRESS REPORT, FOURTH QUARTER 2015 REPORT 2 (2016), available at <http://www.davispolk.com/Dodd-Frank-Rulemaking-Progress-Report/>.

²³¹ Andy Winkler et al., *Dodd-Frank at 4: More Regulation, More Regulators, and a Sluggish Housing Market*, AMERICAN ACTION FORUM, (Jul. 15, 2014), <http://americanactionforum.org/research/dodd-frank-at-4-more-regulation-more-regulators-and-a-sluggish-housing-mark>.

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.²³² But the Bureau is explicitly prohibited by the Dodd-Frank Act from regulating dealers.²³³ 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.²³⁴

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.”²³⁵ This initiative restricts banks from operating accounts associated with a variety of legitimate businesses under the false cover of prosecuting fraud.²³⁶ In essence, laws meant to protect consumers and ensure economic stability are being leveraged by partisan operatives to achieve political ends.

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 Five-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

²³² 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.

²³³ See Dodd-Frank Act § 1029.

²³⁴ 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.

²³⁵ 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>.

²³⁶ See *id.*

from the Executive in Need of Scrutiny (REINS) Act legislation previously passed by the House (H.R. 427). 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 Cost-Benefit Analysis before Issuing Rules

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 cost-benefit 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 cost-benefit analyses insufficient,²³⁷ and former Commissioner Scott O’Malia once lamented the CFTC’s failure to follow executive orders directing agencies to conduct cost-benefit 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-4.²³⁸

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

²³⁷ 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>.

²³⁸ 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>.

failing to consider important alternatives.²³⁹ The GAO has documented cost-benefit analysis shortcomings at both the SEC and CFTC.²⁴⁰

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 cost-benefit analysis, and 85 were accompanied by non-quantitative analyses.²⁴¹ Writing in the *Wall Street Journal*, financial journalist Greg Ip noted that as a result of this failure to perform cost-benefit 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."²⁴²

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."²⁴³ In calling for cost-benefit analysis at federal financial regulators, economist Abby McCloskey and Hester Peirce of the Mercatus Center have urged adoption of "statutory elements that track closely the directives and guidance contained in Executive Orders 12866 and 13563"²⁴⁴ (standards for cost-benefit analysis at Executive branch agencies implemented by Presidents Clinton and Obama, respectively).²⁴⁵

Congressional Democrats have steadfastly opposed legislative proposals to require financial regulatory agencies to conduct cost-benefit analysis, a position that mystifies Stanford University Professor 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

²³⁹ 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>.

²⁴⁰ 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>.

²⁴¹ COMMITTEE ON CAPITAL MARKETS REGULATION, A BALANCED APPROACH TO COST-BENEFIT ANALYSIS (2013), available at <http://capmksreg.org/app/uploads/2013/10/A-Balanced-Approach-to-Cost-Benefit-Analysis-Reform.pdf>.

²⁴² Greg Ip, "Cost Analysis Missing in Bank Rule Debate," *Wall Street Journal*, May 14, 2015, available at <http://www.wsj.com/articles/missing-in-financial-rules-debate-hard-numbers-1431545139>.

²⁴³ 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>.

²⁴⁴ 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.

²⁴⁵ See Regulatory Planning and Review, Exec. Order No. 12866. See also Improving Regulation and Regulatory Review, Exec. Order No. 13563.

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.²⁴⁶

The Financial CHOICE Act will increase regulatory transparency and accountability in the rulemaking process by putting in place cost-benefit 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 cost-benefit 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 restore 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 CFPB'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.²⁴⁷ The Fed serves purely as a rubber stamp, and neither Congress nor

²⁴⁶ *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>.*

²⁴⁷ Discussed in the section of this document titled: Reform the Consumer Financial Protection Bureau (above).

the President has any input into the CFPB's funding or oversight of whether that funding is spent effectively.²⁴⁸

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.²⁴⁹ 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.²⁵⁰ 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."²⁵¹ 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.²⁵²

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: Convert Each Financial Regulatory Agency Currently Headed by a Single Director into a Commission

Currently, the CFPB, the Federal Housing Finance Agency (FHFA), and the Office of the Comptroller of the Currency are each headed by a single individual with unchecked power over his respective agency.²⁵³ The Republican plan converts the leadership of these

²⁴⁸ 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 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").

²⁴⁹ See Dodd-Frank Act § 118; see also *id.* § 152; *id.* § 155.

²⁵⁰ See Ryan Rainey, *House Panel Leans on Treasury Employees for 'Lack of Transparency'*, MORNING CONSULT, Mar. 23, 2016.

²⁵¹ 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/>.

²⁵² 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>.

²⁵³ See 12 U.S.C. § 5491 (2012) (CFPB Director established as sole agency head); 12 U.S.C. § 1 (2012)

agencies to bipartisan commission structures, for several reasons. Bipartisan bodies hold themselves accountable by engaging in robust internal debate, which results in better-informed policies backed by more and better evidence. Their bipartisan nature also helps guard against biased or extreme views dictating regulatory outcomes, and places a premium on consensus-building. Moreover, by having staggered terms for commissioners, agencies avoid the sudden or extreme policy swings that may occur when single directors change control of the agencies.

Democrats initially supported structuring the CFPB as a bipartisan commission. Elizabeth Warren, the primary architect of the CFPB, originally proposed creating a financial services consumer protection agency known as the “Financial Product Safety Commission,” to be governed by a multi-member commission.²⁵⁴ In March 2009, Senator Dick Durbin and six co-sponsors introduced S. 566, the Financial Product Safety Commission Act of 2009.²⁵⁵ In June 2009, the Treasury Department released a white paper that envisioned the creation of an independent “Consumer Financial Protection Agency” to be governed by a five-member board.²⁵⁶ Twenty-one Democrats cosponsored H.R. 1705, the Financial Product Safety Commission Act of 2009, which proposed the creation of a consumer protection agency governed by a commission.²⁵⁷ Eighteen Democrats also cosponsored H.R. 3126, a bill introduced by then-Chairman Frank and entitled the Consumer Financial Protection Agency Act of 2009, which also would have created an agency governed by a five-member commission.²⁵⁸

Some congressional Democrats have come to recognize that a single-director governance model at the CFPB may lose much of its appeal if the day ever comes that one of their ideological soul-mates is no longer occupying the office. As Representative Brad Sherman observed at a 2015 Financial Services Committee hearing:

I think this question has come up a bit, but the issue is whether we should have a commission rather than a single commissioner over at the consumer protection agency. When you have just one commissioner it's of the President's party, and so I strongly believe in having one commissioner right until the end of 2016. But I don't know who the President is going to be in 2017, and neither do the gentlemen over there, so this might be a good time to be bipartisan effective 2017, which has a 50 percent chance of being adverse to one of [sic] the other of us.²⁵⁹

(Comptroller of the Currency established as sole agency head); 12 U.S.C. § 4512 (2012) (Director of the FHFA established as sole agency head).

²⁵⁴ See Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PENN. L. REV. 1, 98-100 (2008) (“We propose the creation of a single federal regulator—a new Financial Product Safety Commission or a new consumer credit division within an existing agency (most likely the FRB or FTC)—that will be put in charge of consumer credit products”).

²⁵⁵ S. 566, 111th Cong. (as introduced Mar. 10, 2009).

²⁵⁶ See Dep't of the Treasury, *Financial Regulatory Reform: A New Foundation*, 55-75 (June 2009).

²⁵⁷ H.R. 1705, 111th Cong. (as introduced in the House Mar. 25, 2009).

²⁵⁸ H.R. 3126, 111th Cong. (as introduced in the House Jul. 8, 2009).

²⁵⁹ *Examining Regulatory Burdens On Non-Depository Financial Institutions: Hearing Before the Subcomm. On Financial Institutions and Consumer Credit of the H. Comm. on Financial Services*, 114th Cong. 37-38 (2015),

The Financial CHOICE Act replaces the CFPB’s unaccountable single-director structure with a bipartisan commission, and makes corresponding changes at the other two federal financial regulatory agencies currently headed by individuals instead of commissions.

Step Five: 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*.²⁶⁰ 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.²⁶¹ In fact, the Supreme Court ruled in the 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.²⁶² 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.²⁶³

This is particularly problematic when agencies like the CFPB depart from decades of settled interpretation, as highlighted in *PHH Corporation v. CFPB*.²⁶⁴ 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.²⁶⁵

This 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. The courts and Congress must begin holding them accountable again.

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.

available at <http://financialservices.house.gov/uploadedfiles/114-13.pdf>.

²⁶⁰ 467 U.S. 837 (1984).

²⁶¹ *See id.*

²⁶² *See* 133 S. Ct. 1863 (2013).

²⁶³ Dodd-Frank Act § 1022(b)(4)(B).

²⁶⁴ *See e.g.*, Opening Brief for Petitioners, *PHH Corporation v. CFPB*, No. 15-1177(D.C. Cir.) (awaiting decision by the D.C. Circuit), available at <http://www.chamberlitigation.com/phh-corporation-v-cfpb>.

²⁶⁵ *See id.* at 1, 25-32.

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 rationale for 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 investment 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 to finance their funds. 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.²⁶⁶ 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.²⁶⁷ 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.²⁶⁸ Yet, the SEC has been able to examine approximately ten percent of all the investment advisers under its purview.²⁶⁹

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

²⁶⁶ 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 fund, which was adopted.

²⁶⁷ 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>.

²⁶⁸ SEC, FY2017 BUDGET JUSTIFICATION, at 76, available at <http://www.sec.gov/about/reports/secfy17congbudgjust.pdf>.

²⁶⁹ SEC, FY2015 ANNUAL PERFORMANCE REPORT, at 33, available at <https://www.sec.gov/about/reports/sec-fy2015-fy2017-annual-performance.pdf>.

of 1934²⁷⁰ and Section 206 of the Investment Advisers Act.²⁷¹ Additionally, the SEC can bring actions against advisers of the exempted funds for breaches of their fiduciary duties.²⁷² The SEC also would still have access to records it requires.

Recent data indicate that private equity-backed companies employ over 7.5 million people nationwide in over 17,700 U.S. companies and have invested over \$3.6 trillion in companies over ten years.²⁷³ 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.

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 it 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.

Accordingly, the plan 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

²⁷⁰ 15 U.S.C. § 78j–2.

²⁷¹ 15 U.S.C. § 80b–6.

²⁷² 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>.

²⁷³ PRIVATE EQUITY GROWTH CAPITAL COUNCIL, 2013 ANNUAL REPORT, available at <http://www.investmentcouncil.org/the-council/annual-reports/2013-annual-report/>.

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. 2187, the Fair Investment Opportunities for Professional Experts Act, introduced by Rep. David Schweikert, and is consistent with recommendations of the SEC's Investor Advisor Committee and Committee on Small and Emerging Companies.²⁷⁴ H.R. 2187 passed the House on a 347-8 vote on February 1, 2016.

²⁷⁴ 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>.

Repeat 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 that 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.²⁷⁵

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.

²⁷⁵ *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.²⁷⁶

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,²⁷⁷ 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.²⁷⁸ 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.”²⁷⁹ Raj Date, the former

²⁷⁶ 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>.

²⁷⁷ *Volcker: Proprietary Trading not central to crisis*, REUTERS, Mar. 30, 2010, available at <http://www.reuters.com/article/us-financial-regulation-volcker-idUSTRE62T56420100330>.

²⁷⁸ *Hearing Before the S. Comm. on Banking* (Feb. 2, 2010).

²⁷⁹ *Hearing Before the Cong. Oversight Panel*, 111th Cong. (Sept. 10, 2009), available at <https://www.gpo.gov/fdsys/pkg/CHRG-111shrg53177/html/CHRG-111shrg53177.htm>.

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.²⁸⁰

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.”²⁸¹ 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.”²⁸²

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% 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.²⁸³ Peter Wallison of the American Enterprise Institute has written that the Volcker Rule is “a throwback to a world that is gone,”²⁸⁴ 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.²⁸⁵

But even though the Obama Administration and Congressional Democrats lacked a coherent or principled reason 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-

²⁸⁰ 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.

²⁸¹ Charles W. Calomiris, Robert A. Eisenbeis, & Robert E. Litan, *Financial Crisis in the U.S. and Beyond*, at 48.

²⁸² 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>.

²⁸³ 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>.

²⁸⁴ 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/>.

²⁸⁵ 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.

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 2008,²⁸⁶ 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 2014.²⁸⁷ 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."²⁸⁸

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."²⁸⁹ In addition to higher costs for 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

²⁸⁶ 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.

²⁸⁷ 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.

²⁸⁸ *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>.

²⁸⁹ *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>.

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 Lew and other Obama Administration officials have consistently rejected the notion that the Volcker Rule and other post-crisis regulatory policies are contributing to illiquidity in the fixed-income markets.²⁹⁰ 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. For example, Richard G. Ketchum, CEO and Chairman of the Financial Industry Regulatory Authority, which oversees broker-dealers, has 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:

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.²⁹¹

There is considerable evidence supporting 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.²⁹² 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."²⁹³

²⁹⁰ 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>.

²⁹¹ *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>.

²⁹² *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>.

²⁹³ *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>.

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.²⁹⁴

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."²⁹⁵

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.

²⁹⁴ *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>.

²⁹⁵ *Why Liquidity-Starved Markets Fear the Worst*, WALL STREET JOURNAL.

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.²⁹⁶ 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.²⁹⁷ Interchange fees are typically a flat fee plus a percentage of the total purchase price.²⁹⁸

To accept certain cards, a retailer must transact with a bank that has access to card networks.²⁹⁹ 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.

²⁹⁶ 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>.

²⁹⁷ See *id.* at 25.

²⁹⁸ See *id.* at 12.

²⁹⁹ 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.³⁰⁰ Senator Durbin’s amendment passed by a vote of 64-33 and ultimately became Section 1075 of the Dodd-Frank Act.³⁰¹ 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.”³⁰² 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—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

³⁰⁰ See 156 CONG. REC. S3651-52 (2010) (introducing amendment SA 3989 to S. 3217).

³⁰¹ See *id.*; Roll Call Vote No. 149, 156 CONG. REC. S3705 (2010).

³⁰² Dodd-Frank Act § 1075(a)(2).

networks have incurred to set up networks capable of processing millions of transactions at low cost per transaction.³⁰³

On June 29, 2011, the Federal Reserve issued its final rule implementing the Durbin Amendment,³⁰⁴ capping interchange fees at 21 cents, plus 5 basis points of the transaction value to adjust for fraud losses.³⁰⁵ The Federal Reserve's rule also permits certain issuers to collect an additional one cent per transaction "fraud prevention adjustment."³⁰⁶ These limits apply only to interchange fees on debit cards issued by banks that have more than \$10 billion in assets.³⁰⁷

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.³⁰⁸ 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]."³⁰⁹ 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."³¹⁰ The article also cited the imposition of higher minimum balance requirements and new account maintenance fees at several large U.S. banks.³¹¹

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 billion in assets.³¹² But as basic economic theory would predict, implementing price caps

³⁰³ See *id.*, § 1075 (a)(4), (5).

³⁰⁴ Debit Card Interchange Fees and Routing, 76 Fed. Reg. 43,394, 49,467 (Jun. 29, 2011) (codified at 12 C.F.R. pt. 235).

³⁰⁵ Debit Card Interchange Fees and Routing, 12 C.F.R. § 235.3(b) (2016).

³⁰⁶ *Id.* § 235.4(a).

³⁰⁷ *Id.* § 235.5(a).

³⁰⁸ 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.

³⁰⁹ Annamarie Andriotis & Saabira Chaudhuri, *Free Checking Is Disappearing Perk*, WALL STREET JOURNAL, Feb. 6, 2014, available at <http://www.wsj.com/articles/SB10001424052702304450904579365251142904312>.

³¹⁰ *Id.*

³¹¹ *Id.*

³¹² See Dodd-Frank Act § 1075(a)(6).

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.³¹³ In a 2014 survey of small banks (with less than \$10 billion in assets), approximately half reported being impacted by the Durbin Amendment.³¹⁴ 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."³¹⁵ 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.³¹⁶ This report also showed that banks affected by the Durbin Amendment raised deposit fees 3 to 5 percent.³¹⁷

Before Dodd-Frank became law, just over 75 percent of banks offered free checking.³¹⁸ By 2015, just 37 percent of banks offered free checking.³¹⁹ 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.³²⁰ 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."³²¹

³¹³ 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.

³¹⁴ 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.

³¹⁵ 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.

³¹⁶ *Id.* at 5.

³¹⁷ *Id.* at 17.

³¹⁸ 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>.

³¹⁹ Claes Bell, *Another record-setting year for checking account fees 2*, BANKRATE, Oct. 5, 2015, <http://www.bankrate.com/finance/checking/record-setting-year-for-checking-account-fees-2.aspx> (last visited Jun. 13, 2016).

³²⁰ Lux and Greene, *Out of Reach: Regressive Trends in Credit Card Access* <https://www.hks.harvard.edu/centers/mrcbg/publications/awp/awp54>.

³²¹ *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."³²² 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.³²³ 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."³²⁴

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.

³²² 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://www.law.uchicago.edu/files/file/658-dse-hj-sj-impact-fixed.pdf>.

³²³ *Id.* at 1.

³²⁴ *Id.*

Eliminate the Office of Financial Research

Executive Summary:

- **By driving regulators towards a homogenized view 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.³²⁵ 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.³²⁶ Dodd-Frank gives the Director “sole discretion” for determining how to carry out his Dodd-Frank authorities.³²⁷ 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.³²⁸

Congress’s oversight over the OFR is limited by its inability to exercise the “power of the purse.” 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.³²⁹ For Fiscal Year 2016, the Obama Administration has estimated that the OFR will collect approximately \$103.6 million from these assessments.³³⁰

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

³²⁵ See Dodd-Frank Act §§ 151-156.

³²⁶ See *id.* § 152(b)(1).

³²⁷ *Id.* § 152(b)(5).

³²⁸ *Id.* § 154(b)(1).

³²⁹ *Id.* § 154(b)(1).

³³⁰ OFR, FY 2016: PRESIDENT’S BUDGET 3 (2015), available at <https://www.treasury.gov/about/budget-performance/CJ16/20.%20OFR%20-%20FY%202016%20CJ.pdf>.

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.³³¹ 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.³³²

The OFR’s analysis of the asset management industry was roundly dismissed by a broad range of commentators as superficial and analytically unsound. The Securities and Exchange Commission (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.³³³ 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.”³³⁴ 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.”³³⁵

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.”³³⁶

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.”³³⁷ 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

³³¹ OFR, ASSET MANAGEMENT AND FINANCIAL STABILITY (2013), available at https://financialresearch.gov/reports/files/ofr_asset_management_and_financial_stability.pdf.

³³² *Id.* at 21-23 (2013).

³³³ 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>

³³⁴ 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-idUSL2NOKY19A20140124>.

³³⁵ *Barney Frank vs. Dodd-Frank*, WALL STREET JOURNAL: REVIEW & OUTLOOK, Dec. 8, 2013, <http://online.wsj.com/news/articles/SB10001424052702304465604579220052504852822>.

³³⁶ Comment Letter from Dennis Kelleher et al., to Elizabeth Murphy, Secretary, Securities Exchange Commission (Nov. 1, 2013), <http://www.sec.gov/comments/am-1/am1-24.pdf>.

³³⁷ 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>.

Committee that the OFR's asset management report "was not something I would hang my hat on."³³⁸

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,³³⁹ features a Division of Financial Stability,³⁴⁰ where the primary mission is to "develop and coordinate staff efforts to identify and analyze potential risks to the financial system and the broader economy, including through the monitoring of asset prices, leverage, financial flows, and other market risk indicators."³⁴¹ 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."³⁴² 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 special research division of the Federal Reserve are at times analyzing the same topic without appropriate coordination."³⁴³

³³⁸ *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. 22 (2014) Financial, available at <http://financialservices.house.gov/uploadedfiles/113-79.pdf>.

³³⁹ See *The Economists*, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, <https://www.federalreserve.gov/econresdata/theeconomists.htm> (last visited Jun. 13, 2016); *Macroeconomics*, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, <https://www.federalreserve.gov/econresdata/macroeconomics-c.htm> (last visited Apr. 25, 2016).

³⁴⁰ 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>.

³⁴¹ *Id.*

³⁴² *Financial and Macroeconomic Stability Studies*, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, <https://www.federalreserve.gov/econresdata/fspr-fms-staff.htm> (last visited Jun. 13, 2016).

³⁴³ 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).

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,”³⁴⁴ and includes a Deputy Assistant Secretary for Macroeconomic Analysis with a dedicated staff of economists.³⁴⁵ And the FDIC maintains a Center for Financial Research, which includes a risk measurement research program.³⁴⁶ As this small sample indicates, eliminating 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.³⁴⁷

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.”³⁴⁸

<https://www.frbatlanta.org/-/media/Documents/news/conferences/2014/cenfis-nonbank-financial-firms/Wall-Stricter-Micro-vs-Macroprudential-Supervision.pdf>.

³⁴⁴ *Economic Policy*, DEPARTMENT OF THE TREASURY, <https://www.treasury.gov/about/organizational-structure/offices/Pages/Economic-Policy.aspx> (last visited Jun. 13, 2016).

³⁴⁵ *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> (last visited Jun. 13, 2016).

³⁴⁶ *Research Programs*, Center for Financial Research, FDIC, <https://www.fdic.gov/bank/analytical/cfr/research.html> (last visited Jun. 13, 2016).

³⁴⁷ *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).

³⁴⁸ *Id.* at 83.

SEC Enforcement Issues

Executive Summary:

- 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 Securities and Exchange Commission (SEC) was created in 1934, its Division of Enforcement (Enforcement Division) was not established until 1972.³⁴⁹ 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 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

³⁴⁹ 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>.

brought a record 807 enforcement actions in FY 2015 and obtained \$4.2 billion in disgorgement and civil penalties resulting from those actions.³⁵⁰

Penalty Authority

The SEC's enforcement program has historically 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 provided criminal penalties enforced by the Department of Justice as well as SEC powers to seek civil monetary penalties, bar directors and officers for violations of antifraud provisions, and the authority to issue administrative cease-and-desist orders, temporary restraining orders, and orders for disgorgement.³⁵¹ 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.³⁵² 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.³⁵³ As such, the SEC has continually increased the maximum statutory amounts consistent with inflation.³⁵⁴

However, the SEC has expressed concerns that the current statutory authorities limit their ability to pursue penalties and influence the structure of settlement agreements.³⁵⁵ 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 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.

³⁵⁰ Press Release, SEC, SEC Announces Enforcement Results for FY 2015 (Oct. 22, 2015), available at <https://www.sec.gov/news/pressrelease/2015-245.html>.

³⁵¹ 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>.

³⁵² *Id.* at 392.

³⁵³ See 28 U.S.C. § 2461.

³⁵⁴ See 17 C.F.R. §§ 201.1001- 201.1005.

³⁵⁵ 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>.

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 will also significantly increase 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 Dodd-Frank, 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 authority 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 six 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 has 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 provide several “home court” advantages to 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.³⁵⁶

The SEC's “home court” advantage in administrative proceedings is 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, compared to only 11 of its 18 cases brought in federal court.³⁵⁷ The Enforcement Division's broad

³⁵⁶ 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>.

³⁵⁷ See Peter K.M. Chan, Kate M. Emminger, Christian J. Mixer, & 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>. See 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

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.³⁵⁸

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 has also 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.

Critics have also pointed out 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, SEC Commissioner Michael 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."³⁵⁹ 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.³⁶⁰ 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

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.").

³⁵⁸ 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).

³⁵⁹ Michael S. Piwowar, SEC Commissioner, Remarks at the "SEC Speaks" Conference 2015: A Fair, Orderly, and Efficient SEC (Feb. 20, 2015), available at <https://www.sec.gov/news/speech/022015-spchcmosp.html>.

³⁶⁰ 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>.

remedial and punitive enforcement authorities, which was not Congress’s original intent in establishing the enhanced enforcement authorities.³⁶¹ These disqualifications were never meant to be enforcement enhancements and even Chair 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.”³⁶² 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.

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 will require the SEC, when issuing a civil penalty against an issuer, to include findings, supported by the SEC Chief Economist, that the

³⁶¹ *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 sanctions.”).

³⁶² 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>.

alleged violations resulted in direct economic benefit to the issuer and that the penalties do not harm the issuer's shareholders.

The Financial CHOICE Act addresses constitutional concerns with the SEC's enforcement program by giving defendants in SEC administrative proceedings the right to remove the enforcement action to federal court. It also requires the SEC to allow defendants 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. 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.

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 2002.³⁶³ The Sarbanes-Oxley Act established the Public Company Accounting Oversight Board (PCAOB),³⁶⁴ 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.³⁶⁵ To ensure that the PCAOB follows its congressionally mandated mission, Congress must have full and

³⁶³ See generally Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (*hereinafter* Sarbanes-Oxley Act).

³⁶⁴ Sarbanes-Oxley Act § 101-109.

³⁶⁵ See Sarbanes-Oxley Act Section 105(b)(5)(B).

complete access to PCAOB documents. The Financial CHOICE Act will ensure that the PCAOB cannot deny Congress access to information.

The Sarbanes-Oxley Act also allows parties to PCAOB disciplinary proceedings to insist that they be held in private, even if the PCAOB shows good cause for making the proceedings public.³⁶⁶ This is in sharp contrast to similar SEC administrative proceedings against auditors. If the SEC were to bring the same case as the PCAOB, alleging the same violations, against the same auditor, the SEC's charges would be disclosed at the time the Commission instituted its proceeding.³⁶⁷ Any administrative trial would be open to the public. If there were an appeal to the Commission and an oral argument, the public could attend. The ability – or inability - of the Commission's staff to prove its charges would be a matter of public record. By conforming the PCAOB's proceedings to the SEC's and making them public unless the Board orders otherwise, the Financial CHOICE Act will apply the “best disinfectant” – sunlight.

³⁶⁶ See *id.* at Section 105(c)(2).

³⁶⁷ See SEC, OFFICE OF ADMINISTRATIVE LAW JUDGES, available at <https://www.sec.gov/alj>.

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 a fiduciary duty 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,³⁶⁸ which empowered the SEC to promulgate an array of new federal regulations that had little or nothing to do 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 and 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 Public Company Accounting Oversight Board, 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

³⁶⁸ Dodd-Frank Act § 901-991.

provisions only compound bureaucratic complexity and inefficiencies at the SEC. For 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),³⁶⁹ which issued a report on its findings in March 2011.³⁷⁰ 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.³⁷¹ 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.³⁷² BCG also recommended that the SEC seek flexibility from Congress regarding certain mandated Dodd-Frank offices so as to avoid unnecessary duplication.³⁷³ 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.³⁷⁴

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.

³⁶⁹ 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>.

³⁷⁰ 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>.

³⁷¹ *Id.* at 5-8.

³⁷² *Id.* at 79.

³⁷³ *Id.* at 98.

³⁷⁴ *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.³⁷⁵ 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.³⁷⁶

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 1974,³⁷⁷ 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 to protect investors with smaller account balances, including workers saving for retirement – something that SEC Chair White has stated is her intention.³⁷⁸ But it should be done only

³⁷⁵ SEC, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS, (2011), *available at* <https://www.sec.gov/news/studies/2011/913studyfinal.pdf>.

³⁷⁶ 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>.

³⁷⁷ Interpretive Bulletins Relating to the Employee Retirement Income Security Act of 1974, 29 C.F.R. § 2509, 2510, 2550 (2015).

³⁷⁸ *See e.g.* Chair Mary Jo White, Chairman's Address at SEC Speaks: Beyond Disclosure at the SEC in 2016, (Feb. 19, 2016), *available at*

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 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.³⁷⁹

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 multi-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.

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

<https://www.sec.gov/news/speech/white-speech-beyond-disclosure-at-the-sec-in-2016-021916.html>.

³⁷⁹ These provisions are drawn from legislation authored by Rep. Ann Wagner (H.R. 1090), which passed the House on October 27, 2015.

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.³⁸⁰ 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.³⁸¹ 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 has 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 2008.³⁸² As economist Lawrence J. White notes:

³⁸⁰ *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).

³⁸¹ 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>.

³⁸² 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), available at http://scholarship.law.umn.edu/cgi/viewcontent.cgi?article=1083&context=faculty_articles.

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.³⁸³

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.³⁸⁴ 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.³⁸⁵

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.³⁸⁶ This proposal was ultimately incorporated in large measure in the Dodd-Frank Act as Sections 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.³⁸⁷

³⁸³ 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.

³⁸⁴ 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”).

³⁸⁵ Mark Calabria, *Best Rx For Rating Agencies: Competition, Not Regulation*, INVESTORS BUSINESS DAILY, January 8, 2016.

³⁸⁶ See Title VI of the Consumer Protection and Regulatory Enhancement Act, H.R. 3310, 111th Congress, (as introduced Jul. 23, 2009).

³⁸⁷ Dodd-Frank Act §§ 939, 939A.

In place of these references, each agency was instructed to establish standards of credit-worthiness that are appropriate for the purposes of the regulations.³⁸⁸ 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.”³⁸⁹

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.³⁹⁰ 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.³⁹¹ 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, nearly 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.³⁹² In addition to repealing Section 939F, the Financial CHOICE Act attempts to eliminate barriers to entry and foster greater competition by making other

³⁸⁸ *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>.

³⁸⁹ 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>.

³⁹⁰ Dodd-Frank Act § 939F.

³⁹¹ *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.”).

³⁹² *See* Securities and Exchange Commission Annual Report on Nationally Recognized Statistical Rating Organizations 12 (2015), available at <https://www.sec.gov/ocr/reportspubs/annual-reports/2015-annual-report-on-nrsros.pdf>.

reforms, including providing the SEC with clear exemptive authority to facilitate a more competitive and efficient marketplace for credit ratings.

Relief for Smaller Issuers

Another Republican proposal that was ultimately incorporated in Dodd-Frank 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.³⁹³ The Financial CHOICE Act increases the exemption to issuers with a market capitalization of up to \$250 million and extends the exemption to depository institutions with less than \$1 billion in assets.

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 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.³⁹⁴

³⁹³ 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>.

³⁹⁴ 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>.

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.

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 2015.³⁹⁵ 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 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.”³⁹⁶ Commissioner Gallagher has

³⁹⁵ See 17 C.F.R. § 229 (2016); 17 C.F.R. § 249 (2016).

³⁹⁶ 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>.

also described the pay ratio rule as “social policy masquerading as disclosure requirements,” which has the effect of encouraging companies to remain private.³⁹⁷

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.”³⁹⁸

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.³⁹⁹

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.

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

³⁹⁷ 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>.

³⁹⁸ *The Warren Commission*, WALL STREET JOURNAL: REVIEW AND OUTLOOK, Aug. 5, 2015, available at <http://www.wsj.com/articles/the-warren-commission-1438814488>.

³⁹⁹ 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>.

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.⁴⁰⁰

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.⁴⁰¹ According to the National Association of Manufacturers, "the cost of compliance with [the pay ratio] rule 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."⁴⁰² 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.⁴⁰³

⁴⁰⁰ 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.

⁴⁰¹ 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>.

⁴⁰² 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.").

⁴⁰³ 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.").

Capital Formation

Executive Summary:

- **Small companies are at the forefront of technological innovation and job creation, they 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."⁴⁰⁴ 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.

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.⁴⁰⁵ For example, rather than devote time

⁴⁰⁴ 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>.

⁴⁰⁵ See e.g. Andrew Ackerman, *CEO-Pay Rule Is 7,196 Hours in the Making*, WALL STREET JOURNAL: MONEYBEAT,

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.⁴⁰⁶

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. SEC Commissioner Michael Piowar 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.”⁴⁰⁷

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.⁴⁰⁸

The SEC has also 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-

Dec. 17, 2014, available at <http://blogs.wsj.com/moneybeat/2014/12/17/ceo-pay-rule-is-7196-hours-in-the-making/>.

⁴⁰⁶ Jumpstart Our Business Startups Act, Pub. L. 112-106, 126 Stat 306 (2012).

⁴⁰⁷ SEC Commissioner Michael S. Piowar, Statement at Open Meeting Regarding Crowdfunding (Oct. 23, 2013), available at <https://www.sec.gov/News/PublicStmnt/Detail/PublicStmnt/1370542558708>.

⁴⁰⁸ 17 CFR § 200, 227, 232, 239, 240, 249, 269, 274 (2016).

business forum to review the current status of problems and programs relating to small business capital formation.⁴⁰⁹ 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:

- In 2014, 291 initial public offerings (IPOs) became effective in the United States. That represents a 29 percent increase over 2013 and a 134 percent increase over 2011, the year prior to the JOBS Act’s enactment. 2014 was one of the strongest years for IPOs in terms of total IPOs and capital raised since 2000.⁴¹⁰
- Approximately 85 percent of the IPOs that have gone effective since April 2012 were filed by EGCs.⁴¹¹
- 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 87 percent of EGCs confidentially submitting at least one draft registration statement before public filing. EGCs have also taken advantage of reduced disclosure requirements for executive compensation under the JOBS Act.⁴¹²

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, 58 percent of respondents believe the current business financing environment is restricting growth opportunities while 50 percent of respondents believe it is restricting their ability to

⁴⁰⁹ See Government-Business Forum on Small Business Capital Formation, *available at* <https://www.sec.gov/info/smallbus/sbforum.shtml>.

⁴¹⁰ See ERNST & YOUNG, THE JOBS ACT: 2015 MID-YEAR UPDATE (2015), *available at* [http://www.ey.com/Publication/vwLUAssets/JOBSAct_2015MidYear_CC0419_16September2015/\\$FILE/JOBSAct_2015MidYear_CC0419_16September2015.pdf](http://www.ey.com/Publication/vwLUAssets/JOBSAct_2015MidYear_CC0419_16September2015/$FILE/JOBSAct_2015MidYear_CC0419_16September2015.pdf).

⁴¹¹ *See id.*

⁴¹² *See id.*

hire.⁴¹³ 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.

What the drafters of the Dodd-Frank Act failed to understand is 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
- 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.⁴¹⁴ 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.⁴¹⁵ 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 establish an independent SEC Small Business Capital Formation Advocate to ensure the SEC no longer neglects its statutory mission.⁴¹⁶

⁴¹³ CRAIG R. EVERETT, PEPPERDINE UNIVERSITY PRIVATE CAPITAL ACCESS INDEX SURVEY RESPONSES FIRST QUARTER 2016 (2016), *available at* http://digitalcommons.pepperdine.edu/cgi/viewcontent.cgi?article=1004&context=gsgm_pcm_pca.

⁴¹⁴ This language is based on legislation authored by Rep. Mick Mulvaney (H.R. 3868), which has been approved by the Financial Services Committee.

⁴¹⁵ This language is based on legislation authored by Rep. Scott Garrett (H.R. 4638), which has been approved by the Financial Services Committee.

⁴¹⁶ This language is based on legislation authored by Rep. Bruce Poliquin (H.R. 4168), which passed the House on February 1, 2016.

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.
- 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.

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."⁴¹⁷

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

⁴¹⁷ Conflict Minerals, 77 F.R. 56274, 56334 (Sept. 12, 2012) (amending 170 C.F.R. §§ 240, 249b).

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.⁴¹⁸ 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.⁴¹⁹

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?"⁴²⁰

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.⁴²¹

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

⁴¹⁸ *National Association of Manufacturers v. SEC*, 800 F.3d 518, 526 (D.C. Cir. 2015).

⁴¹⁹ 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>.

⁴²⁰ 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>.

⁴²¹ 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.

a number of unintended and damaging consequences.”⁴²² 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.”⁴²³

Nor are the Congolese suffering alone. In testimony to the Financial Services Committee in November 2015, Rwanda’s Minister of State for Mining, Evode Imena, argued, “Putting [10 countries] in one group and applying a ‘one size fits all’ regulation is not only an impediment to efficient implementation of the regulations, but further, such an approach fails to recognize efforts made and challenges faced by individual countries.” Minister Imena regretted that, despite Rwanda’s actions to strengthen due diligence in its mining sector, and despite the fact that Rwanda had no armed groups in the first place, “the region is now suffering from an ‘Africa-free’ and not a ‘conflict-free’ minerals situation. Section 1502 has caused a de facto boycott by companies in the U.S. and much of Europe on our most valuable resources,” a disaster that “has largely impacted the livelihood of thousands of miners and their families.”⁴²⁴

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.⁴²⁵

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.”⁴²⁶

⁴²² 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>.

⁴²³ 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>.

⁴²⁴ Testimony of Evode Imena, Rwandan Minister of State for Mining, submitted for the House Committee on Financial Services hearing, “Dodd-Frank Five Years Later: What Have We Learned from Conflict Minerals Reporting,” November 17, 2015. *Available at*: <http://financialservices.house.gov/uploadedfiles/hhrg-114-ba19-wstate-eimena-20151117.pdf>.

⁴²⁵ 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>.

⁴²⁶ 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>.

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.⁴²⁷

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. The SEC’s initial rule was vacated 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 (another being Section 1502) “that appear[s] designed primarily to advance U.S. foreign policy objectives,” not investor protection or capital formation.⁴²⁸ 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 \$105 million to \$601 million annually.

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 (MSHA),⁴²⁹ and adding this duplicative disclosure regime is estimated to increase compliance costs by well over \$1 million annually, according to the SEC itself.⁴³⁰

The SEC has admitted that Sections 1502, 1503, and 1504 present new challenges it is ill-equipped to handle. In the words of 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.”⁴³¹

⁴²⁷ 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/>.

⁴²⁸ Extraction Issuers Proposed Rule, 80 Federal Register (December 23, 2015) pp. 80057 – 80111. <https://www.sec.gov/rules/proposed/2015/34-76620.pdf>.

⁴²⁹ 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>.

⁴³⁰ Mine Safety Disclosure, 76 Fed. Reg. 81,762 (Dec. 28, 2011).

⁴³¹ 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

Chair White's words are echoed in the revised rule the SEC has now 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."⁴³² 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."⁴³³

The Financial CHOICE Act repeals these harmful and counterproductive provisions of the Dodd-Frank Act.

<http://www.sec.gov/News/Speech/Detail/Speech/1370539864016>.

⁴³² Disclosure of Payments by Resource Extraction Issuers, 80 Fed. Reg. 80,057, 80,063 (proposed Dec. 23, 2015).

⁴³³ 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>.

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.⁴³⁴ 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.⁴³⁵ The Dodd-Frank Act also charged the FIO Director with producing several one-time and annual reports on matters relating to the insurance industry.⁴³⁶

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.⁴³⁷ 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.⁴³⁸ The Independent Member is the sole source of expertise among the FSOC's ten voting members.⁴³⁹

⁴³⁴ See Dodd-Frank Act § 502.

⁴³⁵ See *id.* § 502(a).

⁴³⁶ See *id.* § 502(a).

⁴³⁷ See *id.* § 111(b)(1).

⁴³⁸ See *id.*

⁴³⁹ 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.⁴⁴⁰ 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 our 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. The IIA will be required to discuss in testimony 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.

⁴⁴⁰ 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>.