



Prosperity Unleashed: Smarter Financial Regulation

Edited by
Norbert J. Michel, PhD

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Washington, DC 20002
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Printed in the United States of America.

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INTRODUCTION

P*rosperity Unleashed: Smarter Financial Regulation* provides solutions to the core regulatory problems that have existed in U.S. financial markets for decades. Policymakers can implement these solutions to make U.S. financial markets more dynamic, resilient, equitable, and accountable than ever before. Policymakers *should* implement these solutions because a well-functioning financial sector results in a society with more goods and services, more employment opportunities, and higher incomes. A smoothly running financial system makes it easier and less costly to raise the capital necessary for launching or operating a business, to borrow money for buying or building a home, and to invest in ideas that improve productivity and increase wealth.

Financial enterprises are the arteries through which money from one sector of the economy flows into others, creating jobs and wealth in the process. Just as with nonfinancial businesses, excessive government regulation disrupts that smooth functioning, preventing financial firms from serving the needs of their customers and society. Despite these disruptions, policymakers have long treated financial companies differently than nonfinancial businesses. In particular, government policies have—for decades—empowered regulators to manage private risks and mitigate private losses in an effort to prevent financial-sector turmoil from spreading to the rest of the economy. This approach, rarely contemplated in nonfinancial industries, has demonstrably failed.

The 2008 financial crisis is an obvious example of a poorly functioning financial sector. Financial firms funded too much unsustainable activity largely because of the rules and regulations they faced, including the widespread expectation that the federal government would provide assistance to mitigate losses. Yet, the dominant narrative that supported passage of Dodd–Frank in 2010 was that deregulation in financial markets, beginning in the 1990s, caused the crash. Ostensibly, the unbridled pursuit of profits by “Wall Street” drove the global financial system to the brink of collapse. But this story is wrong. There was no substantial reduction in the scale or scope of financial regulations in the U.S. Rather, the sheer number of financial

regulations steadily *increased* after 1999, long before Dodd–Frank was even contemplated.

Financial firms—not just banks—have long dealt with capital rules, liquidity rules, disclosure rules, leverage rules, special exemptions for rules, and the constant threat that regulators would make up new rules or enforce old rules differently. There is no doubt that, for decades, the U.S. regulatory framework has increasingly made it more difficult to create and maintain jobs and businesses that benefit Americans. One of the main reasons the regulatory regime has been counterproductive for so long is because it seeks to micromanage people’s financial risk, a process that substitutes regulators’ judgments for those of private investors. This approach provides a false sense of security because the government confers an aura of safety on all firms that play by the rules, and it is bound to fail for at least three reasons: (1) people take on more risk than they would in the absence of such rules; (2) people have lower incentives to monitor financial risks than they would otherwise; and (3) compared to other actors in the market, regulators do not have superior knowledge of future risks.

In addition to these shortcomings, the U.S. regulatory framework, for at least a century, has repeatedly protected incumbent firms from new competition—the very market forces that drive innovation, lower prices, and prevent excessive risk-taking. The result is that entrepreneurs have suffered from fewer

opportunities, and consumers have suffered from fewer choices, higher prices, and less knowledge regarding financial risks. When the system crashes, as it has done on several occasions, people naturally tend to blame the excesses in the private sector while giving the government more power to stabilize the economy. In the end, this process is a perverse self-reinforcing cycle that fails to make the economy any safer as it chips away at economic freedom and the prosperity it fosters.

Prosperity Unleashed shows how to reverse these trends, so that financial markets will expand economic opportunities and help people achieve financial security. Many authors of this volume recently contributed to *The Case Against Dodd–Frank: How the “Consumer Protection” Law Endangers Americans*. That book exposed the many flaws in the Dodd–Frank Wall Street Reform and Consumer Protection Act, but it also revealed the gross inadequacy of the financial regulatory framework that existed prior to Dodd–Frank. It is clear that even if Congress repealed Dodd–Frank in its entirety, a highly flawed regulatory structure that weakened financial markets and contributed mightily to the 2008 financial crisis would still remain. Solving America’s core regulatory problems in order to expand economic opportunities and help people achieve financial security is the goal of *Prosperity Unleashed*.

While each chapter expresses the views of its authors, each is based, as appropriate, on the following 10 core principles—also included in *The Case Against Dodd–Frank*—about the financial system and how best to regulate it.

TEN CORE PRINCIPLES

1. Private and competitive financial markets are essential for healthy economic growth.
2. The government should not interfere with the financial choices of market participants, including consumers, investors, and uninsured financial firms. Regulators should focus on protecting individuals and firms from fraud and violations of contractual rights.
3. Market discipline is a better regulator of financial risk than government regulation.
4. Financial firms should be permitted to fail, just as other firms do. Government should not “save” participants from failure because doing so impedes the ability of markets to direct resources to their highest and best use.
5. Speculation and risk-taking are what make markets operate. Interference by regulators attempting to mitigate risks hinders the effective operation of markets.
6. Government should not make credit and capital allocation decisions.
7. The cost of financial firm failures should be borne by managers, equity-holders, and creditors, not by taxpayers.
8. Simple rules—such as straightforward equity capital requirements—are preferable to complex rules that permit regulators to micromanage markets.
9. Public-private partnerships create financial instability because they create rent-seeking opportunities and misalign incentives.
10. Government backing for financial activities, such as classifying certain firms or activities as “systemically important,” inevitably leads to government bailouts.

Summaries of Arguments

The chapters in *Prosperity Unleashed* include an expansive list of reforms in both the banking and securities markets, including structural changes to government regulators, improvements to self-regulatory organizations, and better ways for the government to deter fraud. *Prosperity Unleashed* even includes detailed policy reforms to end government preferences, such as federal loan guarantees, bankruptcy protections for derivatives, and emergency lending by the Federal Reserve. This introductory section includes a brief list of the arguments in each section of the book.

Part I. Banking Regulation Reforms

In chapter 1, “Deposit Insurance, Bank Resolution, and Market Discipline,” Mark Calabria explains how government-backed deposit insurance weakens market discipline, increases moral hazard, and leads to higher financial risk than the economy would have otherwise, thus weakening the banking system as a whole.

- Deposit insurance does not primarily benefit low-income and middle-income families. The top 10 percent of households hold 67 percent of all deposits, and the current Federal Deposit Insurance Corporation (FDIC) deposit insurance limit is \$250,000 even though the average account balance is less than \$5,000.
- The public interest would be best served if Congress reduced federal deposit insurance coverage to the pre-savings-and-loan-crisis limit of \$40,000, and provided coverage on a *per individual* basis.
- To further the goal of reducing systemic risk, Congress should also limit the total deposit insurance coverage of any one bank to 5 percent of total insured deposits.
- Bank receivership, as practiced by the FDIC, is inappropriate for non-banks, and weakens market discipline by occasionally protecting uninsured creditors.
- Ultimately, government-provided deposit insurance should be phased out fully. In the interim, coverage should be reduced to more closely align with protecting small retail investors.

In chapter 2, “A Simple Proposal to Recapitalize the U.S. Banking System,” Kevin Dowd follows with a brief look at the failure of the Basel rules and a discussion of how banks’ historical capital ratios—a key measure of bank safety—have fallen as regulations have increased. Dowd proposes a regulatory off-ramp, whereby banks could opt out of the current regulatory framework in return for meeting a minimum leverage ratio of at least 20 percent.

- Instead of proposing more regulation or idealistic reforms, it could be more useful to propose a regulatory off-ramp: Banks would be allowed to opt out of prudential regulation, provided they maintain high capital standards.
- Banks with good prospects could raise capital on the stock market and thereby escape the regulatory system. They could greatly cut costs and improve their competitiveness.
- Zombie banks would be unable to meet these higher capital standards and would self-advertise their true status.
- Over time, the good banks could gradually displace the bad ones, and the whole prudential regulatory apparatus would wither on the vine.

Diane Katz’s chapter, “A Better Path for Mortgage Regulation,” provides a brief history of federal mortgage regulation. Katz shows that, prior to Dodd–Frank, the preferred federal policy was to protect mortgage borrowers through mandatory disclosure as opposed to directly regulating the content of mortgage agreements. Katz argues that the vibrancy of the mortgage market has suffered because the basic disclosure approach has succumbed to regulation via content restrictions.

- Deference to consumer autonomy is now largely defunct. Instead we have a framework of mortgage regulation that treats consumers as fundamentally irrational and prone to act against their self-interest.
- This approach is inherently contradictory. If consumers suffer cognitive limitations with respect to mortgage matters, the politicians and bureaucrats who dictate the borrowing terms for consumers must also be afflicted by the same limitations.
- Much of the reckless lending that played a role in the 2008 crisis resulted from lenders and borrowers responding—rationally—to incentives created by an array of deeply flawed government policies implemented years before the meltdown.

- The best consumer protection for mortgage borrowers is a vibrant and competitive private mortgage lending market. Federal content restrictions on mortgages are directly counter to such an environment.

Norbert J. Michel’s chapter, “Money and Banking Provisions in the 2016 Financial CHOICE Act: A Major Step Toward Financial Security,” completes the first section of the book. Given that the Trump Administration has pledged to dismantle Dodd–Frank, *Prosperity Unleashed’s* banking reform section would be incomplete without discussing the reforms in the CHOICE Act, the first major piece of legislation written to replace large portions of Dodd–Frank. Michel discusses the CHOICE Act’s regulatory off-ramp—and one potential alternative—because a similar approach could be used to implement a broad set of bank regulation reforms.

- The 2016 Financial CHOICE Act would replace large parts of the harmful 2010 Dodd–Frank Act, and provide regulatory relief for banks that *choose* to hold higher equity capital.
- The act’s capital-election provision is a regulatory off-ramp that exempts banks from onerous regulations *if* they meet a higher capital ratio. There is little justification for heavily regulating firms that absorb their own financial risks—and higher capitalized banks do exactly that, lowering the likelihood of taxpayer bailouts.
- The CHOICE Act’s capital election provides statutory language that could be modified to implement similar reforms described in two other chapters in *Prosperity Unleashed*.

Part II. Securities Regulation Reforms

In chapter 5, “Securities Disclosure Reform,” David R. Burton delves into the law and economics of mandatory disclosure requirements, both in connection with new securities offerings and ongoing disclosure

obligations. Burton explains that disclosure requirements have become so voluminous that they obfuscate rather than inform, making it more difficult for investors to find relevant information.

- The current securities disclosure regime has a substantial adverse impact on entrepreneurship, innovation, and economic growth.
- Reasonable, scaled mandatory disclosure requirements have a positive economic effect. Aspects of the current securities disclosure regime harm, rather than help, investors.
- Because the benefits of mandatory disclosure are so much smaller than usually assumed, policymakers should adopt a more skeptical posture toward the existing disclosure regime. Fundamental reform would dramatically reduce the complexity and regulatory burden of the current system and enhance investor protection.
- Substantial improvements to Regulation A, Regulation Crowdfunding, Regulation D, and the regulation of public companies are required to improve the current system.
- The existing rules contain at least 14 different categories of firms issuing securities, each with a different set of exemption and disclosure rules. These categories can easily be replaced with three disclosure regimes—public, quasi-public, and private. Disclosure under the first two categories should be scaled based on either public float or the number of beneficial shareholders.

Rutheford B. Campbell Jr. follows with “The Case for Federal Pre-Emption of State Blue Sky Laws,” a chapter that recommends improving the efficiency and effectiveness of capital markets through federal pre-emption of certain state securities laws. In particular, Campbell calls for pre-emption of state blue sky laws through which states impose registration requirements on firms issuing securities.

- The two broad types of capital formation rules imposed by society—antifraud rules and rules requiring registration—incorporate the efficient disclosure of accurate, material investment information in connection with the offer and sale of securities.
- These societal rules may, however, generate additional costs for the business that is seeking external capital. The additional costs may retard, or in some cases completely choke off, the flow of capital from investors to businesses.
- There are obvious and significant increased costs generated as a result of imposing multiple registration regimes on businesses soliciting capital. Although Congress has to an extent pre-empted the registration requirements of state blue sky laws, the federal pre-emption is largely incomplete.
- Most important is the fact that the pre-emption so far offers scant relief to small businesses when they search for external capital.
- The federal government should completely pre-empt state authority over the registration of securities. Society needs a single set of efficient rules governing the registration of securities.
- The SEC should immediately conduct a holistic equity-market-structure review that acknowledges and addresses the role that legislation and regulation have played in developing the structure of today’s markets. The SEC’s review should inevitably result in recommendations to Congress on how to update or eliminate vestigial statutory provisions.
- In particular, Congress and the SEC should review: (1) the continued utility of Reg NMS and ways to return to a competitive market focused on all best-execution considerations; (2) the trading ecosystem for small-cap stocks and the establishment of venture exchanges; and (3) the proper governance of self-regulatory organizations (SROs).
- The SEC should consider rescinding Reg NMS and replacing it with rules that allow free and competitive markets to dictate much of market structure with rigorous disclosure requirements.
- Congress should enact legislation creating venture exchanges. This legislation should allow market surveillance obligations, SEC oversight, and price transparency for venture exchanges, but also reduced listing standards and regulatory filing requirements. Shares traded on these exchanges would be exempt from state blue sky registration, and the exchanges themselves would be exempt from the SEC’s national market system and unlisted trading privileges rules, so as to concentrate liquidity in these venues.

Next, in chapter 7, Daniel Gallagher tackles the seemingly opaque topic of U.S. equity market structure. Gallagher’s chapter, “How to Reform Equity Market Structure: Eliminate ‘Reg NMS’ and Build Venture Exchanges,” argues that the increasingly fragmented structure of today’s equities markets has been shaped as much, if not more, by legislative and regulatory action than by the private sector. Gallagher calls on the Securities and Exchange Commission (SEC) to consider rescinding Reg NMS and replacing it with rules (and rigorous disclosure requirements) that allow free and competitive markets to dictate much of market structure.

David Burton contributes the final chapter for this section: “Reforming FINRA.” Burton writes that FINRA, the primary regulator of broker-dealers, is neither a true self-regulatory organization nor a government agency, and that FINRA is largely unaccountable to the industry or to the public. The chapter broadly outlines alternative approaches that Congress and the regulators can take to fix these problems, and it recommends specific reforms to FINRA’s rule-making and arbitration process.

- FINRA is a regulator of central importance to the functioning of U.S. capital markets. It is neither a true self-regulatory organization nor a government agency.
- FINRA does not provide the due process, transparency, and regulatory-review protections normally associated with regulators, and its arbitration process is flawed. Reforms are necessary.
- FINRA arbitrators should be required to make findings of fact based on the evidentiary record, and to demonstrate how those facts led to the award given. These written FINRA arbitration decisions should be subject to SEC review and limited judicial review.
- FINRA rules have played a key role in the decline in the number of small broker-dealers. This has an adverse impact on entrepreneurial capital formation.
- Congress and the SEC need to provide greater oversight of FINRA.

Part III. Regulatory Agency Structure Reforms

The first chapter in this section, “Reforming the Financial Regulators,” is coauthored by Mark Calabria, Norbert J. Michel, and Hester Peirce. The chapter argues that financial regulation should establish a framework for financial institutions based on their ability to serve consumers, investors, and Main Street companies. This view is starkly at odds with the current macroprudential trend in regulation, which places governmental regulators—with their purportedly greater understanding of the financial system—at the top of the decision-making chain.

- There is no perfect structure for the financial regulatory system, but design affects how well regulation is carried out, so regulatory re-designers should proceed with care.
- The current trend of regulatory homogenization—the shift toward uniform bank-centric regulation implemented by one “super regulator” at the international

level—threatens to impair the effective functioning of the financial system.

- Regulatory reform is needed, and it should be rooted in a recognition that financial market participants and their regulators respond to incentives in the same way that participants in other markets respond.
- Greater accountability can be introduced, for example, by subjecting financial regulators to appropriations and implementing a commission governing structure.
- Other key reforms include consolidating related powers in one regulator, removing authorities from agencies ill-equipped to perform them, and revamping processes to ensure appropriate accountability for, and public input in, rule-making.

In chapter 10, “The World After Chevron,” Paul J. Larkin, Jr., discusses the Supreme Court’s decision in *Chevron U.S.A. Inc. v. Natural Resources Defense Council*, a case that has generated considerable controversy among policymakers over the past decade. The Chevron decision effectively transferred final interpretive authority from the courts to the agencies in any case where Congress did not itself answer the precise dispute. Reform-minded policymakers have long called on Congress to return that ultimate decision-making authority to the federal courts.

- The Supreme Court’s decision in *Chevron U.S.A. Inc. v. Natural Resources Defense Council* adopted a two-step test to decide whether an administrative agency had correctly interpreted a statute: Did Congress resolve the particular dispute at issue in the relevant law, and is the agency’s interpretation a reasonable one?
- Members of Congress and many scholars believe that *Chevron* improperly delegated the courts’ responsibility to “say what the law is” to unelected members of the administrative state, and they have introduced legislation to overrule *Chevron* or have urged the Supreme Court to do so.

- Overturning *Chevron* would return final decision-making authority to the federal courts, but it would not *eliminate* the influence of administrative agencies. A consistent, long-standing interpretation of a statute governing a technical field will likely always persuade the courts because they will conclude that the agency has figured out what is in the public interest.

Thaya Brook Knight's chapter, "Transparency and Accountability at the SEC and at FINRA," completes this section of the book. Knight describes how these two regulatory bodies—the two mostly responsible for governing the U.S. securities sector—lack the structural safeguards necessary to ensure that they exercise their authority with the consent of the American public. The chapter provides recommendations for fixing these deficiencies, such as giving respondents a choice of federal court or administrative proceedings with the SEC, and allowing FINRA to exist as a purely voluntary, private industry association.

- The SEC's administrative judges have acquired power to rival Article III federal judges, but administrative hearings lack the safeguards that define due process in the courts.
- Those facing an SEC enforcement action should have the same opportunity the government lawyers have to choose between a trial in federal court and an administrative hearing.
- FINRA's quasi-governmental status lacks necessary checks on its power. The solution is to remove FINRA's special status and make it a purely private organization.

Part IV. Government Preference Reforms

Diane Katz's chapter, "The Massive Federal Credit Racket," leads off the section by providing an extensive list of the more than 150 federal credit programs that provide some form of government backing. These programs

consist of direct loans and loan guarantees for housing, agriculture, energy, education, transportation, infrastructure, exporting, and small businesses, as well as insurance programs to cover bank and credit union deposits, pensions, flood damage, crop damage, and acts of terrorism. Government financing programs are often sold to the public as economic imperatives, particularly during downturns, but they are instruments of redistributive policies that mainly benefit those with the most political influence rather than those with the greatest need.

- Collectively, Americans shoulder more than \$18 trillion in total debt exposure.
- Total outstanding loans and loan guarantees backed by taxpayers exceeded \$3.4 trillion at the end of fiscal year 2015.
- Taxpayer exposure from Fannie Mae, Freddie Mac, the Federal Home Loan Banks, the Federal Deposit Insurance Corporation, and the Pension Benefit Guaranty Corporation exceeds \$14 trillion.
- Default rates exceeding 20 percent are common among federal credit programs. Federal accounting methods substantially understate the costs of credit subsidies.
- Trillions of dollars of credit subsidies represent the commandeering of financial services by government and its escalating power over private enterprise.
- This redistribution of taxpayers' money erodes the nation's entrepreneurial spirit, increases financial risk, and fosters cronyism and corruption. It is time to shut it down.

In "Reforming Last-Resort Lending: The Flexible Open-Market Alternative," George Selgin proposes a plan to reform the Federal Reserve's means for preserving liquidity for financial as well as nonfinancial firms, especially during financial emergencies, but also in normal times. Selgin proposes, among other things, to replace the existing Fed framework with a single standing (as opposed to temporary) facility to meet extraordinary as well

as ordinary liquidity needs as they arise. The goal is to eliminate the need for ad hoc changes in the rules governing the lending facility, or for special Fed, Treasury, or congressional action. Among other things, the plan would:

- Make Fed lending to insolvent, or potentially insolvent, institutions both unlikely and unnecessary, no matter how “systemically important” they may be, by allowing most financial enterprises to take part directly in the Fed’s ordinary credit auctions.
- Dispense with any need for direct lending, including both discount window and 13(3) loans, whether aimed at particular institutions or at entire industries, and otherwise radically simplify existing emergency lending provisions of the Federal Reserve Act.
- Eliminate any general risk of Fed mispricing or misallocation of credit, including such underpricing as might create a moral hazard.
- Replace the ad hoc and arbitrary use of open-market operations to favor specific firms or security markets with a “neutral” approach to emergency liquidity provision, by making the same facility and terms available to a wide set of counterparties possessing different sorts of collateral.
- Enhance the effectiveness of the Fed’s open-market purchases during periods of financial distress by automatically providing for extraordinary Fed purchases of less-liquid financial assets.
- Eliminate uncertainty regarding the availability of emergency credit, and the rules governing its provision.

In chapter 14, “Simple, Sensible Reforms for Housing Finance,” Arnold Kling advocates establishing a national title database to prevent the sort of clerical errors that plagued the foreclosure process during the housing crash of 2007 to 2009. Kling also recommends eliminating government support for all mortgages with low down payments, and for refinancing loans that increase the borrower’s mortgage debt. Both types of loans

encourage households to take on debt rather than accumulate wealth.

- Immediately stop purchases by government agencies of mortgages that are for non-owner-occupied homes.
- Immediately stop purchases by government agencies of mortgages for “cash-out” refinances.
- Change risk-based capital regulations to assign 100 percent risk weight to mortgages for non-owner-occupied homes and for mortgages that are cash-out refinances.
- Adopt a national title database in order to eliminate the requirement for title insurance.
- Gradually phase out Freddie Mac and Fannie Mae by decreasing their loan limits.

In the second housing finance chapter, “A Pathway to Shutting Down the Federal Housing Finance Enterprises,” John Ligon provides an overview of all the federal housing finance enterprises and argues that Congress should end these failed experiments. The federal housing finance enterprises, cobbled together over the last century, today cover more than \$6 trillion (60 percent) of the outstanding single-family residential mortgage debt in the U.S. Over time, the policies implemented through these enterprises have inflated home prices, led to unsustainable levels of mortgage debt for millions of people, cost federal taxpayers hundreds of billions of dollars in bailouts, and undermined the resilience of the housing finance system.

- Over the past 80 years, Congress has assembled a system of federal housing finance enterprises (FHFES), which have led to the deterioration of credit underwriting standards and encouraged imprudent risk-taking in the housing finance system.
- FHFES encompass the Federal Housing Administration, the Rural Housing Service, Ginnie Mae, Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.

- FHFEs are antithetical to a free market in housing finance, and have led to less discipline by market participants. FHFEs create moral-hazard dilemmas that put homeowners, taxpayers, and private shareholders at greater risk of financial loss, while increasing home prices relative to what they would be otherwise.
- FHFEs have encouraged an explosion of mortgage debt over the past several decades, while national homeownership is at the lowest rate since the mid-1960s.
- It is time to shut down these FHFEs.

In the final chapter of this section, “Fixing the Regulatory Framework for Derivatives,” Norbert J. Michel discusses government preferences for derivatives and repurchase agreements (repos)—an often ignored but integral part of the many policy problems that contributed to the 2008 crisis. The main problem with the pre-crisis regulatory structure for derivatives and repos was that the bankruptcy code included special exemptions (safe harbors) for these financial contracts. The safe harbors were justified on the grounds that they would prevent systemic financial problems, a theory that proved false in 2008.

- There is no objective economic reason to regulate derivatives or repurchase agreements (repos) as unique products. Financial institutions can best account for the risk of these instruments within their existing regulatory capital frameworks.
- The main problem with the regulatory structure for derivatives and repos pre-2008 was that these financial instruments had special exemptions (safe harbors) from core provisions of the bankruptcy code.
- These safe harbors were justified mainly on the grounds that they would mitigate systemic risk. The 2008 crisis showed that safe harbors worsen, rather than mitigate, systemic risk.
- Systemic concerns cannot justify blanket exemptions from core bankruptcy provisions. Providing safe harbors only to

systemically important firms would blatantly provide special financial protection to a small group of financial firms.

- Eliminating all safe harbors for repos and derivatives would affect the market because counterparties would have to account for more risk, an outcome which should be applauded.

Part V. Protecting the Integrity of Finance

In chapter 17, “Designing an Efficient Securities-Fraud Deterrence Regime,” Amanda M. Rose explains the main flaws in the current approach to securities-fraud deterrence in the U.S., and recommends several reforms to fix these problems. Rose recommends credibly threatening *individuals* who would commit fraud with criminal penalties, and pursuing *corporations* only if their shareholders would otherwise have poor incentives to adopt internal control systems to deter fraud.

- An optimal securities-fraud deterrence regime would minimize the social costs that securities fraud produces, and the social costs that the deterrence regime itself produces—both direct enforcement costs as well as the over-deterrence costs that result when companies fear inaccurate prosecution and legal error.
- The best way to achieve such an optimal regime is to credibly threaten the individuals who would commit fraud with criminal penalties, enforceable by a federal public enforcer when the misconduct implicates the national capital markets.
- Corporations should be pursued only if their shareholders would otherwise have poor incentives to adopt internal control systems to deter fraud—which is not true of most publicly traded firms—and should be threatened only with civil penalties. Fraud victims should also be granted traditional common law compensatory remedies.
- The current approach to securities-fraud deterrence in the United States is flawed in many respects. Most troubling is that

individual fraudsters often escape liability entirely while public companies and, ultimately, their innocent shareholders are routinely punished.

In “Financial Privacy in a Free Society,” David R. Burton and Norbert J. Michel stress the importance of maintaining financial privacy—a key component of life in a free society—while policing markets for fraudulent (and other criminal) behavior. The current U.S. financial regulatory framework has expanded so much that it now threatens this basic element of freedom. For instance, individuals who engage in cash transactions of more than a small amount automatically trigger a general suspicion of criminal activity, and financial institutions of all kinds are forced into a quasi-law-enforcement role. The chapter recommends seven reforms that would better protect individuals’ privacy rights and improve law enforcement’s ability to apprehend and prosecute criminals and terrorists.

- Financial and personal privacy is a key component of life in a free society where individuals have a private sphere free of government involvement, surveillance, and control.
- The existing U.S. financial regulatory framework is inconsistent with these ideas and it often conflicts with basic economic freedoms. Individuals who engage in cash transactions of more than a nominal size trigger a complex set of reporting requirements that has essentially turned many companies into quasi-law-enforcement agencies.
- Individuals should be free to lead their lives unmolested and unsurveilled by government unless there is a reasonable suspicion that they have committed a crime or are involved in illegal activity.
- Any international information-sharing regime must include serious safeguards to protect the privacy of individuals and businesses. All efforts to improve the existing framework must focus on protecting

individuals’ privacy rights while improving law enforcement’s ability to apprehend and prosecute criminals and terrorists.

In “How Congress Should Protect Consumers’ Finances,” Todd J. Zywicki and Alden F. Abbott provide an overview of consumer financial protection law, and then provide several recommendations on how to modernize the consumer financial protection system. The goal of these reforms is to fix the federal consumer financial protection framework so that it facilitates competition, consumer protection, and consumer choice. Zywicki and Abbott recommend transferring all federal consumer protection authority to the Federal Trade Commission, the agency with vast regulatory experience in consumer financial services markets.

- The case for modernization of the consumer financial protection system is independent of the 2008 financial crisis. Fixing the federal consumer financial protection framework will facilitate competition, consumer protection, and choice for consumers.
- Prior to the 2010 Dodd–Frank Act, the consumer financial protection regime was a mishmash system that failed to provide a coherent federal consumer financial protection regime. Authority was scattered among more than six different regulatory bodies with authority over various financial services providers.
- Dodd–Frank consolidated some—but not all—consumer financial protection authority in the newly created Consumer Financial Protection Bureau (CFPB). The CFPB is one of the most powerful and least-accountable regulatory bodies in the history of the U.S., and it intervenes in financial market consumer-related practices in a heavy-handed arbitrary fashion that ignores sound economics.
- Transferring all federal consumer protection authority to the Federal Trade Commission, the agency with vast regulatory

experience in assessing practices affecting consumer financial services markets, would dramatically improve the federal regulatory framework for consumer financial protection.

- Providing this type of single, clearly defined, properly limited, institutional framework for consumer financial protection will provide an incentive for financial institutions to develop innovative financial products and services that can provide consumers with more choices and lower prices.

The final chapter in this section, by Alexander Salter, Vipin Veetil, and Lawrence H. White, examines changes in shareholder liability that could better align incentives and reduce the moral hazard problems that result in excessively risky financial institutions. In “Reducing Banks’ Incentives for Risk-Taking via Extended Shareholder Liability,” the authors describe how under extended liability, an arrangement common in banking history, shareholders of failed banks have an obligation to repay the remaining debts to creditors.

- Under today’s standard arrangement of single liability, shareholders of a failed bank have no obligation to repay the remaining debts to creditors. Under extended liability, an arrangement common in banking history, shareholders do have such an obligation.
- Extended liability incentivizes banks to discover and undertake voluntarily the sort of practices that promote bank and system stability, and avoids the significant information and incentive burdens associated with government regulatory solutions to financial instability.
- The incentive-aligning effects of extended liability have the potential to reduce moral hazard and thereby the social costs of excessively risky bank portfolios and the frequency of (and damage done by) large bank failures.

- Short of eradicating moral hazard by removing all guarantees and restrictions from the banking system, the more limited change of imposing extended liability on shareholders in banks with guaranteed deposits could be a move in the right direction.

Part VI. Enabling Next Generation Finance

In chapter 21, “Improving Entrepreneurs’ Access to Capital: Vital for Economic Growth,” David R. Burton shows how existing rules and regulations hinder capital formation and entrepreneurship. The chapter explains that several groups usually support the current complex, expensive, and economically destructive system because excessive regulation helps keep their competitors at bay. Burton describes more than 25 policy reforms to reduce or eliminate state and federal regulatory barriers that hinder entrepreneur’s access to capital.

- Capital formation and entrepreneurship improve economic growth, productivity, and real wages. Existing securities laws impede entrepreneurial capital formation.
- To promote prosperity, Congress and the SEC need to systematically reduce or eliminate state and federal regulatory barriers hindering entrepreneur’s access to capital.
- The regulatory environment needs to be improved for primary and secondary offerings by private and small public companies.
- Steps should also be taken to improve small firms’ access to credit and to reduce the regulatory burden on small broker-dealers. Because many regulatory provisions are blocking entrepreneurs’ access to capital, there are a large number of policy changes that are warranted.

In “Federalism and FinTech,” Brian Knight provides an in-depth look at how financial technology or “FinTech” companies are beginning to utilize advances in communications, data processing, and cryptography

to compete with traditional financial services providers. Some of the most powerful Fin-Tech applications are removing geographic limitations on where companies can offer services and, in general, lowering barriers to entry for new firms. This newly competitive landscape is exposing weaknesses, inefficiency, and inequity in the U.S. financial regulatory structure.

- Technology is enabling many market participants to provide services on a national basis, but because many of these providers are not banks, they are subject to state-by-state regulation.
- This state-by-state regulation places non-bank providers at a disadvantage relative to their bank competitors because banks enjoy a much more consistent regulatory environment due to powers granted by federal law.
- State-by-state regulation of many innovative financial services is also inefficient and gives large wealthy states an advantage over smaller states because the rich states can, de facto, regulate the national market.
- In cases where state-by-state regulation creates significant inefficiency, harms competitive equity, or creates political inequality, Congress should consider creating a consistent national regulatory environment that displaces state-by-state regulation.
- Conversely, in cases where state regulation does not create inefficiency, harm competitive equity, or create political inequality, such as Rule 147, Congress should refrain from imposing federal requirements.

In the final chapter of the book, “A New Federal Charter for Financial Institutions,” Gerald P. Dwyer and Norbert J. Michel propose a new banking charter under which a financial institution would be regulated more like banks were regulated before the modern era of bank bailouts and government

guarantees. Under the proposed charter, which is similar to a regulatory off-ramp approach, banks that choose to fund themselves with higher equity would be faced mostly with regulations that focus on punishing and deterring fraud, and fostering the disclosure of information that is material to investment decisions. The charter explicitly includes a prohibition against receiving government funds from any source, and even excludes the financial institution from FDIC deposit insurance eligibility.

- There have been many changes to federal banking rules and regulations during the past few decades, but there has never been a substantial reduction in the scale or scope of financial regulations in the U.S.
- Bank regulation has increased episodically while, in the name of ensuring stability, U.S. taxpayers have absorbed more financial losses due to risks undertaken by private market participants.
- This combination of policies has produced a massive substitution of government regulation for market competition that has, in turn, created a false sense of security, lowered private incentives to monitor risk, increased institutions’ financial risk, and protected incumbent firms from new competitors.
- Fixing this framework requires rolling back both government regulation and taxpayer backing of financial losses. Reversing these trends will begin to restore the competitive process and strengthen financial markets.
- This chapter focuses on one reform proposal that can implement both of these changes at once: a new federal charter for financial institutions whose owners and customers absorb all of their financial risks.

PART I

Banking Regulation Reforms

CHAPTER 1:

Deposit Insurance, Bank Resolution, and Market Discipline

Mark A. Calabria, PhD

*At some point I would like to see
a system with no federal deposit
insurance at all.*

—Alan Greenspan, address at
The Heritage Foundation,
March 23, 1985

Government-backed deposit insurance weakens market discipline, increases moral hazard, and leads to higher financial risk than the economy would otherwise have, thus weakening the banking system as a whole. Less government, and more private insurance or shareholder equity, increases private consumers' and capital suppliers' incentives to care about the financial risks and health of banks, thus introducing market discipline into the system, lowering moral hazard, and strengthening the banking system. The provision of government deposit insurance also shifts investment away from equity markets and toward bank-based finance.

A SNAPSHOT OF DEPOSIT INSURANCE

As of the first quarter of 2016, the Federal Deposit Insurance Corporation (FDIC)

guaranteed almost \$6.7 trillion in deposits, backed by an insurance fund of \$75 billion, representing a reserve (or capital) ratio of just over 1 percent. Another \$5.6 trillion in uninsured deposits resides in the U.S. banking system, bringing the total of both insured and uninsured deposits to just over \$11 trillion. The current number of U.S. insured depository institutions (banks and thrifts) is 6,122.¹

Despite the large number of insured depository institutions, over half of insured deposits are held by the 980 banks supervised by the Office of the Comptroller of the Currency (OCC). The vast majority of these insured deposits are held by the 25 institutions whose total assets exceed \$100 billion. An approximate breakdown is that these 25 insured depositories hold total insured deposits equal to the other 6,097 depositories. Combined, the largest three commercial banks—Bank of America, JPMorgan Chase, and Wells Fargo—hold more than one-third of all insured deposits.

Aggregate trends in deposit insurance can mask considerable churning of deposits. In the first quarter of 2016, the FDIC reported that insured deposits increased at 3,900 institutions, decreased at 2,201 institutions, and remained flat at only 30 institutions. This

breakdown is similar to that found in previous quarters. Even during the worst of the financial crisis, between June 30, 2008, and September 30, 2008, insured deposits increased at 4,820 institutions, decreased at 3,508 institutions, and remained flat at 35 institutions.² As will be discussed below, sometimes this churning represents the flowing of deposits away from unhealthy banks, and to healthier banks.

Why Deposit Insurance? Historically, government-provided deposit insurance has been defended on two grounds: (1) protecting the payments system and (2) protecting small, unsophisticated depositors. As bank “demand deposits” are currently payable upon the demand of the depositor, there exist circumstances under which depositors may run to remove their deposits from a bank (or the banking system) even if the bank (or system) in question were perfectly solvent. This outcome is the result of combining a fractional reserve system with requiring that depositors are paid in full sequentially (first come, first served). Relaxing either of these restrictions can eliminate runs. In fact, prior to the widespread adoption of deposit insurance, potential runs were halted via suspension of services—so-called bank holidays.

While protecting the payments system may well be an important end in itself, the more important issue is the impact of a failure of the payments system on the broader economy. If a large number of banks fail, overall lending in the economy may decline if the remaining banks are not able to cover the decline in lending. Failing banks might also push firms and households into bankruptcy as loans are recalled to meet depositor claims. Although the preceding is theoretically feasible, it has rarely, if ever, been witnessed in practice.

A crucial question is to what extent “runs” are largely withdrawals on troubled institutions, as opposed to a system-wide run. Since, as with any industry, failure helps to remove poor or even fraudulent business practices, protecting the payment system should not, itself, be a policy goal. Put differently, runs

on failing banks improve the allocation of financial resources. Protecting failed banks prolongs this misallocation of resources, and can also undermine the viability of otherwise solvent banks as the protected banks pursue risky business strategies. Insulating poorly performing banks from failure can also keep destructive business practices and culture in place. Such propping up can also reduce economic growth and labor productivity as the least-productive banks remain in business instead of being eliminated from the industry.

Whether deposit withdrawals are “indiscriminate panics,” or a reallocation of deposits from troubled to healthy banks, is ultimately an empirical question. Researchers at the FDIC found that between the second quarter (Q2) of 2008 and the end of 2010, the worst of the financial crisis, uninsured depositors were leaving the least-healthy banks (those with CAMELS³ ratings of 4 and 5), and going to the healthiest banks (those with CAMELS ratings of 1 and 2).⁴ This shift is especially impressive given that CAMELS ratings are not public, yet uninsured depositors were largely able to distinguish good banks from bad and move their deposits accordingly. This “reallocation” view is also supported by the fact that during that time the total amount of domestic deposits in U.S. banks and thrifts was continually increasing on a quarterly basis. There quite simply was no broad-based (indiscriminate) run on U.S. banks in the 2008 financial crisis. Such was also true for uninsured deposits, which were not leaving the banking system, but rather were being reallocated within the system.

Economic models of financial crises can generally be characterized as either “belief-based” or “fundamentals-based.”⁵ Belief-based models gained popularity with the work of John Maynard Keynes and later Charles Poor Kindleberger.⁶ This early work was mostly verbal in nature. The most prominent formal model of belief-based crises is that of Douglas Diamond and Philip Dybvig.⁷ Channeling Keynes, these models are essentially driven by “animal spirits,” or depositor

confidence. In their most extreme form, such models imply that financial panics can just happen, indiscriminately and without any change in economic fundamentals. This class of models provides the theoretical foundation for both deposit insurance and broad lender-of-last-resort facilities. As these models rarely offer any empirical predictions, they are notoriously difficult, if not impossible, to test or disprove, which perhaps explains their continued popularity.

In contrast, fundamentals-based models of financial crises are based on the argument that underlying weaknesses in either the economy or the financial system are the drivers of financial crises. Much of this work is empirical, looking for drivers in the data indicating which “fundamentals” drive crises.⁸ It is this work, discussed below, which provides evidence that deposit insurance may be a contributor to financial instability, rather than a stabilizer, as suggested by the beliefs-based models. It is my argument herein that fundamentals-based models offer a more accurate description of real-world financial crises and are better supported by the existing empirical evidence.

While it is beyond the scope of this chapter, deposit insurance has also been explained as an attempt to protect smaller banks from the competitive pressures of larger banks.⁹ To the extent that deposit insurance results in a more fragmented and less-diversified financial system, it further contributes to reducing financial stability.

DEPOSIT INSURANCE, MARKET DISCIPLINE, AND FINANCIAL STABILITY

In a world without government-provided deposit insurance, depositors would seek some assurance that their money was safe. Some might purchase private insurance and, as was long done in the case of credit unions and depositors above the insured limits, most are likely to look for outward signs of bank strength. The most important source of bank strength is the equity of its

shareholders, which would absorb losses before depositors do. In the absence of deposit insurance, banks would be pressured to hold additional capital in order to attract deposits, and indeed this is what was witnessed both before the creation of the FDIC, as well as when comparing uninsured and insured banks in those states that offered deposit insurance before 1934.

With the creation of the FDIC, banks were no longer pressured to increase their own capital by depositors and, unsurprisingly, capital levels quickly declined.¹⁰ Unfortunately, this shift not only reduced the cushion protecting depositors from loss, but in reducing the likelihood of insolvency, it also changed the incentives facing shareholders. When shareholders (and their agents, management) bear most of the downside of their risk-taking, they face strong incentives to internalize that risk. If, however, losses are more likely to fall on others, either depositors or the insurance fund, then shareholders are incentivized to take more risk. Perversely, not only does the provision of deposit insurance reduce the cushion of equity in banks, it also increases the variance (risk) of their investments. Thus, both the asset and liability sides of the bank balance sheet are distorted in destructive ways by deposit insurance.

Proponents also claim that deposit insurance helps mitigate contagion, whereby one bank failure causes other healthy banks to fail, but the contagion effect of panics has been grossly exaggerated.¹¹ The spread of poor incentives encouraged by deposit insurance—another type of contagion—have not been broadly recognized. Because deposit insurance reduces the incentives to hold more capital, shareholders seeking greater returns on equity will shift toward banks with higher leverage. Management will face competitive pressures to increase leverage or else be disadvantaged. As Kevin Dowd has rightly observed, “Deposit insurance thus makes a strong capital position a liability, putting well-capitalized banks at a competitive disadvantage.”¹²

This disadvantage is not just a theoretical curiosity. One of the “victims” of deposit insurance was, ironically enough, First National Bank, which had distinguished itself as a “safe” bank by widely advertising its strong capital position. This strength was one reason it weathered the Great Depression, but the creation of the FDIC eroded its ability to compete for deposits on the basis of that strong capital position. It was ultimately forced to sell out to National City Bank (the early version of Citibank). As *The New York Times* observed on the event of this merger in 1954, “When people began to cease worrying about the safety of their deposits the premium declined on a bank that had made a name for itself as the epitome of conservatism.”¹³

A Brief History of Deposit Insurance in the United States. Deposit insurance is generally associated with the Banking Act of 1933, which also instituted the separation of commercial and investment banking.¹⁴ A handful of states, however, experimented with government-backed deposit insurance, beginning with New York’s bank-obligation fund in 1829, which covered circulating bank notes as well as deposits. Five additional states followed New York’s lead in creating deposit-insurance funds in the antebellum period—Vermont, Indiana, Michigan, Ohio, and Iowa.¹⁵ Ohio and Iowa only insured circulating bank notes, which was the common medium of exchange before the National Bank Act of 1863.

All six state funds worked quite differently than the current FDIC model. Three of the six only paid claims once a bank liquidation was completed, and while two paid claims immediately, those claims were in part covered by special assessments on the remaining solvent banks in the state. All six states established some form of examination and supervision of covered institutions, as well as requiring regular condition reports.

Michigan’s deposit insurance fund was the first to fail, closing its doors in 1842 with a deficit in current dollars of over \$1 million (almost \$28 million in 2016 dollars). Vermont

followed next with a minor deficit. New York, Ohio, and Iowa wound down their funds by 1866 with the spread of “free banking” and the creation of the national banking system. Deposit insurance, at the state level, would continue to be debated, but another fund would not be created until 1908 in Oklahoma. Between then and World War I, Kansas, Nebraska, Texas, Mississippi, South Dakota, North Dakota, and Washington State would follow with their own deposit-insurance funds.

Washington State’s fund was created in 1917 and failed in 1921. By 1930, the remaining state funds had closed, often leaving behind considerable bills to be paid by their citizens.¹⁶ Despite, or perhaps because of, the failure of state-level deposit-insurance funds, and the evidence that such funds increased bank failures, Congress considered around 150 separate proposals between 1886 and 1933, when the Federal Deposit Insurance Fund was created on a temporary basis, and later made permanent in the Banking Act of 1935.

What ultimately provided the momentum for congressional action was the mass of bank failures (suspensions) in the early 1930s. While the boom years of the 1920s witnessed around 600 failures per year, of mostly small agricultural banks, in 1930 alone, bank failures surpassed 1,000. Annual failures eventually peaked with 4,000 failures in 1933, as depositors pulled gold out of banks in anticipation of President Franklin Roosevelt’s eventual devaluation and abandonment of the gold standard. Total losses for depositors were relatively small as a percent of total deposits during this time. Even in the worst year for bank failures, 1933, total losses represented just over 2 percent of total system deposits. Even limited to failing banks in 1933, depositors on average received 85 percent of their deposits.

Under the Banking Act of 1933 the FDIC was authorized to pay a maximum of \$2,500 to depositors of failed, insured banks, equal to around \$46,000 in 2016 dollars. Lydia Lob-siger was the first depositor to receive a check from the FDIC (for \$1,250) when the Fond du

Lac State Bank in East Peoria, Illinois, was the first FDIC-insured bank to fail in May 1934.¹⁷

Between its creation and the beginning of World War II, the FDIC handled the failure of 370 banks. After recoveries, losses amounted to around \$20 million (about \$350 million in 2016 dollars) for those 370 pre-WWII-insured failures. The war years and following Cold War period were quiet ones in terms of bank failures, with annual failures remaining in the single digits until 1975.

Not long after the failure of Fond du Lac State Bank in 1934, coverage was raised to \$5,000 per depositor, where it remained until 1950, when it was raised to \$10,000.¹⁸ Coverage levels were increased to \$15,000 in 1966, to \$20,000 in 1969, and quickly thereafter doubled to \$40,000 in 1974.¹⁹ The increase to \$100,000 occurred in 1980,²⁰ which remained in place until 2005, when it was increased to \$250,000 for retirement accounts,²¹ which was later made permanent for all accounts by the Dodd–Frank Act.²² The current \$250,000 ceiling is, in inflation-adjusted terms, more than six times the original 1933 coverage limit.

The conventional wisdom is that by reducing the number of bank runs, the FDIC has reduced the cost of bank failures. While there are theoretical reasons to both support and reject that contention, it is ultimately an empirical question. Rutgers University professor Eugene White made an initial attempt after the bank failures of the 1980s to determine if the FDIC did indeed reduce costs. Professor White concluded that “deposit insurance did not substantially reduce aggregate losses from bank failures and may have raised them.”²³ White is clear that such a conclusion depends on a number of assumptions, but that reasonable assumptions suggest skepticism over any claim that the FDIC has reduced the losses from bank failures. His analysis also leaves out losses from the savings and loans (S&Ls), as well as those of the 2008 financial crisis.

The period between the New Deal and the S&L crisis is sometimes called the Quiet Period in American banking, for its relative stability. One regularly heard rationale for this

relative stability is the existence of deposit insurance, which is claimed to have ended panics. Undercutting this hypothesis is that the percentage of deposits explicitly insured was considerably *smaller* during the Quiet Period than after, when two major crises occurred and several smaller bank crises ensued. Between the establishment of the FDIC and 1980, approximately half of deposits were insured, implying that the other half were uninsured (and hence subject to runs). Since 1980, almost two-thirds of deposits have been explicitly insured. The 1980s also gave rise to the notion of Too Big to Fail, with the rescue of Continental Illinois. If there has been an implicit guarantee of uninsured deposits, it has undoubtedly been stronger since 1980. In terms of the commercial banking sector, the explicit (and likely implicit) safety net was actually smaller during the Quiet Period relative to recent decades, yet panics have still occurred.²⁴

BROKERED DEPOSITS²⁵

Between 7 percent and 10 percent of deposits are channeled via deposit “brokers”—individuals or organizations that assemble large amounts of deposits and then place those deposits in banks and thrifts. The primary purpose of brokering is to allow individuals to spread their deposits across institutions, thereby obtaining insurance coverage in excess of the coverage cap (currently \$250,000). Brokers are also used to assist large depositors in searching for the banks that offer the highest deposit rates.

The use of brokered deposits has long attracted regulatory scrutiny. In the early 1980s, for instance, the FDIC attempted to deny insurance coverage to brokered deposits, only to have its effort overturned due to a lack of statutory authority.²⁶ This scrutiny derives from two sources: First, brokering can be viewed as an attempt to circumvent the coverage limit, which is intended to restrict coverage to “retail” depositors. It is fair to say that few working-class or middle-class families use deposit brokers; their holdings of deposits are simply too small. Second, the use of

brokered deposits has long been associated with a higher probability of bank failure. Concern about brokered deposits has thus been expressed both in terms of fairness as well as safety and soundness.

The most recent FDIC analysis of brokered deposits finds that the largest 36 banks, those with over \$50 billion in assets, account for half of all brokered deposits. The more than 6,000 banks with under \$1 billion in assets account for less than 9 percent of brokered deposits. Essentially, the largest banks are using brokered deposits as a form of insured wholesale funding. In fact, more than half of insured depositories report not holding any brokered deposits. Just over a third of brokered deposits consist of “sweep” accounts used by investment banks on behalf of their clients, whereby idle customer balances are swept into insured accounts.

Currently, the only significant restrictions on the use of brokered deposits are for banks that are critically undercapitalized, which at any time constitute a small number. To further the public interest and improve financial stability, Congress should eliminate FDIC insurance coverage for brokered deposits. The FDIC lacks authority to do so on its own. This action would end insurance coverage for just over \$500 billion in deposits. Such could be achieved applying insurance coverage limits to individuals, rather than allowing multiple accounts for individuals. If Congress is unwilling, as it has been in the past, to eliminate coverage for brokered deposits completely, the use of brokered deposits for any single bank should be limited to no more than 10 percent of said bank’s total deposits.

DEPOSIT INSURANCE AROUND THE WORLD

Despite the conventional American wisdom that deposit insurance increases financial stability, which is contradicted by a large body of research, few other countries embraced deposit insurance before the 1970s. In fact, before 1970, the number of countries with explicit deposit insurance systems was

still in the single digits. A large push by international government organizations resulted in a massive expansion of deposit insurance with almost 90 countries today having explicit deposit insurance schemes.²⁷ Another 34 countries are currently considering some form of official deposit insurance or are in the process of implementing such.²⁸

The financial crisis of 2008 resulted in substantial increases in explicit government deposit insurance coverage. Before the crisis, most European countries offered coverage equivalent to around 140 percent of per capita income. The United States maintained higher coverage of around 210 percent of per capita income, and, subsequently, expanded coverage to over 540 percent of per capita income. Post-crisis Europe now displays coverage levels of almost 500 percent of per capita income.

In dollar-equivalent terms, only Australia offers higher deposit insurance coverage than the United States. Most countries in Western Europe currently offer coverage of approximately \$137,000, just over 50 percent of the value of U.S. coverage. A number of EU countries also cover the deposits of local branches of foreign banks, where the U.S. does not. The U.S. does, however, offer some coverage to foreign branches of U.S. banks.²⁹

Coverage levels are not the only differences among deposit insurance systems. The U.S., for instance, is one of the few systems that cover interbank deposits. A number of deposit insurance systems require coinsurance, where the depositors bear some portion of the loss, in order to reduce moral hazard. Usually, coinsurance is at the level of 10 percent or 20 percent of coverage, meaning that depositors are responsible for between 10 percent and 20 percent of any losses. Coinsurance is at 10 percent in many European countries.³⁰ A small number of countries, such as Switzerland and Luxembourg, with explicit deposit insurance systems leave the administration and funding of those systems to the private sector.³¹ A few countries also allow deposits to be offered without compulsory coverage. The U.S. system could be improved by adopting

some of the characteristics of other deposit insurance systems, as suggested by Thomas Hogan and Kristine Johnson.³²

The introduction of deposit insurance schemes has direct effects on other financial sectors within the economy. Deposit insurance will change the incentives facing households in terms of where those households should place their savings. Scholars have found, for instance, that countries with explicit deposit insurance schemes have smaller equity markets, all else being equal.³³ Such coverage may not only increase financial instability, it may ultimately reduce economic growth as investment is pulled away from more productive uses within the economy.

While the expansions of coverage in both the U.S. and Europe was mistakenly seen as necessary for stabilizing the financial system and the broader economy, these expansions will likely result in greater financial crises, especially in Europe, where commercial banks dominate the financial system to a greater degree than in the United States. European countries, as well as those in Asia, would better serve the goals of financial stability by rolling back the recent extensions in deposit insurance coverage. Movements toward an EU-wide deposit insurance fund should also be abandoned, as such would greatly reduce market discipline, especially on banks in Southern Europe. Similarly, China should abandon its efforts at creating a government-backed deposit insurance system. The United States' experience with deposit insurance should largely be viewed as model of what not to do.

DEPOSIT INSURER AS RECEIVER

The FDIC is primarily known to the public as the insurer of bank deposits. However, the FDIC plays another important role in our financial markets, especially in times of crisis: the role of receiver, or liquidator, of failed banks.³⁴

A receiver or conservator is essentially an administrative agency that performs the same role as would a bankruptcy court. Prior to the creation of the FDIC, courts were often appointed as receivers for failed institutions.

In some instances, state bank regulators have also served as administrative receivers for banks chartered under their authority.

The primary purpose of a resolution regime, whether an administrative receiver or a court-supervised bankruptcy, is to determine the allocation of losses among shareholders and creditors. A receivership is generally limited to instances where the assets of a bank are less than its liabilities. To put it bluntly, not everyone is going to get what they were promised, and the main task of the receiver is to referee who gets how much.

Generally “who gets what” is determined ahead of time by a “chain of priorities.” For instance, debt holders would be paid in full before any distribution to equity holders. Within the group of equity holders, preferred shareholders would receive funds before any distribution to common shareholders, who generally receive little, if anything, in a resolution. There will also be a chain of priorities among debt holders, with some creditors senior to others. Secured creditors are generally paid before unsecured creditors. Administrative expenses of the receiver, such as maintaining the operations of the bank, are first in priority. Even uninsured depositors are likely to receive something in a receivership, despite their uninsured status. While a receiver has some discretion, chains of priority are often “hardwired” into statute or regulation, with the primary role of the receiver as estimating the value of assets and claims, and accordingly the payouts resulting from those claims.

Bankruptcy courts generally respect the chain of priorities to which private parties have contracted. Common shareholders are paid last; such was the deal going in. Laws governing receivership often explicitly favor certain creditors over others.³⁵ Under a bank receivership, for instance, the FDIC has generally treated foreign depositors differently than U.S. domestic depositors.³⁶ The very structure of the FDIC treats depositors as a class separate from unsecured creditors.

Receivers are occasionally claimed to be superior to a court-supervised bankruptcy

due to concerns over potential contagion or panics. During the 2008 financial crisis, for instance, it was often claimed that firms could not enter bankruptcy without causing a broader panic. The failure of Lehman Brothers is perhaps the best-known example of this concern.³⁷ While there is little debate over the ability of bankruptcy courts to resolve financial firms and allocate losses, the question is often one of speed. The FDIC, for instance, allows insured depositors, and occasionally other creditors, to be paid immediately. While this is allowable under the bankruptcy code, it is not usual practice. Title II of Dodd–Frank is essentially a mechanism for quickly resolving non-bank financials in a manner similar to the mechanism for banks, with the exception that Title II appears on its surface only to allow liquidation. It also allows protection of certain creditors to forestall a panic. Accordingly, an administrative resolution regime is presented as an avenue for containing financial market contagion.

Whether an administrative resolution is quicker than a court-supervised bankruptcy is an empirical question. Both an administrative agency and court face similar tasks, such as judging the validity of claims. For most, if not all, of these tasks the FDIC has no “special sauce” that the courts lack. The limited data that exist suggest that FDIC receiverships are no faster than the typical Chapter 11 proceeding; both have a median time to resolution of 28 months.³⁸ Since the FDIC is generally the largest creditor in the resolution of a depository, FDIC management of a failed depository may indeed offer some cost savings. In the case where the FDIC is not the largest creditor, for instance with an insurance company, it is unlikely that FDIC management is cost-effective.

Prior to the passage of the Dodd–Frank Act, the FDIC could only serve as the receiver for a federally insured depository. If that depository were a subsidiary of a larger holding company, the FDIC could only look to the assets of that subsidiary. For instance, had American International Group (AIG) been allowed to enter

bankruptcy, the receivership authorities of the FDIC would have only applied to the depository subsidiary and not the remainder of AIG. This arrangement has occasionally left the FDIC in the role of general creditor, subject to the deliberations of a bankruptcy court. The FDIC has long sought to have receiver authority over holding companies that contain depository subsidiaries. That authority, along with potential receivership of any failing large non-bank financial, was finally granted under the Dodd–Frank Act.³⁹

A critical difference between a court-supervised bankruptcy and an FDIC-supervised receivership is the relative availability of outside funding. A bankrupt company may seek “debtor-in-possession” or other short-term senior financing to facilitate a re-organization, but the court itself has no access to outside funds that can then be used to pay creditors. In contrast, the FDIC has the deposit insurance fund, which it has occasionally used to cover creditor claims that would not have otherwise been recoverable solely from the assets of a failed institution. Because of this built-in availability of funds, creditors are more likely to be protected in a FDIC receivership than under a court-supervised bankruptcy.

Sections 201 and 204 of the Dodd–Frank Act give the FDIC further authority under the orderly liquidation of a non-bank financial to pay creditors beyond what they could have recovered from a failed institution’s assets. For instance, Section 201 allows the FDIC to pay “any obligations” it believes are “necessary and appropriate.” Section 204 allows the FDIC to purchase any debt obligation of a failing institution at, or even above, par. Depending on how the FDIC chooses to conduct the orderly liquidation of a failing non-bank, creditors to that institution may be ultimately protected from market discipline, increasing moral hazard and undermining financial stability. This may well be the reason that Dodd–Frank’s orderly liquidation authority mirrors a proposal first put forth by a large bank.⁴⁰

Authorities similar to Dodd–Frank’s orderly liquidation authority were created to

cover Fannie Mae and Freddie Mac under the Housing and Economic Recovery Act of 2008. Despite being granted such authorities, and having the ability to protect the taxpayer from loss and the option of imposing losses on creditors, regulators chose to ignore those options and protect creditors at the expense of taxpayers. As regulators were unwilling to protect taxpayers and impose market discipline in the case of Fannie Mae and Freddie Mac, it remains at best an open question whether regulators would take that course of action in the case of large banks or other financial companies.⁴¹

At a minimum, the FDIC's role in the resolution of non-bank financials should return to the role it had prior to the Dodd-Frank Act. If ultimately, as proposed below, deposit insurance coverage is significantly reduced, the role of the FDIC in bank resolution can also be reduced. As long as there are large numbers of FDIC-insured depositors, having a single organization, such as the FDIC, act on their behalf in a resolution is likely the most cost-effective route. Other creditors, such as large debt holders, however, may be best situated to represent their own interests, as would happen under a court-supervised bankruptcy. Congress may also choose to clarify uninsured creditor priorities under a receivership. If there are indeed legitimate concerns regarding depositor runs, uninsured depositors can be made senior to other uninsured creditors, such as bondholders.

POLICY SOLUTIONS

The public interest would be further served if Congress reduced federal deposit insurance coverage to the pre-S&L crisis limit of \$40,000. To further the goal of reducing systemic risk, Congress should also limit the total deposit insurance coverage of any one bank to 5 percent of total insured deposits. Given the current amount of FDIC-insured deposits, approximately \$7 trillion, such would imply that no one bank would hold more than \$350 billion in insured deposits. There are currently only four banks above

that level. A transition plan would have to be developed to allow these banks to either shed their excess insured deposits or shift to other funding sources.

The FDIC, as of (Q1) 2016, backs almost \$7 trillion in deposits, approximately 60 percent of outstanding U.S. domestic deposits. This figure also represents a 50 percent increase—more than \$2 trillion—in insured deposits since year-end 2007. Perhaps more shocking is that the amount also represents an almost doubling of insured deposits since 2003. Part of this increase was due to the Federal Deposit Insurance Reform Act of 2005, which raised the limit for deposit insurance for retirement accounts to \$250,000. Congress should repeal those provisions of the 2005 act that raised the limits. Congress also, within the Troubled Asset Relief Program (TARP), raised the deposit insurance cap to \$250,000 until January 1, 2010. Dodd-Frank essentially made TARP's coverage expansion permanent.

Dodd-Frank's Section 335 extends the 2005 retirement coverage limit of \$250,000 to all accounts. According to the Federal Reserve's Survey of Consumer Finance, the median U.S. household held \$4,100 in a checking account.⁴² For the less than 10 percent that held certificates of deposit, the median holding was \$16,000.⁴³ A cap of \$40,000 (the pre-S&L crisis limit) would more than adequately cover the vast majority of U.S. households while also greatly improving market discipline of U.S. banks. Even the typical (median) retirement account, not all of which are held at banks, is under \$60,000. A reduced cap should also apply to brokered deposits, in order to both reduce the incentives to evade the cap and to reduce moral hazard on the part of depositors. In order to facilitate this reform, insurance coverage should only be available to parties that hold deposit accounts in their own name.

The holdings of deposits are also highly concentrated. For instance, a fourth of all deposits are held by the wealthiest 1 percent of households.⁴⁴ The top 10 percent of households hold 67 percent of all deposits.⁴⁵

These wealthiest households also, on average, have considerable non-deposit sources of wealth. Middle-income and low-income families would still be completely protected after significant reductions are made to FDIC deposit insurance coverage. Furthermore, because the presence of FDIC insurance crowds out firms that would otherwise offer private deposit insurance, reducing the coverage of FDIC insurance would likely bring more private capital into the private deposit insurance market.

CONCLUSIONS

Government-backed deposit insurance weakens market discipline, increases moral hazard, and leads to higher financial risk than would otherwise exist, thus weakening the banking system. Less government and more private insurance or shareholder equity

increases private consumers' and capital suppliers' incentives to worry about the financial risks and health of banks, thus introducing market discipline into the system, lowering moral hazard, and strengthening the banking system.

Ultimately, government-provided deposit insurance should be phased out fully. Doing so would likely result in reduced bank leverage (higher shareholder equity), more market discipline, a larger equity market relative to the banking system, less volatility in bank assets, and overall greater financial stability. In the interim, coverage should be reduced to more closely align with protecting small retail investors. Coverage could easily be reduced to around \$40,000 per individual while continuing to cover the overwhelming majority of household accounts.

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ENDNOTES:

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CHAPTER 2:

A Simple Proposal to Recapitalize the U.S. Banking System

Kevin Dowd, PhD

Proposals to reform the banking system generally fall into two types. The first type are proposals for more regulation—such as that entailed by the Basel accords and the Dodd–Frank Act. However, these “solutions” are costly and never work as intended. The second type can be described as idealistic: These propose idealized radical solutions based on an underlying theory of the way banking is, or is not, supposed to work. These vary in merit from the ridiculous to the sublime. Whatever their intrinsic merits, getting such reforms implemented is a major uphill battle if for no other reason than that they are commonly regarded as politically unthinkable.

There may, however, be a third way: Do not propose ever more regulation, but do not propose to dismantle existing regulatory structures either. Instead, offer banks the choice of opting out of the regulatory system. Such an opt-out has considerable attractions. It is simple, easily implemented, and avoids more regulation, more complexity, and higher compliance costs. It offers more choice rather than more compulsion, and allows bankers to ignore it if they prefer, a feature that also makes it difficult for the banking lobby to mount a credible objection. Most of all, it offers the potential to set in motion a virtuous-circle dynamic that could be not just beneficial, but transformative.

This chapter proposes a regulatory off-ramp in which banks be allowed to opt out of any requirements to comply with federal prudential regulation on the condition that they

provide strong and credible reassurance of their financial robustness. This reassurance would take the form of a binding commitment to maintain a much higher minimum-capital ratio than any major banks currently maintain. The type of capital ratio referred to here is in the traditional pre-Basel sense—a ratio of core capital to total assets, or a similar measure.¹ To use more contemporary terminology, the proposal uses a high minimum-required-leverage ratio.

An intuitive way to think about this proposal is as follows. The purpose of prudential regulation is—so it is claimed—to ensure that the banks are safe; but the purpose of a high-capital/leverage ratio is also to ensure that banks are safe. Prudential regulation and higher capital are substitutes for each other toward the same end. The former can therefore be dispensed with, provided that banks

commit to the latter. However, these substitutes differ in that prudential regulation is very costly and often ineffective, whereas high capital involves near-zero cost and is highly effective. In the current system, the banks are compelled to go the former route, but the latter has considerable upsides and no discernible downside.

This proposal is very much in the spirit of “second-best” economics. In an ideal world—free of government interventions that encourage and subsidize excessive risk-taking—there would be no capital-adequacy issue and no need for any capital adequacy regulation. In such a world, banks’ capital ratios would be decided by the bankers themselves, like any business policy decision, such as how much to lend, to whom to lend, and the reserve ratios they should maintain. Competition among the banks would then help them determine their “optimal” capital ratios. If a bank maintained a very high capital ratio, it would face pressure from shareholders wanting higher returns on their equity. If it maintained a very low capital ratio, it would struggle to reassure depositors that it could withstand a major loss and still be able to pay depositors in full. In the latter case, it would face the danger of being run out of business. There would be no market failure and no case for a regulator to impose minimum (or maximum) capital requirements.

To state the obvious, this ideal world is not the current one. Instead, today’s world features a range of government-sponsored interventions in the banking system that create moral hazards that encourage banks to take greater risks than they otherwise would, had they to bear the downsides themselves. These interventions include, most notably, the “lender of last resort” function, government-deposit insurance, and too-big-to-fail support. One might even say that these moral hazards create a race for the bottom as far as capital adequacy is concerned. In particular, they encourage banks to seek higher returns on their equity, and the easiest way to boost these returns is to substitute debt for equity and run down their capital. The best solution

is to get rid of these interventions, but good luck on that. However, if one accepts for the sake of argument that all these pre-existing interventions are not going to go away any time soon, or would require an immense effort to get them even within the Overton Window²—there remains the question of what to do about undercapitalized banks. There is thus a second-best argument for some form of capital-adequacy regulation to counter the excessive risk-taking created by these pre-existing state interventions.

A natural response would be that systems of capital-adequacy regulation already exist for this reason, most obviously the Basel system. However, Basel is highly inadequate to this task and has been a repeated failure. Apart from anything else, Basel is hugely costly and proved to be of no use in ensuring that the banking system was strong enough to avert the costly bank failures that occurred in the global financial crisis. Indeed, one can argue that the weaknesses of the Basel system—its reliance on useless risk weights, its dependence on the discredited Value-at-Risk risk measure, and its dependence on unreliable risk models—greatly contributed to the severity of the crisis.³ Existing systems of capital-adequacy regulation are therefore not the solution, but part of the problem.

U.S. BANKS’ CAPITAL INADEQUACY

The traditional measure of capital adequacy is a bank’s capital ratio, which is the ratio of core capital to its total assets. In the 19th century, U.S. banks often had capital ratios of between 40 percent and 50 percent. By 1914, the year the Fed came into operation, average capital ratios in the U.S. were 16.5 percent.⁴ They fell a little by 1929, then more than halved in the decade after federal deposit insurance was established in 1934, and have remained in single digits ever since.

So the next question is what should this ratio be. There is no magic number, but a minimum capital ratio should be high enough to remove the overwhelming part of the moral hazard that currently infects the banking

system, and high enough to ensure that banks will never be bailed out again. In this context, many experts have recommended minimum capital-to-total-asset ratios that are much greater than those called for under current Basel rules. In an important letter (“Healthy Banking System Is the Goal, Not Profitable Banks”) to the *Financial Times* in 2010, no less than 20 renowned experts recommended a minimum ratio of equity-to-total-assets of at least 15 percent—five times larger than required under Basel III. Some of these experts wanted minimum requirements that are much higher still. To quote their letter:

Banks’ high leverage, and the resulting fragility and systemic risk, contributed to the near collapse of the financial system. Basel III is far from sufficient to protect the system from recurring crises. If a much larger fraction, at least 15%, of banks’ total, non-risk-weighted, assets were funded by equity, the social benefits would be substantial. And the social costs would be minimal, if any....

If handled properly, the transition to much higher equity requirements can be implemented quickly and would not have adverse effects on the economy. Temporarily restricting bank dividends is an obvious place to start.

Many bankers oppose increased equity requirements, possibly because of a vested interest in the current systems of subsidies and compensation. But the policy goal must be a healthier banking system, rather than high returns for banks’ shareholders and managers, with taxpayers picking up losses and economies suffering the fallout.

Ensuring that banks are funded with significantly more equity should be a key element of effective bank regulatory reform. Much more equity funding would permit banks to perform

all their useful functions and support growth without endangering the financial system by systemic fragility. It would give banks incentives to take better account of risks they take and reduce their incentives to game the system. And it would sharply reduce the likelihood of crises.⁵

Overall, various experts have called for minimum capital-to-asset ratios ranging from as low as 15 percent to as high as 50 percent.⁶ In short, there is a big gap between U.S. banks’ current capital ratios and any reasonable sense of what they should be; that is, U.S. banks have a big capital-adequacy problem.

FALLACIOUS OBJECTIONS TO HIGHER CAPITAL STANDARDS

The banking lobby has campaigned vigorously against higher capital levels. However, its main arguments are demonstrably fallacious, and its real reasons for opposing higher capital requirements are based on naked self-interest, that is, keeping risk-taking subsidies because they are profitable. These arguments are the bankers’ new clothes, to quote the title of Anat Admati and Martin Hellwig’s wonderful book.

The first of these fallacious arguments is that higher capital requirements would increase banks’ costs. However, if this argument were correct, it would apply to non-bank corporations too, and we would expect them to be equally highly leveraged in order to take advantage of the “cheapness” of debt. Instead, most non-bank corporations have capital ratios of over 50 percent and some do not borrow at all. In reality, equity *helps* to reduce the costs associated with potential distress and bankruptcy, and the same benefits apply to banks as to other corporations.

There is, nonetheless, one case where higher equity capital is costly—at least to bank shareholders. When the government intervenes to cover banks’ downside risk, capital becomes expensive to the banks’ shareholders: The higher the banks’ capital level, the more of the risk subsidy they

forgo, because higher capital reduces the cost to third parties of their risk-taking excesses. When bankers complain that capital is expensive, they consider only the costs to shareholders and themselves, and do not take into account the costs of their excessive risk-taking to other parties, including the taxpayers who are then called upon to bail out the banks when the combination of excessive risk-taking and run-down capital leads their banks to fail.

In fact, the social cost of higher equity can be *zero* when the costs of systemic risks are accounted for. To quote Admati and Hellwig:

A bank exposing the public to risks is similar to an oil tanker going close to the coast or a chemical company exposing the environment to the risk that toxic fluid might contaminate the soil and groundwater or an adjacent river. Like oil companies or chemical companies that take too much risk, banks that are far too fragile endanger and potentially harm the public.

But unlike the case of safety risks posed by oil or chemical companies, higher bank safety standards can be achieved at little social cost merely by requiring that banks increase their capital, which they can do by issuing more equity in the capital markets.⁷

A second argument is that high minimum capital requirements would restrict bank lending and hinder economic growth. For example, Josef Ackermann, then-CEO of Deutsche Bank, claimed in 2009 that higher capital requirements “would restrict [banks’] ability to provide loans to the rest of the economy” and that “this reduces growth and has negative effects for all.”⁸ The nonsense of such claims can be seen merely by noting that they imply that further increasing banks’ leverage must be a good thing, notwithstanding the fact that excessive leverage was a key contributing factor to the financial crisis, and that ongoing bank

weakness—weakness associated with too much leverage—is still impeding economic recovery.

One also encounters claims that higher capital requirements would restrict bank lending that are based on a confusion of capital with reserves. This is the capital-is-a-rainy-day-fund fallacy that mixes up the two sides of a bank’s balance sheet. An example by Wane Abernathy:

Think of [capital] as an expanded rainy day fund. When used efficiently, a dollar of capital on reserve allows a bank to put ten dollars to work as expanded economic activity. The new Basel rules would demand that banks would maintain more dollars on reserve for the same amount of business, or more capital for no new economic work.⁹

Alan Greenspan claimed that “[a]ny excess bank equity capital also would constitute a buffer that is not available to finance productivity-enhancing capital investment.”¹⁰

These statements come from experts who should know better. Such statements would be correct if they applied to requirements for higher cash reserves, but are false since they apply to requirements for higher equity capital. Capital requirements constrain how banks obtain their funds but do not constrain how they use them, whereas reserve requirements constrain how banks use their funds but do not constrain how they obtain them.

In fact, evidence suggests that high levels of capital *support* lending. To quote former Bank of England Governor Mervyn King:

Those who argue that requiring higher levels of capital will necessarily restrict lending are wrong. The reverse is true. It is insufficient capital that restricts lending. That is why some of our weaker banks are shrinking their balance sheets. Capital supports lending and provides resilience. And, without a resilient banking system, it will be difficult to sustain a recovery.¹¹

In principle, there is no reason why a higher capital ratio should restrict bank lending at all. On the contrary, if a bank has good lending opportunities, it can raise funds to finance them by issuing more shares, and the only constraint that matters is the willingness of investors to buy those shares.

A REGULATORY OFF-RAMP

Taking all the above into consideration, this chapter offers the following proposal: Any bank operating in the U.S. should be given the choice to opt out of federal prudential regulation provided it commits to maintain a minimum core-capital-to-total-exposure ratio of at least 20 percent.

The regulations from which the bank would be exempted would include all prudential regulation by any federal body, including the Federal Reserve, the Office of the Comptroller of the Currency (OCC), and the prudential regulations of Dodd–Frank. Implicitly, such banks would also be exempt from Basel III requirements and compliance with Federal Reserve stress tests. However, the proposal does not suggest any such bank be exempted from *all* federal regulation. Under this proposal, regulations concerned with anti-money-laundering, know-your-customer conduct, and health and safety regulations would still apply. Whether those regulations should be changed is another issue best left aside for present purposes. Policymakers should also structure the opt-out to allow banks to exit the federal deposit insurance corporation (FDIC) system. In this case, banks would free themselves of FDIC supervision as well as of the obligation to pay deposit insurance premiums at the cost of foregoing FDIC deposit insurance.

There is no doubt that the suggested minimum leverage ratio of 20 percent is an arbitrary one. The exact number—15 percent, 20 percent, 25 percent, or whatever else—is not so important. What matters most is that the minimum should be broadly in line with the consensus expert advice outlined earlier—that is, it should be much higher than existing leverage ratios. The underlying principles

here are that the bank should be sufficiently well capitalized to reassure depositors and other stakeholders that it can withstand major losses and still be viable, and that it has sufficient “skin in the game” to reassure those stakeholders that it has a strong incentive to rein in excessive risk-taking.

Naturally, the numerator and denominator in this capital ratio would need to be specified. In the U.S. context, the simplest solution—though not the theoretically best one, by any means—is to take the core capital numerator to be common equity Tier 1 capital (CET1), and to take the denominator to be the Basel III Leverage Exposure measure.¹² The advantage of these measures is that they are the best currently available in the absence of major reforms to accounting standards or Basel III metrics. The drawback is that both measures have major biases—CET1 capital overstates true core capital, and the Leverage Exposure measure understates the true amount at risk—that combine to produce a measure of the leverage ratio that is biased downward.¹³

A hint at the extent of this bias can be gleaned from banks’ price-to-book valuations, which reflect the market’s perception of the true values of the banks, taking into account the information available to the market and not reflected in banks’ book valuations. Given the scale of the discrepancies between banks’ market and book values, one might even make a case that the numerator should simply be market capitalization. On the other hand, banks’ share prices tend to oscillate excessively, whereas their book values do not, and one should think twice about building a capital-adequacy regime on excessively volatile metrics. Additionally, many depository institutions’ shares are not publicly traded. Thus, on balance, the ratio of (book-value) CET1 capital to Leverage Exposure is probably the best that can be achieved without major reforms in other areas.

One last loose end: To give the proposal teeth, there would also have to be some penalty against backsliding. There needs to be some contingency in the event that a bank

signs up for the opt-out, but then falls below the required minimum standard. The simplest solution would be to prohibit dividend and bonus payments should a bank's leverage ratio fall below the minimum standard. A bank would then have to bring its capital ratio back up above the minimum before such payments could be resumed.

THE REGULATORY OFF-RAMP: COULD TRANSFORM THE BANKING SYSTEM

The banks would now have a choice. They could choose to carry on as before and remain subject to all the existing prudential regulation, including the deposit insurance system, or they could choose to opt out of it all and recapitalize to the proposed minimum standard.

How the banks would respond would depend on their future profit prospects. Imagine a sound bank whose management were confident of its future prospects. Such a bank would now have the opportunity not just to reduce but to eliminate its prudential regulatory compliance costs. This is a *big* benefit. The cost of the bank getting free of all that regulatory compliance burden is the obligation to recapitalize to the required minimum standard, and this cost is negligible. So why would such a bank not jump at the opportunity? I would therefore expect such a bank to respond by going to the stock market and recapitalizing quickly. The key here is that the bank is able to persuade potential shareholders that its prospects are good. Indeed, there is no rational reason for a sound bank *not* to want to go this route. Substantial benefits + minimal costs = no brainer. You could even say that it offers a free lunch.

Naturally, I am presupposing that the bank's existing clients would be willing to accept the bank going this route—otherwise they would take their business elsewhere—but there is every reason to think they would. Existing borrowers would hardly have cause for concern, as their bank would be stronger. The same applies to depositors, too. Before federal deposit insurance existed, evidence indicates that depositors and noteholders in the United States

cared about the financial condition of their banks and carefully scrutinized bank balance sheets. Arthur Rolnick and his colleagues at the Federal Reserve Bank of Minneapolis have shown that this clearly happened before the Civil War. Thomas Huertas and his colleagues at Citicorp have demonstrated the importance of bank capital to depositors by noting that Citibank in its earlier days prospered in periods of general financial distress by maintaining higher-than-average capital ratios and providing depositors with a relatively safe haven.¹⁴

Now consider a bank that does not have good prospects. Such a bank would be unable to recapitalize via the stock market, because it would be unable to persuade potential investors that its equity was a good investment, and would have no choice but to remain under the regulatory status quo. Its failure to recapitalize would then provide a clear signal of its true state. Stakeholders would be asking why the bank was not taking advantage of the “free lunch” provided by the opt-out, and the bank management would be unable to provide a convincing response. The bank would then self-advertise as a zombie that cannot get out of government rehab, and there would be pressure on the bank to improve its capital position and on the regulators to resolve the bank one way or the other, either by recapitalizing it themselves or (my preferred solution) by putting it into bankruptcy.

So, the good banks would escape the regulatory system and rapidly recapitalize, and the zombies would be exposed. The former would then gain a major competitive advantage: being strongly capitalized, free of their former compliance burdens, and having good prospects, they would be well placed to increase their market share at the expense of the zombies still in the state system, which would have none of these advantages. In addition, it would be much easier for new banks to enter the market and further increase competition, thereby providing the maximum scope for, for instance, disruptive FinTech innovators or old-fashioned bankers of the George Bailey mould. Over time, the good banks—new and

old—would gradually displace the bad ones and eventually drive them out of business. In the process, the whole prudential regulatory apparatus would wither on the vine, and the

U.S. banking system would once again become strong, stable and highly competitive. A simple opt-out might just be the key to sort out the banking mess.

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ENDNOTES

1. The term “capital ratio” is not used in the sense in which that term is now commonly used, that is, to refer to the ratio of capital to so-called risk-weighted assets (RWAs). The RWA is a discredited risk measure. See, for instance, A. G. Haldane, “Constraining Discretion in Bank Regulation,” April 9, 2013, speech at the Federal Reserve Bank of Atlanta Conference on “Maintaining Financial Stability: Holding a Tiger by the Tail(s),” Federal Reserve Bank of Atlanta, 2013, <https://www.frbatlanta.org/news/conferences/2013/130408-fmc/agenda> (accessed October 3, 2016), and Kevin Dowd, “Math Gone Mad: Regulatory Risk Modeling by the Federal Reserve,” Cato Institute *Policy Analysis* No. 754, September 3, 2014, <http://www.cato.org/publications/policy-analysis/math-gone-mad> (accessed October 3, 2016).
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3. For more on these issues, see, Kevin Dowd, Martin Hutchinson, Jimi Hinchliffe, and Simon Ashby, “Capital Inadequacies: The Dismal Failure of the Basel System of Capital Adequacy Regulation,” Cato Institute *Policy Analysis* No. 681, July 29, 2011, <http://www.cato.org/publications/policy-analysis/capital-inadequacies-dismal-failure-basel-regime-bank-capital-regulation> (accessed October 3, 2016).
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7. Admati and Hellwig, *The Bankers’ New Clothes*, p. 130.
8. *Ibid.*, p. 5.
9. Wayne Abernathy, “Shrinking Banks Will Drag Down the Economy,” *American Banker*, August 27, 2012, <http://www.americanbanker.com/bankthink/shrinking-banks-will-drag-down-the-economy-1052148-1.html> (accessed October 3, 2016).
10. Alan Greenspan, “Regulators Must Risk More to Push Growth,” *Financial Times*, July 28, 2011, <http://www.ftchinese.com/story/001039834/en/?print=y> (accessed October 3, 2016).
11. Mervyn King, “A Governor Looks Back—and Forward,” speech at the Lord Mayor’s Banquet for Bankers and Merchants of the City of London, June 19, 2013, <http://www.bankofengland.co.uk/publications/Documents/speeches/2013/speech670.pdf> (accessed October 3, 2016).
12. Common equity Tier 1 capital is defined in Title 12, CFR 3.20(b), and leverage exposure is defined in Title 12, CFR 3.10(c)(4)(ii)(A) through (H).
13. For a discussion of the weaknesses of these measures, see Kevin Dowd, “The Average Leverage Ratio Across the UK Banking System: 2007 vs. Now,” Adam Smith Institute blog, June 3, 2016, <http://www.adamsmith.org/average-leverage-ratio/> (accessed October 3, 2016), and Kevin Dowd, *No Stress II: The Flaws in the Bank of England’s Stress Testing Programme* (London: Adam Smith Institute, 2015), <http://www.adamsmith.org/research/no-stress-ii-the-flaws-in-the-bank-of-englands-stress-testing-programme> (accessed October 3, 2016).
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CHAPTER 3:

A Better Path for Mortgage Regulation

Diane Katz

The notion of consumers as incapable of determining their credit preferences and managing their financial affairs is now entrenched in federal statute, as is the caricature of lenders as predators of the clueless. It is this paternalist fallacy upon which Democrats¹ in Congress erected much of the Dodd–Frank Wall Street Reform and Consumer Protection Act. The irony is that the housing collapse at the heart of its passage was largely the result of government interference in the mortgage market.

Until passage of Dodd–Frank in 2010, most consumer protection was designed to equip consumers with the information necessary to act on their preferences, given market conditions, and to punish fraud and other wrongdoing. The role of government, at least theoretically, was to facilitate choice and competition—an approach reflecting the belief that free enterprise, albeit imperfect, yields greater benefit than autocratic alternatives.

That deference to consumer autonomy is now largely defunct. Instead, we have the Consumer Financial Protection Bureau (CFPB) and a framework of mortgage regulation that treats consumers as fundamentally irrational and prone to act against their self-interest. In the words of Oren Bar-Gill and Elizabeth Warren, the academic architects of the bureau, consumers suffer “cognitive limitations” and their “learning is imperfect.”²

Indeed, the bureau takes the position that “too much information” can “detract from

consumers’ decision-making processes.”³ Under this paradigm, regulatory intervention is necessary to protect consumers from themselves by limiting loan options and standardizing mortgages.

This approach, of course, is inherently contradictory. If consumers suffer cognitive limitations with respect to mortgage matters, would the politicians and bureaucrats who dictate the terms and conditions of loans not also be afflicted by biases, particularly those of a political nature? As noted by economist Edward Glaeser, “Human beings surely make mistakes about their own welfare, but the welfare losses created by these errors are surely second order relative to the welfare losses created by governments which not only make errors, but also pursue objectives far from welfare maximization.”⁴

Dodd–Frank’s Title X and Title XIV constitute the response of congressional Democrats to a politicized narrative in which the housing

bubble and subsequent crash were the fault of unscrupulous mortgage lenders who took advantage of naive, uninformed consumers.

Reckless lending did play a role in the crisis, but the reality is that millions of lenders and borrowers were responding rationally to incentives created by an array of deeply flawed government policies, including artificially low interest rates contrived by the Federal Reserve, the massive subsidy of risky loans by Fannie Mae and Freddie Mac,⁵ and the low-income lending quotas set by the Department of Housing and Urban Development.⁶

None of those major factors was addressed by Dodd–Frank; Congress instead opted to further empower the very regulatory establishment that fueled the crisis and then failed to contain it.

There certainly was a need to modernize mortgage regulation prior to the 2008 financial crisis. But Congress’ hastily crafted response—that is, creation of the CFPB and its radical regulatory regime—now constitutes a different threat.

Crisis legislation such as Dodd–Frank is rarely, if ever, elegant. But its blanket restructuring of housing finance confuses government control with financial safety and soundness. That is a mistake that Congress must correct if America’s housing market is to flourish. The most effective remedy is to eliminate the government policies that distorted the financial decisions of both lenders and borrowers, with such disastrous results.

DEREGULATION IS NOT TO BLAME

Mortgage origination and servicing did not exist in a regulatory vacuum before the enactment of Dodd–Frank in 2010. Virtually all financial market activity has taken place under the thumb of federal regulators since at least the 1930s.⁷ States, too, have long regulated banks and mortgage brokers and interest rates.

Mortgages, in particular, were heavily regulated by the federal government prior to 2010, with a focus on disclosure requirements to ensure that consumers were fully apprised of the terms and conditions of their loans.

That approach reflected what George Mason University professor Joshua Wright has described as “the standard economic theory of regulation,” which assumed “standard, stable, rational consumer preferences.”⁸

In contrast, Dodd–Frank’s behaviorist approach substitutes consumer choice with the presumably superior expertise of regulators who are, somehow, free of cognitive bias, and know consumers’ true preferences better than individuals themselves.

THE MODERN REGULATORY WAVE

Federal intervention in mortgage lending took hold as a means of increasing credit to farmers. First was the Federal Farm Land Bank Act of 1916, followed by the National Housing Act of 1934.⁹ Regulation escalated during the Great Depression, with creation of the Federal Housing Administration (FHA), the Federal National Mortgage Association, and the Home Owner’s Loan Corporation.

The next regulatory wave dates to 1960, when Congress began debating disclosure requirements for the cost of credit. In 1968, Congress “intruded” into the long-standing province of the states in regulating consumer transactions¹⁰ with passage of the Consumer Credit Protection Act (CCPA).¹¹ Title I of the CCPA, the Truth in Lending Act (TILA), mandated disclosure of credit charges “clearly and conspicuously” as specified by the Federal Reserve System.¹²

As declared by Congress, the purpose of TILA was to “assure a meaningful disclosure of credit terms” rather than dictate the conduct of lenders or the content of loan agreements.¹³

Title I neither regulates the credit industry, nor does it impose ceilings on credit charges. It provides for full disclosure of credit charges, rather than regulation of the terms and conditions under which credit may be extended. It is the view of [the] committee that such full disclosure would aid the consumer in deciding for himself the reasonableness of the credit charges imposed and

further permit the consumer to “comparison shop” for credit.¹⁴

TILA took effect on July 1, 1969,¹⁵ and it was amended the very next year for the first of more than two dozen times during the next four decades.¹⁶ Every amendment added new disclosure requirements—ultimately reaching at least 110 data points.¹⁷ The attendant implementing rules, known as Regulation Z, increased to 314 pages, with 14 appendices. In the end, the law was unrecognizable from the original statute’s tight focus on disclosure.

As noted by former Federal Reserve economist Thomas Durkin, TILA became a vehicle for the ever-growing demands of consumer “advocates,” including raising consumer awareness and consumer confidence, improving consumer satisfaction, encouraging comparison shopping, enhancing consumer education, and even meeting macroeconomic goals like enhancing economic stabilization.¹⁸

Five years after TILA, Congress enacted the Real Estate Settlement Procedures Act (RESPA) to require disclosure of settlement costs and to bar referral fees and kickbacks in lending services.¹⁹ In so doing, Congress breached the regulatory threshold of the *conduct* of mortgage-settlement-service providers. For example, section 8 of the statute prohibited fee-splitting among service providers, and also prohibited any person from giving or accepting referral fees, kickbacks, or “things of value” unless a commensurate amount of work is performed to earn the fee.²⁰

THE HOEPA STANDARD

Two decades after RESPA, Congress enacted the Home Ownership and Equity Protection Act (HOEPA).²¹ The law subjected certain loans to heightened disclosure requirements if the rates or fees exceed specified limits.²² HOEPA targeted a small subset of the subprime mortgage market.

Under HOEPA, a creditor is required to disclose to borrowers that they are not required to close on the loan even after signing the mortgage application. HOEPA also

required lenders to disclose to borrowers that the loan constitutes a mortgage (as if the borrowers would not know that), and that they could lose the home and any equity if they failed to make payments.²³

HOEPA further encroached into *conduct* regulation by prohibiting loan proceeds to be used as direct payment to a home improvement contractor, and, more important, barring a pattern or practice of making loans without considering a borrower’s ability to repay the loan from sources other than home equity.²⁴

Moreover, for the first time, HOEPA imposed federal restriction on the *content* of mortgage terms. For example, a mortgage agreement could not include a higher interest rate after default; require a balloon payment on a loan with a term of less than five years; include a payment schedule that results in negative amortization; include a prepayment penalty (except in limited circumstances); or require advance payments greater than the sum of two periodic payments from the loan proceeds.²⁵

In regulating such mortgage terms and conditions, Congress infringed on Americans’ freedom of contract, and set a precedent for future government limits on access to mortgage credit.

But such interference was unnecessary to protect consumers from “predatory” lenders.²⁶ To the extent that predation involves fraud or misrepresentation, such conduct was already illegal under state laws.²⁷

A USEFUL CRISIS FOR STATISTS

The U.S. housing market collapsed between 2006 and 2008. The dollar value of mortgage originations for single-family houses fell by half during that period,²⁸ while the delinquency rate increased by 50 percent and the foreclosure rate increased by 175 percent.²⁹ The attendant losses to mortgage-backed securities triggered a major recession.

The crisis was a golden opportunity for activists to promote the wholesale regulation of consumer credit that they had long advocated—despite the fact that the crisis was not caused by a failure of the federal mortgage

regulatory regime embodied by TILA, RE-SPA, and HOEPA. In 2007, for example, then-professor Elizabeth Warren argued for the creation of a financial regulatory agency that would regulate credit products in the same manner that the Consumer Product Safety Commission regulates toasters.³⁰

What Warren and her acolytes apparently fail to grasp is that no one benefits from an exploding toaster, but a mortgage deemed “defective” by regulators is suitable for some borrowers in some situations.

The overhaul began in 2008, with passage of the Housing and Economic Recovery Act, which, among other things, created a federal licensing regime for mortgage loan originators and imposed additional TILA disclosures.³¹

The Federal Reserve likewise revised TILA’s Regulation Z to carve out a new class of “high-cost” mortgages that effectively expanded HOEPA restrictions to all subprime home mortgages.³² Among them was a prohibition on prepayment penalties within the first two years of the loan, and the mandatory establishment of an escrow account for taxes and insurance. Lenders were also required to verify a borrower’s ability to repay the loan, and were prohibited from undertaking certain appraisal and servicing practices.³³

These regulatory encroachments were soon followed by the Obama Administration’s proposal to transform the entire financial system. Titled “A New Foundation: Rebuilding Financial Supervision and Regulation,” the proposal called for a new regulator to “define standards for ‘plain vanilla’ products” and “require all providers and intermediaries to offer these products prominently, alongside whatever other lawful products they choose to offer.”³⁴ The Administration also proposed that the new regulatory agency “be authorized to place tailored restrictions on product terms and provider practices, if the benefits outweigh the costs.”³⁵ In other words, the Administration was seeking to regulate financial services as a utility.

President Barack Obama unveiled the proposal before a congressional commission

released its findings on the causes of the financial crisis.³⁶ Shortly thereafter, urged on by consumer activists and behavioral economists, the Democratic majorities in Congress enacted the Dodd–Frank Act.³⁷

DODD–FRANK LIVES

Divided into 16 titles, Dodd–Frank affects virtually every aspect of the financial system, including checking accounts, credit cards, mortgages, education loans, retirement accounts, insurance, and all manner of securities. The enormity and complexity of this regulatory hijacking is reflected in the thousands of pages of new rules that the various agencies have churned out over the past six years.

The cornerstone of the mortgage regulations by the CFPB is a lender obligation to “make a reasonable and good faith determination based on verified and documented information that the consumer has a reasonable ability to repay the loan according to its terms.”³⁸

This ability-to-repay provision is more than a procedural requirement. It is the basis of an expansive new consumer right to sue lenders for miscalculating their financial fitness for a loan.

Under the new regime, a borrower may sue a lender within three years of an alleged violation, such as improperly documenting income or assets, or incorrectly calculating the borrower’s financial obligations. Those who prevail may recover damages equal to the sum of all finance charges and fees paid—potentially tens of thousands of dollars.

A borrower may also assert a violation of the ability-to-repay requirement as a defense against foreclosure—even if the original lender sold the mortgage or assigned it to a servicing firm. (The lawsuit may ensnare an assignee or holder of the mortgage, as well.) If successful, the borrower may recover all mortgage finance charges and fees paid in addition to actual damages, damages in an individual action or class action, and court costs and attorney fees.³⁹

The obvious consequence of this new cause of action is more litigation and less

credit availability. No longer must borrowers who wish to contest foreclosure initiate a lawsuit against the lender. This reduces borrowers' legal costs, and thus increases the incentive to claim a violation of the ability-to-repay requirement in the event that mortgage payments become burdensome.

A new prohibition on pre-dispute arbitration also is expected to “dramatically increase the litigating of disputes which would have otherwise been resolved by arbitration.”⁴⁰

The rules reflect the notion that dastardly creditors and lax lending standards led consumers to assume mortgages they could not afford. However, in the context of the rising house prices at the time, higher-leveraged loans made financial sense. As explained by Federal Reserve Bank researchers,

If [lenders and borrowers] believe that house prices would continue to rise rapidly for the foreseeable future, then it is not surprising to find borrowers stretching to buy the biggest houses they could and investors lining up to give them the money. Rising house prices generate large capital gains for home purchasers. They also raise the value of the collateral backing mortgages, and thus reduce or eliminate credit losses for lenders.⁴¹

The rules also reflect the low regard in which Americans are held by Congress and the CFPB bureaucrats. Under the ability-to-repay regime, lawmakers shifted accountability for loans from borrowers to lenders. This perversion of credit principles presumes that consumers are incapable of acting in their own interests. Even assuming the most benevolent intentions, such paternalism fosters dependence on government and erodes economic freedom.

Advocates attempt to justify this radical change by citing statistics on the flood of defaults and foreclosures during the housing crash. While many homeowners did incur terrible losses, most were not victims of

predatory lending or fraud.⁴² The hard truth is that most of them bet on rising home values and lost. They were not imbeciles. And, not one person will be made whole by the government abolishing credit options and curtailing financial freedom.

Even CFPB officials acknowledge that the new rules raise the costs and risks of mortgage lending. Creditors were forced to reconfigure policies and procedures, reprogram loan origination systems, and retrain personnel—thereby increasing the costs of underwriting loans. The threat of litigation breeds greater caution among lenders and thus further restricts the availability of credit. The impact has been particularly hard on community banks, which lack the capacity to increase their compliance staff or to hire consultants. Some have simply exited the mortgage market.⁴³

The risks to lenders may be mitigated to some degree by meticulous compliance with the ability-to-repay procedures. But even the most vigilant lender will remain vulnerable because the regulatory parameters are somewhat fluid. (One irrational exception is the outright prohibition of basing a loan decision on the fact that an applicant's income derives from public assistance.)⁴⁴

Although there are specific rules for computing some asset and debt factors, the bureau is allowing some flexibility in underwriting methods. This approach is both a benefit and a bane to lenders. On the one hand, lenders will enjoy some independence in designing ability-to-repay procedures. But it also means that there is no fixed compliance standard to follow, which invites arbitrary enforcement actions. As acknowledged by the bureau, “[The CFPB] does not believe that there is any litmus test that can be prescribed to determine whether a creditor, in considering those factors, arrived at a belief in the consumer's ability to repay which was both objectively reasonable and in subjective good faith.”⁴⁵

In other words, the rule of law is what the bureau deems it to be at any particular point in time. This is a direct and undesirable

consequence of Congress avoiding accountability by delegating its legislative authority to regulators. It is also a direct threat to fundamental principles of representative government.

Even if a lender ultimately prevails in a legal challenge, it will not be spared the costs of litigation. According to data submitted to the CFPB, the average litigation cost to secure a motion to dismiss runs an estimated \$26,000; a summary judgment, \$84,000; and a trial, \$155,000.⁴⁶

Perversely, the CFPB is suggesting that lenders look to governmental entities, such as the FHA, for guidance on underwriting criteria. This is the agency that racked up a \$16 billion deficit to its insurance fund and requested a \$1.7 billion taxpayer bailout in 2013.⁴⁷

vThe Dodd–Frank Act offers a “safe harbor” against potential ability-to-repay litigation in the form of a qualified mortgage (QM).⁴⁸ Lenders who meet specific mortgage criteria, including loan limits, fee caps, and prescribed payment calculations, will be presumed to have satisfied the ability-to-repay criteria. The CFPB has also carved out a less-absolute “rebuttable presumption” for higher-priced mortgages.⁴⁹ The relative safety of the QM means that lenders will be far less likely to offer loans that do not meet the QM criteria.

Lenders lobbied hard for the safe harbor approach as protection from the litigation risk—which only exists because Congress created the new liability scheme to begin with. But there is also general recognition that establishment of the safe harbor will not eliminate litigation risk altogether. Consumers will still be able to file lawsuits; only the scope of the litigation will be delimited.

To be designated as a qualified mortgage, the interest rate cannot exceed 1.5 percentage points over the Average Prime Offer Rate; points and fees must not exceed 3 percent of the loan; and the term of the mortgage cannot exceed 30 years. Of particular importance is the requirement that mortgage payments will not increase the borrower’s debt-to-income (DTI) ratio above 43 percent.

With very limited exception, balloon loans⁵⁰ are not eligible for QM status, nor are interest-only mortgages or negative amortization loans.⁵¹ These limitations are based on the misconception that unconventional loans are “predatory” by nature, and played a major role in the housing collapse.

Notwithstanding incessant banker-bashing, a variety of research documents support that unconventional lending did not cause the crisis. According to economist Yuliya Demyanyk, formerly of the Federal Reserve Bank of St. Louis,

It was a market-wide phenomenon. For example, borrowers with mortgages that carried a fixed-interest rate—the rate that will not reset through the entire term of a loan—had very similar problems to borrowers with hybrid mortgages. Borrowers who obtained a subprime mortgage when they bought a home had the same problems in 2006 and 2007 as those who refinanced their existing mortgages to extract cash. Borrowers who provided full documentation and no documentation followed the same pattern.⁵²

In reality, each type of mortgage is beneficial for specific types of borrowers. Balloon mortgages, which feature lower interest rates and monthly payments, are appropriate for homebuyers who plan to sell their house before the balance of the loan (the balloon payment) is due. They also may prove to be profitable if home values are rising consistently; the additional equity will help to secure refinancing to make the balloon payment. On the other hand, interest-only mortgages are ideal for borrowers with irregular incomes or those who anticipate an increase in earnings in the future.

Barring such loans under the QM regime means fewer options for would-be homebuyers, and a new barrier to the wealth creation associated with property investment. This is not consumer protection, but consumer control.

The same approach pervades the QM's DTI requirement. Although a DTI ratio of 43 percent falls within the range of industry standards, there is infinite variety among borrowers' circumstances that bankers would otherwise take into account. The DTI constraint will increase the number of applicants who will be rejected for loans they could afford while others obtain ones they cannot manage.

The Federal Reserve Board, during previous deliberations on the issue, declined to propose a specific DTI ratio for QMs out of concern that doing so could limit credit availability. The board also concluded that setting a quantitative standard would oblige it to micromanage underwriting, such as defining income and debt obligations and compensating factors.

CFPB officials acknowledge that the 43 percent threshold is problematic for some would-be borrowers. For example, a total of 23 percent of the loans acquired by Fannie Mae and Freddie Mac between 1997 and 2009 had DTI ratios of 44 percent or greater, according to data from the Federal Housing Finance Agency. Over the same period, 19 percent of the loans had DTI ratios of 46 percent or greater.⁵³

The bureau's DTI threshold is based on the "general boundary" of affordability utilized by the FHA—hardly a paragon of prudent lending, as previously noted. In contrast, Fannie Mae's and Freddie Mac's guidelines link the required DTI ratio to the credit score of the borrower. Those with credit scores below 700 generally require a DTI ratio of 36 percent, while borrowers with a credit score above 700 may be eligible with a DTI ratio of 45 percent.⁵⁴

There is a gradual increase in mortgage delinquency rates as debt increases in relation to income. But there is virtually no difference between a DTI ratio of 42 percent and 45 percent. Numerous other factors have a stronger correlation to loan repayment. For example, the loan-to-value ratio and credit score are much more predictive of loan performance than DTI ratios, according to the Mortgage Bankers Association.

The CFPB acknowledges that there is no "magic number" which separates affordable from unaffordable mortgages. Whether the 43 percent DTI ratio is better than, say, 40 percent or 46 percent, is rather beside the point, however. Any fixed standard will inhibit lenders from making judgments based on an applicant's character, the state of the market, their experience, or a host of other factors. But those are better predictors of creditworthiness than the directives of bureaucrats passing judgment from thousands of miles away.

In congressional testimony, bank director James Gardill warned that a static set of loan criteria will mean a lot fewer mortgages. There are "many American families across the country that are creditworthy but do not fit inside the QM 'box,'" he said. Likewise, the California & Nevada Credit Union Leagues note that even more affluent borrowers may find their access to credit diminished under the QM rules. "A borrower earning \$10,000 or \$15,000 a month, with no non-housing debts, might have trouble getting a mortgage if his house payment plus taxes and insurance totaled 45 percent of his gross income."

Particularly hard hit are young adults. As first-time homebuyers, they have limited income and college debt, pushing their DTI above "qualified" status. But these are the very buyers who prompt churn in the market, that is, their entry allows current homeowners to parlay their equity into a second better home, fueling upward mobility along the property chain.

New retirees also are vulnerable because they rely on assets rather than income to cover housing payments. As such, the CFPB rule places "significant limitations on the amount of new mortgage credit available to these customer segments and further restrict their home-buying choices."

Advocates argue that the standardization of mortgages would have gone a long way toward preventing the massive defaults of 2006 to 2009. But it was not lack of regulation that prompted the loosening

of standards. The more salient factors were artificially low interest rates and the shift of mortgage risk from private lenders to government, both of which spurred exuberant investment in housing and lowered underwriting standards.

RECOMMENDATIONS FOR REFORM

Repeal Titles X and XIV. Borrowers and lenders should be free to negotiate the terms of mortgage agreements. There is no justification for government regulators substituting their judgment for that of borrowers. Emerging research indicates that Dodd–Frank’s interventionist approach is harming the very mortgage borrowers Congress intended to protect.

Short of full repeal, Congress should at least permit borrowers to opt out of each of the content restrictions by attestation.

Devolve Mortgage Disclosure to States. To the extent that disclosures require regulation, states are better positioned than the federal government to determine the information deemed necessary for consumers. In fact, nothing in TILA, RESPA, or HOEPA requires borrowers to actually read the disclosures. Moreover, even a full-disclosure regime cannot satisfy all borrower-information needs at all times or prevent all borrowers from making mistakes.

Encourage Market Competition. The best consumer protection for mortgage borrowers is a vibrant and competitive mortgage lending market. To encourage greater competition among mortgage loan originators, Congress should repeal the SAFE Mortgage Licensing Act’s mandatory mortgage loan originator licensure regime. By controlling

entry into the mortgage-originator profession, states restrict the quantity of services provided as much as the quality, which limits competition and increases the price of services for borrowers.

Competition can also be promoted by further unbundling of settlement services and specialization among service providers. To that end, Congress should amend RESPA Section 8 to permit greater fee-splitting among service providers.

Because Dodd–Frank failed to deal with Fannie Mae and Freddie Mac, a future Congress will have to address the problem. In order to protect mortgage borrowers, Congress should wind down Fannie Mae and Freddie Mac and encourage private capital investment as a means of creating a sustainable housing finance system and enhancing market discipline.

CONCLUSION

Washington’s hastily crafted response to the financial crisis is built on the belief that the housing bubble and subsequent crash were the fault of unscrupulous mortgage lenders who took advantage of naive, uninformed consumers. In reality, lenders and borrowers were responding rationally to incentives created by an array of deeply flawed government policies. None of those major factors is addressed by the new regulatory regime. Congress instead opted to further empower the very establishment that fueled the crisis and then failed to contain it. Consequently, the new rules will unnecessarily limit mortgage options and access to credit—and further erode Americans’ freedoms.

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ENDNOTES

1. No House Republicans voted in favor of Dodd–Frank on the first floor vote, although three voted for the conference report: Representatives Joseph Cao (R–LA), Mike Castle (R–DE), and Walter Jones (R–NC). Four Senate Republicans voted for the bill on the first floor vote: Senators Scott Brown (R–MA), Susan Collins (R–ME), Chuck Grassley (R–IA), and Olympia Snowe (R–ME). However, Grassley voted “No” on the conference report, while the other three voted for passage.
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11. Consumer Credit Protection Act (CCPA) of 1968, Public Law 90–321.
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23. *Ibid.*

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25. *Ibid.*, § 129(c)–(g).
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31. Housing and Economic Recovery Act, 2008, Public Law 110–289. Title V of the Housing and Economic Recovery Act, known as the Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (SAFE Act), mandated a nationwide licensing and registration system for residential mortgage loan originators. See 12 U.S. Code § 5101–5116.
32. The regulations defined a higher-priced mortgage as one that is secured by the borrowers’ principal dwelling and has an annual percentage rate that exceeds the “average prime offer rate” by 1.5 percentage points for loans secured by a first lien, by 3.5 percentage points for loans secured by a subordinate lien, and by 2.5 percentage points in the case of a first-lien jumbo loan. 12 C.F.R. 1026.35(a). The rule’s primary objective was to “cover the subprime market and generally exclude the prime market.” See “Truth in Lending,” *Federal Register*, Vol. 73 (July 30, 2008), p. 44532, http://www.federalreserve.gov/reportforms/formsreview/RegZ_20080730_ffr.pdf (accessed October 24, 2016). The rule became effective October 1, 2009.
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49. As crafted by the CFPB, two different classes of loans are eligible to be "qualified mortgages." The distinction between the two is based on the annual percentage rate of the loan. The final rule provides a rebuttable presumption for "higher-priced" loans, that is, a residential mortgage loan with an APR of 6.5 percent above the Average Prime Offer Rate for first-lien loans; 8.5 percent for a second or subordinate-lien loan; total points and fees exceeding 5 percent of transaction amounts of \$20,000 or more; or the lesser of \$1,000 or 8 percent of a transaction smaller than \$20,000. For loans that are not "higher-priced," the final rule provides a conclusive presumption that the creditor has satisfied the ability-to-repay requirements once the creditor proves that he has in fact made a qualified mortgage.
50. A balloon loan originated through 2016 that meets the other requirements may be designated as a "qualified mortgage" if it is originated and held in portfolio by a small creditor—defined as holding less than \$2 billion in assets and originating 500 or fewer first mortgages per year.
51. A negative amortization loan features initial monthly payments that are less than the actual interest due, thereby increasing the total balance of the mortgage over time. Negative amortization loans allow borrowers to make lower monthly payments in the short term in exchange for higher payments in the long term.
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CHAPTER 4:

Money and Banking Provisions in the 2016 Financial CHOICE Act: A Major Step Toward Financial Security

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The contributors to *Prosperity Unleashed* largely assume that the 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act should be repealed, and focus on the solutions necessary to fix the core financial regulatory problems that have existed in the U.S. for decades. The present chapter is a bit of an exception because it discusses details in the Financial CHOICE Act, a bill designed to replace large parts of Dodd–Frank. Given that the Trump Administration has pledged to dismantle Dodd–Frank,¹ *Prosperity Unleashed* would be incomplete without discussing the reforms in the CHOICE Act.² Furthermore, the cornerstone of the CHOICE Act, a regulatory off-ramp, can be used to implement a broad set of bank regulation reforms.

The regulatory off-ramp in the CHOICE Act is a provision that provides regulatory relief to banks *if* they choose to hold higher equity capital than they are currently required to hold. Put differently, banks who choose to improve their ability to absorb losses earn regulatory relief. This approach makes sense because there is little reason to heavily regulate banks that can absorb their own financial risks. Thus, a regulatory off-ramp could be used to provide relief from regulations that have nothing to do with Dodd–Frank. The off-ramp also highlights a problem that any such reform must address: specifying the firm’s capital ratio. Implementing this type of reform requires regulators to choose a numeric value for the capital ratio and to define the components of that ratio.

The latter problem is particularly important given large banks’ use of off-balance sheet items and derivatives. For all of these reasons, this chapter describes the approach taken in the CHOICE Act as well as one possible alternative. More broadly, the chapter reviews the best money and banking features of the 2016 CHOICE Act and offers suggestions for improvements. Adopting the ideas in the 2016 CHOICE Act would be an overwhelmingly positive step for U.S. financial markets because doing so would replace large parts of Dodd–Frank and help to restore market discipline. At the very least, the 2016 CHOICE Act provides a basic blueprint for the Trump Administration to rid U.S. financial markets of the Dodd–Frank Act and to help Americans more easily achieve financial security.³

TITLE I: REGULATORY RELIEF FOR STRONGLY CAPITALIZED, WELL-MANAGED BANKING ORGANIZATIONS

Title I of the 2016 CHOICE Act can be viewed as the bill's centerpiece because it spells out the "capital election" provision of the bill (in Sections 101, 102, and 105). The capital election is optional, and it creates what has been referred to as a regulatory off-ramp for banks. The provision rewards banks by exempting them from onerous regulations if they choose to meet a higher capital ratio, thus credibly reducing their probability of failure and any consequent taxpayer bailouts. This approach makes sense because there is little justification for heavily regulating firms that absorb their own financial risks. Section 102 spells out several regulations that banks which choose to meet the capital election requirements would be exempt from following.

This list of federal rules and regulations includes those which address capital and liquidity standards, capital distributions to shareholders, and mergers and acquisitions. In particular, it exempts qualified banks from these rules that are imposed in the name of mitigating "risk to the stability of the United States banking or financial system," an ill-defined metric in Dodd-Frank that gives overly broad power to federal regulators. These exemptions would effectively exempt qualified banks from all Basel III capital and liquidity rules, a huge improvement, considering how poorly previous iterations of the Basel rules have performed.⁴

Suggested Title I Improvements. Title I of the Financial CHOICE Act represents a major regulatory improvement because it helps restore market discipline while reducing banks' regulatory burdens. It provides a *voluntary* mechanism by which banks can receive regulatory relief for choosing to fund their operations with more equity. The following recommendations would help expand these benefits even further:

- **Eliminate stress tests.** The bill would still allow federal banking regulators to conduct stress tests for banks that qualify for the capital election, but the benefit of these exercises is highly dubious.⁵ Banks that absorb the costs of their own financial risks have every incentive to plan for contingencies, and there is no reason to think that regulators can accurately model the impact of all contingencies in the first place. For example, when Regions Financial Corporation advised investors that it would likely realize \$3.4 billion in combined 2009–2010 losses, Federal Reserve Governor Daniel Tarullo's team of regulators forced Regions to raise enough capital to withstand \$9 billion in losses. Regions showed a combined loss for these two years of just over \$2 billion.⁶
- **Expand the list of exemptions.** The bill could be improved by providing even more regulatory relief for qualifying firms. For instance, qualified banks could be exempt from regulations associated with any, or all, of the following: the Truth in Lending Act (TILA);⁷ the Real Estate Settlement Procedures Act (RESPA);⁸ the Home Mortgage Disclosure Act (HMDA);⁹ the Equal Credit Opportunity Act (ECOA);¹⁰ the Fair Housing Act (FHA);¹¹ and the Community Reinvestment Act (CRA).¹²
- **Use a higher, simpler leverage ratio.** Provided they receive a CAMELS rating of either 1 or 2 from their regulator,¹³ banks that have an average leverage ratio of at least 10 percent qualify for regulatory relief under the capital election. There are many ways to calculate a bank's leverage ratio, and the formula in the discussion draft is the ratio of tangible equity to leverage exposure, where "leverage exposure" is defined as it is for the Basel III supplementary leverage ratio (SLR).¹⁴ Using the SLR in this manner is problematic for several reasons.

First, qualifying banks would be exempt from the Basel III capital rules only if they

TABLE 4-1

Comparative Leverage Ratios of Eight GSIBs

Bank Name	IFRS	Self-Reported Basel III	Alternative IFRS–Basel III
Goldman Sachs	5.00%	5.90%	0.68%
Morgan Stanley	4.22%	5.80%	4.46%
State Street	5.52%	5.80%	5.48%
Bank of NY Mellon	4.31%	4.90%	4.98%
Citibank	6.57%	7.08%	2.40%
Wells Fargo	8.20%	7.70%	5.48%
Bank of America	5.78%	6.40%	4.58%
JPMorgan Chase	5.93%	6.50%	3.04%
Average	5.69%	6.26%	3.89%

GSIB—Global Systemically Important Bank

IFRS—International Financial Reporting Standards

NOTES: The alternative IFRS–Basel III leverage ratio is calculated as “total bank equity capital” (end of Q4 2015) divided by total assets. Total assets include an approximation of off-balance-sheet and net derivative exposures. Net derivative exposure is estimated by summing the categories of “Net Current Credit Exposure” for OTC derivatives, and adding 7 percent of notional derivative exposure (as an estimate of the Basel III potential future exposure). Off-balance-sheet exposure is estimated by summing all unused commitment items as well as all other off-balance-sheet liabilities (excluding derivatives), and all categories of letters of credit.

SOURCES: Federal Deposit Insurance Corporation, “Capitalization Ratios for Global Systemically Important Banks (GSIBs),” December 2015, <https://www.fdic.gov/about/learn/board/hoenig/capitalizationratios4q15.pdf> (accessed July 21, 2016), and author’s calculations based on data from figures reported in the FFIEC Call Report Data.

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already comply with one of the Basel III capital rules. Second, the SLR is a complex risk-weight-based approach that has little to do with how most banks operate in the first place. It assigns 21 weights to the various types of over-the-counter (OTC) derivative contracts, with the lowest weights assigned to interest-rate derivatives. These interest-rate derivatives make up almost 80 percent of the OTC derivatives market and they are heavily concentrated among four large banks.¹⁵ Thus, using the SLR in this manner would impose yet another layer of complex regulation on most of the banking industry because of the way a handful of very large financial institutions operate.

Furthermore, the SLR is not as transparent as other measures that are reported based on standards set according to generally accepted accounting principles (GAAP), and the

required Basel III components for replicating the SLR are currently not included in the Federal Financial Institutions Examination Council (FFIEC) call reports. Finally, using the SLR in this manner gives an international committee undue influence on U.S. law and undermines the authority of the Financial Accounting Standards Board (FASB), the organization responsible for issuing GAAP. One possible benefit of using the SLR is that it (arguably) does a better job than GAAP of accounting for payment risk due to derivative exposure. However, the SLR’s leverage exposure can be approximated using GAAP-based derivative exposures already reported in the FFIEC call report data.¹⁶

Using this type of alternative would be far more transparent, less complex, and would not usurp the FASB. For the eight global systemically important banks (G-SIBs), using

2015 data, this alternative method yields a leverage ratio that is (on average) approximately 2 percentage points lower than the Basel III ratio. (See Table 4-1.) Instead of relying on the SLR for the denominator of the qualifying leverage ratio, the alternative measure presented in the third column of Table 4-1 uses call report items (GAAP figures) to approximate derivative exposure and total off-balance-sheet exposure. These estimates are then added to the firm's total assets to serve as the denominator of the alternative qualifying leverage ratio. The estimates for derivatives exposure and total off-balance-sheet exposure are calculated as follows:

- **Off-balance-sheet exposure:** the sum of all *unused commitments*, all *other off-balance-sheet liabilities* (excluding derivatives), and all categories of *letters of credit*.
- **Derivatives exposure:** the sum of total *net current credit exposure* for OTC derivatives, and 7 percent of total *notional* derivative exposure.

The 7 percent figure is the median of the 21 weights (conversion factors) used in the Basel III rules to estimate potential future exposure (PFE).¹⁷ Thus, the alternative ratio presented on Table 4-1 applies the same weight to *all* derivative contracts to arrive at PFE instead of relying on the Basel weighting system. Table 4-1 shows that this GAAP-based alternative more closely approximates some firms' Basel III ratio than others; the largest differences are for those firms with the largest notional derivatives exposures.¹⁸ Given that the capital election is optional, the added simplicity and transparency of such an alternative measure, as well as its standard reliance on GAAP rules, outweigh using the SLR measure for the denominator.

TITLE II: ENDING "TOO BIG TO FAIL" AND BANK BAILOUTS

Title II of the Financial CHOICE Act takes a major step toward undoing Title I of Dodd-Frank, one of the most controversial titles of the 2010 law. A main problem with Title I of

Dodd-Frank is that it created the Financial Stability Oversight Council (FSOC), a sort of super-regulator tasked with singling out firms for especially stringent regulation. These firms, commonly referred to as systemically important financial institutions (SIFIs), are those which regulators believe would damage the broader economy if allowed to file bankruptcy. In other words, Title I of Dodd-Frank charges the FSOC with identifying those firms regulators deem too big to fail. While the CHOICE Act does not fully repeal Title I of Dodd-Frank, it comes very close.

Rather than eliminate the FSOC completely, the CHOICE Act strips it of its authority to designate nonbank financial firms for stringent regulations (Section 113 of Dodd-Frank), as well as its authority to recommend more stringent regulations for individual financial activities.¹⁹ The CHOICE Act also retroactively repeals any previously made FSOC designations for nonbank financial companies. Additionally, the CHOICE Act repeals Section 115 of Dodd-Frank, which authorizes the FSOC to make recommendations for more stringent regulations to the Federal Reserve Board of Governors for both nonbank financial firms and large bank holding companies.

The CHOICE Act also forces the FSOC to go through the regular congressional appropriations process, and eliminates the Office of Financial Research, an autonomous agency created (by Title I, Subtitle B, of Dodd-Frank) within the U.S. Treasury. Furthermore, the CHOICE Act repeals Title VIII of Dodd-Frank, a section of the law that gives the FSOC similar (overly broad) special-designation authority for specialized companies known as financial market utilities.²⁰ Combined, these changes transform the FSOC into an institution capable of doing much less damage to the economy by essentially converting the FSOC to a regulatory council for sharing information.

Separately, Title II of the CHOICE Act repeals Dodd-Frank's orderly liquidation authority (OLA) and amends the bankruptcy code so that large financial firms can credibly use the

bankruptcy process. Dodd–Frank’s controversial OLA was the 2010 law’s alternative to bankruptcy for large financial firms, and it was based on the faulty premise that large financial institutions cannot fail in a judicial bankruptcy proceeding without causing a financial crisis. The OLA gives these large financial companies access to subsidized funding and creates incentives for management to overleverage and expand their high-risk investments.²¹ The CHOICE Act implements an improved bankruptcy process for large financial firms by adopting the text of H.R. 2947, the Financial Institution Bankruptcy Act of 2016.²²

Title II of the CHOICE Act further guards against bailouts and too-big-to-fail problems by eliminating several harmful government-guarantee programs. Specifically, the CHOICE Act eliminates several so-called emergency liquidity and stabilization guarantee programs implemented by Sections 1104, 1105, and 1106 of Dodd–Frank. Just as important, the CHOICE Act repeals the FDIC’s authority to issue emergency loan guarantees, an authority the FDIC used to guarantee nearly \$350 billion in private debt in the wake of the 2008 crisis.²³ Overall, Title II makes meaningfully positive changes to the U.S. financial regulatory framework.

Suggested Title II Improvement. Title II of the Financial CHOICE Act takes several major steps to reduce the likelihood of bailouts. It stops the FSOC from identifying firms that regulators deem too big to fail, it removes most of the FSOC’s overly broad regulatory authority, and it eliminates Dodd–Frank’s controversial OLA. In other words, the CHOICE Act undoes much of what Dodd–Frank did to enshrine too big to fail. The following recommendation would help reduce the likelihood of bailouts even further:

- **Explicitly convert the FSOC to a sharing council.** The bill would strip most of the regulatory authority from the FSOC, largely converting it to a regulatory council for sharing information. A safer approach—which would better ensure that

the FSOC can *only* share information rather than impose regulations—would be to explicitly amend the council’s authority so that its only responsibility is to provide a mechanism for financial regulators to formally share information.

TITLE VII: FED OVERSIGHT REFORM AND MODERNIZATION (AND TITLE VI SECTION 665)

Title VII of the Financial CHOICE Act would implement several major reforms to the Federal Reserve. To achieve these reforms, the CHOICE Act essentially adopts the text of H.R. 3189, the Fed Oversight Reform and Modernization (FORM) Act of 2015.²⁴ Thus, a main benefit of the CHOICE Act is that it would help to improve economic outcomes by forcing the Fed to conduct monetary policy in a more transparent manner. The FORM Act has been mischaracterized as forcing the Fed to conduct policy using the Taylor Rule,²⁵ but the bill simply does not do so. Instead, the FORM Act forces the Fed to rationalize whatever model it chooses to make its policy decisions against the Taylor Rule. Such a change would represent a major improvement in transparency compared to the ad hoc policymaking that the Fed now conducts purely at its own discretion.²⁶

The CHOICE Act also improves the overall representation of the Federal Reserve District Banks on the Federal Open Market Committee. First, the bill would amend the Federal Reserve Act so that six, rather than five, Fed District presidents would sit on the committee, thus narrowing the majority position that the Fed Board of Governors currently holds on the committee. Additionally, the bill would end the New York Fed’s *permanent* seat on the committee and allow, instead, all district presidents to rotate on an equal footing.²⁷ The CHOICE Act would also subject staff members to more transparency and ethics standards similar to those that apply to Securities and Exchange Commission employees, and would require the board to disclose all staff salaries in excess of the annual rate of

basic pay for GS-15 employees on the General Schedule pay scale.

Section 707 of the CHOICE Act places restrictions on the Federal Reserve's authority to conduct so-called emergency lending under Section 13(3) of the Federal Reserve Act.²⁸ Though it would be better to eliminate this authority altogether—emergency loans are not necessary for providing market-wide liquidity—the bill aims to make it more difficult for the Fed to conduct bailout-style loans to insolvent firms. The restrictions in the CHOICE Act include the following: (1) requiring at least nine Fed District Bank presidents to authorize emergency loans (currently, only the affirmative vote of five members of the Board of Governors is required); (2) barring debt recipients from using equity as collateral; (3) requiring the Fed Board of Governors to promulgate a rule describing acceptable collateral; (4) making emergency loans contingent on the board and all federal banking regulators overseeing a borrower to first certify that the borrower is solvent; and (5) requiring the board to charge borrowers a minimum interest rate that cannot be below a market rate.

The CHOICE Act makes two additional key transparency improvements to the way the Federal Reserve operates. Section 709 removes remaining restrictions that prevent the Government Accountability Office from fully auditing the Fed's operations. In particular, the bill removes restrictions on auditing the Fed's monetary policy decisions as well as its dealings with foreign central banks and governments.²⁹ Also, Section 711 requires the Federal Open Market Committee to record all of its meetings and to release full transcripts to the public. There is no legitimate economic reason for any government agency, including the Federal Reserve, to object to either of these types of reforms.

Another provision of the bill, Section 665 (in Title VI), would greatly improve congressional oversight of the Fed by placing its prudential regulatory and financial supervision activities under the regular congressional

budget process. Finally, the CHOICE Act would allow a major study of the nation's monetary policy. Section 710 (Title VII) establishes a formal monetary commission by incorporating text similar to the Centennial Monetary Commission Act of 2013 (H.R. 1176). The idea is to “establish a commission to examine the United States monetary policy, evaluate alternative monetary regimes, and recommend a course for monetary policy going forward.” This type of commission would provide the appropriate venue for both critics and supporters to discuss the Fed's operations and its proper role.³⁰

Suggested Federal Reserve Reform Improvements. Title VII of the Financial CHOICE Act implements several major reforms to Congress's oversight of the Federal Reserve and the manner in which the central bank conducts monetary policy and emergency lending. Additionally, Title VI, Section 665, of the CHOICE Act subjects the Fed's regulatory activities to congressional appropriations. The following recommendations would help reform and modernize the Federal Reserve's operations even more:

- **End the Fed's role as a regulator.** Removing regulatory functions from the Federal Reserve is long past due.³¹ Prior to the 2008 crisis, a special task force under the direction of former Treasury Secretary Henry Paulson recommended that most of the Fed's regulatory authority be dramatically reduced or transferred to other agencies.³² Stripping the Fed of regulatory authority would have been entirely consistent with the international trend during the last few decades of the 20th century, whereby roughly a dozen developed countries took regulatory authority away from their central banks.³³ Ironically, in an earlier draft of what became the Dodd–Frank Act, Senator Chris Dodd (D–CT) included legislative text that would have transferred the Federal Reserve's regulatory authority to a single financial regulator called the Financial

Institutions Regulatory Administration (FIRA).³⁴

Policymakers should not leave the Fed—with its history of regulatory capture and credit allocation to failing firms (and their creditors)—in charge of regulating financial markets and providing emergency lending, while simultaneously being responsible for conducting the nation’s monetary policy. Beyond the basic temptation to provide so-called emergency funds to failing firms it regulates, the Fed also faces the incentive to use monetary policy actions to counter any regulatory failings. This combination further reduces the ability of markets to discipline poorly managed firms, injects even more politics into central banking, and jeopardizes the long-term price stability goal of monetary policy. A central bank simply does not need to function as a regulator in order to conduct monetary policy.³⁵

- **Fully repeal the Fed’s authority to make emergency loans.** Throughout its history, the Fed’s emergency lending and discount-window loan policies have jeopardized its operational independence and put taxpayers at risk. Congress should restrict the Fed to providing system-wide liquidity on an ongoing basis. A central bank does not need emergency lending authority to conduct monetary policy.³⁶

TITLE IX: REPEAL OF THE VOLCKER RULE AND OTHER PROVISIONS

The main provision in Title IX of the Financial CHOICE Act repeals Section 619 of Dodd–Frank, otherwise known as the Volcker Rule. The Volcker Rule was supposed to protect taxpayers by prohibiting banks from engaging in what is known as proprietary trading—that is, making risky investments solely for their own profit. Although it sounds logical to stop banks from making “risky bets” with federally insured deposits, this idea ignores the basic fact that banks make risky investments with

federally insured deposits every time they make a loan. There is really no reason to think that the Volcker Rule would have prevented—or even softened—the 2008 crisis or any previous financial crisis. The practical difficulties associated with implementing the rule caused regulators to spend years working on what ended up being an enormously complex and largely pointless rule.³⁷

Title IX also repeals several other sections from Title VI of Dodd–Frank, addressing items such as studies on credit cards and on banks’ investment activities, and also an amendment to the Securities Act of 1933 regarding conflicts of interest for certain securitizations.³⁸ There are likely other sections from Title VI of Dodd–Frank worth repealing, but it is hard to improve on Title IX of the CHOICE Act given that it repeals the Volcker Rule. Furthermore, several provisions in Title VI of Dodd–Frank would be obviated for firms that hold higher capital.³⁹

CONCLUSION

The 2016 Financial CHOICE Act includes many ideas that would reduce the risk of future financial crises and bailouts. Implementing these ideas would allow Americans to prosper by reducing overbearing government regulations. The centerpiece of the CHOICE Act, a regulatory off-ramp, is a feature that should be included in any major financial regulatory reform bill. This off-ramp provides regulatory relief to banks that choose to hold higher equity capital, thus improving their ability to absorb losses while reducing the likelihood of taxpayer bailouts.

There is little reason to heavily regulate banks that can absorb their own financial risks, and reducing the likelihood of taxpayer bailouts gives investors and customers the necessary incentives to monitor—and to discipline—firms’ behavior. Thus, the CHOICE Act replaces government regulation with market regulation for firms that absorb their own risks. The CHOICE Act also restructures (or repeals) several harmful sections of the 2010 Dodd–Frank

Act that make future financial crises and bailouts more likely, and makes several major improvements to the Federal Reserve. At the very least, the 2016 CHOICE Act provides a basic blueprint to rid U.S. financial markets of the Dodd–Frank Act and to help Americans more easily achieve financial security.

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ENDNOTES

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2. This chapter borrows heavily from Norbert J. Michel, "Money and Banking Provisions in the Financial CHOICE Act: A Major Step in the Right Direction," Heritage Foundation *Backgrounders* No. 3152, August 31, 2016, <http://www.heritage.org/research/reports/2016/08/money-and-banking-provisions-in-the-financial-choice-act-a-major-step-in-the-right-direction>.
3. Also see Norbert J. Michel, "Six Recommendations for the CHOICE Act 2.0," Heritage Foundation *Issue Brief* No. 4642, December 19, 2016, <http://www.heritage.org/research/reports/2016/12/six-recommendations-for-the-choice-act-20>.
4. Norbert J. Michel and John L. Ligon, "Basel III Capital Standards Do Not Reduce the Too-Big-to-Fail Problem," Heritage Foundation *Backgrounders* No. 2905, April 23, 2014, http://thf_media.s3.amazonaws.com/2014/pdf/BG2905.pdf.
5. Section 665 of the Financial CHOICE Act (discussed below) would improve the transparency of these stress tests, a much-needed improvement over the current framework.
6. Jon Hilsenrath, "Battle Inside Fed Rages Over Bank Regulation," *The Wall Street Journal*, March 8, 2010, <http://www.wsj.com/articles/SB10001424052748704754604575095321531680234> (accessed July 20, 2016). The combined figures are taken from Regions annual reports. Additional annual reports for Regions show that the company lost an additional \$429 million in 2011, and then earned a profit each year from 2012 to 2016, for a total four-year *profit* of more than \$4 billion.
7. 15 U.S. Code 1601 et seq. TILA is implemented by Regulation Z (12 CFR 1026).
8. 12 U.S. Code 2601 et seq. The Department of Housing and Urban Development (HUD) originally implemented RESPA by Regulation X. Under Dodd-Frank, the Consumer Financial Protection Bureau (CFPB) restated HUD's implementing regulation at 12 CFR Part 1024 (76 Fed. Reg. 78978). See Consumer Financial Protection Bureau, "Integrated Mortgage Disclosure Rule Under the Real Estate Settlement Procedures Act (Regulation X) and the Truth in Lending Act (Regulation Z)," *Federal Register*, Final Rule, Vol. 78, No. 251 (December 31, 2013), <https://www.gpo.gov/fdsys/pkg/FR-2013-12-31/pdf/2013-28210.pdf> (accessed July 20, 2016).
9. The HMDA is implemented by Regulation C, and Dodd-Frank transferred HMDA rulemaking authority from the Federal Reserve Board to the CFPB.
10. The ECOA is implemented by the CFPB's Regulation B. (See 12 CFR, part 1002.)
11. The FHA is Title VIII of the Civil Rights Act of 1968, as amended (42 U.S. Code 3601, et seq.). For additional information on the FHA and the ECOA, see John Walter, "The Fair Lending Laws and Their Enforcement," *Federal Reserve Bank of Richmond Economic Quarterly*, Vol. 81 (1995), <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.202.7566&rep=rep1&type=pdf> (accessed July 20, 2016).
12. See 12 U.S. Code 2901; the CRA is implemented by Regulations 12 CFR parts 25, 195, 228, and 345.
13. Banking regulators use the CAMELS rating system to produce a composite rating of individual banks' overall condition and performance. The letters of the acronym represent the following six characteristics: (1) capital adequacy, (2) asset quality, (3) management administration, (4) earnings, (5) liquidity, and (6) sensitivity to market risk. See news release, "Uniform Financial Institutions Rating System," Federal Reserve Board of Governors, December 24, 1996, <http://www.federalreserve.gov/BoardDocs/press/general/1996/19961224/default.htm> (accessed July 20, 2016).
14. See Section 105(4), Section 105(5), and Section 105(9). The supplementary leverage ratio is defined in Title 12, CFR 3.10(c)(4)(ii).
15. Office of the Comptroller of the Currency, "Quarterly Report on Bank Trading and Derivatives Activities," First Quarter 2016, p. 3, <http://www.occ.gov/topics/capital-markets/financial-markets/derivatives/dq116.pdf> (accessed August 2, 2016). The Office of the Comptroller of the Currency reports, "During the first quarter of 2016, four large commercial banks represented 91.0 percent of the total banking industry notional amounts and 81.5 percent of industry NCC [net current credit exposure]." The four banks are J.P. Morgan Chase, Bank of America, Citibank, and Goldman Sachs.
16. Another alternative is to use the International Financial Reporting Standards (IFRS) leverage ratio, a measure that can also be viewed as an approximation of the Basel III SLR. However, using the IFRS would undermine the FASB in the same manner as using the SLR. And, while publicly traded banks do report the IFRS ratio in their financial statements, the figures required to replicate the IFRS ratio are not in the FFIEC call report data.
17. Basel III estimates derivative exposure as the sum of current credit exposure and PFE.
18. The four firms with the largest notional derivatives exposures (from highest to lowest) are J.P. Morgan Chase (71.2 percent in interest-rate contracts), Citibank (73.2 percent in interest-rate contracts), Goldman Sachs (94.3 percent in interest-rate contracts), and Bank of America (71.9 percent in interest-rate contracts). For the percentages, see Office of the Comptroller of the Currency, "Quarterly Report on Bank Trading and Derivatives Activities," Table 3. As mentioned above, these four banks account for more

than 90 percent of the industry's notional derivative exposure. Interest-rate derivatives make up more than 80 percent of the OTC derivatives market, and interest-rate derivatives receive the lowest conversion factors in the Basel III scheme.

19. Dodd–Frank authorizes the FSOC to designate certain activities for special regulation and/or limit/prohibit firms from offering financial services/products in several sections. The CHOICE Act repeals this authority by repealing Sections 115, 120, and 121 of Dodd–Frank, but it does not repeal Section 112 (though it amends Section 112). Section 112(a)(2)(K) confers a duty on the FSOC to (in accordance with Dodd–Frank) “make recommendations to primary financial regulatory agencies to apply new or heightened standards and safeguards for financial activities or practices that could create or increase risks of significant liquidity, credit, or other problems spreading among bank holding companies, nonbank financial companies, and United States financial markets.”
20. Norbert J. Michel, “Fixing the Dodd–Frank Derivatives Mess: Repeal Titles VII and VIII,” in Norbert J. Michel, ed., *The Case Against Dodd–Frank: How the “Consumer Protection” Law Endangers Americans* (Washington, DC: The Heritage Foundation, 2016), <http://www.heritage.org/research/reports/2016/04/the-case-against-dodd-frank>.
21. Paul Kupiec, “Title II: Is Orderly Liquidation Authority Necessary to Fix ‘Too Big to Fail?’” in Michel, ed., *The Case Against Dodd–Frank: How the “Consumer Protection” Law Endangers Americans*.
22. The Financial Institution Bankruptcy Act of 2016 passed the U.S. House by voice vote on April 12, 2016.
23. Norbert J. Michel, “Title XI Does Not End Federal Reserve Bailouts,” in Michel, ed., *The Case Against Dodd–Frank: How the “Consumer Protection” Law Endangers Americans*.
24. H.R. 3189 passed the U.S. House of Representatives on November 19, 2015, by a vote of 241 to 185.
25. Named after Stanford economist John B. Taylor, the Taylor Rule is an equation often used to benchmark a central bank's interest-rate-targeting policy. See John B. Taylor, “Discretion Versus Policy Rules in Practice,” Carnegie-Rochester Conference Series on Public Policy, Vol. 39, 1993, pp. 195–214, <http://web.stanford.edu/~johntayl/Papers/Discretion.PDF> (accessed August 12, 2016).
26. Norbert J. Michel, “Why Congress Should Institute Rules-Based Monetary Policy,” Heritage Foundation *Backgrounder* No. 2991, February 11, 2015, <http://www.heritage.org/research/reports/2015/02/why-congress-should-institute-rules-based-monetary-policy>.
27. These changes would amend Section 12A(a) of the Federal Reserve Act, 12 U.S. Code 263(a).
28. 12 U.S. Code 343(3).
29. Section 709 repeals the four sets of restrictions in 31 U.S. Code 714(b).
30. Norbert J. Michel, “The Centennial Monetary Commission Act of 2013: A Second Look at the Fed and the 2008 Financial Crisis,” Heritage Foundation *Backgrounder* No. 2926, July 1, 2014, <http://www.heritage.org/research/reports/2014/07/the-centennial-monetary-commission-act-of-2013-a-second-look-at-the-fed-and-the-2008-financial-crisis>.
31. Norbert J. Michel, “Improving Financial Institution Supervision Ending the Federal Reserve's Regulatory Role,” testimony before the Financial Institutions and Consumer Protection Subcommittee, Committee on Banking, Housing and Urban Affairs, U.S. Senate, November 21, 2014, <http://www.heritage.org/research/testimony/2014/12/step-one-for-improving-financial-institution-supervision-ending-the-federal-reserves-regulatory-role> (accessed July 21, 2016).
32. U.S. Department of the Treasury, “Blueprint for a Modernized Financial Regulatory Structure,” March 2008, http://www.google.com/url?sa=t&rct=j&q=&esrc=s&frm=1&source=web&cd=1&sqi=2&ved=OCB4QFjAA&url=http%3A%2F%2Fwww.treasury.gov%2Fpress-center%2Fpress-releases%2Fdocuments%2FBlueprint.pdf&ei=ViBqVKyrCMKqNs3ggvgM&usq=AFQjCNEfnzAADfbxAKq4WkwX02A9l_pQ&bvm=bv.79142246.d.eXY (accessed November 18, 2014).
33. Charles Calomiris, “Alan Greenspan's Legacy: An Early Look; The Regulatory Record of the Greenspan Fed,” American Economic Association Papers and Proceedings, Vol. 96 (2006), pp. 170–173, https://www0.gsb.columbia.edu/mygsb/faculty/research/pubfiles/4435/Greenspan_Fed.pdf (accessed November 18, 2014).
34. Section 322(e) of the Restoring American Financial Stability Act of 2009 would have accomplished the transfer.
35. Marvin Goodfriend and Robert G. King, “Financial Deregulation, Monetary Policy, and Central Banking,” *Federal Reserve Bank of Richmond Working Paper* No. 88-1 (May/June 1988), https://www.richmondfed.org/publications/research/working_papers/1988/wp_88-1.cfm (accessed November 18, 2014).
36. Michel, “Title XI Does Not End Federal Reserve Bailouts.”
37. Norbert J. Michel, “The Volcker Rule: Three Years and Nearly 1,000 Pages Later,” *The Daily Signal*, December 12, 2013, <http://dailysignal.com/2013/12/12/volcker-rule-three-years-nearly-1000-pages-later/>.
38. The CHOICE Act repeals Sections 603, 618, 619, 620, and 621 of Dodd–Frank.
39. Sections 606 and 607, for example, amend bank-holding-company capital rules. These provisions would be unnecessary for banks electing to hold higher capital. See Steph Miller, “No Need for Title VI with Simpler, Higher Capital,” in Michel, ed., *The Case Against Dodd–Frank: How the “Consumer Protection” Law Endangers Americans*.

PART II

Securities Regulation Reforms

CHAPTER 5:

Securities Disclosure Reform

David R. Burton

This chapter examines the law and economics of mandatory disclosure requirements both in connection with securities offerings and the ongoing disclosure obligations of companies that have issued securities. It discusses both interim reforms to improve the existing disclosure system to the benefit of both investors and issuers, and fundamental reform to create a much simpler, more coherent disclosure regime. Disclosure requirements have become so voluminous that they obfuscate rather than inform, making it more difficult for investors to find relevant information. It is quite clear that existing regulations, usually imposed in the name of investor protection,¹ go beyond those necessary to deter fraud and achieve reasonable, limited, scaled disclosure for firms. The existing rules have a particularly negative impact on the ability of entrepreneurial firms to raise the capital they need to start, to grow, to innovate, and to create new products and jobs.²

The existing rules contain at least 14 different categories of firms issuing securities, each with a different set of exemption and disclosure rules. The categories are as follows:

- (1) Private companies using section 4(a)(2);
- (2)–(6) Private companies using Regulation D (Rule 504, Rule 505 (with and without non-accredited investors) and, primarily, Rule 506 (with and without non-accredited investors));³
- (7)–(8) Small issuer Regulation A companies (two tiers);
- (9)–(11) Crowdfunding companies (three tiers);
- (12) Smaller reporting companies;
- (13) Emerging growth companies; and
- (14) Fully reporting public companies.

Each of these categories has different initial and continuing disclosure obligations. The rules also create different classes of investors that can invest in securities offerings, and a host of other obligations that vary across the 14 categories. The existing disclosure regime is not coherent: In many cases smaller firms have greater disclosure requirements, and the degree and type of disclosure differs significantly by the type of offering even for firms that are otherwise comparable in all meaningful respects.

THE CORE PURPOSE OF SECURITIES REGULATION

The core purpose of securities market regulation is deterring and punishing fraud, and fostering reasonable, scaled disclosure

of information that is material to investors' choices. Fraud is the misrepresentation of material facts or the misleading omission of material facts for the purpose of inducing another to act, or to refrain from action, in reliance on the misrepresentation or omission.⁴ A transaction induced by fraud (misrepresentation) is not voluntary or welfare enhancing in that it would not be entered into in the absence of the fraud (or would be entered into at a different price).⁵ Federal law prohibits fraudulent securities transactions.⁶ So do state "blue sky" laws.⁷

The second important purpose of securities laws is to foster disclosure to investors by firms that sell securities of material facts about the company needed to make informed investment decisions.⁸ Appropriate mandatory disclosure requirements can promote capital formation, the efficient allocation of capital and the maintenance of a robust, public, and liquid secondary market for securities.⁹ The reasons for this are that (1) the issuer is in the best position to accurately and cost-effectively produce information about the issuer;¹⁰ (2) information disclosure promotes better allocation of scarce capital resources or has other positive externalities;¹¹ (3) the cost of capital may decline because investors will demand a lower risk premium;¹² (4) disclosure makes it easier for shareholders to monitor management;¹³ and (5) disclosure makes fraud enforcement easier because evidentiary hurdles are more easily overcome.¹⁴

The baseline for measuring the benefits of mandatory disclosure is not zero disclosure. Firms would disclose considerable information even in the absence of legally mandated disclosure. It is, generally, in their interest to do so.¹⁵ Even before the New Deal securities laws mandating disclosure were enacted, firms made substantial disclosures, and stock exchanges required disclosure by listed firms.¹⁶ Firms conducting private placements today make substantial disclosures notwithstanding the general absence of a legal mandate to do so.¹⁷ The reason is fairly

straightforward: In the absence of meaningful disclosure about the business and a commitment, contractual or otherwise, to provide continuing disclosure, few would invest in the business and those that did so would demand substantial compensation for the risk they were undertaking by investing in a business with inadequate disclosure.¹⁸ Voluntary disclosure allows firms to reduce their cost of capital and, therefore, they disclose information even in the absence of a legal mandate to do so.

Mandatory disclosure laws often impose very substantial costs. These costs do not increase linearly with company size. Offering costs are larger as a percentage of the amount raised for small offerings. They therefore have a disproportionate adverse impact on small firms. Moreover, the benefits of mandated disclosure are also less for small firms because the number of investors and amount of capital at risk is less. Since the costs are disproportionately high and the benefits lower for smaller firms, disclosure should be scaled so that smaller firms incur lower costs.¹⁹

Disclosure also has a dark side in countries with inadequate property-rights protection. In a study examining data from 70,000 firms, the World Bank found that, in developing countries, mandatory disclosure is associated with significant exposure to expropriation, corruption, and reduced sales growth.²⁰

Nor should it be forgotten that many large businesses and large broker-dealers are quite comfortable with high levels of regulation because regulatory compliance costs constitute a barrier to entry, limiting competition from smaller, potentially disruptive, competitors.²¹ Some have been quite forthright about this. As Goldman Sachs CEO Lloyd Blankfein, for example, said:

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 positioning and relative returns.²²

The securities bar, accounting firms doing compliance work, and regulators all have a strong pecuniary interest in maintaining complex rules. One former Securities and Exchange Commission (SEC) Commissioner noted that:

The other Commissioners seemed to feel that the staff was their constituency and that by supporting staff they were necessarily acting in the public interest...

Most of my close business and personal friends are securities lawyers, and many of them are SEC alumni. I belong to a tight-knit community of interesting and decent people, whose livelihoods depend on the continued existence and vitality of the SEC.²³

Empirical Measures of Disclosure Benefits. There is no small degree of truth in the observation of Georgetown law professors Donald Langevoort and Robert Thompson that “[m]ost all of securities regulation is educated guesswork rather than rigorous cost-benefit analysis because we lack the ability to capture the full range of possible costs or benefits with anything remotely resembling precision.”²⁴ The benefits, and to a lesser extent the costs, of mandatory disclosure are difficult to measure although the benefits are probably substantially less than commonly thought.²⁵ The limited empirical literature examining the issue tends to find little, and often no, net benefit.²⁶ As Yale Law School Professor Roberta Romano has written, “the near total absence of measurable benefits from the federal regulatory apparatus surely undermines blind adherence to the status quo.”²⁷

On the other hand, the United States securities markets are the largest, deepest capital markets in the world. At more than \$25

trillion in 2015, the U.S. stock market capitalization accounts for nearly two-fifths of global equity values.²⁸ The U.S. stock market dwarfs the securities markets of most countries.²⁹ U.S. market capitalization as a percentage of national income is greater than that of all major developed countries’ except Switzerland’s.³⁰ U.S. private capital markets are broad and deep compared to those in other countries.³¹ This implies that the U.S. securities regulatory regime is generally reasonable compared to those in most other countries, although other factors, such as property rights protection, taxation (of both domestic and foreign investors), the legal ability or willingness of banks to undertake equity investment, and the degree of corruption, should also be considered.

It is quite clear that existing regulations, usually imposed in the name of investor protection, go beyond those necessary to deter fraud and achieve reasonable, limited, scaled disclosure for small firms. Existing rules seriously impede the ability of entrepreneurial firms to raise the capital they need to start, to grow, to innovate, and to create new products and jobs.

INVESTOR PROTECTION EXAMINED

“Investor protection” is a central part of the SEC’s mission.³² It is quite clear that existing regulations, usually imposed in the name of investor protection, go beyond those necessary to deter fraud and achieve reasonable, limited, scaled disclosure for small firms. A main problem is that the term “investor protection” is a very ambiguous term that can cover, at least, four basic ideas. The first is protecting investors from fraud or misrepresentation. This is a fundamental function of government. The second is providing investors with adequate information to make informed investment decisions. Although a legitimate function of the securities laws, this requires policymakers to carefully balance the costs (which are typically underestimated by regulators and policymakers) and benefits (which are typically overestimated by regulators and policymakers) of mandatory disclosure.³³

The third is protecting investors from investments or business risks that regulators deem imprudent or ill-advised. This is not an appropriate function of government and can be highly counterproductive. The fourth is protecting investor freedom of choice or investor liberty and, thereby, allowing investors to achieve higher returns and greater liquidity. This primarily requires regulators to exercise restraint, or eliminate existing regulatory barriers, both in the regulation of primary offerings by issuers and of secondary market sales by investors to other investors. In practice, this aspect of investor protection is almost entirely ignored by state and federal regulators.

Disclosure requirements have become so voluminous that they obfuscate rather than inform, making it more difficult for investors to find relevant information.³⁴ Over the past 20 years, the average number of pages in annual reports devoted to footnotes and “Management’s Discussion and Analysis” has quadrupled.³⁵ The number of words in corporate annual 10-Ks has increased from 29,996 in 1997 to 41,911 in 2014.³⁶ Very few investors, whether professional or retail, are willing to wade through lengthy disclosure documents, often running hundreds of pages of dense legalese, available on the SEC’s EDGAR database³⁷ or multitudinous state blue sky filings in the forlorn hope that they will find something material to their investment decision that is not available elsewhere in shorter, more focused, more accessible materials. Many of these more accessible materials are, of course, synopses of both the mandated disclosure documents³⁸ and other voluntarily disclosed information, such as shareholder annual reports or materials provided to securities analysts by companies. But the fact that the vast majority of investors rely on these summary materials strongly implies that the legal requirements exceed what investors find material to their investment decisions.

The law should not, even in principle, adopt a regulatory regime that is designed to protect all investors from every conceivable ill. Even in the case of fraud, there needs to be

a balancing of costs and benefits. Securities law should deter and punish fraud, but, given human nature, it can never entirely eliminate fraud. The only way to be certain that there would be no fraud would be to make business impossible. In other words, the socially optimal level of fraud is not zero.³⁹ While fraud imposes significant costs on the person who is defrauded, preventing fraud also has significant costs (both to government and to law-abiding firms or investors), and at some point the costs of fraud prevention exceed the benefits, however defined.⁴⁰ It is up to policymakers to assess this balance and make appropriate judgments in light of the evidence.

About three-fifths of the states conduct what is called “merit review.”⁴¹ Under merit review, state regulators decide whether a securities offering is too risky or too unfair to be offered within their state, effectively substituting their investment judgment for that of investors. Merit review is wrong in principle. Moreover, it is very unlikely that regulators make better investment decisions than investors. Lastly, merit review is expensive and it delays offerings considerably.⁴²

In a free society, it is inappropriate paternalism for the government to prevent people from investing in companies that they judge to be good investment opportunities, or in which they may invest for reasons other than pecuniary gain (personal relationship or affinity for the mission of the enterprise).⁴³ It is a violation of their liberty and constrains their freedom. Citizens, not government, should be the judge of what is in their interest. This idea, however, is under sustained assault both by progressives and by “libertarian paternalists.”⁴⁴ Both progressives and libertarian paternalists rely on the common sense findings of behavioral economics that people are not always rational, sometimes make poor decisions, and respond to sales pressure or disclosure documents differently.⁴⁵ Securities regulators are increasingly looking to this body of literature to inform or justify their actions.⁴⁶

There are at least eight reasons to doubt that government regulators have better

investment judgment than private investors investing their own money. First, there is the inability of a central regulatory authority to collect and act on information as quickly and accurately as dispersed private actors.⁴⁷ There is a reason why government has a reputation for being ponderous and slow to act.⁴⁸ In the context of securities regulation, it is highly doubtful that government regulators have a better understanding of business and the markets than those participating in those markets. Second, private investors have strong incentives to be good stewards of their own money, both in the sense of not taking unwarranted risks, and in the sense of seeking high returns. Investors may also seek to invest for reasons that do not involve pecuniary gain, including support of the persons launching an enterprise or support for a social enterprise that has a dual mission. Government regulators have an entirely different set of incentives.

Third, individuals, not government officials, know their own risk tolerance and their own portfolios. Investing in a riskier security⁴⁹ can reduce the overall risk of a portfolio if the security in question is negatively correlated or even not highly covariant with price movements of the overall portfolio.⁵⁰ Fourth, government officials are people too, and exhibit the same irrationality and tendency to sometimes make poor decisions as anyone else. There is absolutely no reason to believe that regulators are less subject to the concerns identified by behavioral economics and the “libertarian paternalists” than are others. Moreover, since most securities regulators are lawyers, and a legal education provides no training for making investment decisions, there is no particular reason to believe that they have any relevant “expertise” that will make their investment decisions objectively better than those investing their own money.

Fifth, as public-choice economics has demonstrated, government officials are not angels but act in their own self-interest.⁵¹ This, too, is in keeping with basic common sense. Government officials have an interest in enlarging their agencies, increasing their

power, and improving their employment prospects.⁵² They are no more benevolent than any other group of people, including issuers and investors, and there is no reason to believe that government regulators will act in the interest of investors when those interests conflict with their own interests. The analysis of politics, and the politicians and regulators who conduct politics, should be stripped of its “romance.”⁵³ Sixth, government officials making investments have a notoriously bad track record.⁵⁴ Perhaps the most famous example of poor entrepreneurial investment judgment by regulators is when securities regulators in Massachusetts barred Massachusetts citizens from investing in Apple Computer during its initial public offering.⁵⁵ The regulators had deemed it too risky of an investment.

Seventh, in their capacity as risk assessors, regulators have an increasingly obvious bad track record. In the most recent financial crisis, government regulators’ judgment proved no better than that of private actors.⁵⁶ Eighth, it is a reasonable hypothesis that government regulators are unduly risk averse. There are at least two reasons for this: (1) Government tends to attract people who are risk averse. They have a lower risk tolerance than those making entrepreneurial investments.⁵⁷ (2) Government regulators’ incentives tend to make them unduly risk averse. An investment that goes bad may make the headlines and their regulatory judgment may be criticized. An investment that never happens because it does not receive regulatory approval will not make the headlines, and their judgment will not be second-guessed.

Those states that do not undertake merit review rely on anti-fraud laws and the disclosure of the material facts by issuers but allow investors to make their own decisions, just as federal securities laws rely primarily on disclosure and anti-fraud enforcement.⁵⁸

Current Investor-Protection Regime Is Counterproductive. While doing little to actually protect investors, the current array of state and federal regulatory excesses impose costly requirements and restrictions

that have a disproportionate negative impact on small and start-up firms. Furthermore, although the Jumpstart Our Business Startups (JOBS) Act mitigated the problem, existing rules often, in practice, force these firms to use broker-dealers or venture capital firms to raise capital.⁵⁹ This often raises issuer costs. Being reliant on broker-dealers or venture capital firms to raise capital also increases the likelihood that the entrepreneur will lose control of the company he or she founded because these firms so often require large fees, a large share of the ownership of the company, or effective control of the firm when raising capital for new, unseasoned issuers. The law should allow entrepreneurs to effectively seek investors without reliance on broker-dealers or venture capital firms.

THE PRIVATE-PUBLIC DISTINCTION

The securities laws draw a distinction between public and private companies, imposing a wide variety of disclosure obligations on public companies that are not imposed on private companies. Originally, this distinction was generally one between firms whose securities were traded on stock exchanges and those that were not. The Securities Acts Amendments of 1964⁶⁰ broadened the requirements to register and make periodic disclosures to any company with 500 or more shareholders of record.⁶¹ The 2012 JOBS Act liberalized this rule by allowing a firm to have up to 2,000 accredited investors before being required to register.⁶²

It is far from clear that the current “holder of record” method of drawing the distinction between public and private firms is the best. The number of beneficial owners, public float, or market capitalization—all metrics used in connection with other securities law provisions—are probably better than the traditional shareholder-of-record measure.⁶³ The number of holders of record bears little relationship to any meaningful criteria of when disclosure should be mandated or when disclosure or other requirements should be increased. Its primary virtue is ease of administration.

The distinction between public and private firms is probably best thought of as between a firm with widely held ownership (public) as opposed to closely held ownership (private).⁶⁴ Given the breadth of ownership, the aggregate value of investments made, the fact that management is a more effective producer of information than multiple outside investigators with limited access to the relevant facts absent mandatory disclosure, the agent-principle or collective-action problem and various other factors imposing greater disclosure obligations on larger, widely held firms is appropriate. It is, however, important that even the disclosure and other obligations of public companies be scaled. Compliance costs have a disproportionate adverse impact on small firms, and the benefits are correspondingly less because small firms have fewer investors with less capital at risk.

INTERIM SECURITIES REGULATION REFORM

Fundamental securities regulation reform is necessary, and discussed below, under “Fundamental Securities Regulation Reform.” In the interim, there are steps that should be taken to improve the regulatory environment for small firms seeking access to the capital markets. The major components of an interim disclosure reform program are outlined below.⁶⁵

Reducing Barriers to Raising Private and Quasi-Public Capital. The Securities Act of 1933⁶⁶ makes it generally illegal to sell securities unless the offering is registered with the SEC.⁶⁷ Making a registered offering (“going public”) is a very expensive proposition and well beyond the means of most small and start-up companies. In addition, the costs of complying with continuing disclosure and other obligations of being a registered, public company are quite high.⁶⁸ The act, however, exempts various securities and transactions from this requirement.

Regulation A. The original 1933 Securities Act contained the small-issue exemption that is the basis for Regulation A. Congress has increased the dollar amount of the exemption

over the years.⁶⁹ Overly burdensome regulation by state regulators and, to a lesser extent, by the SEC combined with the opportunity for issuers to avoid burdensome blue sky laws since 1996⁷⁰ via Rule 506 of Regulation D rendered Regulation A a dead letter.⁷¹ In 2011, only one Regulation A offering was completed.⁷² SEC data show that between 2009 and 2012, companies used Regulation A to raise only \$73 million. Comparably sized Regulation D offerings raised \$25 billion and comparably sized public offerings raised \$840 million.⁷³ Thus, in the aggregate, over that three-year period, Regulation A accounted for less than three-tenths of 1 percent of the capital raised in offerings of \$5 million or less.⁷⁴

Title IV of the JOBS Act demonstrates a clear, bipartisan consensus that this is unacceptable and that the section 3(b) small-issues exemption needed to be rethought to promote small-business capital formation. Title IV has come to be known as Regulation A+. It allows Regulation A offerings of up to \$50 million. The SEC promulgated a rule implementing Title IV that went into effect on June 19, 2015.⁷⁵ This regulation creates two tiers, but only the more heavily regulated second tier would be blue sky exempt. Smaller, “Tier 1” companies remain subject to the expense and delay of blue sky laws. Moreover, secondary trading⁷⁶ of Tier 2 securities remains subject to blue sky laws. Congress should implement the following two Regulation A reforms:

1. Congress should pre-empt state registration and qualification laws governing all Regulation A company securities. These companies have substantial initial and continuing disclosure obligations. Congress should either define covered securities to include securities sold in transactions exempt pursuant to Regulation A, or define qualified purchasers to include all purchasers of securities in transactions exempt under Regulation A, or both. The recent Regulation A+ rule would do this for primary offerings of Tier 2 securities.

2. Congress should simplify the statutory small-issue exemption. Specifically, Congress should amend Securities Act section 3(b)(1) so that Tier 1 Regulation A offerings have reasonable requirements for offering statements and periodic disclosure, and that the provisions are self-effectuating without having to wait for the promulgation of SEC regulations. The current rules are nearly as complex as those governing smaller reporting companies.

Regulation D. The Securities Act provides an exemption for offerings “not involving any public offering.” Regulation D, adopted in 1982, provides a safe harbor such that offerings that are compliant with the requirements of Regulation D are deemed not to involve a public offering.⁷⁷

Regulation D has three parts. Rule 504⁷⁸ and Rule 505⁷⁹ were meant for use by small firms. Rule 504 allows firms to raise up to \$1 million annually.⁸⁰ Rule 505 allows firms to raise up to \$5 million annually.⁸¹ In practice, 99 percent of capital raised using Regulation D is raised using Rule 506.⁸² This is because Rule 506 offerings, in contrast to Rule 504 or Rule 505 offerings, are exempt from state blue sky registration and qualification requirements.⁸³ Issuers using Rule 506, therefore, do not have to bear the expense and endure the delay of dealing with as many as 52 regulators,⁸⁴ about three-fifths of whom engage in “merit review” where regulators purport to decide whether an investment is fair or a good investment. Regulation D has become the dominant means of raising capital in the United States, particularly for entrepreneurs.⁸⁵ According to SEC data, in 2014, registered (public) offerings accounted for \$1.35 trillion of new capital raised, compared to \$2.1 trillion raised in private offerings. Regulation D accounted for \$1.3 trillion (62 percent) of private offerings in 2014.⁸⁶

Most Regulation D offerings are sold entirely to accredited investors because selling to non-accredited investors triggers additional disclosure requirements under Regulation D and creates other regulatory risks.⁸⁷

In general, an accredited investor is either a financial institution or a natural person who has either income greater than \$200,000 (\$300,000 joint) or a residence exclusive net worth of \$1 million or more.⁸⁸ There is a major push by liberal organizations and state regulators to increase these thresholds dramatically.⁸⁹

Rule 506 also permits up to 35 “sophisticated investors” to purchase Rule 506 offerings. The problem is that the regulatory definition of what constitutes a sophisticated investor is very amorphous. It turns on whether the investor has such “knowledge and experience in financial and business matters” that the investor “is capable of evaluating the merits and risks of the prospective investment.”⁹⁰

Congress should prevent the promulgation of the Regulation D amendments proposed in July 2013.⁹¹ These rules would substantially increase the regulatory burden for smaller companies seeking to use Regulation D and have no appreciable positive impact. They would require filing three forms instead of one, and would impose a variety of other burdensome requirements.⁹² In addition, a proposed temporary rule would require the mandatory submission of written general solicitation materials, including Web pages.⁹³

Crowdfunding. The story of the investment crowdfunding exemption is an object lesson in how a simple, constructive idea can be twisted by the Washington legislative process into a complex morass. Representative Patrick McHenry (R-NC) introduced his Entrepreneur Access to Capital Act on September 14, 2011.⁹⁴ It was three pages long—less than one page if the actual legislative language were pasted into a Word document. It would have allowed issuers to raise up to \$5 million, and limited investors to making investments equal to the lesser of \$10,000 or 10 percent of their annual income.⁹⁵ The exemption would have been self-effectuating, requiring no action by the SEC in order to be legally operative. The bill reported out of Committee and ultimately passed by the House was 14 pages

long.⁹⁶ By the time the Senate was done with it, it had become 26 pages long.⁹⁷ Many of the additions were authorizations for the SEC to promulgate rules or requirements that it do so. The bill was incorporated into the JOBS Act as Title III. Firms may raise no more than \$1 million annually using Title III crowdfunding.⁹⁸ So it is only an option for the smallest of firms. The PDF of the October 23, 2013, proposed crowdfunding rule is 585 pages long (although double-spaced) and sought public comments on well over 300 issues raised by the proposed rule.⁹⁹ On November 16, 2015, the SEC issued its final 685-page rule.¹⁰⁰ These rules were effective May 16, 2016.

If Congress decides to work with the current crowdfunding statute rather than start over, there are at least eight changes that should be made if crowdfunding is to achieve its promise. Six of these changes relate to how the crowdfunding exemption operates.¹⁰¹ The following two changes relate to disclosure rules for crowdfunding:¹⁰²

1. Congress should eliminate the audit requirements in crowdfunding offerings over \$500,000 required by Securities Act section 4A(b)(1)(D)(iii).
2. Congress should reduce the mandatory disclosure requirements on crowdfunding issuers. They are much too burdensome for the very small firms that are permitted to use Title III crowdfunding.

Congress would probably do better by simply starting over and replacing the existing Title III with a simpler statute more appropriately crafted for very small firms.

Other Improvements. Extremely small firms should not be forced to comply with complex securities laws, including mandatory federal disclosure requirements, to launch a business.

Congress should amend the Securities Act to create a statutory “micro-offering” safe harbor so that any offering is deemed not to involve a public offering for purposes of section 4(a)(2) if the offering (1) is made only to

TABLE 5-1

IPO-Related Fees

AS A PERCENTAGE OF OFFERING SIZE, 1996–2012

	All Offerings (N=4,868)	Offering \$5 Million to \$50 Million (N=2,017)	Offering More than \$50 Million (N=2,851)
Total Fees	9.55%	11.15%	8.44%
Compliance Fees	1.39	1.91	1.03
Registration Fees	0.03	0.04	0.02
Blue Sky Fees	0.03	0.07	0.01
Accounting Fees	0.53	0.72	0.40
Legal Fees	0.80	1.08	0.60
Underwriter Fees	6.45	6.87	6.17
Printing Fees	0.32	0.47	0.22

NOTE: Figures exclude offerings from non-Canadian foreign issuers and blank-check companies.

SOURCE: U.S. Securities and Exchange Commission, Division of Economic and Risk Analysis, "Proposed Rule Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act," *Federal Register*, Vol. 79, No. 15, January 23, 2014, p. 3978, <https://www.gpo.gov/fdsys/pkg/FR-2014-01-23/pdf/2013-30508.pdf> (accessed December 15, 2016).

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people with whom an issuer's officers, directors, or 10 percent or more shareholders have a substantial pre-existing relationship; (2) involves 35 or fewer purchasers; or (3) has an aggregate offering price of less than \$500,000 (within a 12-month period).¹⁰³

REDUCING REGULATORY BURDENS ON SMALL PUBLIC COMPANIES

Regulation S-K¹⁰⁴ is the key regulation governing non-financial statement disclosures of registered (public) companies. The list of items to be disclosed pursuant to Regulation S-K runs to nearly a hundred pages of small type. Regulation S-X¹⁰⁵ generally governs public company financial statements in registration statements or periodic reports. The list of items to be disclosed pursuant to Regulation S-X runs to nearly a hundred pages of small type, not counting the many items incorporated by reference.¹⁰⁶ These two rules, including the various rules and accounting policies that they incorporate by reference

(including those of the SEC, the Public Company Accounting Oversight Board, and the Financial Accounting Standards Board), impose the vast majority of the costs incurred by public companies.

The SEC has estimated that "the average cost of achieving initial regulatory compliance for an initial public offering is \$2.5 million, followed by an ongoing compliance cost, once public, of \$1.5 million per year."¹⁰⁷ This is probably a significant underestimate for many firms.

Costs of this magnitude make going public uneconomic for most smaller firms. Table 5-1 shows the composition and magnitude of the costs, according to the SEC. It also shows that the costs are disproportionately higher for firms conducting offerings of \$50 million or less.

Although there have been some efforts to scale disclosure requirements, notably the emerging growth company provisions contained in Title I of the JOBS Act and the

TABLE 5-2

Proposal for a Reformed Disclosure Regime

Type of Issuer	Type of Solicitation	Size (Public Float/Number of Beneficial Owners)			Secondary Market Status
Private	Private	<i>and</i>	Below specified Threshold A	<i>and</i>	Not traded on a National Securities Exchange, a Venture Exchange, or an Alternative Trading System (ATS)
Quasi-Public	General	<i>or</i>	Above specified Threshold A	<i>and</i>	Not traded on a National Securities Exchange; may be traded on a Venture Exchange or an ATS
Public (Registered)	General	<i>and</i>	Above specified Threshold B	<i>or</i>	National Securities Exchange traded

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smaller reporting company rules promulgated by the SEC, public company compliance costs have grown sufficiently high that many smaller firms are “going private.”¹⁰⁸ Sarbanes–Oxley (2002),¹⁰⁹ Dodd–Frank (2010),¹¹⁰ and other legislation and regulatory actions have contributed to these costs. Moreover, U.S. initial public offering costs are considerably higher than those abroad.¹¹¹ Congress should implement the following public-company disclosure reforms:

1. Pre-empt blue sky registration and qualification requirements with respect to public companies not listed on national exchanges,
2. Increase the smaller reporting company threshold from \$75 million to \$300 million of public float and confirm the “accelerated filer” definition,¹¹²
3. Make all emerging growth company advantages permanent for smaller reporting companies, and
4. Improve the disclosure requirements under Regulation S-K for smaller reporting companies.¹¹³

FUNDAMENTAL SECURITIES REGULATION REFORM

There is a need to fundamentally rethink the regulation of small-company capital formation. The SEC is considering reforms to the current disclosure regime. It has completed a congressionally mandated study,¹¹⁴ and in April 2016 issued a Regulation S-K Concept Release seeking public comment on 340 specific issues.¹¹⁵ This process, while constructive, is unlikely to result in fundamental reforms. Congress must develop and implement a coherent scaled disclosure regime.

This new disclosure framework should address both initial and continuing disclosure. It should be integrated across the various exemptions and categories of reporting companies such that larger firms with more investors and more capital at risk have greater disclosure obligations. Congress should consider the cost of compliance, the investor protection benefits of the added disclosure, the cost to investors of being denied investment opportunities by investment restrictions, and the cost to the public of lost economic growth, capital formation, innovation, and job creation caused by the regulation of issuers.

Congress should reduce the number of categories of firms issuing securities. There are currently 14 categories, each with its own set of exemptions and disclosure rules. One possibility is to establish the following three categories: (1) Private, (2) Quasi Public, and (3) Public. (See Table 5-2.)

In a regime consisting of such categories, companies would report based on the category they were in (private, quasi-public, or public). Blue sky laws regarding registration and qualification would be pre-empted in all cases, but state anti-fraud laws would remain operative. Private companies would have no legally mandated disclosure requirements. Disclosure requirements would be negotiated by the private parties involved much as they usually are now. A company would be deemed private if it did not engage in general solicitation, was below some specified number of beneficial owners,¹¹⁶ or perhaps, some measure of non-insider share value (analogous to public float)—threshold A—and its shares were not traded on a national securities exchange, venture exchange, or alternative trading system (ATS).

Public companies could engage in general solicitation and would be (1) above a specified measure of size (threshold B) or (2) have shares traded on a national securities exchange. Disclosure obligations would be scaled based on some measure of size (probably public float). This is the category into which most full-reporting companies, smaller reporting companies, emerging-growth companies, and perhaps some Regulation A+ companies would fall.

Companies that were neither “public” nor “private” would be intermediate “quasi-public” companies. They could engage in general solicitation and sell to the public. Disclosure obligations would be scaled based on some measure of size (perhaps public float if traded on a venture exchange or an ATS; the number of beneficial owners otherwise). These are the kind of companies that are meant to use the crowdfunding, Rule 505, and Regulation A exemptions, and would include some companies that are smaller reporting companies today.

Disclosure obligations would be scaled within the quasi-public and public category (larger and smaller). Registration statements would be dramatically simplified, describing the security being offered, but the annual (10-K), quarterly (10-Q), and major event (8-K) reporting would become the core of the disclosure system rather than registration statements (except in the case of initial quasi-public offerings (transitioning from private company status) or initial public offerings (transitioning from private or quasi-public status)).

Although it is far from clear that they should be retained, some accredited investor limitations measuring wealth, income, or sophistication could be applied to private offerings should policymakers wish to limit those who may invest in private companies. In that case, however, something similar to the current section 4(a)(2) exemption should remain combined with a statutory exemption for micro issuers. Otherwise, two guys starting a bar would run afoul of the securities laws. Such a regime would constitute a major improvement over the current one. It would be simpler, result in fewer regulatory difficulties and costs, protect investors, and promote capital formation.

FUNDAMENTAL REFORM: MORE DETAILED GUIDANCE

To accomplish disclosure reform while maintaining the basic current exemption structure, Congress would need to amend:

1. **Securities Act Schedule A** (which currently contains a list of 32 disclosure requirements and is about five pages long);
2. **Securities Act sections 7 and 10** (relating to registration statements and prospectuses); and
3. **Securities Exchange Act sections 13, 14, 14A, 16, and 21E** (relating to periodic and other reports, proxies, shareholder approvals, disclosure concerning directors, officers, and principal shareholders, and the safe harbor relating to forward-looking statements).¹¹⁷

A revised Schedule A would list all disclosure requirements applicable to a fully reporting public company and also indicate which provisions did not apply to smaller reporting companies and companies falling into other categories. It would, in effect, become the roadmap with which companies had to comply for disclosure requirements.

Implementing the complete reform program outlined above would involve substantial changes to other provisions in the law, notably sections 3, 4, and 4A of the Securities Act (relating to exempted securities, exempted transactions, and crowdfunding, respectively). This would replace the current patchwork of 14 different categories, each with a different set of exemption and disclosure rules, with three major issuer categories (private, quasi-public, and public), and two scaled disclosure categories (larger and smaller) within the quasi-public and public exemption categories.

CONCLUSION

Because the benefits of mandatory disclosure are so much smaller than usually assumed, policymakers need to adopt a more skeptical posture toward the existing disclosure regime. The costs are significant and have dramatically increased in recent years. The adverse impact on small and start-up entrepreneurial firms, innovation, job creation, and economic growth are substantial. Moreover, disclosure requirements have become so voluminous that they defeat their alleged purpose. They obfuscate rather than inform.

Because the costs are disproportionately high and the benefits lower for smaller firms, disclosure should be scaled so that smaller firms incur lower costs. The current system—a set of 14 different disclosure regimes—is incoherent. In many cases, under current law,

smaller firms have greater disclosure requirements than large firms, and the degree and type of disclosure differs significantly by the type of offering even for firms and offerings that are otherwise comparable in all meaningful respects.

Blue sky laws raise costs and create delays. States that engage in merit review are particularly problematic. There is ample evidence that blue sky laws are one of the central impediments to both primary offerings by small companies and secondary market trading in small company securities by investors. There is little evidence that the registration and qualification provisions of state blue sky laws protect investors. In fact, there is evidence that they hurt investors. State blue sky registration and qualification provisions should be pre-empted by Congress with respect to companies that have continuing reporting obligations, including public companies and those issuing securities under Regulation A or under Regulation Crowdfunding.

This chapter outlines a program of interim reforms to improve the existing disclosure regime. It recommends specific changes to Regulation A, crowdfunding, Regulation D, and the regulation of small public companies and of secondary markets that, taken as a whole, would dramatically improve the current regulatory environment.

This chapter also outlines a program of fundamental reform that would dramatically simplify the existing disclosure regime to the benefit of both investors and issuers. This proposal would replace the current 14 disclosure categories with three disclosure regimes—public, quasi-public, and private—and disclosure under the first two categories would be scaled based on either public float or the number of beneficial shareholders.

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ENDNOTES

1. There are exceptions. For example, the conflict mineral disclosure requirements do nothing to “protect investors.” See Securities and Exchange Commission, 17 C.F.R. §240.13p-1, and “Conflict Minerals,” Final Rule, November 13, 2012, <http://www.sec.gov/rules/final/2012/34-67716.pdf> (accessed November 15, 2016). See also David R. Burton, “How Dodd–Frank Mandated Disclosures Harm, Rather than Protect, Investors,” Heritage Foundation *Backgrounder* No. 4526, March 10, 2016, <http://www.heritage.org/research/reports/2016/03/how-doddfrank-mandated-disclosures-harm-rather-than-protect-investors>.
2. For a more complete discussion of the economic importance of entrepreneurship and existing impediments to entrepreneurship, see David R. Burton, “Building an Opportunity Economy: The State of Small Business and Entrepreneurship,” testimony before the Committee on Small Business, U.S. House of Representatives, March 4, 2015, <http://www.heritage.org/research/testimony/2015/building-an-opportunity-economy-the-state-of-small-business-and-entrepreneurship>.
3. Rule 502(b) imposes significantly greater disclosure requirements on issuers that sell to non-accredited investors in both Rule 505 and Rule 506(b) offerings.
4. *Restatement of the Law Second, Torts*, Vol. 3 (Philadelphia, PA: American Law Institute, 1977), § 525 Liability for Fraudulent Misrepresentation; § 526 Conditions Under Which Misrepresentation Is Fraudulent (Scienter); § 529 Representation Misleading Because Incomplete; and §551 Liability for Nondisclosure.
5. Securities fraud was illegal long before New Deal–era federal securities laws or even earlier state blue sky laws were enacted. Stuart Banner, *Anglo-American Securities Regulation: Cultural and Political Roots, 1690–1860* (Cambridge, MA: Cambridge University Press, 2002). See also Frank H. Easterbrook and Daniel R. Fischel, “Mandatory Disclosure and the Protection of Investors,” *Virginia Law Review*, Vol. 70 (1984), p. 669, http://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?article=2176&context=journal_articles (accessed November 15, 2016); Gordon Walker, “Securities Regulation, Efficient Markets and Behavioural Finance: Reclaiming the Legal Genealogy,” *Hong Kong Law Journal*, Vol. 36, No. 3 (2006), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1099512 (accessed November 15, 2016); and Paul G. Mahoney, *Wasting a Crisis: Why Securities Regulation Fails* (Chicago: University Of Chicago Press, 2015).
6. Securities Exchange Act of 1934 section 10(b) [15 U.S. Code § 78j(b)], regulation of the use of manipulative and deceptive devices. See also 17 C.F.R. 240.10b-5, Employment of manipulative and deceptive devices.
7. State securities laws are known as blue sky laws. For a discussion of the history of blue sky laws, see Jonathan R. Macey and Geoffrey P. Miller, “Origin of the Blue Sky Laws,” *Texas Law Review*, Vol. 70, No. 2 (1991), pp. 347–397, http://digitalcommons.law.yale.edu/fss_papers/1641/ (accessed November 15, 2016), and Paul G. Mahoney, “The Origins of the Blue Sky Laws: A Test of Competing Hypotheses,” *UVA Law & Economics Research Paper* No. 01-11, December 2001, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=296344 (accessed November 15, 2016). See, for instance, section 501 of the 2002 Uniform Securities Act, http://www.uniformlaws.org/shared/docs/securities/securities_final_05.pdf (accessed October 31, 2016).
8. For a general introduction, see Richard A. Posner, “Financial Markets,” in *Economic Analysis of the Law*, 9th ed. (Wolters Kluwer Law & Business, 2014).
9. Robert A. Prentice, “The Economic Value of Securities Regulation,” *Cardozo Law Review*, Vol. 28, No. 1 (2006), pp. 333–389, <http://cardozolawreview.com/Joomla1.5/content/28-1/cross.website.pdf> (accessed November 16, 2016); Bernard S. Black, “The Legal and Institutional Preconditions for Strong Securities Markets,” *UCLA Law Review*, Vol. 48 (2001), pp. 781–855, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=182169 (accessed November 16, 2016); and Luca Enriques and Sergio Gilotta, “Disclosure and Financial Market Regulation,” *Oxford Legal Studies Research Paper* No. 68, 2014, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2423768 (accessed November 16, 2016).
10. Marcel Kahan, “Securities Laws and the Social Cost of ‘Inaccurate’ Stock Prices,” *Duke Law Journal*, Vol. 41, No. 5 (1992), pp. 977–1044, <http://scholarship.law.duke.edu/dlj/vol41/iss5/1/> (accessed November 16, 2016); John C. Coffee Jr., “Market Failure and the Economic Case for a Mandatory Disclosure System,” *Virginia Law Review*, Vol. 70 (1984), pp. 717–753; and Joel Seligman, “The Historical Need for a Mandatory Corporate Disclosure System,” *Journal of Corporation Law*, Vol. 9, No. 1 (1983), p. 1.
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 13. The interests of shareholders and management are often not coincident and may considerably conflict. Corporate managers often operate firms as much for their own benefit as that of shareholders, and shareholders may have difficulty preventing this in a cost-effective way. This incongruity of interest is often described as the agent-principal problem, or collective-action problem, and is significant in larger firms where ownership and management of the firm are separate, and ownership is widely held. See Michael C. Jensen and William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," *Journal of Financial Economics*, Vol. 3, No. 4 (1976), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=94043 (accessed November 16, 2016); Paul G. Mahoney, "Mandatory Disclosure as a Solution to Agency Problems," *University of Chicago Law Review*, Vol. 62, No. 3 (1995), pp. 1047–1112; and Merritt B. Fox, "Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment," *Virginia Law Review*, Vol. 85, No. 7 (1999), pp. 1335–1419.
 14. Requiring certain written affirmative representations in public disclosure documents deters fraud because proving fraud becomes easier if the public, written representations are later found by a trier of fact to be inconsistent with the facts. Periodic reporting (such as 10-Ks, 10-Qs, and 8-Ks) can help police secondary-market manipulation by issuers and insiders.
 15. Roberta Romano, *The Advantage of Competitive Federalism for Securities Regulation* (Washington, DC: AEI Press, 2002), and Healy and Palepu, "Information Asymmetry, Corporate Disclosure, and the Capital Markets."
 16. Frank Easterbrook and Daniel Fishel, *The Economic Structure of Corporate Law* (Cambridge, MA: Harvard University Press, 1991); Michael J. Fishman and Kathleen M. Hagerty, "Disclosure Decisions by Firms and the Competition for Price Efficiency," *The Journal of Finance*, Vol. 44, No. 3 (1989), pp. 633–646, <http://www.jstor.org/stable/pdfplus/2328774.pdf> (accessed November 16, 2016); George J. Stigler, "Public Regulation of the Securities Markets," *The Business Lawyer*, Vol. 19, No. 3 (April 1964), pp. 721–753; and George J. Benston, "Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934," *American Economic Review*, Vol. 63 No. 1 (March 1973).
 17. The Regulation D safe harbor imposes certain additional requirements if the issuer sells securities under Rule 505 or 506(b) to any purchaser that is not an accredited investor. See 17 C.F.R. §230.502(b).
 18. See, for instance, Maureen O'Hara and David Easley, "Information and the Cost of Capital," *Journal of Finance*, Vol. 59, No. 4 (August 2004), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=300715 (accessed November 16, 2016).
 19. Craig M. Lewis, "The Future of Capital Formation," speech by chief economist and director of the Division of Economic and Risk Analysis at MIT Sloan School of Management's Center for Finance and Policy's Distinguished Speaker Series, April 15, 2014, <http://www.sec.gov/News/Speech/Detail/Speech/1370541497283> (accessed November 16, 2016); Jeff Schwartz, "The Law and Economics of Scaled Equity Market Disclosure," *Journal of Corporation Law*, Vol. 39 (2014), p. 347; and C. Steven Bradford, "Transaction Exemptions in the Securities Act of 1933: An Economic Analysis," *Emory Law Journal*, Vol. 45 (1996), pp. 591–671, <http://digitalcommons.unl.edu/cgi/viewcontent.cgi?article=1088&context=lawfacpub> (accessed November 16, 2016). There is a strong argument that scaling should also be a function of the age of the firm, so that relatively young firms with limited compliance experience and, typically, limited cash flow and resources, should have lesser disclosure requirements than more mature firms. See Table 3.3 in Susan M. Phillips and J. Richard Zecher, *The SEC and the Public Interest* (Cambridge, MA: MIT Press, 1981). See also Securities and Exchange Commission, "Economic Analysis, Proposed Rule, Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act," *Federal Register*, Vol. 79, No. 15 (January 23, 2014), pp. 3972–3993 [Release Nos. 33-9497, 34-71120, and 39-2493; File No. S7-11-13], <http://www.gpo.gov/fdsys/pkg/FR-2014-01-23/pdf/2013-30508.pdf> (accessed November 16, 2016).
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 21. Johan E. Eklund and Sameeksha Desai, "Entry Regulation and Persistence of Profits in Incumbent Firms," Swedish Entrepreneurship Forum *Working Paper* No. 25, 2013, http://entreprenorskapsforum.se/wp-content/uploads/2013/06/WP_25.pdf (accessed November 16, 2016); Susan E. Woodward, "Regulatory Capture at the U.S. Securities and Exchange Commission," prepared for the Milken Institute Conference on Capital Markets, March 16, 1998, <http://www.sandhillecon.com/>

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22. "Regulation Is Good for Goldman," *The Wall Street Journal*, February 11, 2015, <http://www.wsj.com/articles/regulation-is-good-for-goldman-1423700859?KEYWORDS=Regulation+Is+Good+for+Goldman> (accessed November 16, 2016).
 23. Roberta S. Karmel, *Regulation by Prosecution: The Securities and Exchange Commission vs. Corporate America* (New York: Simon & Schuster, 1982), p. 18. For a general discussion of these issues, see Paul H. Rubin and Martin J. Bailey, "The Role of Lawyers in Changing the Law," *The Journal of Legal Studies*, Vol. 23, No. 2 (1994), pp. 807–831, and Michelle J. White, "Legal Complexity and Lawyers' Benefit from Litigation," *International Review of Law and Economics*, Vol. 12, No. 3 (1992), pp. 381–395, <http://econweb.ucsd.edu/~miwhite/complexity.pdf> (accessed November 16, 2016).
 24. Donald C. Langevoort and Robert B. Thompson, "'Publicness' in Contemporary Securities Regulation After the JOBS Act," *Georgetown Law Journal*, Vol. 101 (2013), pp. 337–386, <http://scholarship.law.georgetown.edu/cgi/viewcontent.cgi?article=1985&context=facpub> (accessed November 16, 2016). The lack of data available to policymakers regarding the private capital markets, compliance costs, SEC, and other regulator enforcement actions and the types of securities laws violations that occur in practice is startling. Steps need to be taken to rectify this lack of data so that policymakers can make policy in something other than a largely data-free environment.
 25. See "Some Limits and Drawbacks of MD," section in Enriques and Gilotta, "Disclosure and Financial Market Regulation," and Omri Ben-Shahar and Carl E. Schneider, "The Failure of Mandated Discourse," *University of Pennsylvania Law Review*, Vol. 159 (2011), pp. 647–749, http://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?article=2066&context=journal_articles (accessed November 16, 2016).
 26. Elisabeth de Fontenay, "Do the Securities Laws Matter? The Rise of the Leveraged Loan Market," *Journal of Corporation Law*, Vol. 39, No. 4 (2014), pp. 725–768, http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=5944&context=faculty_scholarship (accessed November 16, 2016); Robert Daines and Charles M. Jones, "Truth or Consequences: Mandatory Disclosure and the Impact of the 1934 Act," Stanford University *Working Paper*, May 2012, <https://www.law.stanford.edu/publications/truth-or-consequences-mandatory-disclosure-and-the-impact-of-the-1934-act> (accessed November 16, 2016); Christian Leuz and Peter D. Wysocki, "The Economics of Disclosure and Financial Reporting Regulation: Evidence and Suggestions for Future Research," *Journal of Accounting Research*, Vol. 54, No. 2 (2016), which is an updated version of Christian Leuz and Peter D. Wysocki, "Economic Consequences of Financial Reporting and Disclosure Regulation: A Review and Suggestions for Future Research," SSRN *Working Paper*, May 7, 2008, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1105398 (accessed November 16, 2016); Healy and Palepu, "Information Asymmetry, Corporate Disclosure, and the Capital Markets"; J. Richard Zecher, "An Economic Perspective of SEC Corporate Disclosure," *Journal of Comparative Business and Capital Market Law*, Vol. 7, No. 3 (1985), pp. 307–315, <http://scholarship.law.upenn.edu/jil/vol7/iss3/7/> (accessed November 16, 2016); and Easterbrook and Fischel, "Mandatory Disclosure and the Protection of Investors," pp. 669–715; "Chapter 3. Corporate Disclosure," in Susan M. Phillips and J. Richard Zecher, *The SEC and the Public Interest* (Cambridge, MA: MIT Press, 1981); Homer Kripke, *The SEC and Corporate Disclosure: Regulation in Search of a Purpose* (Harcourt Brace Jovanovich, 1979); George J. Benston, *Corporate Financial Disclosure in the U.K. and the U.S.A.* (Institute of Chartered Accountants, 1976); and George J. Benston, "Corporate Financial Disclosure in the UK and the USA," *The Accounting Review*, Vol. 53, No. 4 (October 1978), pp. 1019–1021. For two pioneering economic studies finding no measurable benefit from the Securities Act of 1933, see George J. Stigler, "Public Regulation of the Securities Markets," *The Business Lawyer*, Vol. 19, No. 3 (April 1964), pp. 721–753, and George J. Benston, "Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934," *American Economic Review*, Vol. 63, No. 1 (March 1973).
 27. Roberta Romano, "Empowering Investors: A Market Approach to Securities Regulation," *Yale Law Journal*, Vol. 107 (1998), pp. 2359–2430, http://digitalcommons.law.yale.edu/cgi/viewcontent.cgi?article=2976&context=fss_papers (accessed November 16, 2016).
 28. Jeff Desjardins, "All of the World's Stock Exchanges by Size," Visual Capitalist, February 17, 2016, <http://www.visualcapitalist.com/all-of-the-worlds-stock-exchanges-by-size/> (accessed November 16, 2016); World Federation of Exchanges, *Annual Statistics Guide*, 2016, Table 1.1, <https://www.world-exchanges.org/home/index.php/files/18/Studies%20-%20Reports/346/WFE%20Annual%20Statistics%20Guide%20v1.xls> (accessed November 16, 2016).
 29. *Ibid.*
 30. The United Kingdom is, however, close, and its market capitalization-to-GDP ratio has in the past sometimes exceeded that of the U.S. See Sibilis Research, "Global Market Cap to GNI/GDP Ratios for 28 Countries," September 30, 2016, <http://sibilisresearch.com/data/market-cap-to-gdp-ratios/> (accessed November 16, 2016), and The World Bank, "Market Capitalization of Listed Domestic Companies (% of GDP)," 1975–2015, <http://data.worldbank.org/indicator/CM.MKT.LCAP.GD.ZS> (accessed November 16, 2016).
 31. "Broad" in the sense that a high number of firms participate in equity markets and "deep" in the sense that markets are liquid with large numbers of investors investing large amounts of capital.

32. “The mission of the U.S. Securities and Exchange Commission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.” U.S. Securities and Exchange Commission, “What We Do: Introduction,” <http://www.sec.gov/about/whatwedo.shtml#intro> (accessed November 16, 2016). The statutory charge is “[w]henever pursuant to this title the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.” See §3(f) of the Securities Exchange Act of 1934 and §2(b) of the Securities Act of 1933.
33. For additional information on mandatory disclosure, see “Some Limits and Drawbacks of MD,” section in Enriques and Gilotta, “Disclosure and Financial Market Regulation.”
34. Troy A. Paredes, “Blinded by the Light: Information Overload and Its Consequences for Securities Regulation,” *Washington University Law Quarterly*, Vol. 81 (2003), pp. 417–485, <http://digitalcommons.law.wustl.edu/lawreview/vol81/iss2/7/> (accessed November 16, 2016), and Troy A. Paredes, “Remarks at The SEC Speaks in 2013,” U.S. Securities and Exchange Commission, February 22, 2013, <http://www.sec.gov/News/Speech/Detail/Speech/1365171492408#.Ut2WJbROmM8> (accessed November 16, 2016). See also Keith F. Higgins, “Disclosure Effectiveness: Remarks Before the American Bar Association Business Law Section Spring Meeting,” U.S. Securities and Exchange Commission, April 11, 2014, <http://www.sec.gov/News/Speech/Detail/Speech/1370541479332#.VltSmXt4zYg> (accessed November 16, 2016).
35. Ernst & Young, “Now is the Time to Address Disclosure Overload,” *To the Point*, No. 2012-18, June 21, 2012, [http://www.ey.com/Publication/vwLUAssets/ToThePoint_BB2367_DisclosureOverload_21June2012/\\$FILE/ToThePoint_BB2367_DisclosureOverload_21June2012.pdf](http://www.ey.com/Publication/vwLUAssets/ToThePoint_BB2367_DisclosureOverload_21June2012/$FILE/ToThePoint_BB2367_DisclosureOverload_21June2012.pdf) (accessed November 16, 2016).
36. Vipal Monga and Emily Chasan, “The 109,894-Word Annual Report: As Regulators Require More Disclosures, 10-Ks Reach Epic Lengths; How Much Is Too Much?” *The Wall Street Journal*, June 1, 2015, <http://blogs.wsj.com/cfo/2015/06/02/the-109894-word-annual-report/> (accessed November 16, 2016).
37. U.S. Securities and Exchange Commission, “[Electronic Data Gathering, Analysis, and Retrieval] EDGAR, Search Tools,” http://www.sec.gov/edgar/searchedgar/webusers.htm#U_ZaTmOC2So (accessed November 18, 2016).
38. Usually, the federal Forms 10-K, 10-Q, or 8-K.
39. Gary S. Becker, “Crime and Punishment: An Economic Approach,” in Gary S. Becker and William M. Landes, eds., *Essays in the Economics of Crime and Punishment* (New York: Columbia University Press, 1974), <http://www.nber.org/chapters/c3625.pdf> (accessed November 16, 2016), and Richard A. Posner, “An Economic Theory of the Criminal Law,” *Columbia Law Review*, Vol. 85 (1985), pp. 1193–1231, http://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?article=2827&context=journal_articles (accessed November 16, 2016).
40. This discussion omits several subsidiary issues, including the relative efficacy of civil and criminal penalties, the degree of deterrence that is socially optimal, and measurement issues. For a recent review of some of these issues, see Keith N. Hylton, “The Theory of Penalties and the Economics of Criminal Law,” *Review of Law and Economics*, Vol. 1, No. 2 (2005), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=337460 (accessed November 16, 2016).
41. For a dated but detailed look at blue sky laws, see U.S. Securities and Exchange Commission, “Report on the Uniformity of State Regulatory Requirements for Offerings of Securities that Are Not ‘Covered Securities,’” October 11, 1997, <http://www.sec.gov/news/studies/uniformy.htm#seci> (accessed November 16, 2016). For a critique of blue sky laws, see Rutheford B. Campbell Jr., “Federalism Gone Amuck: The Case for Reallocating Governmental Authority over the Capital Formation Activities of Businesses,” *Washburn Law Journal*, Vol. 50 (Spring 2011), p. 573, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1934825 (accessed November 16, 2016). (“In retrospect, there can be little doubt that the failure of Congress to preempt state authority over the registration of securities was a significant blunder.”) See also Roberta S. Karmel, “Blue-Sky Merit Regulation: Benefit to Investors or Burden on Commerce?” *Brooklyn Law Review*, Vol. 53 (1987), pp. 105–125. The North American Securities Administrators Association, in its “Application for Coordinated Review of Regulation A Offering,” delineates between merit review and disclosure jurisdictions. There are 49 participating jurisdictions, including Puerto Rico, the U.S. Virgin Islands, and the District of Columbia. Of the states, 28 are merit review states, 16 are disclosure states, and two (New Jersey and West Virginia) are “disclosure” states that “reserve the right” to make “substantive comments.” Four states do not, at this time, participate, North American Securities Administrators Association, <http://www.nasaa.org/wp-content/uploads/2014/05/Coordinated-Review-Application-Sec-3b.pdf> (accessed November 16, 2016).
42. Rutheford B. Campbell Jr., “The Insidious Remnants of State Rules Respecting Capital Formation,” *Washington University Law Quarterly*, Vol. 78 (2000), pp. 407–434, <http://digitalcommons.law.wustl.edu/cgi/viewcontent.cgi?article=1439&context=lawreview> (accessed November 16, 2016); Henry G. Manne and James S. Mofsky, “What Price Blue Sky: State Securities Laws Work Against Private and Public Interest Alike,” in *The Collected Works of Henry G. Manne*, Vol. 3 (Liberty Fund, 1996); Therese H. Maynard, “The Future of California’s Blue Sky Law,” *Loyola of Los Angeles Law Review*, Vol. 30 (1997), pp. 1531–1556, <http://digitalcommons.lmu.edu/cgi/viewcontent.cgi?article=2067&context=llr> (accessed November 16, 2016); Mark A. Sargent, “A

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43. A discussion of the role of benefit corporations (or benefit LLCs) and social enterprises is beyond the scope of this *Backgrounder*. However, it is the strong contention of the author that if there is full disclosure, and investors understand the dual mission of the enterprise, investors should be free to invest in such enterprises, and the founders of such enterprises should be free to sell securities in such enterprises.
 44. Christine Jolls, Cass R. Sunstein, and Richard H. Thaler, “A Behavioral Approach to Law and Economics,” Yale Law School *Faculty Scholarship Series Paper* No. 1765, 1998, http://digitalcommons.law.yale.edu/fss_papers/1765 (accessed November 16, 2016); Richard H. Thaler and Cass R. Sunstein, “Libertarian Paternalism,” *American Economic Association Papers & Proceedings*, May 2003, Cass R. Sunstein and Richard H. Thaler, “Libertarian Paternalism Is Not An Oxymoron,” *The University of Chicago Law Review*, Vol. 70 (2003), pp. 1166–1187, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=405940 (accessed November 16, 2016); and Ted O’Donoghue and Matthew Rabin, “Studying Optimal Paternalism, Illustrated by a Model of Sin Taxes,” *American Economic Association Papers & Proceedings*, May 2003, pp. 186–191. See also Glen Whitman, “Against the New Paternalism: Internalities and the Economics of Self-Control,” Cato Institute *Policy Analysis* No. 563, February 22, 2006, <http://object.cato.org/sites/cato.org/files/pubs/pdf/pa563.pdf> (accessed November 16, 2016).
 45. Jolls, Sunstein, and Thaler, “A Behavioral Approach to Law and Economics,” and Russell B. Korobkin and Thomas S. Ulen, “Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics,” *California Law Review*, Vol. 88, No. 4 (2000), pp. 1051–1144, <http://scholarship.law.berkeley.edu/cgi/viewcontent.cgi?article=1490&context=californialawreview> (accessed November 16, 2016).
 46. See, for example, Kara M. Stein, “Remarks Before the Consumer Federation of America’s 27th Annual Financial Services Conference,” U.S. Securities and Exchange Commission, December 4, 2014, <http://www.sec.gov/News/Speech/Detail/Speech/1370543593434#.VITlxsmwU0Q> (accessed November 16, 2016); Library of Congress and U.S. Securities and Exchange Commission, “Annotated Bibliography on the Behavioral Characteristics of U.S. Investors,” August 2010, <https://www.sec.gov/investor/locinvestorbehaviorbib.pdf> (accessed November 16, 2016); and Securities and Exchange Commission Investor Advisory Committee, Minutes of May 17, 2010, meeting in Washington, DC, <http://www.sec.gov/spotlight/invadvcomm/iacmeeting051710-agenda.pdf> (accessed November 16, 2016).
 47. Friedrich A. Hayek, “The Pretence of Knowledge,” Prize Lecture to the Memory of Alfred Nobel, December 11, 1974, http://www.nobelprize.org/nobel_prizes/economic-sciences/laureates/1974/hayek-lecture.html (accessed November 16, 2016); Friedrich A. Hayek, *Individualism and Economic Order* (1948), <http://mises.org/books/individualismandeconomicorder.pdf> (accessed November 16, 2016); Friedrich A. Hayek, “The Use of Knowledge in Society,” *American Economic Review*, Vol. 34, No. 4 (September 1945), pp. 519–530, <http://www.econlib.org/library/Essays/hykKw1.html> (accessed November 16, 2016); and Friedrich A. Hayek, “Economics and Knowledge,” *Economica* (February 1937), pp. 33–54, <http://www.econlib.org/library/NPDBooks/Thirlby/bcthLS3.html> (accessed November 16, 2016).
 48. Peter H. Schuck, *Why Government Fails So Often: And How It Can Do Better* (Princeton, NJ: Princeton University Press, 2014); Clifford Winston, *Government Failure versus Market Failure: Microeconomics Policy Research and Government Performance* (Washington, DC: American Enterprise Institute and the Brookings Institution, 2006); and William S. Peirce, *Bureaucratic Failure and Public Expenditure* (Academic Press, 1981).
 49. A security with a high degree of unique risk (as opposed to market risk or systemic risk).
 50. This is often called a negative beta or low beta investment. For a discussion of these issues, see, for example, “Introduction to Risk, Return and the Opportunity Cost of Capital,” in Richard A. Brealey, Stewart C. Meyers, and Franklin Allen, *Principles of Corporate Finance*, 8th Edition (New York: McGraw–Hill, 2006), and most introductory-finance textbooks.
 51. Gordon Tullock, Authur Seldon and Gordon L. Brady, *Government Failure: A Primer in Public Choice* (Washington, DC: Cato Institute, 2002).
 52. For a specific discussion of this issue with respect to securities regulation, see Enriques and Gilotta, “Disclosure and Financial Market Regulation.”
 53. William F. Shughart, “Public Choice,” in David R. Henderson, ed., *Concise Encyclopedia of Economics* (Liberty Fund, 2007), <http://www.econlib.org/library/Enc/PublicChoice.html> (accessed November 16, 2016). James M. Buchanan, *The Collected Works of James M. Buchanan, The Logical Foundations of Constitutional Liberty*, Vol. 1, (Liberty Fund, 1999), p. 46, from a lecture originally given at the Institute for Advanced Studies in Vienna, Austria, in 1979. “My primary title for this lecture, ‘Politics without Romance,’ was chosen for its descriptive accuracy. Public choice theory has been the avenue through which a romantic and illusory set of notions about the workings of governments and the behavior of persons who govern has been replaced by a set of notions that embody more skepticism about what governments can do and what governors will do, notions that are surely

more consistent with the political reality that we may all observe about us. I have often said that public choice offers a ‘theory of governmental failure’ that is fully comparable to the ‘theory of market failure’ that emerged from the theoretical welfare economics of the 1930’s and 1940’s.”

54. Burton W. Folsom Jr. and Anita Folsom, *Uncle Sam Can’t Count: A History of Failed Government Investments, from Beaver Pelts to Green Energy* (Broadside Books, 2014); Howard Pack and Kamal Saggi, “The Case for Industrial Policy: A Critical Survey,” *World Bank Policy Research Working Paper* No. 3839, February 2006, <http://elibrary.worldbank.org/doi/pdf/10.1596/1813-9450-3839> (accessed November 16, 2016). (“Overall, there appears to be little empirical support for an activist government policy even though market failures exist that can, in principle, justify the use of industrial policy.”)
55. Richard E. Rustin and Mitchell C. Lynch, “Apple Computer Set to Go Public Today: Massachusetts Bars Sale of Stock as Risky,” *The Wall Street Journal*, December 12, 1980, http://online.wsj.com/public/resources/documents/AppleIPODec12_1980_WSJ.pdf (accessed November 16, 2016).
56. For example, then Federal Reserve Board Chairman Ben Bernanke said in February 2008, “Among the largest banks, the capital ratios remain good and I don’t anticipate any serious problems of that sort among the large, internationally active banks that make up a very substantial part of our banking system.” “Fed Chairman: Some Small US Banks May Go Under,” CNBC, February 28, 2008, <http://www.cnbc.com/id/23390252> (accessed November 16, 2016). Only seven months later, the Emergency Economic Stabilization Act of 2008 established the Troubled Asset Relief Program (TARP), with Bernanke’s support, to bail out the big banks.
57. Michael J. Roszkowski and John E. Grable, “Evidence of Lower Risk Tolerance Among Public Sector Employees in Their Personal Financial Matters,” *Journal of Occupational and Organizational Psychology*, Vol. 82, No. 2 (June 2009), pp. 453–463.
58. There is, however, a creeping introduction of a type of merit review into federal securities laws. Notably, Title III of the JOBS Act limits investments to a specified percentage of income or net worth, and the new Regulation A+ rules would do the same. It does not take too much imagination to envision a federal regulatory regime that has specified diversification or other requirements for most investors that would seriously limit investors’ options, and which most entrepreneurs starting a business with their own funds would fail. Indeed, FINRA Rule 2111 relating to suitability requirements already imposes the broad outlines of such a system for transactions recommended by a broker-dealer. The recently finalized Department of Labor fiduciary standards under the Employee Retirement Income Security Act (ERISA) raise similar issues. Department of Labor, “Definition of the Term ‘Fiduciary’; Conflict of Interest Rule—Retirement Investment Advice,” Final Rule, *Federal Register*, Vol. 81, No. 68 (April 8, 2016), pp. 20946–21002, <http://webapps.dol.gov/FederalRegister/PdfDisplay.aspx?DocId=28806> (accessed November 16, 2016).
59. Examples would include the SEC’s continued limitations on paying finders (or private placement brokers) who bring capital to a small business, limits on peer-to-peer lending, the unduly restrictive rules governing Regulation D general solicitation, and the crowdfunding rules (and proposed FinCEN rules) that would make non-broker-dealer funding portals uneconomic. Moreover, the sheer complexity of SEC and FINRA regulation of broker-dealers acts to limit competition and to create a cartel, resulting in higher broker-dealer fees than would exist in a genuinely competitive market. Regarding the proposed FinCEN rules, see David R. Burton comments to FinCEN Director Jennifer Shasky Calvery on “Amendments to the Definition of Broker or Dealer in Securities,” June 3, 2016, <https://www.regulations.gov/contentStreamer?documentId=FINCEN-2014-0005-0006&attachmentNumber=1&disposition=attachment&contentType=pdf> (accessed November 17, 2016). Regarding crowdfunding, see David R. Burton, comments to SEC Secretary Elizabeth M. Murphy on “Crowdfunding,” February 3, 2014, <https://www.sec.gov/comments/s7-09-13/s70913-192.pdf> (accessed November 17, 2016). With respect to the other issues, see chapter 21 in this book, “Improving Entrepreneurs’ Access to Capital: Vital for Economic Growth.”
60. Public Law 467, 88th Cong., 2nd Sess. (August 20, 1964). See also Richard M. Phillips and Morgan Shipman, “An Analysis of the Securities Acts Amendments of 1964,” *Duke Law Journal* (1964), <http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=1941&context=dlj> (accessed November 17, 2016).
61. See section 12(g) of the Securities Exchange Act. Note: “Holder of record” is not the same as beneficial owner. Most investors hold their stock under “street name” so that all of the stock held by various customers of a particular broker-dealer is held on the records of the company as one holder of record—the broker-dealer. In addition, many investors may combine to form and invest in a special-purpose vehicle that, in turn, actually invests in the company. The special-purpose vehicle counts as only one shareholder of record. The regulations do not require the issuer to “look through” the special-purpose-vehicle investor. In addition, mutual funds, closed-end funds, or private-equity funds are, in effect, entities that represent the investment of many individual investors, yet they, too, would constitute just one holder of record.
62. In addition, under the JOBS Act, investors who bought securities pursuant to the Title III crowdfunding exemption are not counted toward the section 12(g) limit.
63. For a discussion of these issues, see Donald C. Langevoort and Robert B. Thompson, “‘Publicness’ in Contemporary Securities Regulation After the JOBS Act,” *Georgetown Law Journal*, Vol. 101 (2013), pp. 337–386, <http://scholarship.law.georgetown.edu/cgi/viewcontent.cgi?article=1985&context=facpub> (accessed November 17, 2016).

64. Regulation A and crowdfunding securities are public in the sense they may be sold to all investors, and the securities are not restricted securities (in the case of crowdfunding, after one year). They are not public in the sense that the issuer is not subject to the requirements of a reporting company. The term quasi-public is meant to encompass these types of companies, and companies that would be in a similar situation under alternative regulatory regimes.
65. They are discussed in greater detail (along with many non-disclosure-related reforms) in Burton, "Improving Entrepreneurs' Access to Capital."
66. The Securities Act of 1933 (May 27, 1933), Public Law 73-22, 48 Stat. 74, 15 U.S. Code §77a et seq. (as amended through Public Law 112-106, April 5, 2012), <https://www.sec.gov/about/laws/sa33.pdf> (accessed November 17, 2016).
67. See the Securities Act of 1933, §5.
68. The SEC has estimated that "the average cost of achieving initial regulatory compliance for an initial public offering is \$2.5 million, followed by an ongoing compliance cost, once public, of \$1.5 million per year." Proposed Rules, "Crowdfunding," *Federal Register*, Vol. 78, No. 214 (November 5, 2013), p. 66509 (col. 2), <http://www.gpo.gov/fdsys/pkg/FR-2013-11-05/pdf/2013-25355.pdf> (accessed November 17, 2016).
69. Securities Act of 1933, §3(b); 15 U.S. Code 77c(b). It was originally \$100,000 and was increased to \$300,000 in 1945, to \$500,000 in 1970, to \$2 million in 1978, and to \$5 million in 1980. In 2012, the JOBS Act created section 3(b)(2), which allows certain Regulation A offerings to raise as much as \$50,000,000. This is so-called Regulation A+.
70. See section 102 of the National Securities Markets Improvement Act of 1996 [Public Law 104-290, October 11, 1996] incorporating the Capital Markets Efficiency Act of 1996 as section 18(b)(4)(E) of the Securities Act (15 U.S. Code 77r(b)(4)(E)), (treating as covered securities those securities not involving a public offering under Securities Act section 4(a)(2)). Rules 504 and 505 were promulgated under Securities Act section 3(b) and therefore transactions using these rules are not blue sky exempt.
71. See, for instance, Rutheford B. Campbell Jr., "Regulation A: Small Businesses' Search for a Moderate Capital," *Delaware Journal of Corporate Law*, Vol. 31 (2006), pp. 77-123, http://uknowledge.uky.edu/cgi/viewcontent.cgi?article=1125&context=law_facpub (accessed November 17, 2016); Stuart R. Cohn and Gregory C. Yadley, "Capital Offense: The SEC's Continuing Failure to Address Small Business Financing Concerns," *New York University Journal of Law and Business*, Vol. 4, No. 1 (Fall 2007), pp. 1-87, <http://scholarship.law.ufl.edu/cgi/viewcontent.cgi?article=1257&context=facultypub> (accessed November 17, 2016); and Government Accountability Office, "Factors that May Affect Trends in Regulation A Offerings," GAO-12-839, July 2012, <http://www.gao.gov/assets/600/592113.pdf> (accessed November 17, 2016).
72. Government Accountability Office, "Factors that May Affect Trends in Regulation A Offerings," p. 9.
73. "Proposed Rule Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act." *Federal Register*, Vol. 79, No. 15 (January 23, 2014), p. 3928, <http://www.gpo.gov/fdsys/pkg/FR-2014-01-23/pdf/2013-30508.pdf> (accessed November 17, 2016).
74. \$73 million of \$25,840 million. If section 4(a)(2) private offerings made without use of the Regulation D safe harbor were considered, the percentage would be substantially lower still.
75. "Amendments for Small and Additional Issues Exemptions Under the Securities Act," *Federal Register*, Vol. 80, No. 75 (April 20, 2015), pp. 21806-21925, <http://www.gpo.gov/fdsys/pkg/FR-2015-04-20/pdf/2015-07305.pdf> (accessed November 17, 2016).
76. A primary offering is when a company (an issuer) sells securities to an investor. A secondary offering is when an investor sells a security to another investor. A secondary market is a market, such as a stock exchange, where investors trade securities among themselves.
77. "Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers of Sales" (Release No. 33-6389), *Federal Register*, Vol. 47 (March 16, 1982), p. 11251. Regulation D is found at 17 C.F.R. §230.500 through §230.508.
78. 17 C.F.R. §230.504. See also Securities and Exchange Commission, "Fast Answers: Rule 504 of Regulation D," <http://www.sec.gov/answers/rule504.htm> (accessed November 17, 2016).
79. 17 C.F.R. §230.505. See also Securities and Exchange Commission, "Fast Answers: Rule 505 of Regulation D," <http://www.sec.gov/answers/rule505.htm> (accessed November 17, 2016).
80. Rule 504 offerings are exempt from the additional disclosure requirements for sales to non-accredited investors. See Rule 504(b) (1). General solicitation is permitted only in certain specified circumstances.
81. Rule 505 allows up to 35 non-accredited investors, but investments by non-accredited investors trigger additional disclosure requirements under Rule 502(b).
82. Vladimir Ivanov and Scott Bauguess, "Capital Raising in the U.S.: An Analysis of Unregistered Offerings Using the Regulation D Exemption, 2009-2012," U.S. Securities and Exchange Commission, July 2013, p. 7, <http://www.sec.gov/divisions/riskfin/whitepapers/dera-unregistered-offerings-reg-d.pdf> (accessed November 17, 2016).

83. This has been true since the passage of The National Securities Markets Improvement Act (NSMIA) of 1996, which amended section 18 of the Securities Act (15 U.S. Code 77r) to exempt from state securities regulation any “covered security.” 15 U.S. Code 77r(b)(4)(E) provides that a “security is a covered security with respect to a transaction that is exempt from registration under this subchapter pursuant to...commission rules or regulations issued under section 77d(2) of this title, except that this subparagraph does not prohibit a State from imposing notice filing requirements that are substantially similar to those required by rule or regulation under section 77d(2) of this title that are in effect on September 1, 1996. Section 77d(2) is a reference to section 4(2) of the Securities Act (now section 4(a)(2)), to wit, transactions by an issuer not involving any public offering. Only Rule 506 of Regulation D relied on this provision. See “Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers of Sales,” *Federal Register*, Vol. 47 (March 16, 1982), p. 11251. Rule 504 and Rule 505 rely instead on section 3(b) of the Securities Act. See 17 C.F.R. 230.504(a) and 17 C.F.R. 230.505(a). Accordingly, Rule 504 and Rule 505 offerings are not treated as covered securities by the SEC or the state regulators.
84. Fifty states, the District of Columbia, and the SEC.
85. Ivanov and Bauguess, “Capital Raising in the U.S.: An Analysis of Unregistered Offerings Using the Regulation D Exemption, 2009–2012,” pp. 7–9, and David R. Burton, “Don’t Crush the Ability of Entrepreneurs and Small Businesses to Raise Capital,” Heritage Foundation *Backgrounder* No. 2874, February 5, 2014, <http://www.heritage.org/research/reports/2014/02/dont-crush-the-ability-of-entrepreneurs-and-small-businesses-to-raise-capital>.
86. Scott Bauguess, Rachita Gullapalli, and Vladimir Ivanov, “Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009–2014,” U.S. Securities and Exchange Commission, October 2015, <https://www.sec.gov/dera/staff-papers/white-papers/unregistered-offering10-2015.pdf> (accessed November 17, 2016).
87. Rule 502(b).
88. 17 C.F.R. 230.501(a) [SEC Rule 501].
89. For details, see Burton, “Don’t Crush the Ability of Entrepreneurs and Small Businesses to Raise Capital.”
90. Rule 501(e) excludes all accredited investors from the calculation of the number of purchasers. Rule 506(b)(2)(ii) requires that “each purchaser who is not an accredited investor either alone or with his purchaser representative(s) has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description.” The shorthand for this requirement is that each purchaser must be a “sophisticated investor.”
91. Release No. 33–9416; Release No. 34– 69960; Release No. IC–30595; File No. S7–06–13; RIN 3235–AL46, “Amendments to Regulation D, Form D and Rule 156,” *Federal Register*, Vol. 78, No. 142 (July 24, 2013), pp. 44806–44855, and Release No. 33–9458; Release No. 34–70538; Release No. IC–30737; File No. S7–06–13; RIN 3235–AL46; “Amendments to Regulation D, Form D and Rule 156; Re-Opening of Comment Period,” *Federal Register*, Vol. 78, No. 192 (October 3, 2013), p. 61222, <http://www.sec.gov/rules/proposed/2013/33-9416.pdf> (accessed November 17, 2016).
92. However, filing a simple closing Form D indicating the amount actually raised is justified by the need to have improved information about this critical market.
93. This requirement would apply to companies making 506(c) offerings as permitted by Title II of the JOBS Act. See David R. Burton, comments to SEC Secretary Elizabeth M. Murphy on “Amendments to Regulation D, Form D and Rule 156,” November 4, 2013, <http://www.sec.gov/comments/s7-06-13/s70613-462.pdf> (accessed November 17, 2016).
94. H.R. 2930, 112th Cong., <http://www.gpo.gov/fdsys/pkg/BILLS-112hr2930ih/pdf/BILLS-112hr2930ih.pdf> (accessed November 17, 2016).
95. It also excluded crowdfunding investors from the holders-of-record count, pre-empted blue sky laws, and entitled issuers to rely on investor self-certification for income level.
96. H.R. 2930, 112th Cong.
97. Senate Amendment to Title III of H.R. 3606, <http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606eas/pdf/BILLS-112hr3606eas.pdf> (accessed November 17, 2016).
98. Securities Act, Section 4(a)(6).
99. There were 284 actual requests for comment, but many of them are multipart requests. Securities and Exchange Commission, “Proposed Rules: Crowdfunding,” October 23, 2013, <http://www.sec.gov/rules/proposed/2013/33-9470.pdf> (accessed November 17, 2016).
100. “Securities and Exchange Commission: Crowdfunding,” *Federal Register*, Vol. 80, No. 220 (November 16, 2015), pp. 71388–71615, <https://www.sec.gov/rules/final/2015/33-9974.pdf> (accessed November 17, 2016).
101. For a detailed discussion, see Burton, “Improving Entrepreneurs’ Access to Capital.”

102. The other proposed changes are: (1) Permit funding portals to be compensated based on the amount raised by the issuer; (2) make it clear that funding portals are not issuers and not subject to the issuer liability provisions; (3) repeal the restriction on providing investment advice entirely or, alternatively, explicitly permit “impersonal investment advice,” and make it clear that a portal may bar an issuer from its platform if the portal deems an offering to be of inadequate quality without fear of liability to issuers or investors and that this would not constitute providing prohibited investment advice; (4) reduce the administrative and compliance burden on funding portals; (5) allow intermediaries to rely on good-faith efforts by third-party certifiers for purposes of complying with the investment limitation in section (4)(a)(6)(B); and (6) amend the Bank Secrecy Act to make it clear that federal “Know Your Customer” rules do not apply to finders, business brokers, or crowdfunding Web portals that do not hold customer funds.
103. The micro-offering exemption incorporated into the House-passed H.R. 2357 (114th Cong.), while constructive, is much too narrow. Very few firms will qualify for the exemption. H.R. 4850 (114th Cong.) would have had a much more pronounced positive impact for small firms.
104. 17 C.F.R. Part 229.
105. 17 C.F.R. Part 210.
106. For a short discussion of each item, see Securities and Exchange Commission Division of Corporation Finance, *Financial Reporting Manual*, March 17, 2016, <https://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.pdf> (accessed November 17, 2016).
107. Proposed Rules, “Crowdfunding,” *Federal Register*, Vol. 78, No. 214 (November 5, 2013), p. 66509 (col. 2).
108. See, for instance, Committee on Capital Markets Regulation, *Interim Report of the Committee on Capital Markets Regulation*, November 30, 2006, http://www.capmktreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf (accessed November 18, 2016); Ehud Kamar, Pinar Karaca-Mandic, and Eric Talley, “Going-Private Decisions and the Sarbanes–Oxley Act of 2002: A Cross-Country Analysis,” Kauffman–RAND Institute for Entrepreneurship Public Policy, February 2008, http://www.rand.org/content/dam/rand/pubs/working_papers/2008/RAND_WR300-2.pdf (accessed November 18, 2016); and Robert P. Bartlett III, “Going Private but Staying Public: Reexamining the Effect of Sarbanes–Oxley on Firms’ Going-Private Decisions,” *University of Chicago Law Review*, Vol. 76, No. 1 (2009), pp. 7–44, https://lawreview.uchicago.edu/sites/lawreview.uchicago.edu/files/uploads/76.1/76_1_Bartlett.pdf (accessed November 18, 2016).
109. The Sarbanes–Oxley Act of 2002, Public Law 107–204, July 30, 2002.
110. The Dodd–Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, July 21, 2010.
111. See, for instance, Michele Meoli et al., “The Cost of Going Public: A European Perspective,” *International Journal of Economics and Management Engineering*, Vol. 2, No. 2 (May 2012).
112. 17 C.F.R. 240.12b-2. The SEC, to its credit, recently proposed increasing the threshold to \$250 million. See “Amendments to Smaller Reporting Company Definition,” Proposed Rule, *Federal Register*, Vol. 81, No. 127 (July 1, 2016), pp. 43130–43154, <https://www.gpo.gov/fdsys/pkg/FR-2016-07-01/pdf/2016-15674.pdf> (accessed November 18, 2016).
113. David R. Burton, “Reducing the Burden on Small Public Companies Would Promote Innovation, Job Creation, and Economic Growth,” Heritage Foundation *Backgrounder* No. 2924, June 20, 2014, <http://www.heritage.org/research/reports/2014/06/reducing-the-burden-on-small-public-companies-would-promote-innovation-job-creation-and-economic-growth>.
114. Securities and Exchange Commission, *Report on Review of Disclosure Requirements in Regulation S-K, as Required by Section 108 of the Jumpstart Our Business Startups Act*, December 2013, <https://www.sec.gov/news/studies/2013/reg-sk-disclosure-requirements-review.pdf> (accessed November 18, 2016).
115. “Business and Financial Disclosure Required by Regulation S–K,” Concept Release, *Federal Register*, Vol. 81, No. 78 (April 22, 2016), <https://www.gpo.gov/fdsys/pkg/FR-2016-04-22/pdf/2016-09056.pdf> (accessed November 18, 2016).
116. There would need to be a reasonable, administrable look-through rules if beneficial ownership were to replace the holder of record threshold. However, since in the contemplated regulatory regime, the impact of the step up from private to quasi-public status would not be as discontinuous as the step up from private to public today, this break point would be of less importance.
117. In addition, conforming amendments elsewhere in the Securities Act and the Securities Exchange Act would need to be made.

CHAPTER 6: The Case for Federal Pre-Emption of State Blue Sky Laws

Rutheford B. Campbell Jr.

THE NEED FOR LAWS TO GOVERN CAPITAL FORMATION

American society long ago abandoned an unregulated securities market and imposed legal requirements on businesses (issuers) when they offer or sell their securities to investors.¹

In a market economy such as ours, imposing rules on capital formation makes economic sense.² Without some regulation of the conduct of businesses offering and selling their securities to investors, those businesses may have an incentive to misstate or fail to disclose material investment information. This may amount to unfairness to, and an undesirable fraud on, investors in connection with the purchase and sale of securities.

Misstated or undisclosed material investment information may also facilitate an inefficient allocation of precious market capital. There is no way to be sure, for example, that an investor's decision to turn over his or her capital to a business amounts to an efficient allocation of that capital, if that decision is made as a result of the business's misstatements of or failure to disclose material investment information.

Society's rules regulating capital formation are usually of two separate but related types. First is society's antifraud rules, which prohibit businesses offering or selling their

securities to investors from engaging in manipulative or deceptive acts. These antifraud rules require that a business in connection with its offer or sale of securities disclose all material information to investors and refrain from making material misstatements.³

Society's second, related rule governing capital formation requires that a business offering its securities to investors "register" the securities or meet the conditions for an exemption from this registration requirement. Registration typically requires that the business offering securities to investors provide closely prescribed investment information to a designated governmental agency (typically through the filing of a registration statement with, for example, the Securities and Exchange Commission (SEC) and also provide that prescribed investment information to investors (typically by providing investors with a prospectus)).⁴

These two broad types of capital formation rules imposed by society⁵—antifraud rules and rules requiring registration—incentivize the efficient disclosure of accurate, material

investment information in connection with the offer and sale of securities. Disclosure of such investment information by the business offering its securities to investors reduces fraud and unfairness to investors and increases the likelihood that market capital provided by investors will be allocated to its highest and best use.

These societal rules may, however, generate additional offering costs for the business that is seeking external capital. The additional costs may retard, or in some cases completely choke off, the flow of capital from investors to businesses. If, for instance, the costs (such as accounting fees, legal fees, and filing fees) of complying with society's rules regarding capital formation force the company's overall cost of issuing capital to rise above its expected return, the business is unlikely to undertake the project.

The problem with the rules governing capital formation enacted by states, territories, and the District of Columbia (state blue sky laws) is that the registration requirements of those blue sky laws raise the offering costs of capital formation to an inefficient and in some cases an intolerable level.

There are obvious and significant increased costs generated as a result of imposing multiple registration regimes on businesses soliciting capital. If, for example, a company solicits broadly for its capital, it may be required to comply with the separate and independent registration requirements of all of the 50-plus blue sky jurisdictions. There are, however, no material efficiencies or investor protections generated by requiring an issuer to do the same thing 50-plus times under 50-plus separate and different registration regimes.

Unfortunately, the burden imposed by the registration requirements of 50-plus blue sky regimes falls disproportionately on the 5 million or so small businesses in the United States, making it difficult for such small businesses to raise the capital they need to survive and compete.

These small businesses are vital to the national economy.⁶ They provide a wide array of services and products and may account for as

much as 30 percent of the employment in the United States. Even that large number, however, may understate the significance of the economic energy and opportunity generated by small businesses.

Although Congress has to an extent pre-empted the registration requirements of state blue sky laws, the federal pre-emption is largely incomplete. Most important in that regard is the fact that the pre-emption so far offers scant relief to small businesses when they search for external capital.

The federal government should completely pre-empt state authority over the registration of securities. Society needs a single set of efficient rules governing the registration of securities. Imposing 50-plus independent registration regimes on capital formation by businesses generates economic waste, high costs, and inefficient conditions on businesses—especially small businesses—when they attempt to access the external capital that is vital for their survival and ability to compete.

TODAY'S LAWS GOVERNING CAPITAL FORMATION

State Blue Sky Laws. All states, the District of Columbia, and the territories have laws that govern the offer and sale of securities.⁷ These blue sky laws came into existence in a flourish shortly after the beginning of the 20th century.⁸ By the time Congress got around to enacting the Securities Act of 1933, 47 of the then-48 states had enacted blue sky laws.⁹

Not surprisingly, historians may conclude that blue sky laws were a response to perceived fraud and manipulation surrounding the offering and sale of securities.¹⁰

Blue sky laws generally require that businesses offering or selling their securities within the particular state must register those securities with that state, providing the state regulators and investors with prescribed investment information.¹¹ Most blue sky laws also have “merit” or “qualification” requirements, which are substantive standards that must be met in order for a business to sell registered securities within the state.¹²

Blue sky statutes normally contain a number of exemptions from the state registration requirements.¹³ One of the most common, for example, is a small-offering exemption, which may exempt offerings limited to a small number of offerees or purchasers from the state registration requirements.¹⁴

Most states also have a limited exemption for offerings made under Regulation D of the Securities Act of 1933.¹⁵ The prototype for this state exemption, the Uniform Limited Offering Exemption (ULOE),¹⁶ was promulgated by the North American Securities Administrators Association (NASAA). Some form of ULOE has been widely adopted by states. NASAA's version of ULOE provides an exemption from the state's registration obligations for offerings that meet the requirements for exemption from federal registration provided by Rule 505 or Rule 506 of Regulation D and also meet additional requirements imposed by ULOE.¹⁷

Within our system of federalism, each state exercises a significant measure of sovereignty over its rules governing the offer and sale of securities within its state. In the case of the registration requirements imposed by blue sky laws, this means that—barring federal pre-emption of state authority over registration—a business offering its securities widely must meet the particular registration requirements of each state where it offers its securities to investors.¹⁸ Meeting the particular registration requirements of Kansas, for example, does not necessarily mean that the requirements of Nebraska—or any other state—have been met. If, therefore, a business offers its securities in four states, it may be required to meet the separate and distinct registration requirements in each of the four states. If the offer is nationwide, it may be required to meet the registration requirements of all 50-plus blue sky jurisdictions.

Blue sky laws also prohibit fraud or manipulation in connection with the offer and sale of securities within the applicable state.¹⁹ Most important, with regard to business capital formation activities, these laws require

that a business selling its securities refrain from making material misstatements of facts and disclose all material investment information.²⁰ States usually impose criminal, civil, and administrative penalties on a business that violates these rules.²¹

Federal Securities Laws. The bedrock of the federal laws governing capital formation came about with the passage of the Securities Act of 1933 (Securities Act).

The Securities Act requires that businesses offering and selling their securities must either file a registration statement with the SEC and provide investors with investment information or, alternatively, qualify for an exemption from the registration requirement.²² The Securities Act also prohibits fraud and manipulation in connection with the capital raising activities of businesses.²³

Both the registration provisions and the antifraud provisions of the Securities Act are broadly applicable, establishing jurisdiction by even the slightest brush with interstate facilities or transportation.²⁴ This means that any wide offering of securities by a business is subject not only to the 50-plus state blue sky laws but also to the Securities Act as well.

Although there are significant overlaps and duplications, there are differences between blue sky laws and the Securities Act.

One important difference is that the registration requirements of the Securities Act are based on a disclosure philosophy, while the registration requirements of blue sky laws are, as described above, generally based on a qualification or merit philosophy.²⁵ Registration at the federal level, therefore, does not require the registrant to meet any substantive requirements regarding the quality or price of the investment. The issuer's only obligation under the Securities Act is to disclose prescribed investment information to the SEC and to investors.²⁶ The registrant does not have to convince the SEC that the offering is a fair deal for investors.

It is worth noting here that Congress in 1933 got this right. In a market economy, allocation of capital and the pricing of

investments must be left to the capital market. Assigning that responsibility to bureaucrats would amount to an economic disaster. Capital formation would be outrageously expensive and destructively slow. Allowing bureaucrats to limit the flow of capital only to deals that they determine to be well priced and fair would ensure an inefficient allocation of market capital. With the Securities Act, Congress correctly tried to enhance an efficient allocation of capital by improving information flows among the parties. It did this by incentivizing the most efficient provider of investment information, which is the issuer, to make that information available to the parties involved in the reallocation of market capital.

The exemptions from registration in the 1933 act and in state blue sky laws are also different.

While the statutory and regulatory exemptions from federal registration under the Securities Act have not been entirely economically sound in all cases, Congress and the SEC in recent decades have made progress in moving the federal regime in the right direction. They have done this by expanding exemptions in situations in which the costs of registration will practically foreclose small businesses from the capital markets and in situations where the parties to the transaction have cheap access to investment information.

This sensible evolution under the Securities Act is captured by a provision in the National Securities Market Improvement Act (NSMIA) of 1996, which amended Section 2(b) of the Securities Act. As thus amended, Section 2(b) mandates a rational and balanced approach toward the federal regime governing capital formation. Section 2(b) of the 1933 act states that when the SEC is enacting regulations “in the public interest, [it] shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.”²⁷

As originally adopted, there was, however, a fundamental flaw in the 1933 act: It did not pre-empt state authority over registration. States retained authority over the

registration of securities offered in the particular state, including the authority to enforce merit requirements.

Continuing state authority over registration meant, for example, that if an issuer wanted to offer its securities broadly through a public medium—in 1933, perhaps, in a newspaper advertisement, or today by posting a notice on the issuer’s website—the issuer was more than likely required to meet the federal registration requirements, all state registration requirements, and all applicable state merit requirements. The issuer was, in short, subject to 50-plus separate regimes, each with its own individual registration rules and in most cases merit rules.

This overall regime continued unabated for more than half a century and to a significant extent continues today.

THE PRE-EMPTION OF STATE AUTHORITY OVER REGISTRATION

The federal government has pre-empted some state authority over registration. This is a result of provisions in NSMIA and the Jumpstart Our Business Startups (JOBS) Act.

NSMIA pre-empted state registration authority over offerings by issuers traded on national securities exchanges²⁸ and offerings by registered investment companies (mutual funds).²⁹

NSMIA also pre-empted state registration authority over offerings conducted under Rule 506 of Regulation D.³⁰ Meeting the requirements of Rule 506 for an exemption from the federal registration obligation requires that the investors must either be sophisticated or accredited (such as wealthy investors or insiders), and unaccredited investors must be provided with extensive, prescribed investment information.³¹

In NSMIA, Congress also delegated authority to the SEC to expand pre-emption by regulation to offers limited to “qualified purchasers as defined by the Commission.”³² The only restriction on the breadth of this delegation to the SEC to define “qualified purchasers” is that the definition of “qualified purchasers”

must be “consistent with the public interest and the protection of investors.”³³ The SEC has never used this provision to expand pre-emption of state authority over registration.

The JOBS Act pre-empted state registration authority over offerings under the new crowdfunding exemption.³⁴ That exemption from federal registration is available for offerings made exclusively on the Internet, is limited both with regard to the total amount of the offering and the amount any investor may purchase, and requires the disclosure of investment information.³⁵

The JOBS Act³⁶ also delegated authority to the SEC to pre-empt state registration authority over offerings under the new Regulation A rules (generally referred to as Regulation A+ rules), provided the offering is limited to “a qualified purchaser, as defined by the Commission.”³⁷ The exemption provided by Regulation A+ is predicated on the disclosure of prescribed investment information to the SEC and investors, and the amount of information required to be disclosed depends on the size of the offerings. Offerings of up to \$20 million (Tier 1 offerings) require substantially less disclosure than offerings of up to \$50 million (Tier 2 offerings). The final Regulation A+ rules pre-empt state registration authority over Tier 2 offerings but do not pre-empt state registration authority over Tier 1 offerings.

State authority over registration continues for all other offerings of securities by issuers. These include: (1) registered offerings by issuers of its securities that are not traded on a national exchange; (2) private placements under the common law of Section 4(a)(2); (3) offerings under Rule 504;³⁸ (4) offerings under Rule 505;³⁹ (5) Tier 1 offerings under Regulation A+; and (6) intrastate offerings under Rule 147.

Offerings under the exemptions from federal registration listed in the preceding paragraph—exemptions that are important to small businesses seeking external capital and, indeed, are largely designed to facilitate efficient small-business capital formation—continue to be subject to the registration requirements of all blue sky jurisdictions.

IMPACT OF BLUE SKY LAWS ON CAPITAL FORMATION

No argument is made here that states should have no role in the regulation of capital formation. Indeed, state blue sky laws, properly limited and directed, can play a beneficial role in promoting an efficient allocation of capital and protecting investors.

The appropriate state role in the regulation of capital formation involves the robust enforcement of state antifraud rules.

State antifraud laws provide significant economic penalties—for example, private recoveries and civil and criminal penalties—for the failure to disclose all material information in connection with an issuer’s sale of securities. The economic costs to the issuer of such penalties incentivize disclosure of investment information, which in turn promotes fully informed decision making and protects investors. States should continue to enforce their antifraud rules vigorously and, indeed, should increase state resources dedicated to the enforcement of their antifraud rules.

The problem created by blue sky laws is state authority over registration. These laws and regulations significantly impede efficient capital formation that is vital to this country’s market economy. At the same time, these state registration rules offer no economic or societal benefits, such as protection of investors from fraud.

The pernicious effect of state registration rules is easily and vividly demonstrated by considering the impact of those laws on a business that proposes to solicit broadly for investors. If, for example, a business intends to announce its offering by posting information about the offering on its website or by advertising for investors in a widely distributed publication, the business seeking capital would likely be subject to the separate and individual registration requirements of each of the 50-plus jurisdictions that have blue sky laws. In each state, therefore, the issuer would be required either to register its securities under the registration provisions

of that particular state or meet the particular state's requirements for an exemption from registration.

Even if the offering were limited to four states, the business soliciting for investors would have four separate state registration regimes to satisfy, which, again, could be satisfied only by filing registration statements in each of the jurisdictions or by qualifying for an exemption from the registration requirement in each of the four states.

From a policy point of view, this of course makes no sense. It increases the costs of a critical element of an efficient market economy, which is an efficient access to external capital. It is nothing short of bizarre for society to impose an obligation to meet 50-plus—or four, or two—separate registration regimes on businesses seeking external capital.

While the pernicious effects generated by the costs of meeting multiple registration regimes is apparent, it is impossible to find any material benefit in such an overall system. If state registration authority were eliminated, investors would still be protected by federal registration provisions and by both state and federal antifraud requirements. Imposing 50-plus blue sky registration regimes in addition to these investor protections adds nothing of significance, except an increase in offering expenses that makes access to capital more difficult.

In all cases, the registration requirements of state blue sky laws amount to economic waste, generating costs without any economic benefit. These state registration requirements, however, have been especially debilitating on small businesses in need of external capital.

The reason that the harmful effects of state registration provisions fall disproportionately on small businesses is due principally to the structural and economic circumstances that small businesses face when they attempt to access external capital.

Small businesses usually seek relatively small amounts of external capital. This means that financial intermediation is likely

unavailable. Financial intermediation is a fancy term for professional assistance (such as from brokers or underwriters) in finding investors. The yield from small offerings simply will not support the fees required by competent and honest financial intermediation. For example, in my research, I found that only 5.8 percent of Regulation D offerings of \$1 million or less reported having any financial intermediation.⁴⁰

Related to this is the problem of relative offering costs. These are offering costs as a percentage of the size of the deal. Offering costs of \$100,000 are 100 percent of a \$100,000 offering but only 1 percent of a \$10 million offering. It is relative, not absolute, offering costs that foreclose businesses from the capital markets. Using these extreme examples, offering expenses of \$100,000 in an offering of \$100,000 (relative offering expenses of 100 percent) will prevent the offering, while similar offering expenses in a \$10 million offering (1 percent relative offering expenses) should not foreclose the business from the capital market.

These related matters—the absence of financial intermediation and disproportionate relative offering costs—are huge problems for small businesses. Because small businesses typically seek small amounts of external capital, relative offering costs go through the roof when small businesses are saddled with multiple sets of registration rules imposed by state blue sky laws.

A harmful consequence of state blue sky registration requirements—a consequence readily demonstrable by empirical data—is the extent to which those state laws have wrecked well-conceived, efficient federal exemptions from registration designed for small businesses.

Regulation A, for example, is an exemption from federal registration requirements provided by the SEC under authority delegated to it by Congress. The Regulation A exemption requires a disclosure of closely tailored investment information, disclosures designed to ameliorate the stifling requirements of the

extensive disclosures required in a registration statement.⁴¹

Although for decades Regulation A was the only exemption available to small issuers for a broad, interstate solicitation for investors, and although there are more than five million small businesses in the U.S. economy that inevitably will need external capital at some point, offerings under Regulation A have nearly disappeared. Data show, for example that between 1995 and 2004, there were on average only 7.8 Regulation A offerings per year. Between 2005 and 2011, there were on average 23.1 Regulation A offerings per year.⁴²

The apparent principal reason for the non-use of this very attractive exemption was state blue sky registration requirements. If a small business in need of external capital for its operation or expansion used Regulation A as a basis for a broad solicitation for investors, that small offering was subject to the registration requirements of all 50-plus blue sky jurisdictions, which amounted to an intolerable burden for small businesses.

Data regarding the use of the exemptions from federal registration provided by Regulation D⁴³ offer what perhaps is even more vivid evidence of how state blue sky registration requirements have robbed small businesses of the ability to use efficient, balanced federal registration exemptions as a basis for access to external capital.

Regulation D offers businesses three exemptions from federal registration requirements: (1) Rule 504 provides an exemption for offerings of \$1 million or less;⁴⁴ (2) Rule 505 provides an exemption for offerings of \$5 million or less;⁴⁵ and (3) Rule 506 provides an exemption for offerings that are unlimited as to size.⁴⁶

Rule 504 is specially structured for small businesses. There are no disclosures or offerer qualification requirements (such as sophistication or wealth) that are predicates to the availability of the exemption provided by Rule 504. On the other hand, in the largest of the Regulation D offerings—Rule 506 offerings—the exemption is predicated on all accredited investors (generally wealthy investors or

insiders) or, alternatively, requires disclosure of substantial amounts of investment information and sophisticated investors.

This so-called scaled approach of Regulation D—requiring more extensive investor protection as the size of the offering increases—is an appropriate response to the problem of relative offering costs. Small Rule 504 offerings, for example, are simply too small to support the costs associated with extensive and thus expensive disclosure requirements. Capital formation for small businesses in such circumstances would be stymied. In striking a balance, the SEC was content in the case of these small offerings to rely on the ability of the parties to bargain for investment information and the more general requirements of federal antifraud provisions, which require a company selling its securities to provide investors with all material investment information.

Notwithstanding the apparent attractiveness of a Rule 504 for small offerings, small businesses have to a large extent abandoned the use of Rule 504 and made these small Regulation D offerings under Rule 506. In a sample consisting of 7,880 Regulation D offerings of \$1 million or less, 78.6 percent of those offerings were made under Rule 506.⁴⁷ Data also show that more than 80 percent of these small Regulation D offerings that are made under Rule 506 are also limited to accredited investors.⁴⁸

The reason that small businesses abandon Rule 504 and move to Rule 506 and limit their offerings to accredited investors (persons who may amount to less than 5 percent of the total population)⁴⁹ is to avoid state blue sky registration provisions. Offerings under Rule 506 pre-empt state registration authority.

In short, as was the case with Regulation A offerings, state blue sky registration provision wrecked the well-considered, efficient federal registration exemptions provided to small businesses by Regulation D. Again, therefore, small businesses were the losers.

Small businesses are critical to the national economy.⁵⁰ In regard to access to external capital formation, however, they face

significant structural and economic disadvantages, which to a large degree are a result of high relative offering costs and the absence of financial intermediation. Imposing 50-plus separate blue sky registration regimes on small businesses seems to complete the circumstances for the perfect pernicious storm for small businesses seeking external capital necessary for them to survive and compete.

WHAT WON'T—AND WHAT WILL— SOLVE THE PROBLEM

An efficient regulation of capital formation—regulation that ameliorates fraud and misinformed investment decisions and promotes the allocation of capital to its most efficient use—requires a single set of efficient rules regarding the registration of securities. Within our system of federalism, however, achieving this goal has proven difficult.

States Will Never Eliminate State Registration Authority. The problem of the pernicious effects of state registration rules will never be solved by states. The allure of sovereignty and the base instinct of turf protection have proven too much for states to resist.

One should recognize, however, that over the years, states acting through NASAA have offered initiatives and protocols seemingly designed to enhance cooperation and simplification in regard to issuers' meeting state registration requirements.

Data show that although these initiatives have been broadly adopted by states, in the end they have overwhelmingly failed to ameliorate the pernicious impact of state registration requirements on small business capital formation. In that regard, consider the following:

Small Company Offering Registration (SCOR). Today's version of SCOR is designed to provide a simplified state registration and a coordinated review of that registration by states. It is particularly designed for offerings made in reliance on an exemption from federal registration provided by Rule 504 or Regulation A.⁵¹ While the SCOR protocol was adopted by nearly all states⁵² it is today virtually

unused. For example, the total coordinated SCOR reviews in recent years were: four in 2012, four in 2013, and one in 2014.⁵³

Coordinated Review of Equity (CR Equity). NASAA's website describes this protocol as a "uniform procedure designed to coordinate the blue sky registration process among states."⁵⁴ While CR Equity has been adopted by the vast majority of states,⁵⁵ it is, once again, rarely used. Between 2012 and 2014, only one CR Equity was filed.⁵⁶

NASAA Coordinated Review of Regulation A Offerings Review Protocol (Regulation A+ Coordinated Review). After passage of the JOBS Act, NASAA adopted a new coordinated review regime for offerings under new Regulation A+.⁵⁷ The protocol was adopted by 49 of NASAA's 53 members.⁵⁸ As of March 7, 2016, only 10 Regulation A+ offerings had been filed with the states for a Regulation A+ Coordinated Review.⁵⁹

Not only have the NASAA initiatives failed to reduce the burden of state authority over registration, NASAA and state regulators have also, over the past 30 years, waged a coordinated, imaginative, and quite effective campaign to preserve state registration authority over small businesses' offerings. For example, in addition to the usual tactics of offering testimony in the legislative and administrative process and lobbying legislators, the anti-pre-emption forces were able to insert a provision to rescind the NSMIA pre-emption of state authority over Rule 506 offerings in an early iteration of the legislation that became the Dodd-Frank Act.⁶⁰ The provision was not part of the ultimately authorized Dodd-Frank Act.

Most recently, state regulators sued the SEC, claiming that the commission's regulatory pre-emption of state registration authority over Tier 2 Regulation A+ offering exceeded its delegated authority under Title IV of the JOBS Act.⁶¹ The Court of Appeals for the District of Columbia has now ruled in favor of the SEC, holding that the pre-emption did not exceed the Commission's delegated authority under the JOBS Act.⁶²

History demonstrates, therefore, that there is no chance that states will voluntarily surrender, or even reduce, their registration authority.

The SEC Will Never Eliminate State Registration Authority. The SEC has never been willing to facilitate to any material extent the expansion of pre-emption of state registration authority, notwithstanding the demonstrable inefficiency and harm to small-business capital formation wrought by state registration regimes.

When, for example, the legislation that in 1996 became NSMIA was under consideration by Congress, the SEC refused to offer testimony supporting a broad pre-emption of state regulatory authority.⁶³ Nonetheless, in NSMIA, Congress delegated broad authority to the SEC to expand by regulation pre-emption of any offering made to “qualified purchasers, as defined by the Commission.”⁶⁴

Since enactment of NSMIA in 1996, however, the SEC has never once used this delegated authority under NSMIA to expand pre-emption by regulation, even, for example, in the face of overwhelming evidence that state registration authority was wrecking the SEC’s well-conceived exemptions in Regulation A and Regulation D.⁶⁵

In short, while the SEC has, for the past 20 years, enjoyed broad authority to improve the efficient allocation of capital and provide a meaningful remedy to the plight of small businesses searching for external capital, it has chosen not to act. Thus history suggests rather strongly that the Commission will never ameliorate, to any material degree, the problem foisted on to small businesses by state registration rules.

Only Congress Can Solve this Problem. The politics of pre-emption is such that only Congress can solve the problem. Indeed, looking back over the past 20 years, the only meaningful steps to reduce the inefficiency foisted on, and unfairness toward, small businesses caused by state registration authority have been through congressional actions preempting blue sky authority over registration. NSMIA pre-empted state regulation authority over Rule 506 offerings, and the JOBS Act pre-empted state registration authority over offerings under the new crowdfunding exemption.

CONCLUSION

Congress should pre-empt state authority over the registration of securities completely. Efficient regulation of capital formation can occur only if businesses, especially small businesses, searching for external capital are subject to one set of registration rules. Subjecting businesses to more than 50 sets of independent rules requiring the registration of securities makes no sense and can be understood only in light of the history of misguided actions by state and federal regulators.

States do, however, have an important role in the efficient regulation of capital formation, and that role is in the enforcement of their own state antifraud provisions. State laws that prohibit fraud and material misstatements in connection with a company’s offer and sale of its securities make economic sense, especially when backed up by criminal penalties, administrative sanctions, and private rights of recovery. Pre-empting state registration authority would leave states free to join the SEC in its fight against fraud in connection with the offer or sale of securities.

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ENDNOTES

1. States, as opposed to the federal government, were first to offer a comprehensive regime regulating the offer and sale of securities. There are numerous excellent accounts of the history of the enactment of state blue sky laws, for instance, Louis Loss and Edward M. Cowett, *Blue Sky Law* (Boston: Little, Brown and Company, 1958).
2. There has been a long academic debate about the need for the regulation of capital formation. See, for example, George J. Stigler, “Public Regulation of the Securities Market,” *The Business Lawyer*, Vol. 19, No. 3 (April 1964), pp. 721–753. For an exhaustive discussion of the debate, see Louis Loss, Joel Seligman, and Troy Paredes, *Securities Regulation* (Aspen Law and Business, 2013), pp. 285–326. Society, however, has never seriously considered reverting to an unregulated capital market.
3. Certainly the most prominent antifraud provision is Rule 10b-5, 17 C.F.R. § 240.10b-5 (2016), which was enacted by the Securities and Exchange Commission under delegated authority from Congress. 15 U.S. Code § 78j(b) (2016).
4. See, for instance, 15 U.S. Code § 77e (2016).
5. Loss, Seligman, and Paredes, *Securities Regulation*, p. 15: The authors refer to the “prescription of fraud” and the “policing of affirmative disclosure of corporate information” as the “basic foundation of any system of investor protection.”
6. The best empirical data on small businesses are each year collected and rendered by the Small Business Administration. See, for instance U.S. Small Business Administration, *The Small Business Economy: A Report to the President* (Washington, DC: U.S. Government Printing Office, 2010), https://www.sba.gov/sites/default/files/sb_econ2010.pdf (accessed October 5, 2016).
7. Loss, Seligman, and Paredes, *Securities Regulation*, p. 66. (“Today all 50 states, the District of Columbia, Guam, Puerto Rico, and the Virgin Islands have blue sky laws in force.”)
8. Loss and Cowett, *Blue Sky Law*, p. 10 (reporting that within two years of the first adoption of blue sky laws by Kansas in 1911, 23 states had adopted blue sky laws, and that “[a]ll but six...[of those acts] were either identical with the Kansas statute or modeled upon it”).
9. Hawaii, then a territory, also had adopted blue sky laws. See Loss, Seligman, and Paredes, *Securities Regulation*, p. 65.
10. Commentators concede, however, that hard evidence of fraud prior to comprehensive securities laws is difficult to find. See, for instance, James S. Mofsky, *Blue Sky Restrictions on New Business Promotions* (New York: Matthew Bender and Company, 1971). (“Although the amount of fraud has never been measured, it would not be surprising to find an amount of dishonesty among promoters and securities salesmen consistent with the wild times.”)
11. See, for instance, Uniform Securities Act (1956) § 301 and § 304(d). See also the discussion in Rutheford B. Campbell Jr., “An Open Attack on the Nonsense of Blue Sky Regulations,” *The Journal of Corporation Law*, Vol. 10, No. 3 (Spring 1985), pp. 556–557.
12. See, for example, Uniform Securities Act (1956) § 306(a)(2)(F) (for example, no excessive underwriting commissions). For a discussion of merit regulation, including the various merit criteria, see *ibid.*, pp. 563–567. A 1986 American Bar Association report found that some form of a merit regime was applicable in 39 states: American Bar Association, “Report on State Merit Regulation of Securities Offerings,” *The Business Lawyer*, Vol. 41, No. 3 (May 1986), pp. 788–789. Today, more than a majority of blue sky jurisdictions are merit regimes. See, for instance, North American Securities Administrators Association, “Application for Coordinated Review of Regulation A Offering,” <http://www.nasaa.org/wp-content/uploads/2014/05/Coordinated-Review-Application-Sec-3b.pdf> (accessed October 5, 2016).
13. See, for instance, Uniform Securities Act (1956) § 402 (a) (exempting certain securities from the registration requirement) and § 402(b) (exempting certain transactions from the registration requirements).
14. See, for instance, Uniform Securities Act (1956) § 402(b)(9) (exempting from registration an offer by the issuer to not more than 10 offerees within the state, provided the investors are purchasing for investment and no commission is paid for soliciting investors). One finds significant variations among states as to the conditions for this exemption. See Rutheford B. Campbell Jr., “State Blue Sky Laws and the Recent Congressional Preemption Failure,” *The Journal of Corporation Law*, Vol. 22, No. 2 (Winter 1997), p. 175.
15. Regulation D provides an exemption from *federal* registration for offerings. The predicates for the exemption may require disclosure of investment information to investors and sophistication or wealth on the part of investors. The exemption provided by Rule 504 of Regulation D (offerings up to \$1 million), 17 C.F.R. § 230.504 (2016), requires neither disclosure nor sophistication or wealth; Rule 505 of Regulation D (offerings up to \$5 million), 17 C.F.R. § 230.505 (2016), may require disclosure; and Rule 506 (no limitation on the size of the offering), 17 C.F.R. § 230.506 (2016), may require both disclosure and sophistication or wealth. A recent amendment of Regulation D will raise the maximum Rule 504 offering to \$5 million and repeal Rule 505. See Securities Act Release No. 33-10238, October 26, 2016.
16. See, generally, Reg D/ULOE: Uniform m Limited Offering Exemption, NASAA Rep. (CCH) ¶ 6201, at 6101, April 29, 1989.

17. For a discussion of ULOE, including its requirements, extent of adoption by states, and the lack of uniformity among the adopting states, see Rutheford B. Campbell Jr., “The Insidious Remnants of State Rules Respecting Capital Formation,” *Washington University Law Quarterly*, Vol. 78, No. 2 (2000), pp. 419–423.
18. State registration requirements are triggered by an *offer* of securities into the particular state. A violation of a state’s registration requirement, therefore, does not also require that an investor *purchase* the issuer’s securities. Uniform Securities Act (1956) § 301 (“unlawful...to offer or sell any security unless...registered...or...exempted”).
19. See, for instance, Uniform Securities Act (1956) § 101 (making it unlawful “in connection with the offer, sale, or purchase of any security...to make any untrue state of material fact...or...engage in any...fraud or deceit”).
20. Uniform Securities Act (1956) § 101 uses language nearly identical to federal Rule 10b-5, 17 C.F.R. § 240.10b-5 (2016), which is interpreted to require disclosure of all material facts.
21. See, for instance, Uniform Securities Act (1956) § 408 (administrative sanctions), § 409 (criminal sanctions), and § 410 (private, civil right of recovery).
22. 15 U.S. Code § 77e (2016) (requiring registration for a public offering), and 15 U.S. Code § 77d(a)(2) (2016) (providing an exemption from registration for an issuer offering that is not a “public offering”).
23. See, for instance, 15 U.S. Code §§ 77k and 77l (2016).
24. See, for instance, 15 U.S. Code § 77e (2016) (predicating jurisdiction on the “use of any means or instruments of transportation or communication of interstate commerce or of the mails”).
25. Campbell, *An Open Attack*, pp. 563–567. See also footnote 12 and accompanying textual discussion.
26. 15 U.S. Code §§ 77e, 77f, and 77g (2016).
27. 15 U.S. Code § 77b(b) (2016).
28. 15 U.S. Code § 77r(b)(1) (2016).
29. 15 U.S. Code § 77r(b)(2) (2016).
30. 15 U.S. Code § 77r(b)(4)(E) (2016).
31. 17 C.F.R. § 230.506 (2016).
32. 15 U.S. Code § 77r(b)(3) (2016).
33. *Ibid.* The breadth of this delegation to expand pre-emption is illuminated by another part of the NSMIA, which states that the SEC, when acting “in the public interest...shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.” 15 U.S. Code § 77b(b) (2016).
34. 15 U.S. Code § 77r(b)(4)(C) (2016).
35. 15 U.S. Code § 77d(a)(6) and § 77d-1(2016).
36. The statutory authority for the new Regulation A+ rules is found at 15 U.S. Code § 77c(b)(2) (2016).
37. The statutory basis for this pre-emption is found at 15 U.S. Code § 77r(b)(4)(D) (2016); the SEC’s regulatory implementation of this is found at 17 C.F.R. §§ 230.256 (2016).
38. A recent amendment to Regulation D will raise the limit of a Rule 504 offering to \$5 million. See Securities Act Release No. 33-10238, October 26, 2016.
39. A recent amendment of Regulation D will repeal Rule 505. See Securities Act Release No. 33-10238.
40. Rutheford B. Campbell Jr., “The Wreck of Regulation D: The Unintended (and Bad) Outcomes for the SEC’s Crown Jewel Exemptions,” *The Business Lawyer*, Vol. 66, No. 4 (August 2011), pp. 919 and 931.
41. 17 C.F.R. § 230.251-.263 (2011). As a result of the JOBS Act, Regulation A changed significantly. Since those amendments, it is generally referred to as Regulation A+.
42. Rutheford B. Campbell Jr., “The New Regulation of Small Business Capital Formation: The Impact—If Any—of the JOBS Act,” *Kentucky Law Journal*, Vol. 102, No. 4 (2013–2014), pp. 815–848.
43. 17 C.F.R. § 230.501-.508 (2016).
44. A recent amendment of Regulation D will raise the maximum Rule 504 offering to \$5 million. See Securities Act Release No. 33-10238.
45. A recent amendment of Regulation D will repeal Rule 505. See Securities Act Release No. 33-10238.
46. See footnote 15 and accompanying textual discussion.
47. Campbell, “The Wreck of Regulation D,” p. 928, Table III (finding in a sample of 7,880 Regulation D offerings that 78.6 percent of those Regulation D offerings of \$1 million or less were made under Rule 506).

48. *Ibid.*, p. 930, Table VII (finding that 88.3 percent of the sample offerings (203 of 230) of \$1 million or less made under Rule 506 were limited to accredited investors; 91.8 percent of the sample offerings (191 of 208) between \$1 million and \$5 million made under Rule 506 were limited to accredited investors). Subsequent data developed by others are generally consistent with data from my article, although those more recent data are to some extent used to support other points or conclusions. See, for instance, Manning Gilbert Warren III, “The False Promise of Publicly Offered Private Placements,” *SMU Law Review*, Vol. 68, No. 3 (2015), p. 899, and Vladimir Ivanov, “Capital Raising Through Regulation D,” U.S. Securities and Exchange Commission, November 20, 2014, p. 4, <http://www.sec.gov/info/smallbus/sbforum112014-ivanov.pdf> (accessed October 5, 2016).
49. Justin Bryan, “High-Income Tax Returns for 2012,” Statistics of Income, *IRS Statistics of Income Bulletin* (Summer 2015), p. 2, <https://www.irs.gov/pub/irs-soi/soi-a-inhint-1d1510.pdf> (accessed October 5, 2016) (approximately 3.62 percent of all 2012 tax returns reported incomes of \$200,000 or more).
50. Rutheford B. Campbell Jr., “Regulation A: Small Businesses’ Search for ‘A Moderate Capital,’” *Delaware Journal of Corporate Law*, Vol. 31, No. 1 (2005), pp. 77-123 (relying on data provided annually by the Small Business Administration).
51. North American Securities Administrators Association, “Coordinated Review,” <http://www.nasaa.org/industry-resources/corporation-finance/coordinated-review/> (accessed October 5, 2016).
52. NASAA reported that as of 1996, 43 jurisdictions had adopted the CR-SCOR. NASAA, “State Adoptions of Small Corporation Registration Program and Form U-7,” May 1996.
53. E-mail from Joy Sakamoto-Wengel, Assistant Attorney General, Maryland Division of Securities, Atlantic CR-SCOR Region, to author, November 20, 2015, 15:10 EST, on file with author; telephone interview with Lynn Hammes, director, Finance & Administration, Kansas Securities Commissioner’s Office, Midwest CR-SCOR Region, November 19, 2015; telephone interview with Patricia Louterback, director, Registration Division, Texas State Securities Board, Southwest CR-SCOR Region, November 19, 2015; telephone interview with Sarah Reynolds, Division of Securities, Washington State Department of Financial Institutions, West CR-SCOR Region, November 19, 2015.
54. North American Securities Administrators Association, “Coordinated Review.” See also, Coordinated Review, a website that appears to be sponsored by NASAA, <http://www.coordinatedreview.org/cr-equity/overview/> (accessed October 6, 2016): CR-Equity provides a uniform procedure designed to coordinate the blue sky registration process among states in which the issuer seeks to sell its equity securities; offers issuers registration efficiencies by creating a uniform scheme of review; simplifies the process for resolution of issues raised during review of the registration application; and offers issuers expedited review. CR-Equity generally is intended only for initial public offerings of common stock, preferred stock, warrants, rights and units comprised of equity securities.
55. The Coordinated Review website reports that the CR-Equity protocol has been adopted by all but two jurisdictions.
56. Telephone interview with Brett Warren, counsel, Division of Corporation Finance, Pennsylvania Securities Commission, December 28, 2015.
57. NASAA, “NASAA Coordinated Review of Regulation A Offerings Review Protocol,” March 2014, <http://www.nasaa.org/wp-content/uploads/2014/05/NASAA-Regulation-A-Review-Protocol-final-Adopted-March-7.pdf> (accessed October 5, 2016).
58. Amendments to Regulation A, Securities Act Release No. 33-9741, March 25, 2015; 17 C.F.R. §§ 230.251-263 (2016).
59. E-mail from Faith L. Anderson, Esq., Chief of Registration and Regulatory Affairs, Washington Department of Financial Institutions Securities Division, to author, March 7, 2016, 5:28 PM EST, on file with author.
60. Restoring American Financial Stability Act of 2009, § 928.
61. Petition for Review, *Galvin v. SEC*, No. 15-1150 (D.C. Cir. May 22, 2015).
62. *Lindeen v. SEC*, No. 15-1149, 2016 WL 3254610 (D.C. Cir. June 14, 2016).
63. Arthur Levitt, SEC Chairman, hearings of the Capital Markets Deregulation and Liberalization Act of 1995, testimony before the Subcommittee on Telecommunications and Finance, Committee on Commerce, U.S. House of Representatives, 1995, p. 102.
64. 15 U.S. Code § 77r(b)(3) (2016).
65. In 2015, the SEC, operating at that point under broad delegated authority from Congress in the JOBS Act, pre-empted state registration authority over Tier 2 Regulation A+ offerings (limited to \$50 million). 17 C.F.R. § 230.256 (2016). The SEC failed, however, to pre-empt state registration authority over Tier 1 offerings, an exemption designed specifically for small offerings by small businesses under Regulation A+. It seems clear that there will be very few Tier 1 Regulation A offerings, due in large part to the SEC’s failure to pre-empt state registration authority over Tier 1 offerings. As support for my prediction of low use by the approximately 5 million small businesses in this country, consider preliminary data. The SEC’s final Regulation A+ rules became effective on June 19, 2015. Between that date and May 15, 2016, only 37 Tier 1 offerings were filed with the SEC. Regulation A+ data were obtained from the online subscription-only Lexis Securities Mosaic, Form 1-A Data, <http://www.lexissecuritiesmosaic.com> (accessed May 24, 2016). (Click “SEC Filings” tab, follow “SEC Filings” hyperlink, and search for “Form 1-A.”)

CHAPTER 7:

How to Reform Equity Market Structure: Eliminate “Reg NMS” and Build Venture Exchanges

Daniel M. Gallagher

If you have watched a financial news broadcast from the floor of the New York Stock Exchange (NYSE) recently, you may have noticed something interesting—it is rather quiet these days, and computer and television screens outnumber people. This was not always the case. In the 1970s, the floor of the NYSE was a loud beehive of activity where over 5,000 people met in close contact every day to trade stocks.¹ By 1973, more than 80 percent of the dollar volume of exchange-based U.S. stock trading occurred on the floor of the NYSE.² Today, the media and Starbucks occupy as much real estate as the floor traders, who number about 700.³ As of mid-2015, only about 15 percent of the total volume of shares traded on the NYSE actually changed hands on the floor.⁴ Indeed, over the past 20 years, U.S. equity markets have become predominantly electronic—stocks now trade in microseconds across 11 registered exchanges and over 50 off-exchange venues, generally with little human intervention in the process.

The increasingly complex and fragmented structure of today’s equities markets is the product of a series of extraordinary changes that took place over decades.⁵ Some of those changes have come about organically, that is, as the result of market participants innovating with new products and ideas. Many other changes, however, have been imposed by the Securities and Exchange Commission (SEC) and by Congress. Still others were developed by market participants in order to respond to and comply with new and constantly changing laws and regulations. In short, understanding the structure of U.S. equity markets today requires acknowledging that in recent years, changes to the structure of these markets have been driven as much, if not more, by

legislative and regulatory action than by the private sector.

Heavy-handed government intervention in U.S. equity markets is a relatively new phenomenon. From the earliest days of the nation to the Great Depression, self-regulation, rather than government regulation, played the primary role in expanding and shaping the markets, with little or no federal regulation and limited state regulation. Indeed, the origins of U.S. capital-market self-regulation can be traced all the way back to 1792, when 24 traders signed the famous Buttonwood Agreement, so named because the agreement was signed under a buttonwood tree outside 68 Wall Street in lower Manhattan. In the agreement, those traders pledged to conduct their stock

trading directly with one another, rather than through an auctioneer, and to limit their commissions to one-quarter of a percent. Within three decades of those humble beginnings, the organization that grew out of the Buttonwood Agreement—then referred to as the New York Stock & Exchange Board and now known as the NYSE—had in place a constitution and detailed by-laws. The capital markets began, and then grew and flourished for nearly one hundred years, on the back of self-regulation.

It was not until nearly a century and a half later that the first large-scale federal intervention in the U.S. securities markets occurred. In response to the stock market crash of 1929 and the onset of the Great Depression, Congress—primarily through the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act)—established the SEC and codified a comprehensive set of regulations to govern U.S. capital markets, including the self-regulatory role of exchanges.⁶ Balancing concerns over the growing monopoly power of the NYSE with the benefits of self-regulation, Congress in the Exchange Act settled on a model of “supervised exchange self-regulation.”⁷ As the Supreme Court described in *Merrill Lynch, Pierce, Fenner & Smith v. Ware*:

Two types of regulation are reflected in the [Exchange] Act. Some provisions impose direct requirements and prohibitions. Among these are mandatory exchange registration, restrictions on broker and dealer borrowing, and the prohibition of manipulative or deceptive practices. Other provisions are flexible, and rely on the technique of self-regulation to achieve their objectives.... Supervised self-regulation, although consonant with the traditional private governance of exchanges, allows the Government to monitor exchange business in the public interest.⁸

Although the Securities Act and the Exchange Act represented a sea change in the

regulation of U.S. capital markets, the few exchanges that existed at the time continued to conduct business much as they had for the past century, and the NYSE remained by far the dominant market for stock trading.⁹

This began to change in the late 1960s and early 1970s, as both the SEC and Congress grew increasingly concerned about a lack of competition and efficiency in the U.S. securities markets.¹⁰ Lawmakers and regulators were concerned at the time that investors “might not be getting the best price possible when they bought and sold stock—either in terms of the pricing of the stock itself or in the costs involved in completing the transactions.”¹¹ To address these issues, Congress enacted amendments to the Exchange Act designed to allow the SEC to work with the industry in establishing a national market system for securities in which “competitive forces” were supposed to drive market development.¹²

Pursuant to the 1975 Act Amendments, this new national market system would link together trading venues across the country and promote competition so that investors would “get their orders executed at the best price available anywhere in the [U.S.] when they bought or sold stock.”¹³ To guide the SEC, Congress set forth five key components of a properly functioning national market system: (1) efficiency, (2) competition, (3) price transparency, (4) best execution, and (5) order interaction.¹⁴ Congress further specified that new technology would “create the opportunity for more efficient and effective market operations,” and that linking all markets together “through communication and data processing facilities will foster efficiency, enhance competition, increase the information available to brokers, dealers, and investors, facilitate the offsetting of investors’ orders, and contribute to best execution of such orders.”¹⁵ Although Congress again reiterated the important role of self-regulatory organizations (SROs) in securities regulation, the 1975 Act Amendments ushered in a new era of federal regulatory oversight of U.S. equity markets and market participants, including exchanges.

The SEC has taken a number of steps to facilitate the formation of the national market system, including the adoption of the Order Handling Rules in 1997, Regulation Alternative Trading System (Reg ATS) in 1998, decimalization in 2000, and, who could forget, Regulation National Market System (Reg NMS) in 2005. More than any other law or regulation implemented since the 1975 Act Amendments, Reg NMS is responsible for the current structure of U.S. equity markets, as well as many of the problems these markets have experienced over the past decade.

REGULATION NMS

The Commission adopted Reg NMS by a three-to-two vote on April 6, 2005.¹⁶ Reg NMS has four main components:¹⁷

- 1. Rule 610 (Access Rule).** The Access Rule establishes a uniform standard to ensure fair and non-discriminatory access to quotations by non-members of trading centers, and imposes a limit on the amount that trading centers may charge for access to quotations.¹⁸ The term “trading centers” includes exchanges or associations that operate a trading facility, alternative trading systems (ATSs), market makers, and broker-dealers that execute orders internally as principal or agent.¹⁹ The Access Rule also instructs SROs to enforce rules that prohibit their members from engaging in practices that could interfere with the protected quotations of other trading centers or could create locked or crossed markets.²⁰
- 2. Rule 612 (Sub-Penny Rule).** Pursuant to the Sub-Penny Rule, market participants are prohibited from displaying quotations in any increment less than a penny. The rule applies to all Reg NMS securities, except those for which the price of the quotation was less than \$1.00.²¹ The rule was intended to stop market participants, such as traders, from stepping ahead of customers’ orders and preventing those orders from being executed

by out-bidding them by a fraction of a penny.²²

- 3. Rules 601 and 603 (Market Data Rules).** Reg NMS further amends existing SEC rules and joint-SRO plans governing the dissemination of market data.²³ Market Data Rules are designed principally to control how exchanges charge customers for access to data on orders and quotations. Reg NMS modified the formulas used to decide how trading centers could allocate the revenues they make from charging for market data, and allowed trading centers to distribute their own data independently.²⁴
- 4. Rule 611 (Order Protection Rule/Trade-Through Rule).** This rule requires trading centers to establish, maintain, and enforce policies and procedures reasonably designed to prevent trade executions at prices inferior to the best prices displayed by other automated trading centers.²⁵ In other words, a trading center receiving an incoming order cannot “trade through” a better-priced quotation displayed by another automated trading center—it must instead immediately route all incoming orders to the market displaying the best price. Rule 611 thus prioritizes both price and speed in the execution of orders above other indicators of execution quality including, for example, fill rates.

Reg NMS has dramatically altered the structure of the securities markets. If one transported the men and women of the 73rd Congress, which passed both the Securities Act and the Exchange Act, to the mid-1970s and showed them the markets of the day, the legislators would likely have marveled at the increased size and scope of those markets and the dizzying array of products offered and trades conducted. As they scanned the exchange floors, however, they would have seen much that they recognized, with a plethora of traders filling the floors of “mutualized,” or member-owned, exchanges and engaging in trades with their counterparts, that is, human

beings trading with other human beings. They would even, unfortunately, have recognized the bear markets of the time.

Bring them forward another 25 years or so, however, and the time-traveling legislators would be confronted with markets altered beyond recognition, with computers tied into “demutualized” (shareholder-owned, for-profit) exchanges, some now global in nature, and using algorithms to trade decimalized securities at speeds measured in microseconds. They would be intrigued by the existence of a national market system, but bewildered by the multitude of exemptions riddling that system. They would be utterly befuddled by concepts like dark pools²⁶ and ATSS. It is difficult to imagine what they would make of the wildly fluctuating markets of the past several years, but they would certainly be staggered by the numbers involved.

In their joint dissent to Reg NMS, SEC Commissioners Cynthia Glassman and Paul Atkins, rightfully—and presciently—note that the majority’s underlying assumptions about how investors and markets should interact are deeply flawed and that the rule would cause major distortions in the markets. Commissioners Glassman and Atkins dissented from the adoption of Reg NMS²⁷ because they did not believe that the SEC adhered to the goal of Congress to allow competitive forces,²⁸ rather than burdensome regulation, to guide the development of a national market system.²⁹ They asserted that Reg NMS was a series of unnecessarily complex, non-market-based rules.³⁰ One need look no further than the SEC staff’s most recent FAQs on Rules 610 and 611, which alone span 45 pages, to vindicate their prediction of unnecessary complexity.³¹

As Commissioners Atkins and Glassman predicted in 2005, Reg NMS has exacerbated market fragmentation and complexity while at the same time blunting competition and innovation. In particular, Rule 611, the Order Protection Rule, has been a prime example of the many negative, unintended consequences that often flow from overly prescriptive government regulations. As noted above, Reg

NMS prioritizes price and speed above all other best-execution considerations. By mandating that orders be routed immediately to the trading venue with the lowest price—despite the often high costs of doing so³²—Reg NMS has resulted in the proliferation of trading venues, including 11 exchanges (some of which have minimal market share) and over 50 off-exchange trading venues.³³ One of the main problems associated with this fragmentation is that some exchanges survive not because they provide a real, competitive market for orders, but because they can generate revenue through trading and market-data fees.³⁴

With orders being spread around so many trading venues under Reg NMS, exchanges, ATSS, and broker-dealers are forced to offer a variety of incentive programs and order types to attract order flow to their markets—which has injected further complexity into the system. The impact of this complexity can be seen in higher liquidity costs and increased trading volatility.³⁵ Moreover, the complex infrastructure required to handle millions of stock trades taking place in microseconds across a large number of different trading venues has been susceptible to flash crashes and other trading disruptions. Although these trading disruptions ultimately stem from the fragmentation and complexity created by Reg NMS and other regulations, individual market participants often disproportionately bear the brunt of the fallout.

Reg NMS also includes flawed market-data provisions. The Market Data Rules enshrine the ability of exchanges to charge customers monopolistic prices for “direct” data feeds. Securities information processors (SIPs), on the other hand, which disseminate the best bids and offers from each exchange, are effectively non-competitive as public utilities.³⁶ Although all of the equities exchanges are participants in Reg NMS plans that govern the SIPs, there is no competition for consolidated last sale and quotation reporting services between the SIPs. As one commentator said contemporaneously with the passage of Reg NMS, “With Regulation NMS we are entering

into the treatment of the nation's securities markets as one of the most heavily regulated industries in the nation's history in a peacetime economy. We are only a half-step away from the government's acting like a public utility commission."³⁷

In sum, Reg NMS has come to stand as the SEC's poster child for unintended consequences and the need for the commission to institute retrospective reviews of its rules. In general, rules allowing free and competitive markets to dictate much of market structure, with rigorous disclosure requirements, should replace Reg NMS. This would be more in line with Congress's plainly stated intent when it passed the 1975 Act Amendments: "It is the intent of the [House and Senate] conferees that the national market system evolve through the interplay of competitive forces as unnecessary regulatory restrictions are removed."³⁸

For example, a less complex and burdensome alternative to the overly prescriptive Trade-Through Rule (Rule 11)—wisely recommended by Commissioners Atkins and Glassman over a decade ago—would be to clarify the broker's duty of best execution. The Financial Industry Regulatory Authority's best-execution rule identifies five factors in addition to price that must be considered when executing buy-and-sell orders: (1) the character of the market for the security; (2) the size and type of transaction; (3) the number of markets checked; (4) the accessibility of the quotation; and (5) the terms and conditions of the order as communicated to the firm.³⁹ Rather than prohibiting trading at a price different from the national best bid or offer, the SEC could allow such trades, in recognition of the fact that different investors have different best-execution preferences.⁴⁰ In addition, rather than mandating orders to be aggregated in a central system, the SEC could allow investors to deal with trading venues that serve their interests.⁴¹ An order's point of entry into the trading system, while irrelevant under Reg NMS, could become a negotiation point between brokers and clients as customers demand more control over their execution

costs.⁴² After all, trade execution costs—ultimately borne by the investor—can grow exponentially as brokers search through a complex and fragmented market for multiple venues to fill large orders that may not be able to be filled at one venue boasting a certain price.

It has been more than 20 years since the SEC last conducted a comprehensive market-structure review,⁴³ and it is time to do so again, including a review of the self-regulation paradigm as a whole. There has been much rhetoric about such a review by the SEC, but few, if any, real reforms. The formation of the SEC's Market Structure Advisory Committee was advertised as an important part of such a review, and indeed it could be given the expert composition of the committee. The SEC should not overly rely on the committee, as it is the statutory duty of the commission to oversee the equities markets. And, the commission should avoid the incrementalism that invariably leads regulators to attempt to solve every problem, however small, in a vacuum. This inevitably leads to additional layers of regulation. Many recent attempts to "fix" market structure issues, for example, the Dodd-Frank amendments to the Exchange Act Section 19(b) rule filing requirements for SROs, have essentially been grafted onto the existing framework without a re-examination of the validity of that framework. By tweaking the 1975 Act-based requirements without studying whether those requirements make sense at all given the changed market structure, regulators have merely replaced one problematic regime with another.

This incremental approach exacerbates, and is exacerbated by, the regulatory tendency to treat all problems as failures of the markets themselves. Approaching a comprehensive market-structure review with an assumption that markets and their participants are the source of any perceived problems is both intellectually and pragmatically a dead end. Instead, the SEC should recognize that many of today's major market-structure issues have more to do with the unintended effects of regulation than with failures of the

markets themselves. If an issue is serious enough to merit legislative action (as was done in the Dodd–Frank Act), it is serious enough to deserve a re-examination from first principles. The SEC’s review of market structure must acknowledge and address the role that regulation has played in developing the structure of today’s markets, and should inevitably result in recommendations to Congress on how to update or eliminate the vestigial provisions. Everything—including statutes, regulations, and interpretations—must be on the table. The SEC must be willing to return to first principles—encouraging innovation through healthy free-market competition.

VENTURE EXCHANGES AND THE SECONDARY MARKET

A holistic review of market structure should also include new ideas to improve the trading ecosystem for small-capitalization companies. It is widely believed that the increased costs of being public as a result of the Sarbanes–Oxley Act and the Dodd–Frank Act have made it less attractive for smaller and growth-stage companies in the United States to go or remain public, resulting in fewer initial public offerings and more companies considering going private. Some of these costs, like the unanticipated high costs associated with the auditor attestation requirements of Section 404(b) of the Sarbanes–Oxley Act and the rules thereunder, are readily traceable to a particular regulation. Others, however, are the accumulation of a number of small requirements that ultimately result in meaningful burdens, such as the ever-expanding federally mandated corporate governance requirements—for example, the director, audit committee, and compensation-committee independence requirements and mandated say-on-pay votes⁴⁴—as well as required disclosures of information that have little practical usefulness to real investors.

These costs and burdens can be difficult for any public company to bear, but clearly small companies, with their more limited human and

financial legal resources, are often disproportionately affected and discouraged from public offerings. As a result, ordinary American investors will have fewer opportunities to seek higher returns by investing in growth-stage companies.

The SEC has recognized that “secondary market liquidity is an important factor impacting the availability of capital for small businesses.”⁴⁵ However, not all small-cap companies are listed on the NASDAQ. Many small-cap company securities do not meet exchange-listing standards, or are deterred by the high listing fees and compliance requirements required by such listings. Such securities are left to trade through the over-the-counter market or through the private market, which is subject to certain restrictions and generally limited to accredited investors.

A liquid secondary market reduces risk by allowing investors to sell their investments quickly, at reasonable prices, and with low transaction costs. Moreover, the benefits of a liquid market actually encourage investment, making it more likely that investment capital will find its way to entrepreneurial firms. On the other hand, illiquid markets discourage investments, as issuers raising capital and early-round investors seeking an exit will receive less for shares sold in private transactions. In making investment decisions, investors may naturally consider whether they will have the ability to resell their shares in the future, which undoubtedly dissuades entrepreneurs and investors from pursuing these ventures in the first place, depriving the economy of entrepreneurship and innovation.

So what can be done to encourage secondary-market liquidity while relieving the regulatory burden that comes with listing on large exchanges? One innovative approach that recently has piqued interest in both the public and private sectors is the establishment of “venture exchanges”—national exchanges with specially tailored trading and listing rules that would serve as incubators for smaller companies. These exchanges would offer a platform that encourages smaller companies to enter U.S. public markets while at the same

time providing adequate protection for investors. The hope is that small companies would be able to receive public financing through listing on these exchanges and then be able to move onto more robust and liquid markets in the future. The SEC recently has adopted new rules to revitalize Regulation A, as part of its implementation of the Jumpstart Our Business Startups (JOBS) Act; and the development of venture exchanges for small-cap shares, including Regulation A issuances, would greatly enhance liquidity in these shares, thereby facilitating greater demand and higher prices for the initial issuances of these securities.

There have been a number of discussions regarding the establishment of venture exchanges.⁴⁶ The Senate has held hearings on the issue⁴⁷ and considered testimony from several market experts. Stephen Luparello, director of the Division of Trading and Markets at the SEC, stated in his testimony before the Senate Banking Committee that transparent and regulated venture exchanges might be able to provide a balance between the needs of smaller companies against the need for investor protection.⁴⁸ The House Financial Services Committee also recently approved a bill sponsored by Representative Scott Garrett (R-NJ) to provide for the creation and registration of venture exchanges, with approval from the SEC.⁴⁹ Then-SEC Commissioner Luis Aguilar expressed openness to the idea.⁵⁰ Moreover, there is a great amount of interest abroad. Both the United Kingdom and Canada have already established venture exchanges, and many other markets, including Korea and Ireland, have followed suit.⁵¹

Like existing exchanges, venture exchanges would have market-surveillance obligations, SEC oversight, and price transparency, but would also reduce regulatory burdens on small companies by scaling listing standards and regulatory filing requirements. Shares traded on these exchanges would be exempt from state “blue sky” registration, and the exchanges themselves would be exempt from the SEC’s national market system and unlisted trading privileges rules, so as to concentrate liquidity in these venues. This would, in turn, bring market makers and analysts to these exchanges and their issuers, thereby recreating some of the ecosystem supportive of small companies that has been lost over the years.

Other variables, such as continuous trading versus periodic call auctions, tick sizes, and minimum capitalization, would be left to each exchange to determine, with the aim of creating different, idiosyncratic venues that could compete with one another.⁵² Such exchanges could have a transformative impact on small business capital raising, while at the same time balancing the interests of investors in having the strong protections that come with a regulated trading environment.

CONCLUSION

During my time at the SEC, I advocated for a holistic review of U.S. equity-market structure, an effort that has since been supported by the entire commission. Although the formation of the Equity Market Structure Advisory Committee was an important step toward understanding and potentially improving the structure of these markets, as of this writing, the SEC has yet to engage in a truly holistic review.

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ENDNOTES

1. Erin Durkin, "New York Stock Exchange Will Keep Its Iconic Trading Floor Under New Ownership," *New York Daily News*, June 1, 2014, <http://www.nydailynews.com/new-york/n-y-stock-exchange-iconic-trading-floor-article-1.1813393> (accessed October 11, 2016).
2. Robert Pozen, "Competition and Regulation in the Stock Markets," *Michigan Law Review*, Vol. 73 (1974), pp. 317–318.
3. D. M. Levine, "A Day in the Quiet Life of a NYSE Floor Trader," *Fortune*, May 20, 2013, <http://fortune.com/2013/05/29/a-day-in-the-quiet-life-of-a-nyse-floor-trader/> (accessed October 11, 2016).
4. Bob Pisani, "Here's What's Really Surprising About Today's Shutdown of the NYSE Floor," CNBC, July 8, 2015, <http://www.cnbc.com/2015/07/08/heres-whats-really-surprising-about-todays-shutdown-of-the-nyse-floor.html> (accessed October 11, 2016).
5. As described below, the most significant changes to equity market structure have occurred in the past 20 years in response to Congress's directive to the SEC to create a national market system for securities.
6. The Securities Act and the Exchange Act—passed by Congress after years of detailed study and debate informed by the work of the Pecora Commission—were specifically designed to address the actual causes of the stock market crash and the ensuing economic turmoil. This is notably different than the process surrounding the Dodd–Frank Act, in which Congress created a Financial Crisis Inquiry Commission to analyze the causes of the 2008 financial crisis, yet issued the resulting report months *after* the single-party legislation was passed. Moreover, the Dodd–Frank Act is virtually silent regarding the main underlying cause of the financial crisis—failed federal housing policy and the role of the government-sponsored enterprises, Fannie Mae and Freddie Mac.
7. *Gordon v. NYSE*, 422 U.S. 659, 663–66 (1975) (noting congressional recognition of the NYSE's monopoly power leading up to enactment of the Exchange Act and the 1975 Act Amendments).
8. 414 U.S. 117, 127–28 (1973). See also *Gordon*, 422 U.S. 659, 667: "The congressional reports confirm that, while the development of rules for the governing of exchanges, as enumerated in § 19(b), was left to the exchanges themselves in the first instance, the SEC could compel adoption of those changes it felt were necessary to insure fair dealing and protection of the public."
9. Walter Werner, "Adventure in Social Control of Finance: The National Market System for Securities," *Columbia Law Review*, Vol. 75 (1975), pp. 1262–1263, and R. C. Michie, *The Global Securities Market: A History* (Oxford & London: Oxford University Press, 2006), p. 216.
10. Subcommittee on Oversight and Investigations, Committee on Interstate and Foreign Commerce, U.S. House of Representatives, *National Market System: Five Year Status Report*, August 26, 1980, pp. 3–5. Congress was also concerned about "serious strains... in the inefficient system of processing the purchase and sale transactions. Although trading volumes increased, the industry failed to update its operations for recording of sales and purchases, billing of customers, and transferring stock certificates and money from one person to another. These processing inefficiencies were costly to the firms and to investors. In some instances entire brokerage firms collapsed because of the breakdown in the processing operation, posing a threat of financial loss to customers." *Id.*
11. *Ibid.*, p. 5.
12. *Ibid.*, pp. 5–7.
13. *Ibid.*, p. 8.
14. Public Law 94–29, June 4, 1975.
15. *Ibid.*
16. Reg NMS was fully implemented in 2006.
17. William H. Donaldson, Chairman, U.S. Securities and Exchange Commission, at Open Meeting, Regulation NMS Proposal, public address, February 24, 2004.
18. 17 C.F.R. § 242.610 (2005).
19. Norman S. Poser, "Regulation NMS: A Divided SEC Has Adopted New Rules to Prohibit 'Trading Through' Automated Limit Orders and to Ensure Reasonable Access to All Markets in the National Market System. The Rules Should Benefit Investors from Better Executions, Greater Liquidity, Reduced Transaction Costs, and Push the NYSE Toward Electronic Trading," *The Review of Securities & Commodities Regulation*, Vol. 38, No. 18 (October 26, 2005), § Order Protection Rule.
20. *Ibid.*, p. 235, and news release, "Connecticut Department of Banking and SEC Announce Enforcement Actions Against David M. Faubert," U.S. Securities and Exchange Commission, April 5, 2005, <https://www.sec.gov/news/press/2005-47.htm> (accessed October 11, 2016). A locked market occurs when the bid and offer are at the same price, whereas a crossed market occurs when the bid is higher than the offer. Locked and crossed markets are of concern because of the inefficiency they signal—if two investors want to buy and sell at the same price (or the seller is willing to accept a lower price than the buyer is willing to pay),

they would normally trade with each other: Poser, “Regulation NMS,” § Locked and Crossed Orders. Market makers are prohibited from entering price quotes that would create locked or crossed markets.

21. 17 C.F.R. § 242.612 (2005).
22. News release, “SEC Adopts Regulation NMS and Provisions Regarding Investment Advisers Act of 1940,” U.S. Securities and Exchange Commission, April 7, 2005, <https://www.sec.gov/news/press/2005-48.htm> (accessed October 12, 2016).
23. Poser, “Regulation NMS,” § Market Data Rules and Plan Amendments.
24. News release, “SEC Adopts Regulation NMS and Provisions Regarding Investment Advisers Act of 1940.”
25. Poser, “Regulation NMS,” § Purposes of Reg. NMS: Assure best execution.
26. Dark pools are private exchanges for trading securities, but they (unlike stock exchanges) are not accessible to the general investing public.
27. U.S. Securities and Exchange Commission, “Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins to the Adoption of Regulation NMS,” June 9, 2005, <http://www.sec.gov/rules/final/34-51808-dissent.pdf> (accessed October 11, 2016).
28. *Ibid.*, footnote 3, quoting Senate Committee on Banking, Housing and Urban Affairs, Senate Report No. 94-75, 94th Cong., 1st Sess., 1975, pp. 13-14: [T]he Commission’s responsibility [is] to balance the perceived anti-competitive effects of the regulatory policy or decision at issue against the purposes of the Exchange Act that would be advanced thereby and the costs of doing so. Competition would not thereby become paramount to the great purposes of the Exchange Act, but the need for and effectiveness of regulatory actions in achieving those purposes would have to be weighed against any detrimental impact on competition.
29. “Dissent to Regulation NMS,” p. 2, footnote 4, quoting H.R. Report No. 94-229, 94th Cong., 1st Sess., 1975, p. 92: “It is the intent of the [House and Senate] conferees that the national market system evolve through the interplay of competitive forces as unnecessary regulatory restrictions are removed.” See also “Dissent to Regulation NMS,” footnote 5, quoting Senate Report No. 94-75, 94th Cong., 1st Sess., p. 12: “This is not to suggest that...[t]he SEC would have either the responsibility or the power to operate as an ‘economic czar’ for the development of a national market system.”
30. *Ibid.*, p. 2.
31. U.S. Securities and Exchange Commission, “Division of Trading and Markets: Responses to Frequently Asked Questions Concerning Rule 611 and Rule 610 of Regulation NMS,” <https://www.sec.gov/divisions/marketreg/nmsfaq610-11.htm> (accessed October 11, 2016).
32. Jacob Bunge, “A Suspect Emerges in Stock-Trade Hiccups: Regulation NMS,” *The Wall Street Journal*, January 27, 2014, <http://www.wsj.com/articles/SB10001424052702303281504579219962494432336> (accessed October 11, 2016).
33. Laura Tuttle, “OTC Trading: Description of Non-ATS OTC Trading in National Market System Stocks,” U.S. Securities and Exchange Commission, March 2014, http://www.sec.gov/marketstructure/research/otc_trading_march_2014.pdf (accessed October 11, 2016). The list of ATSs registered with the SEC is available at <http://www.sec.gov/foia/ats/atlist0914.pdf> (accessed October 11, 2016).
34. Steven Lofchie, “Equity Market Structure: A Review of SEC Regulation NMS,” written testimony before the Subcommittee on Capital Markets and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives, February 28, 2014, <http://financialservices.house.gov/uploadedfiles/hhrg-113-ba16-wstate-slofchie-20140228.pdf> (accessed October 11, 2016).
35. Philip Stafford and Nicole Bullock, “Small Investors Focus of Trading Shake-Up,” *Financial Times*, May 11, 2015, <https://www.ft.com/content/a20588a4-f7c0-11e4-8bd5-00144feab7de> (accessed October 11, 2016), and David Weisberger and Paul Rosa, “Automated Equity Trading: The Evolution of Market Structure and Its Effect on Volatility and Liquidity,” Two Sigma Securities, June 2013, <https://www.twosigmasecurities.com/uploads/TSS.White%20Paper.Volatility.June%202013.pdf> (accessed October 11, 2016).
36. Dale A. Oesterle, “Congress’s 1975 Directions to the SEC for the Creation of a National Market System: Is the SEC Operating Outside the Mandate?” Ohio State Public Law *Working Paper* No. 11, May 2004, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=539723 (accessed October 11, 2016) (citing Senate Report No. 94-75, 94th Cong., 1st Sess., p. 11 and H.R. Report No. 94-229, 94th Cong., 1st Sess., p. 93).
37. Dale A. Oesterle, “Regulation NMS: Has the SEC Exceeded Its Congressional Mandate to Facilitate a National Market System in Securities Trading?” *NYU Journal of Law and Business*, Vol. 1 (2005), p. 673.
38. H.R. Report No. 94-229, 94th Cong., 1st Sess., p. 92.
39. Financial Industry Regulatory Authority, “Rule 5310. Best Execution and Interpositioning,” http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=15739&element_id=10455&highlight=5310#r15739 (accessed October 11, 2016).

40. Stavros Gadinis, "Market Structure for Institutional Investors; Comparing the U.S. and E.U. Regimes," *Virginia Law and Business Review*, Vol. 3 (2008), <http://scholarship.law.berkeley.edu/cgi/viewcontent.cgi?article=1947&context=facpubs> (accessed October 11, 2016).
41. *Ibid.*
42. *Ibid.*
43. In 1994, led by Brandon Becker, the Division of Market Regulation released the Market 2000 Report. The report was largely an evaluation of the principles underlying the 1975 Act Amendments as they applied to the markets at the time. U.S. Securities and Exchange Commission, "Market 2000: An Examination of Current Equity market Developments," Division of Market Regulation, 1994, <https://www.sec.gov/divisions/marketreg/market2000.pdf> (accessed October 11, 2016).
44. "Say-on-pay" votes are advisory votes by shareholders on executive compensation.
45. See, for instance, Mary Jo White, "Opening Remarks at Meeting of SEC Advisory Committee on Small & Emerging Companies," March 4, 2015, <http://www.sec.gov/news/statement/opening-remarks-to-acsec.html> (accessed October 11, 2016).
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47. Hearing, *Venture Exchanges and Small-Cap Companies*, before the Subcommittee on Securities, Insurance, and Investment, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, March 10, 2015, <http://www.banking.senate.gov/public/index.cfm/hearings?ID=68652D9F-3C34-4620-A9EC-58740E3A4750> (accessed October 11, 2016).
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CHAPTER 8: Reforming FINRA

David R. Burton

AN INTRODUCTION TO FINRA

The Financial Industry Regulatory Authority (FINRA) is the primary regulator of broker-dealers.¹ It regulates 3,895 broker-dealers and 641,761 registered representatives.² The Securities Exchange Act requires that a broker-dealer be a member of a registered “national securities organization,”³ and FINRA is the only extant registered “national securities association.”⁴ Thus, broker-dealers must be members of FINRA in order to do business, and if FINRA revokes their membership, they may not do business.

In 2015, FINRA levied \$94 million in fines against broker-dealers, took 1,512 disciplinary actions against broker-dealers, and ordered \$97 million in restitution to harmed investors.⁵ FINRA conducts the arbitration of almost all disputes between a customer and a broker-dealer as well as the arbitration of intra-industry disputes.⁶ Investors are generally barred from pursuing relief in state or federal courts.⁷ As discussed below, if conducted fairly, arbitration can be a cost-effective means of resolving disputes.

FINRA maintains an Office of the Ombudsman to resolve investor, broker-dealer and other complaints about FINRA operations.⁸ This office handles more than 500 inquiries annually.⁹

FINRA is a Delaware not-for-profit corporation that is tax exempt under section 501(c)(6) of the Internal Revenue Code.¹⁰ The Securities and Exchange Commission (SEC) is responsible for the oversight of FINRA.¹¹ In

2015, FINRA had 3,500 employees.¹² In fiscal year (FY) 2015, the SEC had 4,300 employees.¹³ FINRA has an annual budget of \$1 billion,¹⁴ and has \$2 billion in cash and investments on hand.¹⁵ The SEC has an annual budget of \$1.6 billion.¹⁶ FINRA contracts to perform regulatory functions for a wide variety of exchanges. The fees it receives from these contracts account for \$126 million of its annual revenues.¹⁷

FINRA was formed when the regulatory functions of the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) were merged and given to FINRA¹⁸ as part of a series of transactions in which both the NYSE and NASDAQ¹⁹ became public, investor-owned enterprises.²⁰ These changes were approved by the SEC on July 26, 2007.²¹

FINRA is commonly called a self-regulatory organization (SRO) by both commentators

and the SEC.²² By “SRO,” commentators typically mean an organization whereby the industry regulates itself. Although FINRA’s predecessor organizations (the NASD and the NYSE’s regulatory arm) were once true SROs,²³ FINRA is not.²⁴ FINRA is governed by a 23-member board.²⁵ Under the eighth article of its articles of incorporation, the number of its “public governors” (those not chosen by industry) “shall exceed the number of Industry Governors.”²⁶ Industry governors are those elected by the industry. Currently, there are 10 board members who are industry governors. There are 12 public governors. In addition, FINRA’s CEO, Robert Cook, also serves on its board. Thus, the industry controls only 10 of 23 governors, 43 percent of the board.²⁷ Because the industry does not control FINRA, it is inappropriate to regard FINRA as an SRO.

The Potential Virtues of Self-Regulation. Private individuals have the right to conduct their business, within the law, as they see fit. Firms should be free to hold themselves to higher standards than the law requires, or to establish standards, procedures, and practices by mutual agreement that improve the functioning of a market. True self-regulation by industry is one way to do that, and has potential merit.²⁸ Self-regulation may be thought of as spontaneous private legal ordering.²⁹

Law professors William Birdthistle and Todd Henderson argue that “[i]ndustry professionals have strong incentives to police their own, since many of the costs of misbehavior are born by all members of the profession, while the benefits inure only to the misbehaving few. So long as the few do not control the regulatory process, self-regulation could in theory work as well or better than external regulation.”³⁰ Industry representatives often have greater expertise than government regulators and are closer to the market. They may be able to more rapidly respond to changing circumstances and their regulatory response may be more proportional or scaled.³¹ When the “self-regulator” becomes intertwined with government, however, self-regulation

presents potential conflicts of interest and is often a guise for erecting barriers to entry in a market to protect incumbent firms and to extract economic rents at the expense of customers or clients.³²

WHY REFORM IS NECESSARY

FINRA is an unusual entity. FINRA is a key regulator with a budget nearly two-thirds the size of the SEC’s budget and a staff numbering more than 80 percent that of the SEC, but it is not a government agency. While critical to the functioning of the finance industry, and having industry representation on its board, it is not controlled by the industry. While it serves a governmental function and has coercive power, including the ability to completely bar firms and individuals from the marketplace,³³ it is not subject to any of the normal transparency, regulatory review, or due-process protections normally associated with government. It is not, for example, subject to the notice-and-comment provisions of the Administrative Procedure Act,³⁴ the Freedom of Information Act,³⁵ the Regulatory Flexibility Act,³⁶ the Sunshine Act,³⁷ the Paperwork Reduction Act,³⁸ or cost-benefit-analysis requirements.³⁹ In contrast to a court, FINRA’s arbitration and disciplinary hearings are not generally open to the public.⁴⁰ Its arbitrators are not usually required to provide reasons for their decisions.⁴¹ Its rule-making is generally done in private,⁴² and its Board of Governors meetings are closed.

Unless FINRA is ultimately held to be a state actor, constitutional due-process protections, either for broker-dealers or for investors, do not apply.⁴³ In *Jackson v. Metropolitan Edison Co.*, the Supreme Court held that in determining whether the actions of a private party constitute state action, “the inquiry must be whether there is a sufficiently close nexus between the State and the challenged action of the regulated entity so that the action of the latter may be fairly treated as that of the State itself.”⁴⁴ In *Blum v. Yaretsky*, the Supreme Court held that “a State normally can be held responsible for a private decision only when

it has exercised coercive power or has provided such significant encouragement, either overt or covert, that the choice must in law be deemed to be that of the State. [T]he required nexus may be present if the private entity has exercised powers that are “traditionally the exclusive prerogative of the State.”⁴⁵

In an unpublished⁴⁶ 2015 opinion, the Second Circuit held that FINRA is not a state actor.⁴⁷ In a similarly unpublished 2011 opinion, the Eleventh Circuit raised, and then side-stepped, the issue by finding that even if FINRA were a state actor, FINRA had provided due process in the case being considered.⁴⁸ Courts determining whether FINRA’s predecessor organizations, the NASD and the NYSE, were a state actor were divided (although a majority found in most contexts relating to due process that they were not).⁴⁹ These cases, however, are of uncertain relevance given the differences between FINRA and NASD or NYSE governance structures, the monopoly status that FINRA enjoys, changes in the statutory and regulatory structure over time, and evolution in the judicial state action doctrine and the Supreme Court’s separation of powers jurisprudence.

The IRS, however, has found that “FINRA is a corporation serving as an agency or instrumentality of the government of the United States” for purposes of determining whether FINRA fines are deductible as a business expense.⁵⁰ A “penalty paid to a government for the violation of any law” is not deductible under Internal Revenue Code section 162(f).

Furthermore, courts have routinely held that FINRA and its predecessor organizations *are* government actors for purposes of immunity from private lawsuits against them.⁵¹ For example, in *Standard Investment Chartered Inc. v. National Association of Securities Dealers*,⁵² the Second Circuit held that:

There is no question that an SRO and its officers are entitled to absolute immunity from private damages suits in connection with the discharge of their regulatory responsibilities. This

immunity extends both to affirmative acts as well as to an SRO’s omissions or failure to act.... It is patent that the consolidation that transferred NASD’s and NYSE’s regulatory powers to the resulting FINRA is, on its face, an exercise of the SRO’s delegated regulatory functions and thus entitled to absolute immunity.... The statutory and regulatory framework highlights to us the extent to which an SRO’s bylaws are *intimately intertwined with the regulatory powers delegated to SROs by the SEC* and underscore our conviction that immunity attaches to the proxy solicitation here.⁵³ (Emphasis added.)

Thus, when dealing with FINRA, the many protections afforded to the public when dealing with government are unavailable, and the recourse that one would normally have when dealing with a private party—both access to the courts and the ability to decline to do business—is also unavailable. Like Schrödinger’s cat, simultaneously dead and alive, FINRA is, under current rulings, both a state actor (for purposes of barring liability and for tax purposes) and, generally, not a state actor (for purposes of absolving it of due process and other requirements and for liability purposes).

Professors Birdthistle and Henderson have written that:

SROs have been losing their independence, growing distant from their industry members, and accruing rule-making, enforcement, and adjudicative powers that more closely resemble governmental agencies such as the Securities and Exchange Commission and the Commodity Futures Trading Commission.... This process by which these self-regulatory organizations shed their independence for an increasingly governmental role is highly undesirable from an array of normative viewpoints. For those who are skeptical of

governmental regulation, deputizing private bodies to increase governmental involvement is clearly problematic.⁵⁴

Former SEC Commissioner Daniel M. Gallagher has raised similar concerns:

This decrease in the “self” aspect of FINRA’s self-regulatory function has been accompanied by an exponential increase in its regulatory output. As FINRA acts more and more like a “deputy” SEC, concerns about its accountability grow more pronounced.⁵⁵

Law professor Emily Hammond refers to FINRA’s current status as “double deference” and argues that “the combination of oversight agencies’ deference to SROs and judicial deference to oversight agencies undermines both the constitutional and regulatory legitimacy of SROs” and that reforms would “better promote accountability and guard against arbitrariness not only for SROs but also for the modern regulatory state.”⁵⁶

The U.S. Chamber of Commerce, referring to FINRA and the proxy adviser firm Institutional Shareholder Services, wrote:

Despite their tremendous influence over the workings of the capital markets, these organizations are generally subject to few or none of the traditional checks and balances that constrain government agencies. This means they are devoid of or substantially lack critical elements of governance and operational transparency, substantive and procedural standards for decision making, and meaningful due process mechanisms that allow market participants to object to their determinations.⁵⁷

It is also unclear how well FINRA is discharging its core mission of preventing fraud, misappropriation of funds, and other misconduct by those it regulates.⁵⁸ A recent empirical analysis found:

Roughly 7% of advisers have misconduct records. At some of the largest financial advisory firms in the United States, more than 15% of advisers have misconduct records. Prior offenders are five times as likely to engage in new misconduct as the average financial adviser. Firms discipline misconduct: approximately half of financial advisers lose their job after misconduct.... [O]f these advisers, 44% are reemployed in the financial services industry within a year.⁵⁹

Some of the largest firms have committed multibillion dollar frauds with few consequences for the individuals who committed this fraud.⁶⁰ There is bipartisan, bi-ideological concern about FINRA enforcement.⁶¹ It is, of course, possible that the high level of advisers with misconduct records is due to aggressive FINRA enforcement, and that the high level (44 percent) of re-employment in the financial industry of advisers with misconduct records is because the misconduct involved was minor. Given the information currently available to the public and policymakers, it is simply impossible to know.

FINRA’s Office of the Chief Economist⁶² has conducted research on FINRA enforcement. In August 2015, it released a working paper that found that the “20% of brokers with the highest ex-ante predicted probability of investor harm are associated with more than 55% of investor harm events and the total dollar harm in our sample.”⁶³ Thus, the one-fifth of brokers that FINRA’s algorithm predicts have the highest likelihood of misconduct do, in fact, account for over half of the misconduct. Presumably, FINRA’s Enforcement Department is taking this predictive algorithm into account when assessing its enforcement priorities. The study also found that “[w]ith respect to the impact of releasing additional non-public CRD information on BrokerCheck, we find that HAC [harm associated with co-workers] leads to an economically meaningful increase in the overall power

to predict investor harm.”⁶⁴ HAC is FINRA jargon that means if a firm employs or has employed brokers that engage in misconduct, other brokers at that firm are more likely to engage in misconduct, presumably because of the culture at the firm or poor internal controls. Releasing additional CRD information, then, may allow the public to better assess whether their broker, or a broker whom they are considering, is likely to harm them by engaging in misconduct. Among other things, unreleased information includes complaints, test scores, felonies, and bankruptcies, and some of the information is quite old. Release of unadjudicated complaint information where there has been no finding of fault by the broker-dealer is probably not warranted. FINRA should evaluate whether additional information should be released.

The bottom line is this. FINRA has a monopoly. It is the only SRO for broker-dealers. Broker-dealers must be a member of FINRA in order to do business. Quitting FINRA is not an option given the legal requirement to be a member of an SRO. FINRA is virtually immune to legal challenges to its regulatory decisions. Thus, the normal recourse when dealing with a private party is not available. FINRA also has a virtual monopoly on arbitration of disputes between FINRA members and between a FINRA member and investors. Both investors and broker-dealers are generally barred from accessing the courts. FINRA has coercive authority over its members and investors. The federal government has effectively delegated regulatory and dispute-resolution authority to a private organization. When they are dealing with FINRA, neither broker-dealers nor investors enjoy the many protections that the law affords in dealing with government regulators in any court⁶⁵ or in the regulation formulation process. Furthermore, it is far from clear that FINRA is doing an adequate job of policing fraud, misappropriation, and other serious misconduct. FINRA is not adequately accountable to Congress, to the public, or to those it regulates. Reforms, discussed below, are necessary.

FINRA'S CONSTITUTIONALITY

It is an open question whether FINRA, as currently constituted, is constitutional.⁶⁶ It is arguably unconstitutional for at least two reasons: (1) the separation of powers, and (2) the Fifth Amendment due-process clause and the associated private non-delegation doctrine. No matter how the courts ultimately rule on the constitutionality of FINRA's current structure, the due-process, transparency, accountability, and governance questions raised are policy questions that Congress should address.

The Supreme Court in *Free Enterprise Fund v. Public Company Accounting Oversight Board*⁶⁷ held the dual “for cause” provisions⁶⁸ in the section of Sarbanes–Oxley creating the Public Company Accounting Oversight Board (PCAOB)⁶⁹ to be unconstitutional on separation-of-powers grounds.

In *Free Enterprise*, the Supreme Court asked: “May the President be restricted in his ability to remove a principal officer, who is in turn restricted in his ability to remove an inferior officer, even though that inferior officer determines the policy and enforces the laws of the United States?”⁷⁰

The Supreme Court's answer:

We hold that such multilevel protection from removal is contrary to Article II's vesting of the executive power in the President. The President cannot “take Care that the Laws be faithfully executed” if he cannot oversee the faithfulness of the officers who execute them. Here the President cannot remove an officer who enjoys more than one level of good-cause protection, even if the President determines that the officer is neglecting his duties or discharging them improperly.⁷¹

Because FINRA is tasked with enforcing the securities laws,⁷² and its board and officers are not removable by the President, and SEC Commissioners are only removable for cause, it is quite possible that a court would

conclude that FINRA, as currently structured, violates the separation-of-powers clause. The Supreme Court, however, did distinguish the PCAOB from “private self-regulatory organizations in the securities industry—such as the New York Stock Exchange.”⁷³ So the central question becomes whether FINRA is exercising “executive power” within the meaning of the Constitution, or whether it is a truly private self-regulatory organization.⁷⁴

Discussing the Supreme Court’s private non-delegation doctrine in another context, Heritage Foundation Legal Research Fellow Paul Larkin wrote:

The Fifth Amendment Due Process Clause ensures that the actors in each department cannot evade the Framers’ carefully constructed regulatory scheme by delegating their federal law-making power to unaccountable private parties, individuals beyond the direct legal and political control of superior federal officials and the electorate. That is, the due process requirement that federal government officials act pursuant to “the law of the land” when the life, liberty, or property interests of the public are at stake prohibits the officeholders in any of those branches from delegating lawmaking authority to private parties who are neither legally nor politically accountable to the public or to the individuals whose conduct they may regulate.⁷⁵

In *Todd & Co. v. SEC*⁷⁶ and *R. H. Johnson & Co. v. Securities & Exchange Commission*,⁷⁷ two circuits ruled the Maloney Act⁷⁸ delegation to the NASD (FINRA’s predecessor organization) to be constitutionally compliant. The *Todd* court, however, explicitly disclaimed making a ruling on the 1975 amendments to the Securities Act,⁷⁹ let alone changes since FINRA was created.⁸⁰ As discussed above, the NASD and the NYSE were controlled by members of the organizations, while FINRA is not. Moreover, at the time of those decisions, the

NYSE and NASDAQ were mutualized. Furthermore, the decisions predate the SEC’s role in approving all SRO rules. Finally, the courts’ state action and separation-of-powers jurisprudence has evolved considerably since the *Todd* and *R.H. Johnson* courts considered the issue.

THREE PATHS TO REFORM

There are three basic approaches to reforming FINRA. First, it could be changed back into a truly private SRO, controlled by the industry, with the SEC resuming its traditional regulatory role. This would, in effect, be a return to the regulatory environment before the NYSE and NASD handed off their regulatory function to FINRA.⁸¹ Second, FINRA could be incorporated into the SEC. FINRA’s status as a “national securities organization” would be terminated, its employees would have the option of becoming government employees,⁸² and FINRA’s regulatory functions would be discharged by the SEC, presumably by its Division of Trading and Markets. Those educational functions not conducted by its foundation and perhaps its market surveillance⁸³ and intra-industry dispute resolution functions could be retained. As discussed below, ideally, its arbitration function would be spun off. This approach would provide the transparency, due-process protections, and congressional oversight typically associated with government. Significant changes to the Securities Exchange Act provisions governing national securities organizations would be required. Third, the existing framework could be substantially reformed. This latter, incremental, approach is likely to have the best chance of success in the current policy environment.

In August 2016, Robert Cook became president and CEO of FINRA, and chairman of the FINRA Investor Education Foundation.⁸⁴ Jack Brennan was named FINRA’s chairman.⁸⁵ Previously, Richard Ketchum had been both chairman and CEO. In addition, Bob Muh, the CEO of Sutter Securities, Inc., was elected in September as a small-firm governor on a platform of reducing the regulatory burden on

small broker-dealers.⁸⁶ With new leadership may come a new openness to reform.

Incremental Reforms. Incremental—although major—reforms that would address the most substantial problems with FINRA’s current structure are outlined below. In principle, many of these reforms could be implemented by FINRA itself, with SEC approval. Alternatively, Congress could amend § 15A and § 19 of the Securities Exchange Act, such that a national securities association (that is, an SRO) must meet the outlined requirements as a condition of registration. Current law already imposes more than 20 requirements.⁸⁷

Transparency. Given FINRA’s importance to U.S. financial markets, and the effective delegation to it of key regulatory functions by the SEC and Congress, openness and transparency in its regulatory and adjudicatory functions is entirely appropriate. FINRA should comply with a set of rules substantially similar to the requirements imposed on government agencies under the Freedom of Information Act.⁸⁸

FINRA’s Board of Governors meetings should be open to the public, unless the board votes to meet in executive session. The criteria for whether they can close the meeting should be established in advance and carefully circumscribed. FINRA currently does not make available in advance rule-makings that the FINRA board is expected to consider.⁸⁹ The complete board agenda should be made available to the public in advance, and board minutes describing actions taken should be published with alacrity. Such requirements are analogous to, but less stringent than, the requirements imposed on government agencies by the Sunshine Act.⁹⁰

Given that under current law FINRA proceedings supplant a civil trial and there is no means of accessing the courts, FINRA arbitration hearings should be open to the public and reported. This is analogous to the public-trial requirement in the Sixth Amendment and the long-standing presumption that *all* court proceedings in the United States are open to the public.⁹¹ Just as trials in criminal

and civil courts and hearings in administrative courts are open to the public, so should disciplinary hearings.

In 1884, Oliver Wendell Holmes, then a justice on the Massachusetts Supreme Court, held in *Cowley v. Pulsifer*⁹² that members of the public enjoy a right of access to civil trials. This right, he said, is rooted in democratic principles:

It is desirable that the trial of [civil] causes should take place under the public eye...not because the controversies of one citizen with another are of public concern, but because it is of the highest moment that those who administer justice should always act under the sense of public responsibility, and that every citizen should be able to satisfy himself with his own eyes as to the mode in which a public duty is performed.

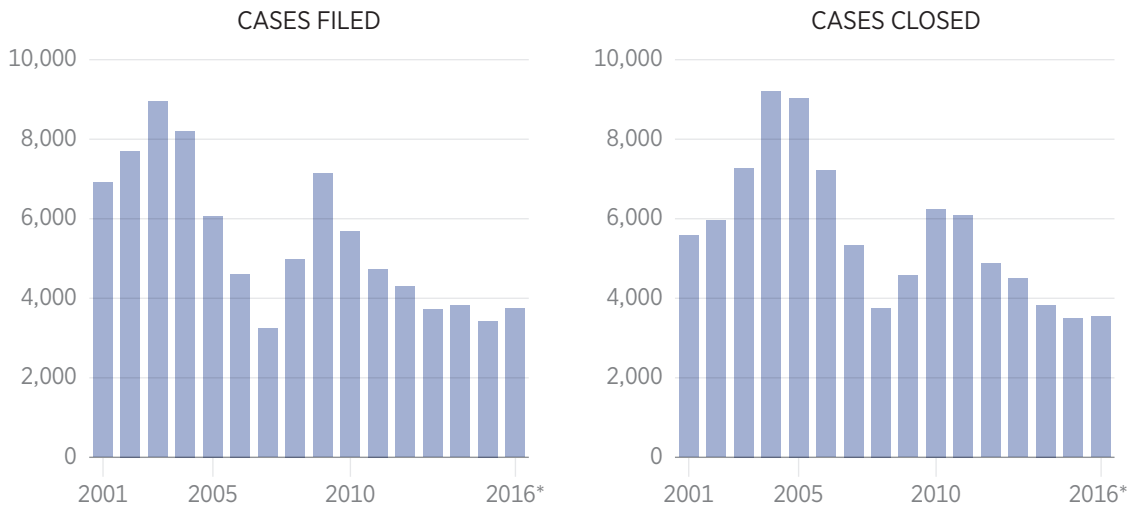
Although proceedings are not public, adverse results in many disciplinary matters are made public via a database called Broker-Check.⁹³ Broker-Check, however, reports only some of the information available on FINRA’s Central Registration Depository. FINRA’s Office of the Chief Economist has found that the unreported information is relevant to predicting broker misconduct.⁹⁴ Other than unauthenticated complaint data,⁹⁵ FINRA should consider whether this information should be made public. As discussed below, FINRA’s rule-making process should also be made more transparent.

Arbitration and Dispute Resolution. FINRA handles about 4,000 arbitration cases annually. About 70 percent of these involve customer complaints, and the remainder consist of intra-industry cases.⁹⁶

Arbitration can be a lower cost, fair way of resolving disputes.⁹⁷ However, for the reasons discussed below in detail, FINRA’s arbitration system is flawed and should be improved.

Alternatively, Congress should consider a different approach. It could create a specialized court, analogous to the Tax Court, to hear

FINRA Arbitration Cases



* Projected.

SOURCE: Financial Industry Regulatory Authority, “Dispute Resolution Statistics,” <http://www.finra.org/arbitration-and-mediation/dispute-resolution-statistics> (accessed December 22, 2016).

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intra-industry and customer-securities cases. This could be a specialized Article III court with limited jurisdiction, or a non-Article III court, such as the U.S. Tax Court⁹⁸ or the U.S. Court of Federal Claims.⁹⁹ It should have a small claims division like the Tax Court and many state courts so that small claims can be handled in a less-formal and less-expensive manner. The small-claims division should be open to *pro se* litigants, and judges should take a more active role in fact finding. Such an approach would have two primary advantages. First, there would be no doubt about its impartiality as there is in the case of FINRA. These doubts arise because, although not controlled by industry, FINRA certainly has strong industry influence. Second, its judges would develop expertise in securities-law cases. Often, neither an Article III court of general jurisdiction nor current FINRA arbitrators have expertise in securities cases.

Due Process. Due process may be summarized as providing to a person who may suffer loss of life, liberty, or property with “notice,

an opportunity to be heard, and a determination by a neutral decisionmaker”¹⁰⁰ in an open forum. In the words of the Supreme Court:

Secrecy is not congenial to truthseeking.... No better instrument has been devised for arriving at truth than to give a person in jeopardy of serious loss notice of the case against him and opportunity to meet it. Nor has a better way been found for generating the feeling, so important to a popular government, that justice has been done.¹⁰¹

Due-process protections would, at a minimum, include (1) adequate notice of the charges or complaint; (2) the right to be present at a hearing or trial; (3) a public forum; (4) the right to be heard and to present evidence; (5) the right to be retain counsel; (6) trial by jury or, at least, an impartial, neutral decision maker; (7) an adequate ability to compel the opposing party to disclose facts and documents that are material to the dispute

(adequate discovery); (8) an adequate ability to call witnesses and to cross-examine witnesses called by the opposing party; (9) a requirement that findings of fact are made and legal reasons are given for a decision; and (10) an adequate review by an impartial party of the triers' decision to ensure that it is not arbitrary or capricious and has a rational basis in law and in fact (adequate appeal rights). Each of these is addressed in turn below.

1. *Notice.* FINRA appears to provide adequate notice both in disciplinary hearings and in its arbitrations.¹⁰²
2. *The Right to be Present.* FINRA allows the parties to be present during proceedings.¹⁰³
3. *Public Forum.* FINRA does not generally provide a public forum. Its proceedings are generally closed to the public.¹⁰⁴ As discussed above under "Transparency," these proceedings should generally be open to the public.¹⁰⁵
4. *The Right to Be Heard and Present Evidence.* FINRA provides the opportunity for parties to be heard and to present evidence. As discussed below, however, parties' rights to present and obtain evidence are circumscribed, and the federal rules of evidence do not apply.¹⁰⁶
5. *The Right to Retain Counsel.* The right to retain and be represented by counsel is preserved in FINRA proceedings.¹⁰⁷
6. *Impartial Decision Maker.* FINRA does not provide the right to a trial by jury as is guaranteed in federal court by the Seventh Amendment¹⁰⁸ and in state courts by most state constitutions.¹⁰⁹ FINRA arbitration chairpersons are not judges. Although there are some requirements for arbitration chairpersons, there is no requirement that arbitrators have any special expertise in finance or the law. In fact, FINRA actively recruits from outside those fields.¹¹⁰ FINRA arbitrators must be approved by FINRA and complete 13.5 hours of FINRA training.¹¹¹ FINRA maintains a list of 6,000 approved arbitrators¹¹² and generates a random list of arbitrators (typically

10 public arbitrators, 10 non-public arbitrators, and 10 chairpersons) from which the parties can choose.¹¹³ FINRA changed its rules in 2011,¹¹⁴ however, so that in arbitrations involving a dispute between customers and a firm, the customer may elect to have the arbitration panel composed of entirely public arbitrators rather than industry representatives.¹¹⁵

7. *Adequate Discovery.* FINRA discovery rules differ depending on the type of proceeding.¹¹⁶ Discovery is more limited than it would be in a federal court.¹¹⁷ In particular, the ability to depose witnesses is severely circumscribed.¹¹⁸ This may make it more difficult for a party to pursue a claim. FINRA discovery is, however, more extensive than discovery made under American Arbitration Association rules.¹¹⁹ Excess discovery costs are one of the primary reasons why conventional litigation is so expensive, and controlling dispute resolution costs is one of the primary advantages of arbitration.¹²⁰ Controlling costs is one of the core rationales underlying the Federal Arbitration Act,¹²¹ which generally requires courts to enforce arbitration awards and bars access to courts when the parties have entered into a pre-dispute arbitration agreement¹²² (as would be the case in virtually every customer-broker agreement). Whether FINRA discovery rules should be modified should be studied further.
8. *Calling Witnesses and Witness Cross-Examination.* Witnesses may generally be called, and opposing witnesses cross-examined. The limits on conducting witness deposition discussed above make it much more difficult to adequately rebut surprise testimony or to impeach a witness.
9. *Findings of Fact and Law.* In general, FINRA arbitrators need not explain their reasoning or make findings of fact or law. If, however, all parties agree in advance,¹²³ they may request and pay \$400 for an "explained decision."¹²⁴ But even an explained decision need not include

FINRA: Regulated Firms and Registered Representatives



SOURCES: Financial Industry Regulatory Authority, “Annual Reports and Financials, 2007-2010,” <http://www.finra.org/about/annual-reports-financials> (accessed December 22, 2016), and Financial Industry Regulatory Authority, “Statistics,” <http://www.finra.org/newsroom/statistics> (accessed December 22, 2016). Note: FINRA data for 2008-2010 are approximate.

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“legal authorities and damage calculations.”¹²⁵ Thus, neither the parties nor anyone reviewing the arbitrators’ decision can meaningfully assess how much, or how little, thought or analysis about the facts or the law went into deciding the case or the amount, if any, of the award. Neither the parties nor anyone else can meaningfully assess whether the arbitrators’ reasoning was flawed or sound. In contrast to very high compensation for FINRA employees,¹²⁶ arbitrators are paid between \$300 (for a session up to four hours) and \$600 (for a session lasting up to a day).¹²⁷ This amounts to \$75 per hour—and substantially less than that, once the time traveling to and from the hearing and preparation time is considered. In contrast, the reimbursement rate for attorneys under the Equal Access to Justice Act is about \$190 per hour.¹²⁸

Arbitrators are not paid for time spent on preparation, analysis, or discussion outside the actual arbitration session. Thus, they have every incentive to make a quick decision rather than a well-reasoned decision.

Administrative-law courts are required to make “findings and conclusions, and the reasons or basis therefore, on all the material issues of fact, law, or discretion presented on the record.”¹²⁹ FINRA arbitrators should be required to do the same for those cases where more than \$100,000¹³⁰ is at stake or severe disciplinary sanctions are possible. This may be difficult for many existing FINRA arbitrators who do not have training in finance or in the law. If raising FINRA arbitrator honoraria is necessary in order to attract those with the requisite skills, FINRA should do so.

10. Adequate Review of Arbitration Decisions.

Either party can appeal the result of a disciplinary hearing to the National Adjudicatory Council (NAC).¹³¹ The NAC is a FINRA committee¹³² with 14 members.¹³³ Any governor may request that FINRA's Board of Governors review the decision of the NAC.¹³⁴ A respondent may ask the SEC to review a final FINRA decision.¹³⁵ The SEC's decision, in turn, is subject to limited judicial review.¹³⁶

There is no comparable review in customer or intra-industry arbitrations. The arbitrators' decisions are final.¹³⁷ The combination of arbitrators not needing to provide reasons for their decision and the near-total lack of review for customer or intra-industry arbitrations is fundamentally unfair and affords no recourse to either customers or firms that are the victims of poorly reasoned, unjust, or arbitrary decisions. Some of these disputes, of course, involve modest amounts of money. But others involve substantial sums and can, in the case of customers, involve their life savings. Similarly, a firm that is forced to unjustly pay an award has no recourse.

FINRA arbitrators should be required to make findings of fact based on the evidentiary record and to demonstrate how those facts led to the award given. These written FINRA arbitration decisions should be subject to SEC review and limited judicial review. Policymakers should carefully evaluate whether the current practice in disciplinary proceedings is sufficient to provide adequate review. Specifically, those reviewing the outcome in a disciplinary decision should be able to assess whether the findings of fact actually have an adequate basis, and to assess a written finding of how, in light of those facts, a specific FINRA rule or provision in the securities law was violated.

Improved Oversight. The Government Accountability Office (GAO) has found the SEC's oversight of FINRA to be insufficient.¹³⁸ In response, in October 2016, the SEC started a new office called the FINRA and Securities Industry Oversight (FISO) group, designed to

enhance its oversight of FINRA.¹³⁹ The new FISO should issue annual reports describing its oversight of FINRA and addressing the issues raised in this chapter.

Congressional oversight of FINRA has been light. To improve oversight, Congress should:

- Require that FINRA submit an annual report to Congress with detailed, specified information about its budget and fees; its enforcement activities (including sanctions and fines imposed by type of violation and type of firm or individual); its dispute resolution activities; and its rule-making activities;
- Conduct annual oversight hearings on FINRA, its budget, its enforcement activities, its dispute resolution activities, and its rule-making activities;
- Require an annual GAO review of FINRA with respect to its budget, its enforcement activities, its dispute resolution activities, and its rule-making activities and a separate review of the SEC's oversight of FINRA; and
- Consider making FINRA, the Municipal Securities Rulemaking Board (MSRB),¹⁴⁰ and the National Futures Association (NFA)¹⁴¹ each a "designated federal entity"¹⁴² and establishing an inspector general with respect to financial SROs, including FINRA, the MSRB, and the NFA or, alternatively, placing FINRA, the MSRB, and the NFA within the ambit of an existing inspector general.¹⁴³

Small Broker-Dealer Relief. As Table 8-2 shows, the number of broker-dealers has declined by nearly 13 percent over the past five years (2011–2016), and 23 percent in the nine years since FINRA was created in 2007.¹⁴⁴

Since 2009, the number of registered representatives who work for broker-dealers has remained fairly constant, but the number of firms has continued to decline. This reflects the concentration in the market and the decline in the number of small broker-dealers.

The registered representatives that once worked for these smaller firms have found employment with the remaining firms.

A similar phenomenon is occurring in the banking sector.¹⁴⁵ The number of small banks has declined by 28 percent since 2000, and small banks' share of total domestic deposits has declined from 40 percent to less than 22 percent.¹⁴⁶ There are many reasons for the decline in small broker-dealers and small banks, but one obvious factor common to both banks and broker-dealers is the ever-increasing rise in the regulatory burden on small broker-dealers and small banks. FINRA rules are a major component of that regulatory burden for broker-dealers. Regulatory compliance costs do not increase linearly with size, and place a disproportionate burden on small firms, making them less competitive in the marketplace.¹⁴⁷ Small broker-dealers are more willing to underwrite the offerings of small and start-up businesses. The decline in the number of small broker-dealers impedes the ability of entrepreneurs to raise capital.

FINRA needs to undertake a systematic review of its rules and regulatory practices comparable to the small-entity impact review required of federal agencies under the Regulatory Flexibility Act.¹⁴⁸ This review should include the impact of stress tests, the nature of FINRA audits, FINRA rules relating to the interaction between research and corporate finance, FINRA rules and practices relating to sanctions for inadequate policies and procedures or failure to supervise, the operation of "remedial" sanctions imposed without a hearing,¹⁴⁹ and other matters. FINRA needs to be open to experimentation and financial-technological innovation that most commonly occurs in small firms.

Budget and Finance. FINRA fees are not voluntary. As a matter of economics, though not law, they are effectively a tax. And, at \$789 million in 2015, they are substantial.¹⁵⁰ The businesses that pay these fees must recover the costs.¹⁵¹ Before raising these fees, FINRA should be required to obtain an affirmative vote by Congress or, at least, by the SEC.

The fines leveled by FINRA in 2015 (\$94 million) were 263 percent higher than the \$25.9 million in fines levied in 2008, its first full year of operation.¹⁵² Average fines per member were \$5,286 in 2008, and \$23,755 in 2015, a 349 percent increase.¹⁵³ It is difficult to judge the appropriateness of FINRA fines without additional information, but FINRA should not have a budgetary incentive to impose fines. Currently, it is FINRA policy that FINRA fines are used to fund "capital expenditures and specified regulatory projects."¹⁵⁴ Revenues from fines imposed (\$97 million in FY 2015)¹⁵⁵ should go to either a newly established investor reimbursement fund¹⁵⁶ or to the Treasury, not to FINRA's budget.

Congress should consider making FINRA "on budget" for purposes of the federal budget, along with various other government-sponsored enterprises, quasi-governmental entities, agency-related nonprofit organizations, and the like that currently escape congressional oversight during the budget process.¹⁵⁷ The Securities Protection Investors Corporation and the PCAOB are District of Columbia not-for-profit organizations but are on budget.¹⁵⁸ The MSRB and NFA are not.¹⁵⁹

Regulatory Process. FINRA's rule-making process should also be made more transparent. Currently, it solicits comments from the public for many of its rules.¹⁶⁰ But this solicitation is not required. Its committee process is opaque and its Board of Governors' meetings, where final rules decisions are made, are closed. The proposed rules are subject to public scrutiny once they are submitted to the SEC for approval.¹⁶¹ But, by this juncture, it is unusual for changes to be made, and the SEC rarely disapproves a rule proposed by FINRA.¹⁶² In its rule-making process, FINRA should comply with a set of rules substantially similar to the requirements imposed on government agencies relating to the notice-and-comment provisions of the Administrative Procedure Act.¹⁶³

Although FINRA made improvements in the economic analysis of its rules by creating its Office of the Chief Economist in 2013, its efforts are

still relatively rudimentary compared to those of the SEC and most other government agencies.¹⁶⁴ FINRA should also examine whether its rules have a disproportionate impact on small, more entrepreneurial broker-dealers.¹⁶⁵

CONCLUSION

FINRA is a key regulator of central importance to the functioning of U.S. capital markets. It is neither a true self-regulatory organization nor a government agency. It is largely unaccountable to the industry or to

the public. Due process, transparency, and regulatory-review protections normally associated with regulators are not present, and its arbitration process is flawed. Reforms are necessary. FINRA itself, the SEC, and Congress should reform FINRA to improve its rule-making and arbitration process. Congress should amend § 15A and § 19 of the Securities Exchange Act such that a national securities association (FINRA) must meet the reforms outlined in this chapter as a condition of registration.

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ENDNOTES

1. Financial Industry Regulatory Authority, "What We Do," <http://www.finra.org/about/what-we-do> (accessed December 9, 2016).
2. Financial Industry Regulatory Authority, "Statistics," September 2016 data, <http://www.finra.org/newsroom/statistics> (accessed December 9, 2016).
3. Securities Exchange Act sections 15(b)(8) ("It shall be unlawful for any registered broker or dealer to effect any transaction in, or induce or attempt to induce the purchase or sale of, any security (other than commercial paper, bankers' acceptances, or commercial bills), unless such broker or dealer is a member of a securities association registered pursuant to section 78o-3 of this title or effects transactions in securities solely on a national securities exchange of which it is a member.") and 15(b)(1)(A) (i). ("A broker or dealer may not register under this paragraph unless that broker or dealer is a member of a national securities association registered under section 15A(k).")
4. FINRA is registered pursuant to Securities Exchange Act section 15A [15 U.S. Code § 78o-3].
5. Financial Industry Regulatory Authority, *FINRA 2015 Year in Review and Annual Financial Report*, p. 3, http://www.finra.org/sites/default/files/2015_YIR_AFR.pdf (accessed December 9, 2016).
6. Financial Industry Regulatory Authority, "Arbitration and Mediation," <https://www.finra.org/arbitration-and-mediation> (accessed December 9, 2016), and Financial Industry Regulatory Authority, *Final Report and Recommendations of the FINRA Dispute Resolution Task Force*, December 16, 2015, <http://www.finra.org/sites/default/files/Final-DR-task-force-report.pdf> (accessed December 9, 2016). For a discussion of the history of securities-dispute arbitration in the U.S., see Jill Gross, "The Historical Basis of Securities Arbitration as an Investor Protection Mechanism," *Journal of Dispute Resolution*, Vol. 171 (2016), pp. 171-186, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2728978 (accessed December 9, 2016). For statistics on FINRA arbitrations, see Financial Industry Regulatory Authority, "Dispute Resolution Statistics," <http://www.finra.org/arbitration-and-mediation/dispute-resolution-statistics> (accessed December 9, 2016).
7. This is because virtually all brokers require customers to sign a mandatory arbitration agreement, and FINRA's decisions are final in most cases. The Supreme Court has upheld the mandatory arbitration clauses in customer agreements. See *Shearson/American Express Inc. v. McMahon*, 482 U.S. 220, 107 S.Ct. 2332, 96 L.Ed.2d 185 (1987), and *AT&T Mobility LLC v. Concepcion*, 563 U.S. 333, 131 S. Ct. 1740, 179 L.Ed. 2d 742 (2011). Under FINRA Rule 12904(b) (approved by the SEC), "[u]nless the applicable law directs otherwise, all awards rendered under the Code are final and are not subject to review or appeal." Code in this context means the FINRA Code of Arbitration Procedure for Customer Disputes, FINRA Rules 12000 et seq., http://finra.complinet.com/en/display/display_viewall.html?rbid=2403&element_id=4096&record_id=5174&filtered_tag (accessed December 9, 2016). See also the arbitration discussion below, in the section titled "Arbitration and Dispute Resolution."
8. FINRA, "Office of the Ombudsman," <http://www.finra.org/about/office-ombudsman> (accessed January 4, 2017).
9. FINRA, *Office of the Ombudsman 2014 Report*, p. 3 http://www.finra.org/sites/default/files/Office_Ombudsman_Report_072815.pdf (accessed January 4, 2017).
10. Foundation Center, IRS Form 990, http://990s.foundationcenter.org/990_pdf_archive/521/521959501/521959501_201312_9900.pdf (accessed December 9, 2016); Delaware Department of State: Division of Corporations, Entity Search, <https://icis.corp.delaware.gov/Ecorp/EntitySearch/NameSearch.aspx> (accessed December 9, 2016); and FINRA Articles of Incorporation, http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=4589 (accessed December 9, 2016).
11. Securities Exchange Act section 19 [15 U.S. Code § 78s]; 17 C.F.R. §§ 240.19b-4-240.19h-1; Securities and Exchange Commission, "Self-Regulatory Organization Rulemaking," <https://www.sec.gov/rules/sro.shtml> (accessed December 9, 2016); Government Accountability Office, "SEC Can Further Enhance Its Oversight Program of FINRA," April 2015, GAO-15-376, <http://gao.gov/assets/670/669969.pdf> (accessed December 9, 2016). In October 2016, the SEC started a new office called the FINRA and Securities Industry Oversight (FISO) group designed to enhance its oversight of FINRA. The SEC will also be reducing the number of examiners dedicated to broker-dealer examinations. See Marc Wyatt, "Inside the National Exam Program in 2016," Securities and Exchange Commission, keynote address at National Society of Compliance Professionals conference, Washington, DC, October 17, 2016, <https://www.sec.gov/news/speech/inside-the-national-exam-program-in-2016.html> (accessed December 9, 2016); Elizabeth Dilts, "SEC Says to Monitor Partner Regulator's Brokerage Oversight," Reuters, October 17, 2016, <http://www.cnbc.com/2016/10/17/reuters-america-sec-says-to-monitor-partner-regulators-brokerage-oversight.html> (accessed December 9, 2016); and "SEC Launches Dedicated FINRA Oversight Unit: Watching the Detectives," *National Law Review*, October 27, 2016, <http://www.natlawreview.com/article/sec-launches-dedicated-finra-oversight-unit-watching-detectives> (accessed December 9, 2016).
12. Financial Industry Regulatory Authority, *2015 Year in Review and Annual Financial Report*, p. 13, http://www.finra.org/sites/default/files/2015_YIR_AFR.pdf (accessed December 9, 2016).
13. On a full-time-equivalent (FTE) basis. FY 2017 SEC Congressional Budget Justification, p. 14.
14. *FINRA 2015 Year in Review and Annual Financial Report*, p. 14.

15. *Ibid.*, p. 15.
16. Securities and Exchange Commission, *FY 2017 Congressional Budget Justification, FY 2017 Annual Performance Plan, FY 2015 Annual Performance Report*, p. 15, <https://www.sec.gov/about/reports/secfy17congbudjust.pdf> (accessed December 9, 2016).
17. FINRA performs market regulation under contract for the New York Stock Exchange LLC (NYSE); NYSE Arca, Inc. (NYSE Arca); NYSE MKT LLC (NYSE MKT); The Nasdaq Stock Market LLC (NASDAQ); Nasdaq BX, Inc. (Boston); Nasdaq PHLX LLC (Philadelphia); BATS Global Markets, Inc. (the BZX, BYZ, EDGA and EDGX exchanges, collectively referred to as BATS); the International Securities Exchange, LLC (ISE, ISE Gemini, and ISE Mercury); the Chicago Board Options Exchange and the C2 Options Exchange (CBOE and C2); and other exchanges. See *FINRA 2015 Year in Review and Annual Financial Report*, pp. 12 and 19.
18. News release, “NASD and NYSE Member Regulation Combine to Form the Financial Industry Regulatory Authority–FINRA,” Financial Industry Regulatory Authority, July 30, 2007, <http://www.finra.org/newsroom/2007/nasd-and-nyse-member-regulation-combine-form-financial-industry-regulatory-authority> (accessed December 9, 2016); and Securities and Exchange Historical Society, “Creation of FINRA,” <http://www.sechistorical.org/museum/galleries/sro/sro06g.php> (accessed December 9, 2016).
19. NASDAQ was originally the acronym for National Association of Securities Dealers Automated Quotations.
20. The NYSE is owned by Intercontinental Exchange Inc. traded on the NYSE under the symbol ICE. Nasdaq, Inc. is traded on NASDAQ under the symbol NDAQ. Previously, NYSE and NASDAQ had been member (broker-dealer) owned (sometimes called “mutualized” exchanges).
21. “Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change To Amend the By-Laws of NASD To Implement Governance and Related Changes To Accommodate the Consolidation of the Member Firm Regulatory Functions of NASD and NYSE Regulation, Inc.,” Notices, *Federal Register*, Vol. 72, No. 147 (August 1, 2007), pp. 42169–42190 and 42190–42192, <https://www.gpo.gov/fdsys/pkg/FR-2007-08-01/pdf/E7-14855.pdf> (accessed December 14, 2016).
22. For more on the history of securities, SROs and FINRA in particular, see Roberta S. Karmel, “Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?” *Stanford Journal of Law, Business & Finance*, Vol. 14, No. 1 (Fall 2008), pp. 163 and 164, <http://brooklynworks.brooklaw.edu/cgi/viewcontent.cgi?article=1376&context=faculty> (accessed December 9, 2016); Hester Peirce, “The Financial Industry Regulatory Authority: Not Self-Regulation after All,” *Mercatus Center Working Paper*, January 2015, https://www.mercatus.org/system/files/Peirce-FINRA_0.pdf (accessed December 9, 2016); and Jonathan Macey and Caroline Novogrod, “Enforcing Self-Regulatory Organization’s Penalties and the Nature of Self-Regulation,” *Hofstra Law Review*, Vol. 40 (2012), pp. 963–1003, http://digitalcommons.law.yale.edu/cgi/viewcontent.cgi?article=5671&context=fss_papers (accessed December 9, 2016).
23. However, aspects of the NASD’s regulatory function had left industry control as early as 1996. See Karmel, “Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?” In addition, the NYSE regulatory function was no longer under industry control by the 1990s. For a discussion of the history of the evolution of SROs, see Daniel M. Gallagher, “U.S. Broker-Dealer Regulation,” Chapter 6 in Hester Peirce and Benjamin Klutsey, eds., *Reframing Financial Regulation*, (Arlington, VA: Mercatus Center at George Mason University, 2016) https://www.mercatus.org/system/files/peirce_reframing_web_v1.pdf (accessed January 4, 2017).
24. See, for example, Peirce, “The Financial Industry Regulatory Authority: Not Self-Regulation after All,” and William A. Birdthistle and M. Todd Henderson, “Becoming a Fifth Branch,” *Cornell Law Review*, Vol. 99, No. 1 (2013), pp. 1–69, <http://cornelllawreview.org/files/2013/11/99CLR1.pdf> (accessed December 9, 2016).
25. Financial Industry Regulatory Authority, “FINRA Board of Governors,” <http://www.finra.org/about/finra-board-governors> (accessed December 9, 2016).
26. Financial Industry Regulatory Authority, “Restated Certificate of Incorporation of Financial Industry Regulatory Authority, Inc.,” Eighth Article, subsection (b), paragraph 2, http://finra.complanet.com/en/display/display.html?rbid=2403&element_id=4589 (accessed December 14, 2016), and Financial Industry Regulatory Authority, “By-Laws, Article VII, Board of Governors,” http://finra.complanet.com/en/display/display_main.html?rbid=2403&element_id=4628 (accessed December 14, 2016).
27. Financial Industry Regulatory Authority, “FINRA Board of Governors.”
28. Neil Gunningham and Joseph Rees, “Industry Self-Regulation: An Institutional Perspective,” *Law & Policy*, Vol. 19, No. 4 (October 1997), <http://onlinelibrary.wiley.com/doi/10.1111/1467-9930.t01-1-00033/epdf> (accessed December 9, 2016).
29. Anthony Ogus, “Self-Regulation (9400),” in Boudewijn Bouckaert and Gerrit De Geest, eds., *Encyclopedia of Law and Economics, Vol. 1. The History and Methodology of Law and Economics* (Cheltenham, PA: Edward Elgar, 2000), <http://encyclo.findlaw.com/9400book.pdf> (accessed December 9, 2016).
30. Birdthistle and Henderson, “Becoming a Fifth Branch,” p. 10.

31. See Securities and Exchange Commission, “Foundations of Self-Regulation” section in “Concept Release Concerning Self-Regulation,” *Federal Register*, Vol. 69, No. 235 (December 8, 2004), pp. 71256–71282, <https://www.gpo.gov/fdsys/pkg/FR-2004-12-08/pdf/04-26154.pdf> (accessed December 9, 2016).
32. SEC Commissioner Luis A. Aguilar, “The Need for Robust SEC Oversight of SROs,” Securities and Exchange Commission, May 8, 2013, <https://www.sec.gov/News/PublicStmnt/Detail/PublicStmnt/1365171515546> (accessed December 9, 2016); Ogus, “Self-Regulation (9400)”; Birdthistle and Henderson, “Becoming a Fifth Branch,” pp. 11 and 12; and Andrew F. Tuch, “The Self-Regulation of Investment Bankers,” *George Washington Law Review*, Vol. 83, No. 1 (December 2014), pp. 101–175, <http://www.gwlr.org/wp-content/uploads/2015/03/83-Geo-Wash-L-Rev-101.pdf> (accessed December 9, 2016). Occupation licensing is often controlled by SROs or quasi-governmental organizations. On occupation licensing generally as a barrier to entry, see The White House, “Occupational Licensing: A Framework for Policymakers,” July 2015, https://www.whitehouse.gov/sites/default/files/docs/licensing_report_final_nonembargo.pdf (accessed December 9, 2016), and Dick M. Carpenter et al., “License to Work: A National Study of Burdens from Occupation Licensing,” Institute for Justice, May 2012, https://www.ij.org/images/pdf_folder/economic_liberty/occupational_licensing/licensetowork.pdf (accessed December 9, 2016).
33. “One cannot deal in securities with the public without being a member of FINRA. When a member fails to pay a fine levied by FINRA, FINRA can revoke the member’s registration, resulting in exclusion from the industry.” See *Fiero v. Financial Industry Regulatory Authority*, 660 F.3d 569, 576 (2d Cir. 2011).
34. 5 U.S. Code § 553.
35. 5 U.S. Code § 552.
36. 5 U.S. Code §§ 601–612.
37. 5 U.S. Code § 552b.
38. 44 U.S. Code §§ 3501–3531.
39. See, for example, Executive Orders 12866 and 13563 and Office of Management and Budget (OMB) Circular A-4.
40. FINRA Manual, Code of Arbitration Procedure for Customer Disputes, FINRA Rule 12602, Attendance at Hearings. See also FINRA Rules 9261 and 9265.
41. See detailed discussion below, in the section titled “Due Process.”
42. However, once a rule is finalized by FINRA and submitted to the SEC for approval, the SEC does make the rule available for public comment. Dodd–Frank required that the SEC conduct its review of FINRA rules within 45 days. In FY 2015, only 63 percent were approved or disapproved within 45 days. Securities and Exchange Commission, *FY 2015 Annual Performance Report*, p. 25, <https://www.sec.gov/about/reports/sec-fy2015-fy2017-annual-performance.pdf> (accessed December 9, 2016).
43. Karmel, “Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?” pp. 151–197; Michael Deshmukh, “Is FINRA a State Actor? A Question that Exposes the Flaws of the State Action Doctrine and Suggests a Way to Redeem It,” *Vanderbilt Law Review*, Vol. 67, No. 4 (2014), pp. 1173–1211, <https://www.vanderbiltlawreview.org/wp-content/uploads/sites/89/2014/06/Is-FINRA-a-State-Actor.pdf> (accessed December 9, 2016); and Steven Irwin et al., “Self-Regulation of the American Retail Securities Markets—An Oxymoron for What Is Best for Investors?” *University of Pennsylvania Journal of Business Law*, Vol. 14, No. 4 (2012), pp. 1055–1084, <http://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=1421&context=jb1> (accessed December 9, 2016).
44. *Jackson v. Metropolitan Edison Co.*, 419 U.S. 345, 351, 95 S.Ct. 449, 42 L.Ed.2d 477 (1974).
45. *Blum v. Yaretsky*, 457 U.S. 991, 1004–05, 102 S.Ct. 2777, 73 L.Ed.2d 534 (1982).
46. See Federal Rules of Appellate Procedure (FRAP) 32.1, and John Szmer, Robert K. Christensen, and Ashlyn Kuersten, “The Efficiency of Federal Appellate Decisions: An Examination of Published and Unpublished Opinions,” *The Justice System Journal*, Vol. 33, No. 3 (2012), p. 319, http://spia.uga.edu/faculty_pages/rc/law_pa_files/Pub12_JSJ_EfficiencyFedAppCourts.pdf (accessed December 9, 2016), finding that three-quarters of federal appellate decisions are now unpublished (unreported) and given that FRAP 32.1, after January 1, 2007, allows attorneys to cite opinions “designated as ‘unpublished,’ ‘not for publication,’ ‘non-precedential,’ ‘not precedent,’ or the like,” unpublished opinions are of greater importance.
47. *Santos-Buch v. Financial Industry Regulatory Authority, Inc.*, U.S. Court of Appeals for the Second Circuit, No. 14-2767-cv, January 30, 2015, <http://www.leagle.com/decision/In%20FCO%2020150130104/SANTOS-BUCH%20v.%20FINANCIAL%20INDUSTRY%20REGULATORY%20AUTHORITY,%20INC> (accessed December 9, 2016).
48. *Busacca v. S.E.C.*, U.S. Court of Appeals for the Eleventh Circuit, No. 10-15918, December 28, 2011, unpublished opinion, <https://www.sec.gov/litigation/opinions/2010/34-63312-appeal.pdf> (accessed December 9, 2016).
49. *DAlessio v. S.E.C.*, 380 F.3d 112, 120 n.12 (2d Cir. 2004) [discussing whether the NASD is a state actor, but asserting that a determination of that issue was not necessary in that case]; *D.L. Cromwell Investments v. NASD Regulation*, 279 F.3d 155 (2d Cir. 2002) [finding that NASD is not a state actor]; *Desiderio v. NASD*, 191 F.3d 198, 206 (2d Cir. 1999) [finding that NASD is not a state

- actor but recognizing that “private entities may be held to constitutional standards if their actions are ‘fairly attributable’ to the state”]; *Gold v. SEC*, 48 F.3d 987 (7th Cir. 1995) [finding that due process was provided and side-stepping the state action issue]; and *Intercontinental Industries, Inc. v. American Stock Exchange*, 452 F.2d 935 (5th Cir. 1971) [“The intimate involvement of the [American Stock] Exchange with the Securities and Exchange Commission brings it within the purview of the Fifth Amendment controls over governmental due process.”]. The American Stock Exchange was acquired by the NYSE in 2008 and since 2012 has been called NYSE MKT. See also *Saad v. SEC*, 718 F. 3d 904 (D.C. Cir. 2013) [finding that the commission abused its discretion in failing to address several potentially mitigating factors when upholding a FINRA lifetime bar].
50. Internal Revenue Service, Memorandum No. 201623006, Office of Chief Counsel, June 3, 2016, <http://brokeandbroker.com/PDF/IRSFINRAFines.pdf> (accessed December 9, 2016).
 51. “The NYSE, as a[n] SRO, stands in the shoes of the SEC in interpreting the securities laws for its members and in monitoring compliance with those laws. It follows that the NYSE should be entitled to the same immunity enjoyed by the SEC when it is performing functions delegated to it.” See *D’Alessio v. New York Stock Exchange, Inc.*, 258 F.3d 93 (2d Cir. 2001). See also *Sparta Surgical Corp. v. National Association of Securities Dealers, Inc.*, 159 F.3d 1209 (9th Cir. 1998), and *Weissman v. Nat’l Association of Securities Dealers, Inc.*, 500 F.3d 1293 (11th Cir. 2007).
 52. 637 F.3d 112 (2d Cir. 2011), cert. denied January 17, 2012. Citations omitted. Both progressive organizations and free-market groups filed amicus briefs urging the Supreme Court to grant *certiorari*.
 53. *Ibid.*
 54. Birdthistle and Henderson, “Becoming a Fifth Branch” (quote is from the introductory abstract).
 55. Gallagher, “U.S. Broker-Dealer Regulation.” See also Commissioner Daniel M. Gallagher, “Market 2012: Time for a Fresh Look at Equity Market Structure and Self-Regulation,” Securities and Exchange Commission, October 4, 2012, <https://www.sec.gov/News/Speech/Detail/Speech/1365171491376> (accessed December 9, 2016).
 56. Emily Hammond, “Double Deference in Administrative Law,” *Columbia Law Review*, Vol. 116, No. 7 (November 2016), <http://columbialawreview.org/content/double-deference-in-administrative-law/> (accessed December 9, 2016).
 57. Center for Capital Markets Competitiveness, “U.S. Capital Markets Competitiveness: The Unfinished Agenda,” Summer 2011, p. 5, https://www.uschamber.com/sites/default/files/legacy/reports/1107_UnfinishedAgenda_WEB.pdf (accessed December 9, 2016).
 58. For the first nine months of 2016, FINRA statistics show the following misconduct-controversy types in customer arbitrations: Breach of Fiduciary Duty (1,572); Negligence (1,465); Failure to Supervise (1,417); Misrepresentation (1,300); Suitability (1,239); Breach of Contract (1,207); Omission of Facts (1,086); Fraud (1,010); Unauthorized Trading (279); Violation of State Blue Sky Laws (254); Churning (201); Manipulation (191); Margin Calls (62); Errors-Charges (44); and Transfer (28). See Financial Industry Regulatory Authority, “Top 15 Controversy Types in Customer Arbitrations,” <http://www.finra.org/arbitration-and-mediation/dispute-resolution-statistics> (accessed December 9, 2016).
 59. Mark Egan, Gregor Matvos, and Amit Seru, “The Market for Financial Adviser Misconduct,” SSRN, March 2016, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2739170 (accessed December 9, 2016).
 60. David Burton, “No Get-Out-of-Jail-Free Card for Bankers,” *Newsweek*, February 28, 2015, <http://www.newsweek.com/no-get-out-of-jail-free-card-bankers-310256> (accessed December 9, 2016).
 61. See, for example, letter by Senators Elizabeth Warren (D-MA) and Tom Cotton (R-AR) to FINRA, May 11, 2016, https://www.warren.senate.gov/files/documents/2016-5-11_Warren-Cotton_Letter_to_FINRA.pdf (accessed December 9, 2016).
 62. FINRA created its Office of the Chief Economist in 2013: Financial Industry Regulatory Authority, “Office of the Chief Economist,” <http://www.finra.org/industry/chief-economist> (accessed December 9, 2016).
 63. Hammad Qureshi and Jonathan Sokobin, “Do Investors Have Valuable Information About Brokers?” FINRA Office of the Chief Economist *Working Paper*, August 2015, p. 21, <http://www.finra.org/sites/default/files/OCE-Working-Paper.pdf> (accessed December 9, 2016), and Qureshi and Sokobin, “Do Investors Have Valuable Information About Brokers?” non-technical summary, August 2015, <http://www.finra.org/sites/default/files/OCE-Non-technical-Summary.pdf> (accessed December 9, 2016).
 64. *Ibid.*, *Working Paper*, p. 4.
 65. Including “regular” Article III courts, Article II courts like the Tax Court, federal administrative law courts or, for that matter, any state court.
 66. Joseph McLaughlin, “Is FINRA Constitutional?” *Engage*, Vol. 12, No. 2 (September 2011), pp. 111-114, <http://www.fed-soc.org/publications/detail/is-finra-constitutional> (accessed December 9, 2016).
 67. 561 U.S. 477, 130 S. Ct. 3138, 177 L. Ed. 2d 706 (2010).
 68. 15 U.S. Code § 7211(e)(6).

69. Public Company Accounting Oversight Board, "About the PCAOB," <https://pcaobus.org/About/pages/default.aspx> (accessed December 9, 2016).
70. 561 U.S. 477, 483–484.
71. 561 U.S. 477, 484.
72. The Free Enterprise decision found that the PCAOB being charged with enforcement of Sarbanes–Oxley was of central importance to determining if it was exercising executive power. FINRA is statutorily charged with enforcing the securities laws. See Securities Exchange Act § 15A(b)(2). See also FINRA By-Law Article XI ("to carry out the purposes of the Corporation and of the Act, the Board is hereby authorized to adopt such rules for the members and persons associated with members"). "The Act" is defined in FINRA By-Law Article I as the Securities Exchange Act of 1934.
73. 561 U.S. 477, 484.
74. McLaughlin, "Is FINRA Constitutional?" pp. 113–114. McLaughlin argues that FINRA does exercise executive power. For a discussion of these issues, also see *PHH Corporation v. Consumer Financial Protection Bureau* (DC Cir., October 11, 2016), [https://www.cadc.uscourts.gov/internet/opinions.nsf/AAC6BFFC4C42614C852580490053C38B/\\$file/15-1177-1640101.pdf](https://www.cadc.uscourts.gov/internet/opinions.nsf/AAC6BFFC4C42614C852580490053C38B/$file/15-1177-1640101.pdf) (accessed December 9, 2016). ("Applying the Supreme Court's separation of powers precedents, we therefore conclude that the CFPB is unconstitutionally structured because it is an independent agency headed by a single Director.")
75. Paul J. Larkin Jr., "The Dynamic Incorporation of Foreign Law and the Constitutional Regulation of Federal Lawmaking," *Harvard Journal of Law & Public Policy*, Vol. 38, No. 1 (2015), pp. 416 and 417, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2556440 (accessed December 9, 2016).
76. 557 F. 2d 1008 (3d Cir. 1977).
77. 198 F.2d 690 (2d Cir.), cert. denied, 344 U.S. 855, 73 S. Ct. 94, 97 L.Ed. 664 (1952).
78. The Maloney Act, Public Law No. 75–719 (June 25, 1938), created section 15A of the Securities Exchange Act and extended the role of SROs beyond exchanges. The NASD was created as a result, and it registered as an SRO on August 7, 1939. The Maloney Act is available at http://www.sechistorical.org/collection/papers/1930/1938_0625_MaloneyAct.pdf (accessed December 9, 2016). For more on the history of SROs and links to many historical documents, see Securities and Exchange Commission Historical Society, "The Institution of Experience: Self-Regulatory Organizations in the Securities Industry, 1792–2010, Self Help and the New Deal," <http://www.sechistorical.org/museum/galleries/sro/sro04b.php> (accessed December 9, 2016).
79. Securities Acts Amendments of 1975 Public Law No. 94–29, 89 Stat. 97 (1975), <https://www.gpo.gov/fdsys/pkg/STATUTE-89/pdf/STATUTE-89-Pg97.pdf> (accessed December 9, 2016). These amendments made a wide variety of changes to the Exchange Act provisions governing national securities associations, their members, and hearings conducted by SROs.
80. 557 F. 2d 1008 (3d Cir. 1977) at footnote 6. ("There are some changes in the amendments as they apply to hearings before the Commission, e.g., under the 1934 Act, the S.E.C. is to make its decision 'upon consideration of the record before the association and such other evidence as it may deem relevant...' The 1975 amendment, on the other hand, states '...which hearing may consist solely of consideration of the record before the self-regulatory organization and opportunity for the presentation of supporting reasons to affirm, modify, or set aside the sanction ...' Our consideration of this case is confined to the 1934 act, and we do not intimate any view on the constitutionality of the 1975 amendment.")
81. However, some of the governance changes made by the NASD and the NYSE in 1996 before FINRA's creation were important steps away from truly private, self-regulatory status. See Karmel, "Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?" p. 163, n. 58, discussing NASD bylaw changes.
82. The details of this conversion process and the degree to which the SEC would preserve the right to not hire FINRA employees would need to be decided.
83. It is possible that an organization with strong industry representation could be more effective in discharging this function. The issue would need to be evaluated carefully.
84. Liz Moyer, "Finra Names Robert Cook Its Chief Executive," *The New York Times*, June 13, 2016, http://www.nytimes.com/2016/06/14/business/dealbook/finra-names-robert-cook-its-chief-executive.html?_r=0 (accessed December 9, 2016).
85. News release, "John J. Brennan Elected Chairman of FINRA Board of Governors," Financial Industry Regulatory Authority, July 15, 2016, <http://www.finra.org/newsroom/2016/john-j-brennan-elected-chairman-finra-board-governors> (accessed December 9, 2016).
86. David Michaels, "FINRA Board Seat Goes to Ex-Bear Stearns Partner in Tight Race," *The Wall Street Journal*, September 19, 2016. Bob Muh is quoted as saying: "So many small firms are angry over the huge increase in compliance costs to meet the many new rules."
87. Securities Exchange Act § 15A(b)-(d).

88. 5 U.S. Code § 552.
89. FINRA, “Board of Governors Meetings,” <http://www.finra.org/industry/governors-meetings> (accessed January 4, 2017).
90. 5 U.S. Code § 552b.
91. *Richmond Newspapers, Inc. v. Virginia*, 448 U.S. 555, 580 n. 17 (1980) (“Whether the public has a right to attend trials of civil cases is a question not raised by this case, but we note that historically both civil and criminal trials have been presumptively open.”); *Press-Enterprise Co. v. Superior Court*, 478 U.S. 1 (1986); *Press-Enterprise v. Superior Court*, 464 U.S. 501 (1984); and *Globe Newspaper Co. v. Superior Court*, 457 U.S. 596 (1982). See also *Gannett Co. v. DePasquale*, 443 U.S. 368 (1979) (“The experience in the American Colonies was analogous. From the beginning, the norm was open trials.... If the existence of a common-law rule were the test for whether there is a Sixth Amendment public right to a public trial, therefore, there would be such a right in civil as well as criminal cases.... Indeed, many of the advantages of public criminal trials are equally applicable in the civil trial context.”). See also Jeanne L. Nowaczewski, “The First Amendment Right of Access to Civil Trials after *Globe Newspaper Co. v. Superior Court*,” *University of Chicago Law Review*, Vol. 51, No. 1 (1984), pp. 286–314, <http://chicagounbound.uchicago.edu/uclrev/vol51/iss1/10> (accessed December 9, 2016).
92. 137 Mass. 392 (1884), <http://masscases.com/cases/sjc/137/137mass392.html> (accessed December 9, 2016).
93. Financial Industry Regulatory Authority, BrokerCheck, <http://brokercheck.finra.org/> (accessed December 9, 2016).
94. Qureshi and Sokobin, “Do Investors Have Valuable Information About Brokers?” *Working Paper*, p. 4. The nature of this unreported information is not entirely clear.
95. A mere complaint where there is no finding of wrong-doing, no award, no fine, or any adverse disciplinary action does not imply misconduct.
96. Financial Industry Regulatory Authority, “Dispute Resolution Statistics.”
97. Securities Industry and Financial Markets Association, “White Paper on Arbitration in the Securities Industry,” October 2007, http://www.sifma.org/uploadedfiles/societies/sifma_compliance_and_legal_society/whitepaperonarbitration-october2007.pdf (accessed December 9, 2016), and Barbara Black, “The Irony of Securities Arbitration Today: Why Do Brokerage Firms Need Judicial Protection?” *University of Cincinnati Law Review*, Vol. 72 (2003), <http://digitalcommons.pace.edu/lawfaculty/16> (accessed December 9, 2016).
98. The Tax Court was created in 1942 as the successor to the U.S. Board of Tax Appeals. Major changes were made in 1969. For a history of the Tax Court and a discussion of its constitutional status, see Harold Dubroff and Brant J. Hellwig, *The United States Tax Court, An Historical Analysis*, 2nd ed. (Washington, DC: Government Printing Office, 2014), https://www.ustaxcourt.gov/book/Dubroff_Hellwig.pdf (accessed December 9, 2016). See also 26 U.S. Code § 7441, and *Freytag v. Commissioner*, 501 U.S. 868 (1991).
99. United States Court of Federal Claims, “The People’s Court,” http://www.uscfc.uscourts.gov/sites/default/files/USCFC%20Court%20History%20Brochure_0.pdf#overlay-context=about-court (accessed December 9, 2016).
100. Edward J. Eberle, “Procedural Due Process: The Original Understanding,” *Constitutional Commentary*, Vol. 4 (1987), pp. 339–362 and 339, http://docs.rwu.edu/cgi/viewcontent.cgi?article=1057&context=law_fac_fs (accessed December 9, 2016).
101. *Joint Anti-Fascist Refugee Committee v. McGrath*, 341 U.S. 123, 171-172 (1951).
102. FINRA Rule 9212; FINRA Rule 12302; and FINRA Rule 13302.
103. FINRA Rule 9261; FINRA Rule 12602; and FINRA Rule 13602.
104. FINRA Rule 9265; FINRA Rule 12602; and FINRA Rule 13602.
105. This, of course, means that the date, time, and place of the proceeding must be made public. In addition, documents (notably pleadings) pertaining to the hearings should generally be made public as in court proceedings, perhaps using a database similar to the Public Access to Court Electronic Records (PACER), <https://www.pacer.gov/> (accessed December 9, 2016).
106. FINRA Rule 12604(a).
107. FINRA Rule 9141; FINRA Rule 12208; and FINRA Rule 13208.
108. See also Federal Rule of Civil Procedure 38.
109. Margaret L. Moses, “What the Jury Must Hear: The Supreme Court’s Evolving Seventh Amendment Jurisprudence,” *The George Washington Law Review*, Vol. 68 (2000), pp. 183–257, http://lawecommons.luc.edu/cgi/viewcontent.cgi?article=1301&context=fac_pubs (accessed December 9, 2016).
110. Financial Industry Regulatory Authority, “FINRA Arbitrators,” <http://www.finra.org/arbitration-and-mediation/finra-arbitrators> (accessed December 9, 2016).

111. Financial Industry Regulatory Authority, "Required Basic Arbitrator Training," <http://www.finra.org/arbitration-and-mediation/required-basic-arbitrator-training> (accessed December 9, 2016).
112. Financial Industry Regulatory Authority, "FINRA Arbitrators."
113. FINRA Rule 12403.
114. FINRA Notice 11-05, "Customer Option to Choose an All Public Arbitration Panel in All Cases," effective February 1, 2011, http://finra.complinet.com/en/display/display.html?bid=2403&element_id=9973 (accessed December 9, 2016).
115. By striking all of the non-public (industry) arbitrators during the arbitrator-selection process; see FINRA Rule 12403.
116. For disciplinary proceedings, see FINRA Rules 9251–9253; for customer disputes, see FINRA rules 12505–12512; and for intra-industry disputes, see FINRA Rules 13505–13512.
117. See Federal Rules of Civil Procedure 26–37.
118. See FINRA Rule 12510. Federal administrative law courts permit depositions; see 5 U.S. Code § 556(c)(4).
119. American Arbitration Association, "Consumer Arbitration Rules: R-22. Exchange of Information between the Parties," 2016, <https://www.adr.org/aaa/ShowProperty?nodeId=/UCM/ADRSTAGE2021425&revision=latestreleased> (accessed December 9, 2016).
120. Steven Shavell, "Alternative Dispute Resolution: An Economic Analysis," *The Journal of Legal Studies*, Vol. 24, No. 1 (1995), pp. 1–28; Christopher R. Drahozal and Samantha Zyontz, "An Empirical Study of AAA Consumer Arbitrations," *Ohio State Journal on Dispute Resolution*, Vol. 25, No. 4 (2010), pp. 843–930, https://kb.osu.edu/dspace/bitstream/handle/1811/76944/OSJDR_V25N4_0843.pdf?sequence=1 (accessed December 9, 2016); and Theodore J. St. Antoine, "Mandatory Arbitration: Why It's Better than It Looks," *University of Michigan Journal of Law Reform*, Vol. 41, No. 4 (2008), pp. 783–812, <http://repository.law.umich.edu/cgi/viewcontent.cgi?article=1466&context=articles> (accessed December 9, 2016).
121. United States Arbitration Act, Public Law 68–401, 43 Stat. 883, February 12, 1925, codified at 9 U.S. Code §§ 1-16.
122. *Shearson/American Express Inc. v. McMahon*, 482 U.S. 220, 107 S.Ct. 2332, 96 L.Ed.2d 185 (1987), and *AT&T Mobility LLC v. Concepcion*, 563 U.S. 333, 131 S. Ct. 1740, 179 L.Ed. 2d 742 (2011).
123. FINRA Rule 12514(d).
124. FINRA Rule 12904(g).
125. FINRA Rule 12904(g)(2).
126. In 2015, FINRA had 3,500 employees with compensation, including benefits, of \$688.7 million. This amounts to *average* compensation of \$196,771 per employee: *FINRA 2015 Year in Review and Annual Financial Report*, p. 20. FINRA's compensation for arbitrators, making the unrealistic assumption that they worked every work day with two weeks of vacation, amounts to the equivalent of \$150,000 annually (\$600 per day times 50 weeks times five days).
127. Financial Industry Regulatory Authority, "What to Expect: Honorarium," <http://www.finra.org/arbitration-and-mediation/what-expect-training-case-service-and-honorarium> (accessed December 9, 2016).
128. "Statutory Maximum Rates Under the Equal Access to Justice Act," Ninth Circuit Court of Appeals, http://www.ca9.uscourts.gov/content/view.php?pk_id=0000000039 (accessed December 9, 2016), and 28 U.S. Code § 2412 (d)(2)(A). The DC Circuit is \$190 per hour; see *Security Point Holdings, Inc. v. TSA*, September 2, 2016, p. 12, [https://www.cadc.uscourts.gov/internet/opinions.nsf/FEED2F100B567F3F85258022004E9F5F/\\$file/13-1068-1633546.pdf](https://www.cadc.uscourts.gov/internet/opinions.nsf/FEED2F100B567F3F85258022004E9F5F/$file/13-1068-1633546.pdf) (accessed December 9, 2016).
129. 5 U.S. Code § 557(c).
130. This is the threshold for a three-arbitrator panel under current FINRA rules. See FINRA Rule 12401.
131. FINRA Rule 9311.
132. Financial Industry Regulatory Authority, "National Adjudicatory Council," <http://www.finra.org/industry/nac> (accessed December 9, 2016).
133. Financial Industry Regulatory Authority, "NAC Committee Members," <http://www.finra.org/industry/nac-committee-members> (accessed December 9, 2016).
134. FINRA Rule 9351.
135. FINRA Rule 9370, and Securities Exchange Act section 19(d)(2).
136. "The SEC reviews sanctions imposed by the NASD to determine whether they 'impose any burden on competition not necessary or appropriate' or are 'excessive or oppressive.'" *Siegel v. SEC*, 592 F.3d 147, 155 (DC Cir. 2010) (quoting 15 U.S. Code § 78s(e)(2)). "This court reviews the SEC's conclusions regarding sanctions to determine whether those conclusions are arbitrary, capricious, or an abuse of discretion," *Saad v. SEC*, 718 F. 3d 904 (DC Cir. 2013).
137. FINRA Rule 12904(b), and FINRA Rule 13904(b).

138. Government Accountability Office, “Opportunities Exist to Improve SEC’s Oversight of the Financial Industry Regulatory Authority,” GAO-12-625, May 30, 2012, <http://www.gao.gov/products/GAO-12-625> (accessed December 9, 2016), and Government Accountability Office, “SEC Can Further Enhance Its Oversight Program of FINRA,” GAO-15-376, April 30, 2015, <http://www.gao.gov/products/GAO-15-376> (accessed December 9, 2016).
139. Wyatt, “Inside the National Exam Program in 2016”; Elizabeth Dilts, “SEC Says to Monitor Partner Regulator’s Brokerage Oversight,” Reuters, October 17, 2016, <http://www.cnbc.com/2016/10/17/reuters-america-sec-says-to-monitor-partner-regulators-brokerage-oversight.html> (accessed December 9, 2016); and “SEC Launches Dedicated FINRA Oversight Unit: Watching the Detectives,” *National Law Review*.
140. Municipal Securities Rulemaking Board, “About the MSRB,” <http://www.msrb.org/About-MSRB.aspx> (accessed December 9, 2016).
141. The National Futures Association, “Who We Are,” <http://www.nfa.futures.org/nfa-about-nfa/index.HTML> (accessed December 9, 2016).
142. See §8G(a)(2) of the Inspector General Act of 1978, https://www.law.cornell.edu/uscode/html/uscode05a/usc_sup_05_5_10_sq2.html (accessed December 9, 2016).
143. Council of the Inspectors General on Integrity and Efficiency, “The Inspectors General,” July 14, 2014, https://www.ignet.gov/sites/default/files/files/IG_Authorities_Paper_-_Final_6-11-14.pdf (accessed December 9, 2016). For the Inspectors General Act of 1978, as amended, see [https://www.ignet.gov/sites/default/files/files/igactsof1010\(1\).pdf](https://www.ignet.gov/sites/default/files/files/igactsof1010(1).pdf) (accessed December 9, 2016).
144. For years 2011 to 2016, see FINRA, Statistics, <http://www.finra.org/newsroom/statistics> (accessed December 9, 2016), and FINRA Annual Reports 2007–2010, <http://www.finra.org/about/annual-reports-financials> (accessed December 9, 2016). For the years 2008–2010, FINRA provides only approximate numbers.
145. Hester Peirce and Stephen Matteo Miller, “Small Banks by the Numbers, 2000–2014,” Mercatus Center, March 17, 2015, <https://www.mercatus.org/publication/small-banks-numbers-2000-2014> (accessed December 9, 2016); Hester Peirce, Ian Robinson, and Thomas Stratmann, “How Are Small Banks Faring Under Dodd–Frank?” Mercatus Center, February 27, 2014, <https://www.mercatus.org/publication/how-are-small-banks-faring-under-dodd-frank> (accessed December 9, 2016); and Roisin McCord, Edward Simpson Prescott, and Tim Sablik, “Explaining the Decline in the Number of Banks Since the Great Recession,” Federal Reserve Bank of Richmond, March 2015, https://www.richmondfed.org/-/media/richmondfedorg/publications/research/economic_brief/2015/pdf/eb_15-03.pdf (accessed December 9, 2016).
146. Peirce and Miller, “Small Banks by the Numbers, 2000–2014.”
147. Goldman Sachs CEO Lloyd Blankfein, for example, recently said: “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 positioning and relative returns.” See “Regulation Is Good for Goldman,” *The Wall Street Journal*, February 11, 2015, <http://www.wsj.com/articles/regulation-is-good-for-goldman-1423700859?KEYWORDS=Regulation+Is+Good+f+or+Goldman> (accessed December 9, 2016); Craig M. Lewis, “The Future of Capital Formation,” Chief Economist and Director of the Division of Economic and Risk Analysis, MIT Sloan School of Management’s Center for Finance and Policy’s Distinguished Speaker Series, April 15, 2014, <http://www.sec.gov/News/Speech/Detail/Speech/1370541497283#.VITmlsmwUOQ> (accessed December 9, 2016); Jeff Schwartz, “The Law and Economics of Scaled Equity Market Disclosure,” *Journal of Corporation Law*, Vol. 39 (2014); and C. Steven Bradford, “Transaction Exemptions in the Securities Act of 1933: An Economic Analysis,” *Emory Law Journal*, Vol. 45 (1996), pp. 591–671, <http://digitalcommons.unl.edu/cgi/viewcontent.cgi?article=1088&context=lawfacpub> (accessed December 9, 2016). See also Securities and Exchange Commission, “Economic Analysis, Proposed Rule Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act,” *Federal Register*, Vol. 79, No. 15 (January 23, 2014), pp. 3972–3993 [Release Nos. 33-9497, 34-71120, and 39-2493; File No. S7-11-13], <http://www.gpo.gov/fdsys/pkg/FR-2014-01-23/pdf/2013-30508.pdf> (accessed December 9, 2016).
148. 5 U.S. Code § 603.
149. For a discussion of these issues, see Barbara Black, “Punishing Bad Brokers: Self-Regulation and FINRA Sanctions,” *The Brooklyn Journal of Corporate, Financial & Commercial Law*, Vol 8 (2013), pp. 23–55, http://scholarship.law.uc.edu/cgi/viewcontent.cgi?article=1221&context=fac_pubs (accessed December 9, 2016).
150. Regulatory revenues (\$445 million); user revenues (\$218 million); and contract services revenues (\$126 million) in FY 2015 for a total of \$789 million (excluding fines, dispute resolution, and other revenues). See *FINRA 2015 Year in Review and Annual Financial Report*, p. 19.
151. As with any tax, barring extreme assumptions about elasticities, the incidence of the tax is borne partially by shareholders and partially by consumers (and potentially by employees).
152. *FINRA 2008 Year in Review and Annual Financial Report: Reforming Regulation to Better Protect Investors*, p. 10, <http://www.finra.org/sites/default/files/Corporate/p119061.pdf> (accessed December 9, 2016).

153. The figures in the previous sentence divided by the number of members in Table 8-2 (3,957 in 2015 and 4,900 in 2008).
154. Financial Industry Regulatory Authority, "Fines Policy," <http://www.finra.org/industry/fines-policy> (accessed December 9, 2016).
155. *FINRA 2015 Year in Review and Annual Financial Report*, p. 3.
156. Such a fund would reimburse consumers when sufficient funds cannot be recovered from the firm or individual committing the misconduct.
157. Kevin R. Kosar, "The Quasi Government: Hybrid Organizations with Both Government and Private Sector Legal Characteristics," Congressional Research Service, June 22, 2011, <https://www.fas.org/sgp/crs/misc/RL30533.pdf> (accessed December 9, 2016).
158. See appendix of *Budget of the U.S. Government, FY 2017*.
159. *Ibid.*
160. Financial Industry Regulatory Authority, "Requests for Comments," <http://www.finra.org/industry/requests-comments> (accessed December 9, 2016).
161. See §19(b) of the Securities Exchange Act.
162. It is the understanding of the author that the SEC staff has a major role in formulating FINRA rules and informally reviews proposed rules before they are formally submitted to the SEC.
163. 5 U.S. Code § 553.
164. Financial Industry Regulatory Authority, "Office of the Chief Economist," <http://www.finra.org/industry/chief-economist> (accessed December 9, 2016); Financial Industry Regulatory Authority, "Framework Regarding FINRA's Approach to Economic Impact Assessment for Proposed Rulemaking," September 2013, http://www.finra.org/sites/default/files/Economic%20Impact%20Assessment_0_0.pdf (accessed December 9, 2016); RSFI and OGC, "Current Guidance on Economic Analysis in SEC Rulemakings," *Memorandum*, March 16, 2012, https://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf (accessed December 9, 2016); Executive Order 12866; and Office of Management and Budget Circular A-4.
165. This is analogous to Small Business Regulatory Enforcement Fairness Act (SBREFA) requirements that amended the Regulatory Flexibility Act, 5 U.S. Code §§ 601 et seq. See also Executive Order 13272.

PART III

Regulatory Agency Structure Reforms

CHAPTER 9:

Reforming the Financial Regulators

Mark A. Calabria, PhD, Norbert J. Michel, PhD,
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Bank regulation is often based on the idea that banks are special because bank failures might lead to widespread economic damage due to the role of banks in the U.S. payments system. Under this theory, strict regulation—and, if this regulation fails—government backstops, are warranted. Since the 2007–2009 financial crisis, this regulatory approach has bled from banks to other types of financial firms, such as broker-dealers, insurance companies, and asset managers. Historically, these non-bank financial firms have not been painted with the same regulatory brush as banks, but the crisis marks a clear shift from the “banks are special” doctrine to the “all financial institutions are special” doctrine.

Proponents of the shift worry that failures of these non-banks would lead to the same economy-wide problems they fear from bank failure. According to this perspective, dividing regulatory authority among different agencies that take different regulatory approaches weakens regulation, invites arbitrage, and prevents any single regulator from having a clear picture of the overall financial system. Though the U.S. financial regulatory structure needs reform, a single “super” regulator with a banking mindset and a ready safety net would not improve economic outcomes.

During its post-crisis negotiations, Congress considered creating a consolidated financial regulator.¹ The ultimate product of those discussions—the Dodd–Frank Wall Street Reform and Consumer Protection Act²—did not on its face include such a super regulator. Nevertheless, Dodd–Frank, as it

has taken shape during its first half-decade, is moving the financial system toward uniform regulation. If this trend continues, the system may well end up under the de facto control of a super regulator: the Board of Governors of the Federal Reserve.

The move toward more uniform financial regulation is occurring in a number of ways. First, Dodd–Frank increased the scope of the Federal Reserve’s authority to include new powers, such as an explicit systemic-risk mandate, and new supervised entities, such as savings-and-loan holding companies, securities holding companies, and systemically important financial institutions (SIFIs).³ For example, as of May 2016, the Federal Reserve had supervisory authority over approximately 25 percent (based on total assets) of the insurance industry.⁴

The Federal Reserve is also active in international regulatory efforts to identify and

establish regulatory standards for SIFIs.⁵ Domestic regulators face substantial pressure to follow the international consensus regarding the regulation of individual companies and industry sectors.⁶ Additionally, the Financial Stability Oversight Council (FSOC)—in which federal banking regulators play an outsized role—has authority to override the decisions of individual regulators, even independent regulatory agencies.⁷ Finally, the Federal Reserve has been actively advocating changes outside its normal regulatory sphere.⁸

This chapter argues that regulatory homogenization threatens to impair the effective functioning of the financial system. Regulatory reform is needed, but should be rooted in a recognition that financial market participants and their regulators respond to incentives in the same way that participants in other markets do. This chapter lays out several structural, procedural, and policy reforms that would produce more effective financial regulation by making financial market participants, including regulators, more accountable for their actions.

LAYING THE PROPER GROUNDWORK FOR FINANCIAL REGULATION

Before identifying regulatory solutions, policymakers need to consider regulatory justifications. Which problems are regulations supposed to solve? Policymakers can only design appropriate solutions after clearly answering this question. It is not enough simply to point to the potential for a financial crisis to justify a particular regulation. Likewise, a stated desire to maintain financial stability is not sufficient because nobody knows what the term means, let alone how to measure it.⁹ Rather, policymakers must understand the particular problems they are trying to solve before they can design effective solutions.

Common Justifications for Financial Regulation. Policymakers and regulatory advocates have identified several problems they believe financial regulation can and should address. These include threats to

macroeconomic stability, consumer harm, and potential drains on taxpayer resources. Proponents argue that government regulation is the most effective way to keep all of these problems in check.

Coloring the assessment of problems and solutions is a belief that the financial industry is different from other industries. The idea that financial firms require stringent regulations because they are different from nonfinancial companies used to be confined to the banking sector.¹⁰ As the relative share of bank financing has declined, however, policymakers have extended this aura of exceptionality to virtually all forms of non-bank financing.¹¹ Policymakers, in the name of global macroeconomic stability, also have increasingly embraced a homogenous, complex regulatory framework for the whole financial system. The approach ignores industry distinctions and national boundaries in favor of a uniform, bank-regulatory approach.

The financial system is central to the functioning of the rest of the economy, so policymakers' concern for financial stability is not surprising. Financial firms facilitate commerce among nonfinancial firms, so failures in the financial sector could impede business activity at nonfinancial companies. Main Street is interconnected with Wall Street, and problems in the financial sector can give rise to problems in the rest of the economy. Non-financial companies, consumers, and investors all may suffer if one or more large financial firms fail. However, the very same reasoning could be used to justify heavy regulation of nonfinancial firms, which are also deeply interconnected with one another. To see this, one need only imagine the failure of a large company, such as Walmart, and the grave consequences for its millions of customers, employees, and suppliers.

In addition to financial stability, policymakers cite consumer and investor protection as a justification for an increasingly intensive financial regulatory system. Traditionally, regulators have sought to protect consumers from fraud, but consumer protection has

expanded to include averting financial loss, constraining consumers' choices for their own good, or—even more expansively—maintaining confidence in the financial sector.¹² The consumer confidence justification complements the goal of ensuring macroeconomic stability.¹³ If consumers and investors lack confidence in the financial system, so the theory goes, the system will crumble and carry down the rest of the economy with it. Together, the macroeconomic stability and consumer protection justifications undergird calls for an expanded financial regulatory framework.

Another reason policymakers call for expanding bank-like regulation to non-banks is the need to protect the integrity of governmental financial guarantees. These guarantees are claimed to protect consumers and ensure financial stability. Both the federal and state governments provide taxpayer-backed guarantees. The main federal guarantee for the financial system is federally backed deposit insurance through the Federal Deposit Insurance Corporation (FDIC). The FDIC collects premiums from banks to establish the Deposit Insurance Fund (DIF), but the U.S. Treasury is obligated to cover any shortfall when the DIF is insufficient to cover depositors' losses. As the 2007–2009 financial crisis illustrated, the federal government also may create special programs to assist banks and other financial firms during times of stress.¹⁴ States maintain industry-funded, but ultimately taxpayer-backed, guaranty funds that provide financial protection to insurance policyholders in the event an insurance company becomes insolvent.¹⁵ Thus, governments justify imposing strict capital and other regulations on the grounds that doing so protects taxpayers.¹⁶

On the surface it makes sense to protect taxpayers in this manner. However, the evidence shows that extensive regulation has not actually worked as intended,¹⁷ and that implementing government-backed insurance schemes has likely done more harm than good. In particular, countries with more government involvement in a deposit insurance

system, and with higher levels of deposit insurance coverage, tend to have more bank failures and financial crises.¹⁸

One problem with this type of government-backed insurance is that it gives deposit holders and investors an incentive to stop carefully monitoring the risks firms are taking. This problem magnifies what is known as moral hazard, whereby government backing gives managers the incentive to take on more risk than they would without a taxpayer backstop.¹⁹ Therefore, while it seems laudable to protect taxpayers from potential losses through the DIF, an alternative to government-backed guarantees and government-imposed regulation could more readily accomplish that goal.

The moral hazard created by government guarantees can be in itself a justification for prudential regulation. Such regulation, however, is only justified when it reduces risk, whereas some regulations, like the Community Reinvestment Act, push banks to take more risks, not fewer. In many cases, the actual justification for financial regulation is not safety and soundness or the greater public interest, but the redistribution of income via the financial system. Financial regulation can also have fiscal goals, as illustrated by the favoring of sovereign debt in most regulatory schemes.

A MARKET-BASED APPROACH TO FINANCIAL REGULATION

The goals of maintaining macroeconomic stability, protecting consumers, and exercising good stewardship over taxpayer resources provide policymakers broad cover to micromanage the financial system. Almost any regulatory intervention can hide under the shadow of one of these broad and superficially appealing themes. More precise identification of the problems at issue leads to a narrower, more tailored, and more realistic regulatory framework and leaves room for private-market-based solutions.

Financial regulation should establish the framework within which financial institutions survive and thrive based on their

ability to serve consumers, investors, and Main Street companies. Financial regulators have historically punished fraud and encouraged sound disclosure, but did not micro-manage decision making. Such an approach runs counter to the current macroprudential trend in regulation, which places governmental regulators—with their purportedly greater understanding of the financial system—at the top of the decision-making chain.

Experience clearly shows that the government may not be the best regulator of financial markets. The financial crisis of 2007–2009 occurred despite—and perhaps partly because of—heavy regulation.²⁰ Government regulations can be gamed and sometimes create incentives for companies to take actions that make them less resilient. The competitive process that is a natural part of a free enterprise system is an alternative, and often more effective, way to regulate markets. Firms have to figure out how to provide products and services at prices that customers are willing and able to pay. If, for instance, bank customers value deposit insurance, firms will provide it at a price that reflects its cost. The firms that provide the insurance will monitor the insured banks. The government, by contrast, assumes that all depositors want deposit insurance, does not charge economically appropriate rates, and does not monitor banks as closely as a private insurer with money on the line would do.

Ultimately, if private firms cannot provide such insurance, consumers do not value it. To provide more market discipline and move toward such a system, Congress can lower the amount of FDIC deposit insurance coverage to (at least) the pre-Dodd-Frank limit of \$100,000 per account.²¹ Even lowering the value to the pre-1980 limit of \$40,000 per account would insure a level (based on 2014 data) nearly 10 times the average transaction-account balance of approximately \$4,000.²² The same market principles apply to the extensive set of government-imposed regulations that determine banks' capital position.

Under the current system, financial firms must conduct their business and adhere to various capital and liquidity ratios based on regulators' subjective risk assessments. These rules impose needlessly complex requirements, and there is no reason to expect regulators to make better risk assessments than the market participants who stand to increase or lose their investments.²³ Rather than forcing banks and other financial firms to adhere to arbitrary standards set by regulatory fiat, policymakers should introduce more market discipline into the system so that, ultimately, market participants can impose their own capital rules. While allowing market participants to determine the appropriate equity levels for funding still fails to *guarantee* a stable banking system and macroeconomy, evidence clearly shows that allowing regulators to set statutory capital requirements fails as well.²⁴

What is more, both theory and evidence suggest that the banking system will perform better when banks' capital suppliers face more market discipline.²⁵ A common empirical finding is that companies that use more debt generally have to pay higher costs in order to borrow. This constrains both their ability to borrow and to grow. The exception to this finding is financial institutions that are backed by government. That backing pushes out the private monitoring of financial leverage, resulting in greater instability. The guarantee business of Fannie Mae and Freddie Mac was leveraged at more than 200 to 1.²⁶ Such massive leverage would never occur in the absence of government guarantees.

Government simply cannot impose financial stability on the economy, and any such macro-stability objectives are best achieved through a competitive market process.²⁷ Unlike government regulation, this process provides incentives for firms to monitor themselves, their counterparties, their competitors, and market conditions to prepare for adverse events. Markets function best when this competitive process is allowed to work, and it requires that the government allow the weakest, poorest-run firms to fail. These are

the companies that do not serve their customers well, and preventing their failure works against macroeconomic stability because it prevents the migration of resources to people and companies who are better able to put them to good use.

The overall failure of government rules and regulation to create a sound system is partly due to an insurmountable knowledge problem.²⁸ In particular, no group of experts can know precisely how to prevent future events that are themselves uncertain. Market participants cannot accomplish this task either, but the competitive process forces those with the most to lose to use their judgment. At best, government rules that profess to guarantee financial market safety create a false sense of security. Worse, over time, these rules have a tendency to increase in volume and complexity, thus protecting incumbent firms from new competitors. This outcome hinders innovation, tends to raise prices, and prevents people from learning the best ways to employ resources.

Government can play a role in protecting consumers, investors, and policyholders, particularly in mitigating and punishing fraudulent behavior. However, competitive markets have the most important role to play here. The competitive market process can, for example, help to root out fraudulent actors through monitoring and short-selling. In fact, one recent study found that short sellers “are proficient at identifying financial misrepresentation before the general investing public,” and that, even net of their profits, short sellers “generate external benefits for uninformed investors.”²⁹ Furthermore, the competitive process is likely the best way to generate effective consumer and investor-tailored disclosures. Any reforms to the U.S. financial regulatory framework should recognize that effective regulation—regulation that rigorously and relentlessly ferrets out and punishes bad behavior—is more likely to come from markets than from government.

Misleading and fraudulent behavior for all products and services—including financial

products and services—are prohibited by both state and federal law. Furthermore, while government-mandated disclosures aimed at mitigating fraud and misrepresentation are one type of regulation, they are properly viewed as distinct from regulations that dictate, for instance, the type and amount of capital that financial firms may use. Even disclosure-based regulations can be used to indirectly shape market behavior rather than to ensure that consumers and investors have the information they need to make decisions.

Market-based regulatory solutions can be more tailored, more flexible, and more effective than government mandates. Thus, as problems arise in the markets, policymakers should look for market-based solutions. Such solutions may be easier to implement if, as discussed in the next section, reforms are made to the financial regulatory structure and its degree of accountability to the American people.

THE ELUSIVE OPTIMAL FINANCIAL REGULATORY STRUCTURE

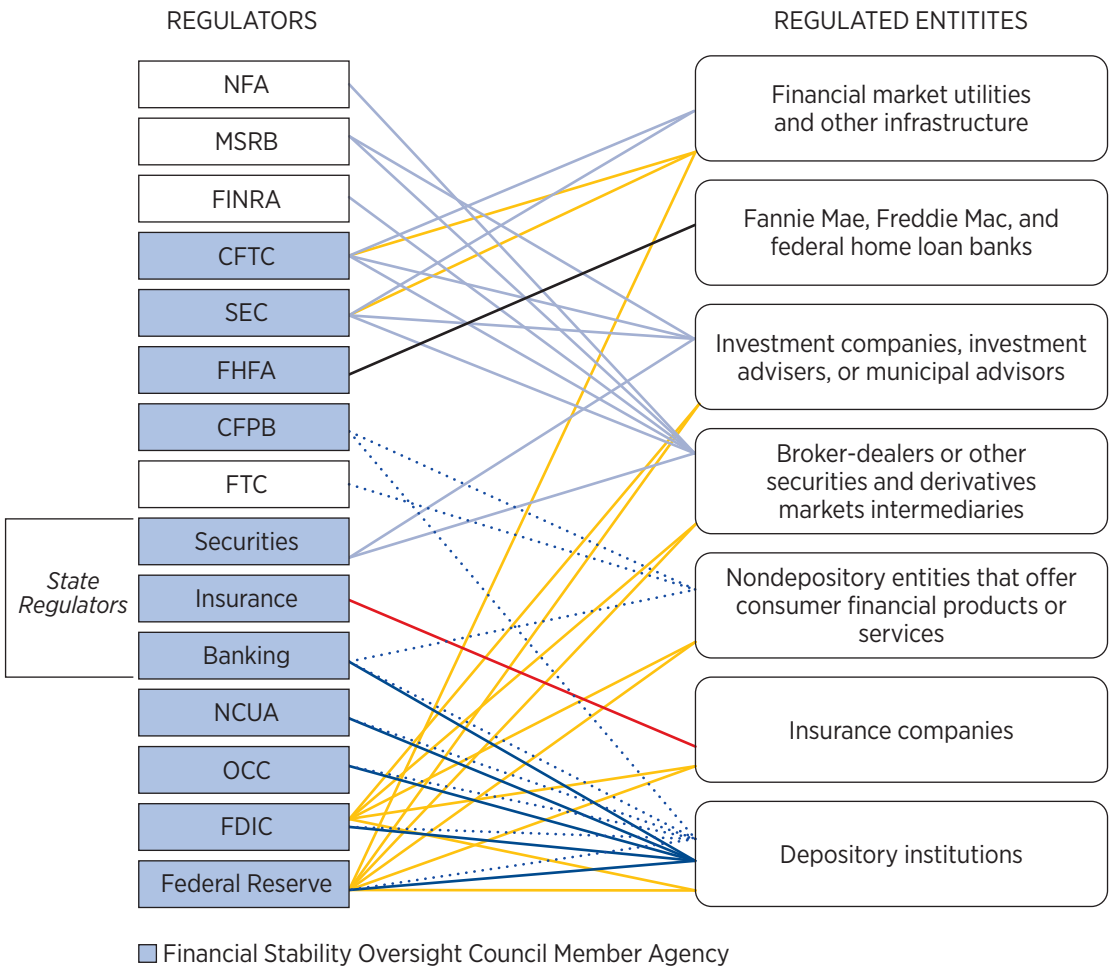
There is no perfect structure for the financial regulatory system, but design affects how well regulation is carried out, so regulatory re-designers should proceed with care. The quest for the holy grail of regulatory structure has resulted in periodic reconsideration of optimal regulatory structure in the United States and abroad, and some countries have consolidated many regulatory functions into a single financial regulator.³⁰ Others have embraced functional regulation. The fact that countries have modified their approaches over time reflects the universal difficulty of this exercise.³¹ We argue against a super-regulator, but recommend some areas in which consolidation could generate improved financial regulation. We do not undertake to prescribe the precise form the U.S. regulatory structure should take, but rather to suggest broad outlines.

AVOIDING A SUPER-REGULATOR

The blatant inefficiency and complexity of our regulatory system has prompted multiple

FIGURE 9-1

U.S. Financial Regulatory Structure, 2016



REGULATED ENTITIES

- Safety and soundness oversight
- Consumer financial protection oversight
- Securities and derivatives markets oversight
- Insurance oversight
- Housing finance oversight
- Consolidated supervision or systematic risk-related oversight

- CFPB Consumer Financial Protection Bureau
- CFTC Commodity Futures Trading Commission
- FDIC Federal Deposit Insurance Corporation
- FHFA Federal Housing Finance Agency
- FINRA Federal Industry Regulatory Authority
- FTC Federal Trade Commission
- MSRB Municipal Securities Rulemaking Board
- NCUA National Credit Union Administration
- NFA National Futures Association
- OCC Office of the Comptroller of the Currency
- SEC Securities and Exchange Commission

SOURCE: U.S. Government Accountability Office, “Complex and Fragmented Structure Could Be Streamlined to Improve Effectiveness,” February 2016, p. 12, Figure 2, <http://www.gao.gov/assets/680/675400.pdf> (accessed December 7, 2016).

efforts toward consolidation. For example, as the recent financial crisis was breaking out, the Department of Treasury issued a regulatory reform blueprint that posited an “optimal” regulatory structure as comprising three regulators—responsible respectively for “market stability regulation, safety and soundness regulation associated with government guarantees, and business conduct regulation.”³² This so-called objectives-based approach is attractive in its potential to eliminate regulatory arbitrage, but it also could aggravate the current tendency of bank regulation to seep into capital markets regulation. In other words, such a re-organization could further open the door for the banks-are-special doctrine to expand into the all-financial-institutions-are-special doctrine. After the financial crisis, Treasury issued another report, this time calling for a less-streamlined regulatory approach.³³ Under the latter approach, Treasury called for one national bank supervisor, a new consumer regulator, expanded powers for the Federal Reserve, and a new systemic risk council.³⁴ At the time, Congress also contemplated big changes, such as the merger of the SEC and Commodity Futures Trading Commission (CFTC),³⁵ and the creation of a super-regulator.³⁶

The attempts to consolidate regulators ran into political roadblocks and were dropped in favor of Dodd–Frank’s more politically palatable, but complex, regulatory structure. Nevertheless, Dodd–Frank implemented major changes—most notably the elimination of the Office of Thrift Supervision³⁷ and addition of the Consumer Financial Protection Bureau (CFPB), the FSOC, and the Office of Financial Research (OFR). Naturally, the fact that a large number of regulators remain continues to draw recommendations to consolidate. For example, the Government Accountability Office (GAO) recently issued a comprehensive look at financial regulation completed after the Dodd–Frank Act, and titled the report “Financial Regulation: Complex and Fragmented Structure Could Be Streamlined to Improve Effectiveness.”³⁸ The

report explored many ways in which the post-Dodd–Frank regulatory framework results in duplicative and inconsistent regulation. The dizzying array of financial regulators makes attractive the prospect of a super-regulator or—as the Treasury plans recommended—a much smaller set of financial regulators with expanded jurisdiction.

Regulatory diversity, even if not the most efficient approach, however, has certain advantages. First, it allows regulators to specialize in particular types of institutions.³⁹ Second, it allows regulatory experimentation and competition.⁴⁰ Third, it helps to highlight an error that one regulator is making. Regulators’ decisions can be measured in the context of other regulators’ approaches to similar issues. Fourth, if a regulator does make an error, only the subset of entities it regulates will be directly affected. Fifth, maintaining distinct capital markets and banking regulators provides speed bumps to banking regulators’ efforts to apply bank-like regulation more broadly.⁴¹

In short, one of the advantages of the current system is that regulators can be measured against one another, and their mistakes are bounded by the limits of their jurisdiction.⁴² Competition among regulators can also reduce the possibility that regulators choose the “quiet life” of not raising too many objections about the entities they regulate.⁴³ One of the reasons why the failings of supervision at the Office of Thrift Supervision (OTS) have been so well publicized is the parallel oversight by the FDIC. The material-loss reviews independently conducted by the Inspector General of the Treasury Department have also helped to expose regulatory failings.⁴⁴ Such reviews should be expanded to cover broader issues of regulatory performance.

One argument for consolidating regulators is to avoid “charter-shopping” or a “race to the bottom” among regulators.⁴⁵ This argument, however, assumes a degree of competition between financial regulators that is at odds with the existing regulatory system. Many of the institutions at the heart of the crisis, such as the government-sponsored enterprises

Fannie Mae and Freddie Mac, had no ability to choose their regulator. While banks and thrifts had some ability to shift their charters, such was only a choice between federal and state or between the Office of the Comptroller of the Currency (OCC) and the OTS.

Contrary to the charter-shopping argument is that, during the recent financial crisis, banks failed at roughly similar rates across the various bank regulators.⁴⁶ Despite its many well-documented failings, the OTS was not an outlier. Furthermore, as professors Henry Butler and Jonathan Macey have so aptly observed, competition among banking regulators is largely a myth.⁴⁷ In surveying the literature of state corporate governance and banking laws, one recent article found that such competition did not generally lead to a “race to the bottom” but rather a sorting into alternative regulatory systems.⁴⁸ While the extent of competition between bank regulators can certainly be debated, the fact remains that state bank regulators may not face the full costs of their decisions, given that banks they charter are ultimately backed by the federal government.⁴⁹

STREAMLINING REGULATION

Although full regulatory consolidation could harm financial markets, some streamlining is important. The existing regulatory structure embodies certain inefficiencies and redundancies. Regulators coordinate, but “this coordination requires considerable effort that, in a more efficient system, could be directed toward other activities.”⁵⁰ The following discussion offers some examples of areas in which regulatory consolidation could make financial regulation more effective at achieving its goals and less costly for regulated companies—and ultimately their consumers and investors.

Removing the Federal Reserve’s Regulatory and Supervisory Powers. As the United States central bank, the Federal Reserve’s primary roles are in the monetary policy arena. Specifically, the Federal Reserve Act directs the central bank to “maintain long

run growth of the monetary and credit aggregates commensurate with the economy’s long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices and moderate long-term interest rates.”⁵¹ The Federal Reserve has struggled to fulfill these macroeconomic responsibilities, and its supplementary regulatory and supervisory responsibilities—particularly as they have expanded since the financial crisis⁵²—are simply unnecessary for conducting monetary policy.

First, these responsibilities take the time of the Federal Reserve Board of Governors and staff. The Federal Reserve has been actively engaged in regulation and supervision in the post-crisis years. Second, the chairman of the Federal Reserve is typically chosen for her monetary policy expertise. Expecting the chair to also master a massive regulatory and supervisory portfolio is unreasonable. Dodd-Frank, in conjunction with increasing the responsibilities it placed on the Federal Reserve, established a new, Senate-confirmed position—Vice Chairman for Supervision.⁵³ This as-yet-unfilled position is to be filled by one of the Federal Reserve Governors, whose ability to focus on monetary policy would therefore be attenuated. Third, allowing the same entity to exercise regulatory and monetary functions gives rise to unnecessary and potentially dangerous conflicts of interest. A central bank that is also a regulator and supervisor could be tempted to use monetary policy to compensate for mistakes on the regulatory side, and financial stability concerns could sometimes lead to regulatory forbearance.

Fourth, as discussed earlier, the larger the Fed’s regulatory role, the greater the magnitude of the effects of its policy mistakes. These mistakes will reverberate across the full range of financial institutions, rather than be limited to banks and bank holding companies. Fifth, the Federal Reserve’s responsibilities overlap with those of other financial regulators.⁵⁴ The overlap results in inconsistencies and duplicative efforts by both regulators and regulated entities.⁵⁵ Efforts at inducing

coordination, including the Federal Financial Institutions Examination Council (FFIEC)⁵⁶ and the FSOC’s mandate to encourage cooperation among regulators, have not addressed this problem adequately. Removing the Federal Reserve’s regulatory and supervisory powers would allow it to focus on monetary policy. The Federal Reserve’s regulatory and supervisory responsibilities could be shifted to either the OCC or the FDIC.

Repurposing the FSOC and Eliminating the OFR. The missions of two of the new agencies created by Dodd–Frank—the Financial Stability Oversight Council and the Office of Financial Research—do not contribute to the efficacy and efficiency of the financial regulatory system. Dodd–Frank’s framers ambitiously envisioned that the FSOC and OFR would work together to identify systemic risks and prevent them from harming the economy. The FSOC, a more powerful version of the President’s Working Group (PWG) on Financial Markets,⁵⁷ was a natural result of concerns of poor regulatory coordination leading up to the crisis. The new entity, however, unlike its predecessor, was given regulatory functions. Its key functions include identifying systemically important financial institutions,⁵⁸ identifying systemically important financial market utilities and activities,⁵⁹ and making recommendations to other financial regulators.⁶⁰ Identifying individual firms that pose a systemic risk is a futile mission that serves mostly to strengthen bailout expectations.⁶¹ Furthermore, its power to make regulatory recommendations makes other regulators accountable to the FSOC rather than to the President, Congress, or the public.

A more useful mission would look more like that of the PWG—bringing regulators (albeit not exclusively agency heads) together to discuss issues that cut across their jurisdictions. The regulators could share concerns with one another, identify financial market trends, and play a valuable role in discussing ways in which regulators’ actions are complementary or conflicting. A more collegial mission would avoid some of the problems that

the FSOC has exhibited to date, such as imposing a bank-centric view, an undue deference to foreign regulators, and a tendency to perpetuate too-big-to-fail expectations.⁶²

The OFR, although rarely the subject of much public attention, has the potential to impose substantial pecuniary and privacy costs on the financial industry and the American public without clear benefits.⁶³ The OFR director has the authority to collect (including by subpoena) data from financial companies and has broad power to share that information with the industry.⁶⁴ Regulated financial firms cannot hide data from their primary regulators, so it was unnecessary to create a new government agency for such a narrow regulatory purpose. Creating a new agency, such as the OFR, with broad powers and very little accountability, was entirely unwarranted. While some have suggested refocusing the OFR so that it that could assess “the impact of regulation on economic growth as well as the impacts of the financial system and financial regulation on consumers and businesses,”⁶⁵ all existing financial regulators—in addition to the Congressional Budget Office and the Office of Management and Budget—can already conduct such assessments.

If the PWG was ineffective, thus necessitating a new agency created via legislation, Congress should formally ask the President to rescind the executive order that created the PWG. Then, Congress should eliminate the OFR, and also restructure the FSOC so that it is nothing more than a regulatory council for sharing information. In particular, Congress should reorient the FSOC so that its only responsibility is to provide a mechanism for financial regulators to formally share information.⁶⁶ Because these agencies are charged with broad powers to maintain financial stability, the FSOC and the OFR have the perverse effect of lessening market discipline, which runs directly counter to their stated purposes.⁶⁷

Consideration of an SEC–CFTC Merger. The SEC and CFTC regulate markets that have increasingly blurred into one another over the years. Yet the two agencies have

approached their regulatory responsibilities in different and sometimes conflicting ways, causing market participants to struggle to navigate the resulting regulatory morass.⁶⁸ There is a theoretical case for allowing the two regulators, which historically have taken very different regulatory approaches,⁶⁹ to exist side-by-side. If one regulator's approach is flawed, for instance, regulated entities may be able to migrate to the markets in the other regulator's purview. In practice, however, the bifurcated responsibility has resulted in tense regulatory battles and duplicative effort by regulators and market participants.

Periodic attempts to address the problem have helped calm some of the interagency fighting, but the agencies' closely related mandates promise continued discord.⁷⁰ For example, the Shad-Johnson Jurisdictional Accord of the early 1980s brought a measure of peace, but jurisdictional disputes continued. Dodd-Frank, which awkwardly split regulatory responsibility for the over-the-counter derivatives market between the two agencies, only compounded the problem with overlapping authorities.⁷¹ The CFTC, although built on the hedging of agricultural commodities, now is primarily a financial markets regulator. The markets it regulates are closely tied—through common participants and common purposes—with SEC-regulated markets. The U.S. is unusual in having separate regulators for these markets.

A merged SEC and CFTC might be better able to take a holistic view of the capital and risk-transfer markets. A single regulator could conserve resources in overseeing entities that are currently subject to oversight by both the SEC and CFTC. In addition, a unified regulator would eliminate discrepancies in the regulatory approaches that can frustrate good-faith attempts by firms to comply with the law. Cultural differences between the agencies could initially make such a merger messy,⁷² but serious consideration of a merger of the two entities is long overdue.⁷³ In order to facilitate such a merger, Congress could consider creating a joint committee,

composed of members from both the agriculture and banking committees, to oversee the new merged agency.

Transferring Department of Labor Investment Regulatory Authority to the SEC. Although not included in a typical list of financial regulators, the Department of Labor plays an increasingly important role in financial regulation. Specifically, under the Employee Retirement Income Security Act of 1974 (ERISA),⁷⁴ the Labor Department regulates private pension plans; the department also has some regulatory authority over individual retirement accounts (IRAs).⁷⁵ The Labor Department regulates interactions of financial professionals with these tax-advantaged plans and the retail investors that rely on them to save for their retirement.

The Labor Department's financial regulatory role has recently attracted particular attention in connection with a controversial rule-making related to financial professionals working with retail retirement investors.⁷⁶ The rule-making changes the way broker-dealers and other financial firms interact with clients, the way financial firms are compensated, the disclosures these firms must make, the records they must keep, and the liability they face.⁷⁷ It also may change the availability and cost of financial services.

The breadth of the rule and the novelty of the standards it applies mean that it will govern much of the retail financial services industry. Because of the importance of ERISA plans and IRAs, the changes made in this context will spill over into other contexts and likely overshadow any potential future rule-making by the SEC regarding a broker-dealer's standard of care. The Labor Department's rule-making occupies a space—retail investors' interactions with their financial professionals—that more naturally belongs to the SEC, and the Labor Department's rules may conflict with SEC rule-making. Given the SEC's greater experience in regulating broker-dealers and investment advisers, Congress should shift responsibility for regulating the relationship between pension

plan and IRA investors and their fiduciaries to the SEC.

Reconsidering the Nature of Self-Regulation. Self-regulatory organizations (SROs) are a key set of players in the U.S. financial regulatory landscape. These organizations include securities and futures exchanges, the Financial Industry Regulatory Authority (FINRA), the National Futures Association, and the Municipal Securities Rulemaking Board (MSRB).⁷⁸ These entities are rooted in the notion that market participants have an incentive to self-regulate to maintain the integrity of the markets and customer trust. If members of an industry collectively set and enforce strong standards, investors will have the necessary confidence to participate in markets. For example, a stock exchange regulates its listed companies to make those companies and hence its marketplace more attractive to investors.⁷⁹ FINRA (like its predecessor entity, the National Association of Securities Dealers) regulates brokerage firms and their employees to ensure that customers are comfortable trusting them with their money.

Over time, self-regulation has changed. These self-regulators have begun to look more governmental, and the industry's tether on the governance of these organizations has loosened.⁸⁰ In large part, this change is due to a tendency by regulators to formally delegate responsibilities to these private organizations. The change is also driven by a fear that, left to themselves, industry members will be too lenient. History shows, however, that self-regulation in its more traditional form can work well.

Financial firms rely heavily on reputation, so they have an incentive to maintain strong standards to ensure that customers feel comfortable dealing with them. That incentive would be particularly strong if there are competing SROs that market themselves on the quality of the standards they maintain. Competition among SROs obviates the need for the government to micromanage the approaches that SROs take. SROs can experiment with different approaches, and customers can

choose the SRO that establishes the level and nature of regulation they prefer.

Allowing Federal Pre-Emption and State Reciprocity. The financial services marketplace is increasingly national, but much of the regulatory structure is still state based. A state-based approach can work for products and services that are offered locally. It can also work for national markets, as it does in the corporate chartering space, where companies choose their state of incorporation and that state's laws govern the company's relationships with its shareholders wherever they reside.⁸¹ In much of financial regulation, however, the model is more complicated—a company must satisfy the laws of every state in which it operates. The Internet conveniently matches customers with far-flung financial service providers, but also exposes companies to the legal risk arising from potential violations of every customer's state laws.⁸²

The process of learning which obligations apply in each state and coming into compliance is burdensome, particularly for would-be new entrants, and the burden of state-by-state compliance is especially evident in the marketplace-lending and securities sectors.⁸³ In some markets, a better model is federal pre-emption of state law or, alternatively, state "passporting," which allows a company that complies with one state's laws to operate across the nation. Both of these approaches ensure that financial companies are regulated, but they also streamline the regulation and avoid duplicative and overlapping regulation.

Considering a State-Based Competitive Model for Insurance Regulation. The troubles of American International Group (AIG) during 2008 that prompted the government to rush to the aid of the company and its creditors renewed questions about the existing system of insurance regulation. Dodd-Frank, although widely characterized as not having substantially altered insurance regulation, added a new layer of federal regulation that is likely to expand over time.⁸⁴ The FSOC can designate—and has designated—insurance companies as systemically important

and thus subject to Federal Reserve regulation. The Federal Insurance Office can negotiate international agreements that override state law. Prior to Dodd–Frank, the existing state regulatory system subjected insurers to multiple state regulators. Thus, by adding a more active role for federal regulators, Dodd–Frank increased the regulatory hurdles to competition in the insurance industry.

In the past, there have been calls for a federal insurance charter to streamline regulations. An optional federal charter would, for instance, enable nationwide insurers to avoid the hassle of dealing with multiple state regulators.⁸⁵ However, a federal charter would increase the temptation of federal policymakers to wrap insurance companies into the federal safety net, thus increasing moral hazard problems in the industry.⁸⁶ In addition, insurance-regulation expertise largely resides at the state level. Building a new federal bureaucracy seems wasteful, although the process is already underway due to Dodd–Frank.

A state-based approach might be more effective and less costly than federal regulation. The state model has succeeded in the corporate-law area, whereby companies are chartered in and governed by the laws of a single state. Delaware courts have developed particular expertise in dealing with corporate law matters, and other states can experiment with different approaches.⁸⁷ Professors Henry Butler and Larry Ribstein have argued that a similar state-based competitive approach could work in the insurance context.⁸⁸ Under such a model, an insurer would only have to be licensed in one state to operate nationwide. States, competing for chartering revenues, would have an incentive to design effective regulatory systems and to refine them in response to changes in the industry.

Butler and Ribstein further propose supplementing the existing state-guaranty funds with solvency bonds the value of which would fluctuate in response to the market's assessment of the efficacy of a state's insurance regulation, and that would default upon failure of the fund.⁸⁹ These bonds also would play a role

in signaling market participants' beliefs that one of the state's large insurers was in trouble. Such a state-based system would build on states' regulatory expertise in insurance, while obviating the need for a new federal regulator and the likely associated expansion of future federal bailouts.

RETHINKING AGENCY STRUCTURE, FUNDING, AND ACCOUNTABILITY

In addition to thoughtful consolidation and reorganization of regulatory authority, policymakers should consider procedural changes to strengthen financial regulation. Who makes rules and the nature of the process by which they are made influence the effectiveness of those regulations. This section sets forth some principles of sound regulatory and procedural design.

Improving Accountability Through Structure and Funding. The way a financial-regulation agency is structured and funded affects its accountability and therefore the quality of its regulation. Typically, agencies are accountable to the President, who directs their actions, and Congress, which controls their funding. Many financial regulators do not fit this mold because historically they have been funded by assessments on the firms they regulate, and in some instances have been outside the traditional congressional appropriations process. The reliance on industry assessments for funding can also distort regulators' incentives, particularly when a small number of institutions constitute a large percentage of the assessment base.

At the time of its failure, assessments on Washington Mutual constituted just over 12 percent of the OTS budget.⁹⁰ At one extreme, the entire budget of the Office of Federal Housing Enterprise Oversight was derived from two companies: Fannie Mae and Freddie Mac. As the financial services industry continues to consolidate, these incentives will only become more perverse. Due to peculiarities of funding and structure, these agencies tend to be less politically accountable than many of their non-financial counterparts.

Greater accountability can be introduced by, for example, subjecting financial regulators to appropriations and implementing a commission governing structure.

Regulatory structure has drawn much attention recently on account of two new Dodd-Frank regulators' unusual design. The CFPB is a single-director agency with complete autonomy from its host agency and, more important, little accountability to Congress and the President.⁹¹ The FSOC comprises the heads of the federal financial regulators, an insurance expert, the head of the Federal Insurance Office, and some state regulators. The FSOC depends on the OFR for funding. The FSOC's structure poses a number of problems: (1) The presence of state officials raises potential constitutional concerns; (2) the exclusion of non-chair members of financial regulators gives undue power to the chairmen of those agencies; and (3) the ability of the FSOC to force independent regulators to act undermines the independence of those agencies.

The design and funding of other financial regulators also give rise to accountability concerns. The OCC, Federal Housing Finance Agency (FHFA), and OFR have some of the same markers of autonomy as the CFPB—a single director, funding autonomy, and, in the case of the OCC and OFR—no accountability to the Treasury Department of which they are part. The Federal Reserve is governed by a board, but enjoys a high degree of independence from accountability.

Because financial regulators are deeply involved in setting financial policy, rather than just implementing laws and supervising financial institutions, political accountability is important. As the mandates and scope of discretion of these agencies expands, the need for accountability also increases. Furthermore, agencies designed to be independent of outside influence are not the most effective regulators.⁹² The CFPB, OCC, and FHFA will better incorporate a broad range of policy views if they are governed by multimember boards with mandatory political balance. Such a structure will help to ensure

policy continuity over time, thus affording the industries they regulate and the public greater certainty about the future of the financial markets. The CFTC and SEC, both of which are governed by five-member politically balanced commissions, can serve as models in this regard.

Congress's greatest ability to guide and direct regulators comes through the appropriations process. Even though the SEC is funded through fees paid by the industry, Congress can determine how much the SEC can spend. The Congressional Research Service explains how "the annual appropriation processes and periodic reauthorization legislation provide Congress with opportunities to influence the size, scope, priorities, and activities of an agency."⁹³ We propose that all financial regulatory activity be funded via the appropriations process, which would reduce the perverse incentives that arise from having regulators' budgets so heavily dependent on a small number of entities. The appropriations process also provides an important avenue for additional congressional oversight that can complement the oversight process of the Senate Committee on Banking, Housing, and Urban Affairs and House Financial Services Committees.

Opponents of this view fear that Congress might cut regulatory budgets to curtail agencies' ability to supervise financial firms, but this argument is a broader critique of Congress's ability to make sound decisions. Furthermore, there is no reason to anticipate better decision making, relative to private market participants, from the unelected heads of federal regulators. Federal regulators should be conformed to the constitutional allocation of the appropriations power to Congress.⁹⁴ While Congress is subject to its own failings, this process improves accountability because Members of Congress can be removed at the ballot box, whereas financial regulators have historically faced little public accountability for their failures.

Increasing Congressional Accountability for Regulation. In Dodd-Frank,

Congress delegated to financial regulators the job of filling in many important aspects of the post-crisis regulatory framework. Within that broad authority, regulators have written rules that impose substantial costs on financial institutions and their customers. Because of how important these delegations are, congressional review of the completed rules is necessary to ensure that they achieve congressional objectives. The Congressional Review Act allows Congress to overturn major agency rules before they take effect.

Requiring Congress to sign off on major financial regulations would ensure that this review actually happens and is not merely perfunctory; congressional failure to approve a rule would preclude it from going into effect. Such an approach has been proposed in Congress.⁹⁵ A congressional review requirement for major rules would recognize the reality that many of the meaningful decisions about financial regulation are currently delegated to regulatory agencies. Allowing political review of these decisions would provide a political check on unelected officials. Requiring Congress to affirmatively assent to a rule *after* the contours and nuances of the rule are defined would allow Congress to take into account the new information generated in the rule-making process. Congress would also be reluctant to approve a rule the costs of which exceeded the benefits.

Mandating Economic Analysis. As a counterpart to enhanced congressional review, financial regulation would be improved by a requirement that regulators conduct more robust economic analysis. Regulatory scholar Jerry Ellig explains that “legislators [cannot] make a responsible decision to approve or disapprove a regulation if they do not know whether the regulation solves a real problem or whether there is a better alternative solution than the proposed regulation.”⁹⁶ These are questions that a proper economic analysis answers.

Financial regulators, many of which are structured as independent regulatory agencies, do not have a strong tradition of

economic analysis. They are not subject to the regulatory impact-analysis requirement applicable to executive branch agencies⁹⁷ and, with only a few exceptions, their organic statutes do not require economic analysis. Financial regulators, bolstered by academic arguments that financial regulation does not lend itself to economic analysis, have tended to downplay their limited statutory obligations to conduct cost-benefit analysis. As a consequence, financial regulators are regulating in the dark—deprived of the light that economic analysis would shed on the consequences of regulation and alternatives available to them.

Economic analysis is a useful rule-making tool. It allows regulators to assess the nature and magnitude of a problem, determine whether regulation is an appropriate response, and—if it is—assess alternative regulatory solutions. This tool is as helpful for financial regulators as it is for other regulators.⁹⁸ A congressional mandate to conduct economic analysis, backed by a judicial-review requirement, would help to ensure that regulators have access to the information they need to think through regulatory problems and design effective solutions.

Resisting Internationalization. The international character of the financial markets has naturally led to cross-border regulatory cooperation and coordination. The financial system generally benefits from these transnational efforts. In recent years, however, international cooperation has increasingly resulted in what are effectively mandates crafted at the international level for domestic application. Organizations like the Group of 20, the Financial Stability Board (FSB), the International Organization of Securities Commissions, and the International Association of Insurance Supervisors issue statements that reflect a common understanding of appropriate regulatory approaches. The implicit—and sometimes explicit—understanding among participants in some of these groups is that group decisions will be translated into domestic regulations.⁹⁹

Cooperation and conversation with foreign regulators is important, but commitments cannot be made internationally to take particular domestic regulatory actions.¹⁰⁰ Doing so cedes sovereignty over domestic financial regulation. It also violates Administrative Procedure Act (APA) requirements that regulations be the product of a public notice and comment rule-making process. To maintain the integrity of the domestic rule-making process, financial regulators should be precluded from making international pre-arrangements about what regulations should be and to which entities they should apply.

Requiring Transparent and Tested Rule-Making. Rule-making through international cooperation is not the only way that financial regulators evade the APA. The APA requires agencies, before imposing new regulatory obligations, to publish a proposal, seek public comment on that proposal, and to consider the feedback in developing its final rule-making.¹⁰¹ Dodd-Frank placed heavy rule-writing requirements on financial regulators.¹⁰²

Faced with so many statutory mandates, financial regulators have been particularly tempted to cut corners by supplementing their regulatory activity with less-formal means than the standard notice-and-comment rule-making.¹⁰³ These methods include regulating through staff letters, enforcement actions, guidance documents, examination findings, and even speeches.¹⁰⁴ Although not technically binding, regulators can force change in the industry without engaging in a transparent discussion with the public about the costs and benefits of the change, as well as potential superior alternatives.

Regulators should use transparent rule-making methods that are consistent with the APA to regulate financial markets. Notice-and-comment rule-making is time-consuming and expensive, but it generates benefits for the agency, regulated entities, and the public that is supposed to benefit from regulation. Government agencies have limited information, and putting a proposal out for public

comment generates additional information. The public may, for instance, raise awareness of costs, benefits, alternatives, or interactions with other rules that the regulator had not considered.¹⁰⁵ Commenters can also challenge the assumptions underlying the rule and fill in data gaps in the proposal. The notice-and-comment process is particularly important when Congress makes broad delegations to agencies, thus leaving the regulators—which are not as accountable to the public as Congress—with leeway to craft rules in a way that may particularly affect certain groups of consumers or firms. To raise the quality of regulation, financial regulators should be held to the standard set forth in the APA.

Dis-Embedding Bank Examiners. Financial-industry supervisors often work in the offices of the companies they oversee and report daily to those firms.¹⁰⁶ While this practice enables supervisors to get to know the people, practices, and culture of the companies they supervise, embedded supervision also breeds capture. Moreover, it is an outgrowth of the flawed notion that banks (and, increasingly, other financial institutions) are different from other companies and need government micromanagement. This intensive, long-term engagement with regulated entities suggests to the entities' managers, shareholders, and customers that firm decision making is blessed by the regulators. It thus shifts responsibility from the private sector to the government sector. A better approach would not rely on permanent on-site supervision, but on targeted inspections.

Facilitating Innovation. Financial regulators, as other regulators, have an incentive not to approve innovation. By approving innovation, they expose themselves to future criticism if the innovation is later associated with customer harm. Thus, a rational regulator might delay or deny requests to make the legal accommodations necessary for new financial products and services. Naturally, the financial industry's ability to serve the rest of the economy suffers from regulatory roadblocks to innovation. These natural anti-innovation

tendencies have drawn public attention, and some regulators have looked at ways to counteract the problem.

The United Kingdom's Financial Conduct Authority (FCA), for example, set up a "regulatory sandbox," which the FCA defines as "a 'safe space' in which businesses can test innovative products, services, business models and delivery mechanisms in a live environment without immediately incurring all the normal regulatory consequences of engaging in the activity in question."¹⁰⁷ Similarly, the CFPB established Project Catalyst, which offers joint CFPB–financial-company pilot programs¹⁰⁸ and staff "no action" letters to provide a temporary promise not to recommend an enforcement action "for a new product or service that offers the potential for significant consumer-friendly innovation."¹⁰⁹ The OCC, acknowledging a "low risk tolerance for innovative products and services,"¹¹⁰ has also indicated a new openness to financial technology.¹¹¹ Among other things, it is considering offering a special charter for FinTech companies.¹¹²

Although the regulatory desire to lower barriers to innovation is commendable, the approaches that regulators are using raise concerns. The regulators, by asking financial companies to prove that their innovations will benefit consumers¹¹³ or that their innovations are "responsible,"¹¹⁴ are placing themselves in the role of the market. Regulators need not make these assessments; if they allow companies to innovate, consumers will decide which innovations they like. When a regulator tries to usurp this market function to screen out bad products, it inhibits innovation.

Financial regulators, therefore, should look for ways to make it easier for financial firms to develop new products regardless of whether the regulator thinks the effort will be successful. Making a concerted effort to modify existing rules so they accommodate new technologies and taking care to avoid cementing a particular technology into new rules are two ways regulators can foster innovation without attempting to direct it. An individual or office within a regulator that is

charged with shepherding products through the difficult-to-navigate approval process could also help, but financial regulators' overall approach toward innovation must change. CFTC Commissioner Christopher Giancarlo put it succinctly when he called for a "do no harm" approach that "open[s] wider our agency doors and regulatory minds to benefit from FinTech innovation."¹¹⁵

Thriving innovation can reshape the financial industry so dramatically that the notion of banks being special falls by the wayside. When that happens, the door to regulatory innovation will also be open wide.

REMOVING FAILED REGULATORS

Financial regulators are subject to failure, just as market participants are. Private-sector failure is met with market discipline, but because of the muted accountability mechanisms in government, regulatory failure is rarely punished. After the financial crisis, regulators who had not performed well were rewarded with new jurisdiction and powers. An effective financial regulatory system holds regulatory bodies and the people that lead and staff them responsible for their failures and rewards them for their successes.

Appropriate incentives for regulators will encourage them to perform their jobs carefully and diligently. Regulators should not be punished when regulated entities or regulated products and services fail—failure is a natural occurrence in properly functioning market systems. Regulators should be held responsible for decisions that induce, abet, or cover up failure.

CONCLUSION

This chapter takes a broad view of the financial regulatory framework. Far from being the product of a careful architect, the regulatory system has been built in pieces. The result is much like a house, each successive owner of which has fitted it with an awkward addition in the style of the time. The resulting house is an eyesore that does not accommodate the needs of its current occupants.

We have attempted here to suggest some areas that could benefit from reorganization—consolidating related powers in one regulator, removing authorities from agencies ill-equipped to perform them, and revamping processes to ensure appropriate accountability for and public input in rule-making.

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ENDNOTES

1. Restoring American Financial Stability Act of 2009, discussion draft, http://thf_media.s3.amazonaws.com/2016/DoddSenateBankingMarkup.pdf (accessed November 22, 2016). The discussion draft included statutory language to create a single financial regulator called the Financial Institutions Regulatory Administration (FIRA).
2. Public Law 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 5, 7, 12, 15, 22, 26, 28, 31, and 42 U.S. Code).
3. For a discussion of this expansion, see Hester Peirce and Robert Greene, “The Federal Reserve’s Expanding Regulatory Authority Initiated by Dodd–Frank,” Mercatus Center at George Mason University, November 13, 2013, <http://mercatus.org/publication/federal-reserves-expanding-regulatory-authority-initiated-dodd-frank> (accessed October 8, 2016).
4. Daniel K. Tarullo, speech at the National Association of Insurance Commissioners’ International Insurance Forum, Washington, DC, May 20, 2016, <https://www.federalreserve.gov/newsevents/speech/tarullo20160520a.htm> (accessed October 8, 2016).
5. See, for example, Financial Stability Board, “About the FSB,” <http://www.fsb.org/about/> (accessed October 8, 2016). (“The FSB promotes international financial stability; it does so by coordinating national financial authorities and international standard-setting bodies as they work toward developing strong regulatory, supervisory and other financial sector policies. It fosters a level playing field by encouraging coherent implementation of these policies across sectors and jurisdictions.”) The Federal Reserve, along with the Federal Insurance Office at the Treasury and state insurance regulators, represents the United States in the International Association of Insurance Supervisors, which is working on identifying and establishing regulatory approaches for globally systemically important insurers. International Association of Insurance Supervisors, “Financial Stability and Macroprudential Policy & Surveillance,” <http://www.iaisweb.org/page/supervisory-material/financial-stability-and-macroprudential-policy-and-surveillance> (accessed October 8, 2016).
6. For a discussion of these issues, see Peter J. Wallison, “The Regulators’ War on Shadow Banking,” AEI Research, January 2015, <https://www.aei.org/wp-content/uploads/2015/01/Regulators-war-on-shadow-banking.pdf> (accessed October 8, 2016).
7. 12 U.S. Code § 5330 (Dodd–Frank § 120) sets forth a procedure for the FSOC to “provide for more stringent regulation of a financial activity by issuing recommendations to the primary financial regulatory agencies to apply new or heightened standards.”
8. See, for example, Daniel K. Tarullo, speech at the Brookings Institution, Washington, DC, November 17, 2015, <https://www.federalreserve.gov/newsevents/speech/tarullo20151117a.htm> (accessed October 8, 2016). Federal Reserve Governor Tarullo calls for “market regulation,” which he illustrates by citing the Federal Reserve’s plans to “establish minimum haircuts for securities financing transactions (SFTs) on a market-wide basis, rather than just for specific classes of market participants.” See also Stanley Fischer, Vice Chairman, Board of Governors of the Federal Reserve System, speech at the Debt and Financial Stability—Regulatory Challenges Conference at the Bundesbank and the German Ministry of Finance, Frankfurt, Germany, March 27, 2015, <https://www.federalreserve.gov/newsevents/speech/fischer20150327a.htm> (accessed October 8, 2016). Fischer calls for additional reforms in the non-bank financial sector.
9. This term is so conveniently nebulous that it is easily used to justify a range of regulatory interventions. See, for example, the January 28, 2016, letter from Mark A. Treichel, Executive Director of the National Credit Union Administration, to Christine Houle of the U.S. Government Accountability Office. Treichel explains that multiple measures of financial stability are appropriate because: “There is still wide disagreement within the financial community as well as across regulators about what constitutes financial stability and how it should be measured.” Treichel’s letter is appended to the end of the following report: U.S. Government Accountability Office, “Financial Regulation: Complex and Fragmented Structure Could Be Streamlined to Improve Effectiveness,” GAO-16-175, February 2016, pp. 121 and 122, <http://www.gao.gov/assets/680/675400.pdf> (accessed November 22, 2016). Given the uncertainty about how to identify and measure financial stability, it is difficult to design regulations that can achieve it.
10. Vern McKinley, “After the Crisis: Revisiting the ‘Banks Are Special’ and ‘Safety Net’ Doctrines,” Mercatus Center at George Mason University, 2015, <http://mercatus.org/sites/default/files/McKinley-Are-Banks-Special.pdf> (accessed July 18, 2016).
11. Daniel K. Tarullo, “Exploring Shadow Banking: Can the Nation Avoid the Next Crisis?” opening remarks at Center for American Progress and Americans for Financial Reform Conference, Washington, DC, July 12, 2016, <https://www.federalreserve.gov/newsevents/speech/tarullo20160712a.pdf> (accessed July 18, 2016). Federal Reserve Governor Tarullo argues that: “Thus, in deciding where—from a prudential viewpoint—to concentrate analysis and policy initiatives within the broad universe of activities that can be described by the term shadow banking, it seems to me that the presence of runnable funding is the key, though perhaps not the only, consideration.”
12. See, for example, U.S. Securities and Exchange Commission, “Equity Market Structure Advisory Committee: Subcommittees,” <https://www.sec.gov/spotlight/equity-market-structure/equity-market-structure-advisory-committee-subcommittees.htm> (accessed August 24, 2016). The purpose of the Customer Issues Subcommittee is to “consider initiatives to protect investor interests and promote investor confidence.” Commissioner Michael Piwowar countered that it is better to provide investors the information they need to make wise decisions rather than trying to boost their confidence. Michael S. Piwowar, speech at the

Equity Market Structure Advisory Committee Meeting, August 2, 2016, https://www.sec.gov/news/statement/piwowar-remarks-emsmac-meeting-080216.html#_ftnref1 (accessed October 8, 2016).

13. George Benston, "Consumer Protection as Justification for Regulating Financial-Services Firms and Products," *Journal of Financial Services Research*, Vol. 17 (2000), pp. 277–301. Also see George Benston, "Is Government Regulation of Banks Necessary?" *Journal of Financial Services Research*, Vol. 18 (2000), pp. 185–202, and George Kaufman, "Bank Failures, Systemic Risk, and Bank Regulation," *Cato Journal*, Vol. 16 (Spring/Summer 1996), pp. 17–45, <http://object.cato.org/sites/cato.org/files/serials/files/cato-journal/1996/5/cj16n1-2.pdf> (accessed July 18, 2016).
14. For an overview of TARP programs, see Office of the Special Inspector General for the Troubled Asset Relief Program, Quarterly Report to Congress, July 27, 2016, pp. 107–246, https://www.sigtar.gov/Quarterly%20Reports/July_27_2016_Report_To_Congress.pdf (accessed October 8, 2016). For an overview of other crisis-era programs, see Board of Governors of the Federal Reserve System, "Credit and Liquidity Programs and the Balance Sheet," https://www.federalreserve.gov/monetarypolicy/bst_lendingother.htm (accessed November 22, 2016).
15. For a discussion of state guaranty funds, see Peter G. Gallanis, "Policyholder Protection in the Wake of the Financial Crisis," in John H. Biggs and Matthew P. Richardson, eds., *Modernizing Insurance Regulation* (New York: Wiley, 2014), pp. 207–240.
16. In many cases, safety and soundness regulations imposed on U.S. banks are justified by citing systemic-risk concerns (financial and macroeconomic stability) as well as the necessity of protecting the FDIC insurance fund. Mark Flannery, "Supervising Bank Safety and Soundness: Some Open Issues," Federal Reserve Bank of San Francisco, Conference on Safe and Sound Banking: Past, Present, and Future, August 17–18, 2006, <http://www.frbsf.org/economic-research/files/flannery.pdf> (accessed December 18, 2015).
17. In the 1980s, regulators implemented the Basel capital rules, and banks are now dealing with the third iteration of these rules, known as Basel III. See Norbert J. Michel and John L. Ligon, "Basel III Capital Standards Do Not Reduce the Too-Big-to-Fail Problem," Heritage Foundation *Background* No. 2905, April 23, 2014, <http://www.heritage.org/research/reports/2014/04/basel-iii-capital-standards-do-not-reduce-the-too-big-to-fail-problem?ac=1> (accessed July 18, 2016).
18. For an overview, see Thomas Hogan and Kristine Johnson, "Alternatives to FDIC Deposit Insurance," *Independent Review*, forthcoming, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2568767 (accessed December 18, 2015). According to the World Bank, 87 countries have explicit deposit insurance, as opposed to a system where people simply expect the government to cover deposit losses in the event of bank failures. Of these 87 countries, 21 countries had (as of 2003) some form of private co-insurance requirement as part of their deposit insurance system. See Asli Demirguc-Kunt, Baybars Karacaovali, and Luc Laeven, "Deposit Insurance Around the World: A Comprehensive Database," The World Bank, April 2005, http://siteresources.worldbank.org/INTRES/Resources/469232-1107449512766/DepositInsuranceDatabasePaper_DKL.pdf (accessed December 12, 2015).
19. The same arguments apply to the state insurance guaranty funds. See Elijah Brewer, Thomas Mondschean, and Philip Strahan, "The Role of Monitoring in Reducing the Moral Hazard Problem Associated with Government Guarantees: Evidence from the Life Insurance Industry," *The Journal of Risk and Insurance*, Vol. 64, No. 2 (1997), pp. 301–322, http://www.jstor.org/stable/pdf/253732.pdf?_id=1468861525292 (accessed July 18, 2016).
20. See, for example, RegData, "Did Deregulation Cause the Financial Crisis? Examining a Common Justification for Dodd–Frank," Mercatus Center at George Mason University, <http://regdata.org/did-deregulation-cause-the-financial-crisis-examining-a-common-justification-for-dodd-frank/> (accessed November 22, 2016).
21. The Federal Deposit Insurance Reform Act of 2005 (Title II, Subtitle B, of the Deficit Reduction Act of 2005, Public Law 109–171, February 8, 2006) raised the coverage limit to \$250,000 for retirement accounts, and Dodd–Frank (Title III, Subtitle C, Section 335) permanently extended this coverage limit to all insured deposits. See 12 U.S. Code §1821 (a)(1)(E).
22. Transaction accounts include checking, savings, money market, and call accounts. See Federal Reserve Board of Governors, "Changes in U.S. Family Finances from 2010 to 2013: Evidence from the Survey of Consumer Finances," *Federal Reserve Bulletin*, Vol. 100, No. 4 (September 2014), p. 16, <http://www.federalreserve.gov/pubs/bulletin/2014/pdf/scf14.pdf> (accessed March 15, 2016). Also see Christine M. Bradley, "A Historical Perspective on Deposit Insurance Coverage," *FDIC Banking Review*, December 2000, https://www.fdic.gov/bank/analytical/banking/2000dec/brv13n2_1.pdf (accessed March 15, 2016).
23. The Basel rules came under criticism in the wake of the Greek debt crisis because they allowed banks to hold no capital—via zero-risk weights—against sovereign government debt. In January 2015, the Basel Committee initiated a review of its existing treatment of sovereign debt. See Huw Jones, "Global Bank Watchdog to Review Rule on Zero-Risk Weighting for Sovereign Debt," Reuters, January 23, 2015, <http://www.reuters.com/article/2015/01/23/basel-sovereign-regulations-idUSL6N0V2Z20150123#2MI4gx2T3BydgvQ.97> (accessed March 15, 2016).
24. In an ideal world—free of government interventions that encourage and subsidize excessive risk-taking—there would be no capital-adequacy issue and no need for any capital adequacy regulation. Obviously, the ideal world is not the current one, and many policymakers support trading off higher capital requirements in return for less regulation. See chapter 3, Kevin Dowd, "A Simple Proposal to Recapitalize the U.S. Banking System."

25. One author argues: "Although bank supervision under the National Banking System exercised a light hand and panics were frequent, depositor losses were minimal." Eugene N. White, "To Establish a More Effective Supervision of Banking": How the Birth of the Fed Altered Bank Supervision," NBER *Working Paper* No. 16825, February 2011, <http://www.nber.org/papers/w16825> (accessed March 15, 2016). Also see Jonathan Macey and Geoffrey Miller, "Double Liability of Bank Shareholders: History and Implications," *Wake Forest Law Review*, Vol. 27 (1992), pp. 31–62.
26. Fannie and Freddie were allowed to borrow more than \$200 for each dollar of capital used to guarantee mortgage-backed securities. Combined, Fannie and Freddie owned or guaranteed \$5.3 trillion of mortgage-related assets at the end of 2007 against just \$70.7 billion of capital, a ratio of 75:1. See *The Financial Crisis Inquiry Report* (Washington, DC: U.S. Government Printing Office, 2011), p. 65, <https://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf> (accessed November 22, 2016).
27. Furthermore, stability itself should not be a goal, as it ensures very few risks are ever taken.
28. Friedrich A. Hayek, "The Use of Knowledge in Society," *The American Economic Review*, Vol. 35, No. 4 (September 1945), pp. 519–530, <http://home.uchicago.edu/~vlima/courses/econ200/spring01/hayek.pdf> (accessed October 8, 2016).
29. J.M. Karpoff and X. Lou, "Short Sellers and Financial Misconduct," *The Journal of Finance*, Vol. 65 (2010), pp. 1879–1913.
30. For example, Japan's Financial Services Authority "is responsible for ensuring stability of Japan's financial system, protection of depositors, insurance policyholders and securities investors, and smooth finance through such measures as planning and policymaking concerning the financial system, inspection and supervision of private sector financial institutions, and surveillance of securities transactions." Japanese Financial Services Agency, "Financial Services Agency," February 2016, p. 3, <http://www.fsa.go.jp/en/about/pamphlet.pdf> (accessed October 8, 2016).
31. The United Kingdom provides a good example of changing structures. Going into the financial crisis of 2007 to 2009, the U.K.'s Financial Services Authority and Bank of England regulated the financial system. As in the U.S., the financial crisis prompted regulatory restructuring. Regulation is now divided among: (1) the Financial Conduct Authority, which regulates business conduct, markets, and firms not subject to the Prudential Regulation Authority; (2) the Prudential Regulation Authority, a subsidiary of the Bank of England that regulates the safety and soundness of deposit-taking institutions and certain systemically important companies; (3) the Bank of England, which regulates clearinghouses and payment and settlement systems; and (4) the Bank of England's Financial Policy Committee, which is the U.K.'s macroprudential regulator. For a diagram and general discussion of the new regulatory structure, see the Financial Services Authority, "Journey to the FCA," October 2012, pp. 11 and 12, <https://www.fca.org.uk/publication/corporate/fsa-journey-to-the-fca.pdf> (accessed October 8, 2016).
32. Department of the Treasury, "Blueprint for a Modernized Financial Regulatory Structure," March 2008, p. 14, <https://www.treasury.gov/press-center/press-releases/Documents/Blueprint.pdf> (accessed October 8, 2016). Multiple Administrations have initiated similar reform efforts through the Treasury Department. For instance, a 1991 Treasury report recommended shrinking the number of federal banking regulators from four to two, and also focusing the FDIC's mission solely on administering deposit insurance and bank resolutions. See U.S. Treasury, "Modernizing the Financial System: Recommendations for Safer, More Competitive Banks," February 1991, pp. 68–70, http://thf_media.s3.amazonaws.com/2016/ModernizingFinancialSystem.pdf (accessed November 22, 2016).
33. Department of the Treasury, "Financial Regulatory Reform: A New Foundation," June 17, 2009, https://www.treasury.gov/initiatives/wsr/Documents/FinalReport_web.pdf (accessed October 8, 2016).
34. *Ibid.*, p. 3.
35. House Financial Services Chairman Barney Frank (D-MA) proposed legislation to merge the SEC and CFTC. See Sarah N. Lynch, "Retiring US Lawmaker Barney Frank Seeks SEC-CFTC Merger," Reuters, November 29, 2012, <http://www.reuters.com/article/sec-cftc-merger-idUSL1E8MTGFA20121129> (accessed November 24, 2016).
36. Senate Banking Committee Chairman Christopher Dodd (D-CT) proposed the creation of a "Financial Institutions Regulatory Administration," an independent agency that would have taken over the regulatory and supervisory functions of the OCC, OTS, FDIC, and the Board of Governors of the Federal Reserve System. See Restoring American Financial Stability Act of 2009, discussion draft.
37. More accurately, the OTS was not so much eliminated as it was simply made a department of the OCC. For instance, no OTS employees were fired, nor was the thrift charter eliminated.
38. U.S. Government Accountability Office, "Financial Regulation."
39. Lawrence A. Cunningham and David Zaring, "The Three or Four Approaches to Financial Regulation: A Cautionary Analysis Against Exuberance in Crisis Response," *George Washington University Law Review*, Vol. 78 (2009), pp. 1–56, http://scholarship.law.gwu.edu/cgi/viewcontent.cgi?article=1551&context=faculty_publications (accessed October 8, 2016).
40. *Ibid.*, p. 50.

41. Former SEC Commissioner Daniel Gallagher has frequently discussed the importance of preventing bank regulators from taking over capital markets regulation. See, for example, Daniel M. Gallagher, “Bank Regulators at the Gates: The Misguided Quest for Prudential Regulation of Asset Managers,” speech at the 2015 Virginia Law and Business Review Symposium, April 10, 2015, <https://www.sec.gov/news/speech/041015-spch-cdmg.html> (accessed November 22, 2016).
42. Spillover effects from bad decisions by one regulator can affect regulated entities outside that regulator’s jurisdiction.
43. Allan Berger and Timothy Hannan, “The Efficiency Cost of Market Power in the Banking Industry: A Test of the ‘Quiet Life’ and Related Hypotheses,” *Review of Economics and Statistics*, Vol. 80 (1998), pp. 454–465.
44. For example, see Office of the Inspector General, Department of the Treasury, “Material Loss Review of IndyMac Bank, FSB,” OIG-09-032, <https://www.treasury.gov/about/organizational-structure/ig/Documents/oig09032.pdf> (accessed November 22, 2016).
45. Jessica Silver-Greenberg, “Small Banks Shift Charters to Avoid US as Regulator,” *The New York Times*, April 2, 2012, <http://www.nytimes.com/2012/04/03/business/small-banks-shift-charters-to-avoid-us-as-regulator.html> (accessed November 22, 2016), and Sumit Agarwal et al., “Inconsistent Regulators: Evidence from Banking,” *The Quarterly Journal of Economics*, Vol. 129, No. 2 (2014), pp. 889–938.
46. U.S. Government Accountability Office, “Causes and Consequences of Recent Bank Failures,” *Report to Congressional Committees*, GAO-13-71, 2013, <http://www.gao.gov/assets/660/651154.pdf> (accessed November 22, 2016).
47. Henry Butler and Jonathan Macey, “The Myth of Competition in the Dual Banking System,” *Cornell Law Review*, Vol. 73 (1988).
48. Bruce G. Carruthers and Naomi R. Lamoreaux, “Regulatory Races: The Effects of Jurisdictional Competition on Regulatory Standards,” *Journal of Economic Literature*, Vol. 54, No. 1 (2016), pp. 52–97.
49. State-chartered banks that are members of the Federal Reserve System are subject to oversight by both the Federal Reserve Board and by state regulators, whereas non-Fed-member state-chartered banks that are insured by the FDIC are regulated by the FDIC and state regulators.
50. U.S. Government Accountability Office, “Financial Regulation,” p. 64.
51. Federal Reserve Act § 2A [12 U.S. Code 225a].
52. Peirce and Greene, “The Federal Reserve’s Expanding Regulatory Authority Initiated by Dodd–Frank.” Also see Patrick McLaughlin, Chad Reese, and Oliver Sherouse, “Dodd–Frank and the Federal Reserve’s Regulations,” Mercatus Center at George Mason University, February 4, 2016, <http://mercatus.org/publication/dodd-frank-and-federal-reserve-s-regulations> (accessed October 8, 2016).
53. Dodd–Frank § 1108(a). To date, the President has not nominated anyone for this position, the holder of which is responsible for “develop[ing] policy recommendations for the Board regarding supervision and regulation of depository institution holding companies and other financial firms supervised by the Board, and shall oversee the supervision and regulation of such firms.” *Ibid.*
54. See, for example, U.S. Government Accountability Office, “Financial Regulation,” p. 28, which explains that “[a]ll forms of consolidated supervision by the Federal Reserve create overlap with authority of the primary regulators of the holding company’s regulated subsidiaries.”
55. See, for example, U.S. Government Accountability Office, “Financial Regulation,” p. 36, which noted that “the Federal Reserve’s data requests can be very similar to the OCC’s requests and that often the two requests will ask for the same data but in different formats.” See also Office of the Inspector General to the Board of Governors of the Federal Reserve System, “2015 List of Major Management Challenges for the Board,” *Memorandum*, September 30, 2015, <https://oig.federalreserve.gov/reports/board-management-challenges-sep2015.pdf> (accessed October 8, 2016). Among the items in the list was “maintaining effective relationships with other regulators.” The Inspector General noted: “While the Board has taken steps to improve interagency collaboration and cooperation...continued coordination with other federal supervisory agencies, such as the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency, is crucial to implementing the financial stability regulatory and supervisory framework.” *Ibid.*, p. 6.
56. The FFIEC is “a formal interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions by the” Board of Governors, FDIC, National Credit Union Administration, OCC, and CFPB.
57. The PWG was formed after the October 1987 crash. See Ronald W. Reagan, “Working Group on Financial Markets,” Executive Order 12631, March 18, 1988, <http://www.archives.gov/federal-register/codification/executive-order/12631.html> (accessed October 8, 2016).
58. Dodd–Frank § 113.
59. Dodd–Frank § 804.
60. Dodd–Frank §§ 115 and 120.

61. Peter Wallison, "Title I and the Financial Stability Oversight Council," in Norbert J. Michel, ed., *The Case Against Dodd–Frank: How the "Consumer Protection" Law Endangers Americans* (Washington, DC: The Heritage Foundation, 2016), <http://thf-reports.s3.amazonaws.com/2016/The%20Case%20Against%20Dodd-Frank.pdf>, and Norbert J. Michel, "The Financial Stability Oversight Council: Helping to Enshrine 'Too Big to Fail,'" Heritage Foundation *Backgrounder* No. 2900, April 1, 2014, <http://www.heritage.org/research/reports/2014/04/the-financial-stability-oversight-council-helping-to-enshrine-too-big-to-fail>.
62. Norbert Michel, "Dodd–Frank's Financial Monster Council: The FSOC," *Forbes*, July 7, 2014, <http://www.forbes.com/sites/norbertmichel/2014/07/07/dodd-franks-financial-monster-council-the-fsoc/#357f5afa4ffb> (accessed October 8, 2016).
63. Hester Peirce, "Dodd–Frank's Office of Financial Research Is an Affront to Privacy," Real Clear Markets, April 19, 2012, http://www.realclearmarkets.com/articles/2012/04/19/dodd-franks_office_of_financial_research_is_an_affront_to_privacy_99624.html (accessed October 11, 2016).
64. 12 U.S. Code § 5343(f) and § 5344(b)(6).
65. Bipartisan Policy Center, "Did Policymakers Get Post-Crisis Financial Regulation Right?" September 2016, p. 17, <http://cdn.bipartisanpolicy.org/wp-content/uploads/2016/09/BPC-FRRI-Post-Crisis-Financial-Regulation.pdf> (accessed October 11, 2016).
66. The Financial CHOICE Act takes a similar approach. See Norbert J. Michel, "Money and Banking Provisions in the Financial CHOICE Act: A Major Step in the Right Direction," Heritage Foundation *Backgrounder* No. 3152, August 31, 2016, <http://www.heritage.org/research/reports/2016/08/money-and-banking-provisions-in-the-financial-choice-act-a-major-step-in-the-right-direction?ac=1>.
67. Dodd–Frank § 112(1)(B).
68. See, for instance, U.S. Government Accountability Office, "Financial Regulation," p. 41, which observes: "Over time, separate regulation of the securities and futures markets has created confusion about which agency has jurisdiction and has raised concerns about duplicative or inconsistent regulation of entities that engage in similar activities."
69. Historically, the CFTC applied a principles-based approach to regulation, whereas the SEC's approach was more rule-based. The two agencies' approach is now very similar, particularly since Congress passed the 2010 Dodd–Frank Act.
70. For a discussion of cooperative efforts over the years, see U.S. Government Accountability Office, "Financial Regulation," pp. 43 and 44.
71. See, for instance, Annette L. Nazareth and Gabriel D. Rosenberg, "The New Regulation of Swaps: A Lost Opportunity," *Comparative Economic Studies*, Vol. 55, No. 3 (September 2013), pp. 535–548.
72. Jerry W. Markham, "Merging the SEC and CFTC—A Clash of Cultures," *University of Cincinnati Law Review*, Vol. 78, No. 2 (2009), p. 537. Markham's concerns about a cultural barrier to the merger may not be as relevant now that the CFTC has moved toward the SEC's rules-based approach and away from the CFTC's more traditional principles-based approach.
73. Jerry Markham lays an important foundation for such consideration. See Markham, "Merging the SEC and CFTC."
74. Public Law 93–406.
75. Department of Labor, Reorganization Plan No. 4 of 1978, http://www.dol.gov/ebsa/regs/exec_order_no4.html (accessed October 11, 2016).
76. Department of Labor, "Definition of the Term 'Fiduciary': Conflict of Interest Rule—Retirement Investment Advice," *Federal Register*, Vol. 81 (April 8, 2016), p. 20945, and Department of Labor, "Best Interest Contract Exemption," *Federal Register*, Vol. 81 (April 8, 2016), p. 21002. The rule-making is complicated, but the Labor Department describes it as follows: "Going forward, those that provide investment advice to plans, plan sponsors, fiduciaries, plan participants, beneficiaries and IRAs and IRA owners must either avoid payments that create conflicts of interest or comply with the protective terms of an exemption issued by the Department. Under new exemptions adopted with the rule, firms will be obligated to acknowledge their status and the status of their individual advisers as 'fiduciaries.'" Department of Labor, "Fact Sheet: Department of Labor Finalizes Rule to Address Conflicts of Interest in Retirement Advice, Saving Middle Class Families Billions of Dollars Every Year," <https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/dol-final-rule-to-address-conflicts-of-interest> (accessed October 11, 2016).
77. For a helpful analysis of the rule, see Shearman & Sterling LLP, "The U.S. Department of Labor's Final 'Fiduciary' Rule Incorporates Concessions to Financial Service Industry but Still Poses Key Challenges," April 14, 2016, <http://www.shearman.com/en/newsinsights/publications/2016/04/fiduciary-rule-but-still-poses-key-challenges> (accessed October 11, 2016). The memorandum concluded that "the rule will still have a profound and, if it survives any ensuing court challenges, lasting effect on the retail retirement market and the business of many financial institutions." *Ibid.*, p. 17.
78. The Public Company Accounting Oversight Board (PCAOB), formed pursuant to the Sarbanes–Oxley Act of 2002, is an odd entity that combines self-regulatory and governmental features. Donna M. Nagy, "Playing Peekaboo with Constitutional Law: The PCAOB and its Public/Private Status," *Notre Dame Law Review*, Vol. 80 (2005), pp. 975–1071. The Supreme Court adjusted its accountability mechanism to correct a constitutional violation, but its unusual structure continues to raise questions of accountability and effectiveness. *Free Enterprise Fund v. Public Company Accounting Oversight Board*, 561 U.S. 477 (2010).

79. Edward Stringham, “The Past and Future of Exchanges as Regulators,” in Hester Peirce and Benjamin Klutsey, eds. *Reframing Financial Regulation: Enhancing Stability and Protecting Consumers* (Arlington, VA: Mercatus Center at George Mason University, 2016) <https://www.mercatus.org/publications/reframing-financial-regulation> (accessed December 14, 2016).
80. For a discussion of the transformation of self-regulation of broker-dealers, see William A. Birdthistle and M. Todd Henderson, “Becoming a Fifth Branch,” *Cornell Law Review*, Vol. 99 (2013), and Hester Peirce, “Financial Industry Regulatory Authority: Not Self-Regulation After All,” Mercatus Center at George Mason University *Working Paper*, January 6, 2015, <http://mercatus.org/sites/default/files/Peirce-FINRA.pdf> (accessed October 11, 2016).
81. Roberta Romano, “The States as Laboratory: Legal Innovation and State Competition for Corporate Charters,” *Yale Journal on Regulation*, Vol. 23, No. 2 (2006), pp. 209–247, and J. W. Verret, “Uber-ized Corporate Law: Toward a 21st Century Corporate Governance for Crowdfunding and App-Based Investor Communications,” *Journal of Corporation Law*, Vol. 41, No. 4 (2016), pp. 927–969.
82. This issue as it applies to FinTech companies is considered in cross-reference to chapter 22, Brian Knight, “FinTech and Federalism.”
83. *Ibid.*
84. For a discussion of these issues, see Hester Peirce, “Title V and the Creeping Federalization of Insurance Regulation,” in Michel, ed., *The Case Against Dodd-Frank*.
85. See, for example, Scott Harrington, “Federal Chartering of Insurance Companies: Options and Alternatives for Transforming Insurance Regulation,” Networks Financial Institute *Policy Brief* No. 2006-PB-02, February 2006, and Peter J. Wallison, ed., *Optional Federal Chartering and Regulation of Insurance Companies* (Washington, DC: AEI Press, 2000).
86. See, for instance, Bert Ely, “The Fate of the State Guaranty Funds After the Advent of Federal Insurance Chartering,” in Wallison, ed., *Optional Federal Chartering and Regulation of Insurance Companies*, p. 137. Ely observes that government backing inevitably follows regulation.
87. See, for instance, Roberta Romano, *The Genius of American Corporate Law* (Washington, DC: AEI Press, 1993). Romano explains: “Competition for incorporation revenues makes U.S. states sensitive to investor concerns: such competition is the genius of American corporate law.” *Ibid.*, p. 149.
88. Henry N. Butler and Larry E. Ribstein, “A Single-License Approach to Regulating Insurance,” Northwestern Law Faculty *Working Paper* No. 154, 2008, <http://scholarlycommons.law.northwestern.edu/facultyworkingpapers/154/> (accessed November 22, 2016).
89. Henry N. Butler and Larry E. Ribstein, “The Single-License Solution,” *Regulation* (Winter 2008–2009), p. 40, <https://object.cato.org/sites/cato.org/files/serials/files/regulation/2008/11/v31n4-6.pdf> (accessed November 22, 2016).
90. Office of Thrift Supervision, “Washington Mutual Bank,” *Fact Sheet*, September 25, 2008, <https://occ.gov/static/news-issues/ots/press-releases/ots-pr-2008-46b.pdf> (accessed November 22, 2016).
91. For a discussion of the structural oddity of the CFPB, see Todd Zywicki, “The Consumer Financial Protection Bureau: Savior or Menace,” *The George Washington Law Review*, Vol. 81, No. 3 (April 2013), pp. 856–928.
92. Mark Calabria, “Capture and Ignorance in Financial Regulation,” ProMarket, September 28, 2016, <https://promarket.org/capture-ignorance-financial-regulation/#comments> (accessed October 11, 2016). Calabria points out that mechanisms, such as a board structure, independent reviews, and the notice-and-comment process for regulations, can help to prevent regulatory capture and thus produce better regulation.
93. Henry B. Hogue, Mark Labonte, and Baird Webel, “Independence of Federal Financial Regulators,” Congressional Research Service *Report for Congress*, February 24, 2014, p. 25.
94. U.S. Constitution, Article 1, Section 9, Clause 7.
95. See, for instance, S. 226, Regulations from the Executive in Need of Scrutiny Act of 2015, January 21, 2015.
96. Jerry Ellig, “Comprehensive Regulatory Impact Analysis: The Cornerstone of Regulatory Reform,” testimony before the Senate Committee on Homeland Security and Governmental Affairs, February 25, 2015, <https://www.mercatus.org/publication/comprehensive-regulatory-impact-analysis-cornerstone-regulatory-reform> (accessed October 11, 2016).
97. For an overview of the use of economic analysis by federal financial regulators, see Hester Peirce, “Economic Analysis by Federal Financial Regulators,” *George Mason Journal of Law, Economics, and Policy*, Vol. 9 (2013), p. 576.
98. For an analysis of the feasibility of economic analysis in financial regulation, see Jerry Ellig and Vera Soliman, “Is Regulatory Impact Analysis of Financial Regulations Possible?” in Peirce and Klutsey, eds., *Reframing Financial Regulation*.
99. See, for instance, Financial Stability Board, “What We Do,” <http://www.fsb.org/what-we-do/> (accessed October 12, 2016), which explains that the FSB “operates by moral suasion and peer pressure, to set internationally agreed policies and minimum standards that its members commit to implement at national level.” For a discussion of how this issue in the insurance context,

- see Therese M. Vaughan and Mark A. Calabria, "International Developments in the Insurance Sector: The Road to Financial Instability?" *Cato Working Paper*, No. 30/CMFA No. 5, May 27, 2015, <http://object.cato.org/sites/cato.org/files/pubs/pdf/working-paper-30.pdf> (accessed October 12, 2016).
100. See, for instance, Peter J. Wallison and Daniel M. Gallagher, "How Foreigners Became America's Financial Regulators," *The Wall Street Journal*, March 19, 2015, <http://www.wsj.com/articles/peter-wallison-and-daniel-gallagher-how-foreigners-became-americas-financial-regulators-1426806547> (accessed October 12, 2016), and Peter J. Wallison, "Transparency on FSO Designations and its Relations with the FSB," testimony before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, March 25, 2015, <https://www.aei.org/wp-content/uploads/2015/05/Senate-Banking-Testimony-3-25-15-FSB-FSO-2.pdf> (accessed October 12, 2016).
 101. 5 U.S. Code § 553. As an alternative, the APA offers regulators an even more formal process, which is rarely used.
 102. The law firm Davis Polk counts 390 rule-making requirements in Dodd-Frank. Davis Polk, "Dodd-Frank Progress Report," July 19, 2016, p. 2, <https://www.davispolk.com/sites/default/files/2016-dodd-frank-six-year-anniversary-report.pdf> (accessed October 12, 2016). See also Patrick McLaughlin and Oliver Sherouse, "The Dodd-Frank Wall Street Reform and Consumer Protection Act May Be the Biggest Law Ever," Mercatus Center at George Mason University, July 20, 2015, <https://www.mercatus.org/publication/dodd-frank-wall-street-reform-and-consumer-protection-act-may-be-biggest-law-ever> (accessed October 12, 2016).
 103. See, for instance, Hester Peirce, "Regulating Through the Back Door at the Commodity Futures Trading Commission," *Harvard Journal of Law and Public Policy*, Federalist Edition (2014), pp. 321-393, http://www.harvard-jlpp.com/wp-content/uploads/2010/01/Peirce_7.pdf (accessed October 12, 2016). The article documents methods, including staff no-action letters and undertakings in enforcement actions, used by the CFTC to regulate without going through notice-and-comment rule-making.
 104. There is a large body of literature on the use of so-called nonlegislative rule-making. See, for example, Robert A. Anthony, "Interpretive Rules, Policy Statements, Guidances, Manuals, and the Like—Should Federal Agencies Use Them to Bind the Public?" *Duke Law Journal*, Vol. 41 (1992), pp. 1311-1384; Michael Asimow, "Nonlegislative Rulemaking and Regulatory Reform," *Duke Law Journal*, Vol. 1985 (1985), pp. 381-426; and William Funk, "A Primer on Nonlegislative Rules," *Administrative Law Review*, Vol. 53 (2001), pp. 1321-1352.
 105. These benefits have been the subject of much academic discussion. See, for instance, Stephen M. Johnson, "Good Guidance, Good Grief!" *Missouri Law Review*, Vol. 72 (2007), p. 703; and Cary Coglianese, Heather Kilmartin, and Evan Mendelson, "Transparency and Public Participation in the Rulemaking Process: A Nonpartisan Presidential Transition Task Force Report," July 2008.
 106. See, for instance, Aaron Lucchetti, "The Regulator Down the Hall: Fed and Comptroller of the Currency Bolster the Ranks of Staffers 'Embedded' at Nation's Biggest Banks," *The Wall Street Journal*, June 20, 2011.
 107. Financial Conduct Authority, "Regulatory Sandbox," <https://www.fca.org.uk/firms/project-innovate-innovation-hub/regulatory-sandbox> (last updated September 12, 2016). See also Christopher Woolard, speech at the Innovate Finance Global Summit, April 11, 2016, <https://www.fca.org.uk/news/speeches/innovate-finance-global-summit> (accessed October 12, 2016).
 108. Consumer Financial Protection Bureau, "Project Catalyst," <http://www.consumerfinance.gov/about-us/project-catalyst/> (accessed October 12, 2016). Director Cordray recently described such a partnership with American Express "to structure a pilot program focused on promoting savings." Richard Cordray, speech at Corporation for Enterprise Development Assets Learning Conference, September 29, 2016, <http://www.consumerfinance.gov/about-us/newsroom/prepared-remarks-cfpb-director-richard-cordray-corporation-enterprise-development-assets-learning-conference/> (accessed October 12, 2016).
 109. News release, "CFPB Finalizes Policy to Facilitate Consumer-Friendly Innovation," Consumer Financial Protection Bureau, February 18, 2016, <http://www.consumerfinance.gov/about-us/newsroom/cfpb-finalizes-policy-to-facilitate-consumer-friendly-innovation/> (accessed October 12, 2016).
 110. Office of the Comptroller of the Currency, "Supporting Responsible Innovation in the Federal Banking System: An OCC Perspective," March 2016, p. 6, <https://www.occ.gov/publications/publications-by-type/other-publications-reports/pub-responsible-innovation-banking-system-occ-perspective.pdf> (accessed October 12, 2016).
 111. See, for example, Thomas J. Curry, Comptroller of the Currency, speech at the Federal Home Loan Bank of Chicago, August 7, 2015, p. 7, <https://occ.gov/news-issuances/speeches/2015/pub-speech-2015-111.pdf> (accessed October 12, 2016). Curry committed the OCC to having "a robust process in place to understand and evaluate new approaches to permit and encourage responsible innovation that has benefits for consumers and businesses, while ensuring appropriate risk management and compliance with laws and regulations."
 112. Thomas J. Curry, Comptroller of the Currency, speech at the Marketplace Lending Summit 2016, September 13, 2016, <https://www.occ.gov/news-issuances/speeches/2016/pub-speech-2016-111.pdf> (accessed October 12, 2016).
 113. The CFPB's Project Catalyst is limited to products that offer "the promise for significant consumer benefit." Consumer Financial Protection Bureau, "CFPB Finalizes Policy to Facilitate Consumer-Friendly Innovation."
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114. Office of the Comptroller of the Currency, “Supporting Responsible Innovation in the Federal Banking System: An OCC Perspective,” p. 5. The OCC pledges to “support responsible innovation,” which it defines as “The use of new or improved financial products, services, and processes to meet the evolving needs of consumers, businesses, and communities in a manner that is consistent with sound risk management and is aligned with the bank’s overall business strategy.”
115. J. Christopher Giancarlo, Commissioner, Commodity Futures Trading Commission, speech at the American Enterprise Institute, September 21, 2016, <http://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo-17> (accessed October 12, 2016).

CHAPTER 10:

The World After Chevron

Paul J. Larkin, Jr.

Administrative law has been a greenfield for scholars for quite some time because it stands at the confluence of American constitutional law and political theory regarding the proper structure of American government.¹ Most administrative law is made not by Congress, but by the federal courts, particularly the Supreme Court of the United States. The last major statute that Congress enacted was the Administrative Procedure Act (APA),² and it became a part of the federal code 70 years ago. Since then, the Supreme Court has principally been responsible for the development of administrative law. Some of the Court's decisions interpreting the APA—such as *Citizens to Preserve Overton Park v. Volpe*³ and *Vermont Yankee Nuclear Power Corp. v. Natural Resources Defense Council*⁴—are landmark decisions in the administrative law field because they defined the “arbitrary and capricious” standard for review of federal agency actions and prohibited the federal courts from imposing rulemaking requirements on administrative agencies that Congress chose not to adopt itself.⁵ To some extent, those decisions have become so closely allied with the meaning and role of the APA in governance that they might as well have been written into the text of the statute itself.

But the Court's 1984 decision in *Chevron U.S.A. Inc. v. Natural Resources Defense Council*⁶ stands head and shoulders above any other administrative law decision rendered during the past several generations. *Chevron* created a new two-step test for courts to use when interpreting a statute that Congress has directed an agency to implement. The test gave federal agencies a potentially commanding role in the interpretive process even though American jurisprudence had long vested that authority in the federal courts.

Like most issues of administrative law, *Chevron* was largely noncontroversial for most of its early life. Times have changed,

however, and *Chevron* is now the subject of considerable legal and policy debate. Its elevated treatment of agency interpretive authority rests uncomfortably alongside a long tradition of judicial primacy. Its foundation in the Progressive-Era belief in the wisdom of delegating vast amounts of decision-making authority to expert agency officials is jarring to a public that has become distrustful of losing any control of or influence over an increasingly vast portion of American life that is now regulated by remote, unknown officials.

What perhaps brought that dispute to a boil has been President Barack Obama's oft-repeated resort to administrative lawmaking

when he could not achieve the same legislative success that he enjoyed during the early portion of his first Administration. Over the past five years, the question whether *Chevron* was wrongly decided and, if so, whether its two-part analysis should be abandoned has been a subject of considerable ferment among certain members of the Supreme Court and the academy. Whether *Chevron* will survive may well turn on what happens this November.

It might be useful to ask, however, what the world would look like if *Chevron* were legislatively or judicially overruled. Would the federal courts still give deference to an agency's interpretation of a statute? If so, how much deference? Would the courts defer to an agency even if they would have construed the statute differently? Would the courts treat the agency's opinion as if it were a law review article? Does all the hoopla over *Chevron* matter very much in the long run?⁷

THE RISE OF CHEVRON AND DEFERENCE TO A FEDERAL AGENCY'S INTERPRETATION OF AN ACT OF CONGRESS

The issue in *Chevron* was whether the Environmental Protection Agency (EPA) could reasonably interpret the term "stationary source" for purposes of the Clean Air Act Amendments of 1977⁸ as an entire plant rather than as each separate smokestack, an interpretation that had come to be known as the "bubble" concept. The Reagan Administration had interpreted that term to apply to each facility, not each smokestack, while the environmental organizations took the contrary position. Unfortunately, neither the text of the statute nor its legislative history offered more than a wisp of evidence as to what "stationary source" meant, and the competing policy arguments seemed to wrestle themselves to a draw. All of the traditional tools of statutory interpretation left the Supreme Court in equipoise. The result was that the Court found itself with only two choices: flip a coin or devise a new approach to statutory construction.

In an opinion written by Justice John Paul Stevens, the Supreme Court chose the latter approach. In reviewing the validity of the EPA's interpretation of the statute, the Court wrote, a court should not follow the traditional approach to the construction of a law set forth by the Court's 1803 decision in *Marbury v. Madison*,⁹ which had explained that the courts have the responsibility "to say what the law is."¹⁰ Instead, in *Chevron*, the Court established a two-step test for judicial review of an agency's interpretation of a statute. The first step is to ask whether Congress has answered the particular question in dispute in the statute itself.¹¹ If so, that answer (absent some constitutional flaw) is dispositive.¹² But if the statute is ambiguous on the issue, the next step for a reviewing court is to ask whether the agency's interpretation is reasonable.¹³ If so, that ends the controversy. The court may not disagree with the agency as long as its interpretation is a plausible construction of the act. Why? When a statute is ambiguous, the Court wrote, there is a presumption that Congress implicitly delegated to the agency the authority to fill in the blanks,¹⁴ which is a policymaking function.¹⁵ Unlike courts, agencies may make policy judgments, and if Congress empowered an agency to do so, the courts may not overrule the agency's decision.¹⁶

Having identified how it would answer the question, the Court then applied its new two-step test to the Clean Air Act. Applying *Chevron* Step 1, the Court concluded that neither the statute nor its legislative history defined the term "stationary source," nor did either one prohibit the EPA from adopting its "bubble" concept.¹⁷ Moving then to *Chevron* Step 2, the Court decided that the agency's "bubble" concept was a reasonable interpretation of the term "stationary source" and entered judgment in the agency's favor.¹⁸

Chevron adopted a two-step test, but in *King v. Burwell*¹⁹ the Court added a third step, which some commentators have labeled "*Chevron* Step 0."²⁰ *King* involved an interpretation of the Patient Protection and Affordable Care Act of 2010,²¹ known to some

as Obamacare.²² The question before the Court was whether the phrase “[e]xchange established by a state” included an exchange established by the federal government. The Internal Revenue Service had promulgated a rule answering that question in the affirmative, and the Solicitor General argued that the IRS’s interpretation was entitled to *Chevron* deference. Although the majority, in an opinion written by Chief Justice John Roberts, reached the same conclusion on statutory grounds, the majority declined to defer to the IRS’s interpretation. Instead, the Court concluded that this was one of those “extraordinary cases” in which it would be unreasonable to presume that Congress delegated interpretive authority to an agency instead of resolving an issue itself.²³ The Court stated that it had reached this conclusion because the phrase “[e]xchange established by a state” was critical to one of that act’s “key reforms,” involved “billions of dollars in spending each year,” “affect[ed] the price of health insurance for millions of people,” and was therefore “a question of deep economic and political significance that is central to [the Obamacare] statutory scheme; had Congress wished to assign that question to an agency, it surely would have done so expressly.”²⁴

King therefore adds a new step to *Chevron*, one that asks whether the matter is of such importance that a court should not presume that Congress implicitly delegated interpretive authority to an agency to resolve it. Given the plasticity of that inquiry, that step could render *Chevron* inapplicable in an unknown number of cases.²⁵

THE STEADY TRANSFER OF LAWMAKING POWER FROM CONGRESS TO ADMINISTRATIVE AGENCIES

Chevron did not appear at first to be a major decision in administrative law.²⁶ The Supreme Court had been interested in how an agency construed a statute long before *Chevron* was decided, and the Court often gave the agency’s interpretation deference in a

variety of circumstances.²⁷ For example, the Court was likely to defer to an agency’s position that was consistent, long-standing, or technical in nature. Even *Chevron* acknowledged those points.²⁸ Moreover, a court would not reach *Chevron* Step 2 unless it found that Congress did not itself answer the issue in the case. Instances in which Congress had directed an agency to promulgate regulations to implement a statutory program were the most likely to receive judicial deference. Yet since the Court decided *Chevron* in 1984, the decision has taken on enormous importance. One reason why is that, given the deep political disagreements in American politics today, Congress has not passed any major legislation since Obamacare in 2010, and the President has stepped forward to take up the slack, whether or not he possesses the statutory authority to do so.

The Framers anticipated that Congress would be the principal lawmaking body for the federal government. That explains why they spent most of the Convention of 1787 debating how to select Members of Congress²⁹ and what legislative powers Congress should have.³⁰ Early on, President Barack Obama accepted that norm, working with Congress to enact as law policies that he believed were necessary to benefit the nation. An example is his economic stimulus package. Yet since his party lost control of the Senate and House of Representatives, President Obama has shifted gears and used executive orders and administrative regulations or decrees to create law. In fact, he has issued some decrees that are inconsistent with the very laws he helped enact in his first term.³¹

The result of the President’s resort to lawmaking by administrative regulation or order has been to cause several Members of Congress to attempt to reclaim their principal role in the federal lawmaking process. Various commentators have also decried the administrative state’s usurpation of Congress’s lawmaking authority.³² Along the way, lawmakers and scholars have focused on *Chevron* as epitomizing the out-of-kilter nature of

federal governance, one in which unelected administrative officials exert more effective lawmaking power through their interpretation of statutes than either Congress or the federal courts are able to exert. Members of Congress have introduced legislation that would overrule *Chevron*,³³ and members of the academy have urged the Supreme Court to clean up the mess it created by overruling the decision itself.³⁴

Critics of *Chevron* have offered several arguments to show why they believe it was wrongly decided and should be abandoned.³⁵ But the central argument against *Chevron* is that it conflicts with a fundamental principle of our constitutional system: The federal courts have the responsibility to interpret federal law and enter final judgments reflecting how that law applies to the facts in a particular case. The Constitution's text, its English and American common-law history, and the need for (and textual guarantees of) judicial independence, the argument goes, make it clear that the third branch of government must have the final say as to a law's meaning.³⁶ *Chevron*, critics correctly say, gave no weight to any of those concerns. In fact, Justice Stevens's opinion does not even mention them.

So far, neither the full Congress nor the Supreme Court has taken up those invitations, and it is uncertain whether they ever will. Presidential and congressional elections are just over the horizon, and the outcome of those races could decide whether any legislation to overrule *Chevron* advances in either chamber of Congress. The death of Justice Antonin Scalia earlier this year left the Court with only eight members, which meant that some cases were decided by a 4-to-4 vote³⁷ and some might as well have been for all of the clarity that the Court's decision provided.³⁸ It is unlikely that the Supreme Court would be willing to reconsider a precedent with the significance of *Chevron* without a full complement of justices. The appointment of a new justice will occasion debate in the Senate over the role that administrative agencies should play in the interpretation of law, but it is

unlikely that the nominee will say very much about the matter or that Congress will resolve it during confirmation proceedings (in which the House of Representatives plays no part).

Accordingly, the eventual fate of *Chevron* is a question mark. Yet equally important to the debate about whether the *Chevron* doctrine should ride off into the sunset like *Shane*³⁹ or remain firmly in place like *Horton*⁴⁰ is this question: Where would we be if Congress or the Supreme Court overruled *Chevron*?

WHAT WOULD FOLLOW *CHEVRON'S* DEMISE?

Bills introduced in the Senate and House of Representatives would overrule *Chevron* by modifying the APA to make clear that federal courts must independently resolve any legal issue posed by a case.⁴¹ The goal of those bills is to eliminate *Chevron* Step 2 and reestablish the default position in administrative law that applied before the Court in *Chevron* devised its new two-step analysis. Were one of those bills to become law, the federal courts would no longer be free to avoid deciding the meaning of a statute by relying on the agency's interpretation. That would also be true if the Supreme Court were to overrule *Chevron* and return administrative law to its pre-*Chevron* status quo. The federal courts would once again have final decision-making authority over the interpretation of federal statutes—at least in the short run. But two features of the *Chevron* decision suggest that the Supreme Court may be unwilling over the long haul to reassume the burden of final responsibility for the interpretation of acts of Congress that are meant to be implemented by the administrative state.

The first one is that the *Chevron* two-step analysis represents an odd marriage of common-law decision-making and statutory construction at a time when the former has largely become a thing of the past. The common-law courts resolved disputes by inching their way along from the guideposts set by analogous precedents in cases involving comparable facts. The courts did not defer to the position of the government (including an executive

branch agency) as a litigant because they saw their role as being that of an impartial referee: an adjudicator charged with deciding cases based on the strength of a party's arguments rather than on the identity of a litigant.

That approach made sense at a time when Congress had not yet begun to turn out statutes like so many loaves of bread for executive branch officials to manage economic and social affairs through a distinct "fourth branch" of government. But the world changed during the New Deal. The birth of the administrative state forced the Supreme Court to decide how to treat the opinions of officials who were not parties to litigation but were held out as experts and utility infielders⁴² with congressionally assigned rulemaking, management, and adjudicatory responsibilities, thereby effectively becoming junior varsity versions of Congress, the executive branch, and the judiciary. The result was to give agencies deference in their area of expertise in order to give effect to Congress's judgment that agency officials, not courts, should manage the economy at the granular level.

The effect of *Chevron* was to mix all of that together into one approach to statutory analysis. Since *Erie R. Co. v. Tompkins*, the federal courts have been unable to engage in the type of common-law lawmaking necessary to fill the gaps left by legislation.⁴³ But *Erie* does not limit the power of agencies to assume that role. Accordingly, where an issue arises that Congress did not answer, whether due to an unforeseen problem or to a crevice between two parts of a statute, *Chevron* directs the federal courts to leave the responsibility for filling that gap to the agency that Congress chartered to perform that task. That is, given the administrative state, the task of filling in the blanks—the role that courts performed when the law consisted of judicial decisions rather than statutes—now falls to the agencies. In other words, federal administrative agencies have become the new common-law courts in "the age of statutes,"⁴⁴ authorized to engage in the same "molar to molecular" lawmaking that the pre-New Deal courts had long

performed.⁴⁵ The role for the federal courts was now the subsidiary one of making sure that an agency remained within the bounds of reason. Otherwise, agencies had the power to act interstitially.

The second noteworthy feature of *Chevron* is closely related to the first one. The Supreme Court's decision in *Chevron* represents a renewed belief in the Progressive-Era dogma that agency officials are subject-matter experts who know better than anyone else what a statute means and how it must be read so that it can work.⁴⁶ The problem with such a canon is that it is neither always right nor always wrong. Some agency officials—biochemists, epidemiologists, hydrogeologists, nuclear engineers, astrophysicists, and so forth—will know more about a particular subject matter than even Supreme Court justices think they know and also will have a better grasp of the on-the-ground tasks that must be accomplished to make a regulatory program work. Other agency officials will be no smarter or better equipped to manage a complicated regulatory program than are the people behind the counter at your local DMV. Uttering that conclusion certainly is not politically correct, and it is highly unlikely that the Supreme Court would ever endorse it in a written opinion published for posterity in the United States Reports. But Supreme Court justices are people—actually, very savvy people—and like everyone else, they will hold a personal view of the different competencies of various agencies and administrative officials.

The consequence is that even if *Chevron* were overruled, the Court is likely to defer to different federal agencies based on the factors to which it pointed before *Chevron*.⁴⁷ When did the agency first adopt its interpretation (e.g., when the statute was adopted or 50 years later)?⁴⁸ How long has the agency had that position (e.g., for 50 years or since last year)?⁴⁹ Has the agency interpretation remained consistent over time?⁵⁰ Is the field at issue one that is evolving or highly technical?⁵¹ Did Congress instruct the agency to decide what was in the "public interest"?⁵² And

so forth. A contemporaneous, consistent, long-standing interpretation of a statute governing a technical field is likely to receive deference because it reveals that—from the outset and through Administrations of both parties—the agency has figured out what is in the public interest.

Here is another way to answer the question of what the world will look like after *Chevron*. The Supreme Court may replace *Chevron* deference with what has been (mis)labeled as *Skidmore* deference, after the case that first articulated the standard, *Skidmore v. Swift & Co.*⁵³ *Skidmore* involved the question of whether employees were entitled to overtime pay for the hours they spent at or nearby their job in a state of readiness in case of a fire. The Fair Labor Standards Act of 1938⁵⁴ did not expressly answer that question, but the relevant federal official, the Administrator of Wages and Hours, had concluded in an agency bulletin that a flexible approach was the best way to decide whether such “waiting” time should be deemed overtime. No statute identified the weight that the Administrator’s opinions should receive, but his views reflected his experience in applying the act.⁵⁵ For that reason, the Supreme Court decided that it would be guided by the persuasiveness of the Administrator’s interpretation: We consider that the interpretations and opinions of the Administrator under this Act, while not controlling upon the courts by reason of their authority, do constitute a body of experience and informed judgment to which courts and litigants may properly resort for guidance. The weight of such a judgment in a particular case will depend upon the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade, if lacking power to control.⁵⁶

Were *Chevron* gone, the Supreme Court would likely apply the *Skidmore* standard to an agency’s interpretations of one of its organic statutes. Pre-*Chevron* Supreme Court case law suggests as much.⁵⁷

Overturing *Chevron* by statute might prevent the Supreme Court from delegating responsibility for statutory interpretation to an agency, but no act of Congress could force the Court to completely disregard what an agency says a law means. At a minimum, the Court would likely place an agency’s construction of a statute on a par with the interpretation adopted by a learned member of the bar or a scholar in the academy. A persuasive agency position would carry the same weight as an opinion by Arthur Corbin on contract law, Herbert Hovenkamp on antitrust law, William Prosser on tort law, David Shapiro on federal jurisdiction, Herbert Wechsler on criminal law, or Charles Allen Wright on federal civil procedure. Each one is a recognized and highly regarded expert in his field whose opinions are valued and sought throughout the legal community.

Of course, each of those experts could be wrong about a particular point—even Homer nodded⁵⁸—and the courts would have the responsibility to accept or reject their opinions. But it would be irrational to disregard a persuasive argument of theirs just because their views are not final. It would be equally irrational to reject an otherwise persuasive argument just because an agency made it, not a law professor. Under *Skidmore*, a federal court would likely give an agency’s opinion whatever persuasive force its reasoning deserved. The difference between *Skidmore* and *Chevron* is that *Skidmore* lets a court decide what is persuasive. A persuasive agency argument is no less persuasive just because the court has the final say.

CONCLUSION

The Supreme Court’s *Chevron* decision has generated considerable controversy over the past decade because it has the effect of transferring the final interpretive authority from the courts to the agencies in any case where Congress did not itself answer the precise dispute. The effect of *Chevron* was to transform agencies into common-law courts because only agencies can engage in the blank-filling necessary when Congress has failed to answer a question.

Overturing *Chevron* would return that ultimate decision-making authority to the federal courts, but it would not eliminate the importance of an agency's interpretation of a statute. The agency's position would have the same status as the interpretation offered by a scholar in the particular field: an opinion that must be considered and should be endorsed if it is persuasive, even if is not controlling.

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ENDNOTES

1. The literature in the field, to use a colloquialism, is “ginormous.” See, e.g., STEPHEN BREYER, *REGULATION AND ITS REFORM* (1984); KENNETH CULP DAVIS, *ADMINISTRATIVE LAW AND GOVERNMENT* (1975); DAVID R. ERNST, *TOCQUEVILLE’S NIGHTMARE: THE ADMINISTRATIVE STATE EMERGES IN AMERICA, 1900–1940* (2014); PHILIP HAMBURGER, *IS ADMINISTRATIVE LAW UNLAWFUL?* (2015); PHILIP K. HOWARD, *THE DEATH OF COMMON SENSE: HOW LAW IS SUFFOCATING AMERICA* (2011); JERRY L. MASHAW, *CREATING THE ADMINISTRATIVE STATE: THE LOST ONE HUNDRED YEARS OF AMERICAN ADMINISTRATIVE LAW* (2012); THOMAS K. McCRAW, *PROPHETS OF REGULATION* (1986); PETER SCHUCK, *WHY GOVERNMENT FAILS SO OFTEN: AND HOW IT CAN DO BETTER* (2014); PETER M. SHANE, *MADISON’S NIGHTMARE: HOW EXECUTIVE POWER THREATENS AMERICAN DEMOCRACY* (2009); CASS R. SUNSTEIN, *AFTER THE RIGHTS REVOLUTION: RECONCEIVING THE REGULATORY STATE* (1993); JAMES Q. WILSON, *BUREAUCRACY: WHAT GOVERNMENT AGENCIES DO AND WHY THEY DO IT* (1991); Harold H. Bruff, *Presidential Power and Administrative Rulemaking*, 88 *YALE L.J.* 451 (1979); Colin S. Diver, *Statutory Interpretation in the Administrative State*, 133 *U. PA. L. REV.* 549 (1985); John F. Duffy, *Administrative Common Law in Judicial Review*, 77 *TEX. L. REV.* 113 (1998); Elena Kagan, *Presidential Administration*, 114 *HARV. L. REV.* 2245 (2001); Richard B. Stewart & Cass Sunstein, *Public Programs and Private Rights*, 95 *HARV. L. REV.* 1193 (1982); Robert L. Rabin, *Federal Regulation in Historical Perspective*, 38 *STAN. L. REV.* 1189 (1986); Richard B. Stewart, *The Reformation of American Administrative Law*, 88 *HARV. L. REV.* 1669 (1975); Peter L. Strauss, *The Place of Agencies in Government: Separation of Powers and the Fourth Branch*, 84 *COLUM. L. REV.* 573 (1984).
2. The Administrative Procedure Act, Pub. L. No. 79-404, 60 Stat. 237 (codified, as amended, at 5 U.S.C. § 500 et seq. (2012)).
3. 401 U.S. 402 (1971).
4. 435 U.S. 519 (1978).
5. *Overton Park* directed federal courts to ensure that agency decision-making complies with the “arbitrary and capricious” and “substantial evidence” APA standards, while *Vermont Yankee* prohibited the courts from imposing additional requirements on agencies or reviewing their decision-making more strictly than the APA requires. See also, e.g., *Michigan v. EPA*, 135 S. Ct. 2699 (2015) (ruling that the EPA’s failure to consider the costs imposed by its proposed rule was “arbitrary and capricious” and therefore invalid under the APA); *Motor Vehicle Mfrs. Ass’n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983) (ruling that the APA “arbitrary and capricious” standard of review applies to an agency’s rescission of a regulation); *Metro. Edison Co. v. People Against Nuclear Energy*, 460 U.S. 766 (1983) (ruling that a federal agency need not consider “risk qua risk” under the federal environmental laws).
6. 467 U.S. 837 (1984).
7. A closely related but legally distinct issue is the standard of review of an agency’s interpretation of one of its own regulations or some other sub-statutory form of law, such as an agency guidance manual. One of the leading cases is *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944), which ruled that an agency’s interpretation of such forms of law (there, a contract) should be accepted if it is persuasive. *Id.* at 140 (“We consider that the rulings, interpretations and opinions of the Administrator under this Act, while not controlling upon the courts by reason of their authority, do constitute a body of experience and informed judgment to which courts and litigants may properly resort for guidance. The weight of such a judgment in a particular case will depend upon the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade, if lacking power to control.”). A later case, *Bowles v. Seminole Rock & Sand Co.*, 325 U.S. 410 (1945), held that when an agency’s interpretation of its own regulation is at stake, “the ultimate criterion is the administrative interpretation, which becomes of controlling weight unless it is plainly erroneous or inconsistent with the regulation.” *Id.* at 414. The Court has reaffirmed and applied the *Seminole Rock* standard in numerous later cases in a diverse variety of settings: when the agency acted in a formal or informal proceeding, when it interpreted a rule in the context of litigation, when its later interpretation appeared to conflict with a different one, and when the “agency” was a nontraditional regulatory agency. See, e.g., *Long Island Care at Home, Ltd. v. Coke*, 551 U.S. 158, 170–71 (2007) (“[W]e concede that the Department may have interpreted these regulations differently at different times in their history.... But as long as interpretive changes create no unfair surprise[,...] the change in interpretation alone presents no separate ground for disregarding the Department’s present interpretation.”) (citations omitted); *Stinson v. United States*, 508 U.S. 36, 44–45 (1993) (U.S. Sentencing Commission); *Robertson v. Methow Valley Citizens Council*, 490 U.S. 332, 359 (1989); *Udall v. Tallman*, 380 U.S. 1, 16–17 (1965) (oil and gas leases). The Supreme Court recently reaffirmed *Seminole Rock* in *Auer v. Robbins*, 519 U.S. 452 (1997). The *Seminole Rock* standard, however, has been controversial of late. Several justices and scholars have questioned its legitimacy. Their argument is that *Seminole Rock* allows an agency to draft a regulation whose text is ambiguous, shepherd that regulation through the APA notice-and-comment process without identifying a controversial interpretation, and then obtain virtually complete deference for that interpretation in an enforcement action. See, e.g., *Perez v. Mortgage Bankers Ass’n*, 135 S. Ct. 1199, 1210 (2015) (Alito, J., concurring in part and concurring in the judgment); *id.* at 1212–13 (Scalia, J., concurring in the judgment) (“I am unaware of any such history justifying deference to agency interpretations of its own regulations. And ‘[T]here are weighty reasons to deny a lawgiver the power to write ambiguous laws and then be the judge of what the ambiguity means.... would therefore restore the balance originally struck by the APA.’”) (citation omitted); *id.* at 1213–25 (Thomas, J., concurring in the judgment) (“That line of precedents, beginning with *Bowles v. Seminole*

Rock & Sand Co., 325 U.S. 410 (1945), requires judges to defer to agency interpretations of regulations, thus, as happened in these cases, giving legal effect to the interpretations rather than the regulations themselves. Because this doctrine affects a transfer of the judicial power to an executive agency, it raises constitutional concerns. This line of precedents undermines our obligation to provide a judicial check on the other branches, and it subjects regulated parties to precisely the abuses that the Framers sought to prevent.”); John F. Manning, *Constitutional Structure and Judicial Deference to Agency Interpretations of Agency Rules*, 96 COLUM. L. REV. 612 (1996). Justice Scalia expressed a willingness to reconsider *Seminole Rock* before his death, but it is uncertain whether a majority of the Court is willing to do so. As a matter of policy, the best defense of *Auer* deference is the same one that is offered to support *Chevron*. See Cass R. Sunstein & Adrian Vermeule, *The Unbearable Rightness of Auer*, 83 U. CHI. L. REV. (forthcoming 2016). Accordingly, if *Chevron* falls so does *Auer*.

8. Pub. L. No. 95-95, 91 Stat. 685 (1977).
9. 5 U.S. (1 Cranch) 137 (1803).
10. *Id.* at 177.
11. *Id.* at 842.
12. *Id.* at 842–43 (“When a court reviews an agency’s construction of the statute which it administers, it is confronted with two questions. First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress.”) (footnote omitted).
13. *Id.* at 843.
14. *Id.* (“If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, as would be necessary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency’s answer is based on a permissible construction of the statute.”) (footnotes omitted).
15. *Id.* at 843–44 (“The power of an administrative agency to administer a congressionally created...program necessarily requires the formulation of policy and the making of rules to fill any gap left, implicitly or explicitly, by Congress.... If Congress has explicitly left a gap for the agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation. Such legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute. Sometimes the legislative delegation to an agency on a particular question is implicit rather than explicit. In such a case, a court may not substitute its own construction of a statutory provision for a reasonable interpretation made by the administrator of an agency.”) (citation and footnotes omitted).
16. *Id.* at 865–66 (“Judges are not experts in the field, and are not part of either political branch of the Government. Courts must, in some cases, reconcile competing political interests, but not on the basis of the judges’ personal policy preferences. In contrast, an agency to which Congress has delegated policy-making responsibilities may, within the limits of that delegation, properly rely upon the incumbent administration’s views of wise policy to inform its judgments. While agencies are not directly accountable to the people, the Chief Executive is, and it is entirely appropriate for this political branch of the Government to make such policy choices—resolving the competing interests which Congress itself either inadvertently did not resolve, or intentionally left to be resolved by the agency charged with the administration of the statute in light of everyday realities.”).
17. *Id.* at 845–64.
18. *Id.* at 864–66.
19. 135 S. Ct. 2480 (2015).
20. See Cass R. Sunstein, *Chevron Step Zero*, 92 VA. L. REV. 187 (2006).
21. Pub. L. No. 111-148, 124 Stat. 119 (2010).
22. And to others as “SCOTUScare.” *King*, 135 S. Ct. at 2507 (Scalia, J., dissenting).
23. *King*, 135 S. Ct. at 2488–89 (quoting *FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 159 (2000)).
24. *King*, 135 S. Ct. at 2489 (citations and internal punctuation omitted).
25. There is also the question whether an agency’s action pursuant to its interpretation of a statute is arbitrary and capricious, which some have labeled a fourth step in the analysis. See Jack M. Beermann, *End the Failed Chevron Experiment Now: How Chevron Has Failed and Why It Can and Should Be Overruled*, 42 CONN. L. REV. 779, 834–35 (2010) (noting the discussion about whether arbitrary-and-capricious review should be collapsed into *Chevron* Step 2 or be a separate final step in the analysis). That debate does not bear directly on the issues discussed herein.

26. Aside from the absence of any statement in the opinion to that effect, two facts support the conclusion stated in the text above. One is that only six of the nine justices participated in that case; three were recused. 467 U.S. at 866. It seemed unlikely that the Court intended to make a tectonic shift in the law with a third of its members on the sidelines. The other fact is that the Court was unanimous. Dissenting opinions tend to challenge the reasoning of the majority, which forces the majority to address what one or more colleagues deem flaws in the majority's reasoning or unfortunate consequences that will follow from the Court's decision. Justice Stevens's opinion did not have to undertake any such burden in *Chevron*, perhaps because the other five justices were just happy to find some way to dispose of the case without playing the role of a referee.
27. See *infra* notes 44–50 and accompanying text.
28. See, e.g., *Chevron*, 467 U.S. at 844 (“We have long recognized that considerable weight should be accorded to an executive department’s construction of a statutory scheme it is entrusted to administer, and the principle of deference to administrative interpretations has been consistently followed by this Court whenever decision as to the meaning or reach of a statute has involved reconciling conflicting policies, and a full understanding of the force of the statutory policy in the given situation has depended upon more than ordinary knowledge respecting the matters subjected to agency regulations.”) (footnote and internal punctuation omitted); *id.* at 844 n.14 (collecting cases in which the Court deferred to an agency’s interpretation of a statute).
29. See U.S. CONST. art. I, § 2, cl. 1 (“The House of Representatives shall be composed of Members chosen every second Year by the People of the several States, and the Electors in each State shall have the Qualifications requisite for Electors of the most numerous Branch of the State Legislature.”); *id.* amend. XVII (“The Senate of the United States shall be composed of two Senators from each State, elected by the people thereof, for six years; and each Senator shall have one vote. The electors in each State shall have the qualifications requisite for electors of the most numerous branch of the State legislatures.”).
30. See U.S. CONST. art. I, § 8 (specifying the powers of Congress).
31. Numerous commentators have criticized President Obama’s “I don’t need no stinking statute” approach to governance. (For his possible muse, see *The Treasure of the Sierra Madre* (Warner Bros. 1948), <https://www.youtube.com/watch?v=nsdZKCh6RSU>.) For two excellent, detailed treatments, see DAVID E. BERNSTEIN, *LAWLESS: THE OBAMA ADMINISTRATION’S ASSAULT ON THE RULE OF LAW* 81 (2015), and Written Statement of Elizabeth Slattery Before the Task Force on Executive Overreach of the House Judiciary Comm., *Executive Overreach in Domestic Affairs Part I—Health Care and Immigration* (Mar. 18, 2016), <http://www.heritage.org/research/testimony/2016/executive-overreach-in-domestic-affairs-part-ihealth-care-and-immigration>.
32. See, e.g., Robert A. Anthony, *The Supreme Court and the APA: Sometimes They Just Don’t Get It*, 10 AM. U. ADMIN. L.J. 1 (1996); Gary Lawson, *The Rise and Rise of the Administrative State*, 107 HARV. L. REV. 1231 (1994); Cory R. Liu, *Chevron’s Domain and the Rule of Law*, 20 TEX. REV. L. & POL. 391 (2016); Patrick J. Smith, *Chevron’s Conflict with the Administrative Procedure Act*, 32 VA. TAX REV. 813, 818 (2013).
33. Parallel bills were introduced in the Senate and House of Representatives. See S. 2724, The Separation of Powers Restoration Act, 114th Cong. (2016); H.R. 4768, The Separation of Powers Restoration Act, 114th Cong. (2016). The House passed an amended version of the House bill on July 12, 2016. Congress.gov, <https://www.congress.gov/bill/114th-congress/house-bill/4768> (last accessed Aug. 9, 2016). The Senate has not yet acted on its version.
34. Professor Jack Beermann has been a particularly vocal critic of *Chevron*. See Jack M. Beermann, *Chevron at the Roberts Court: Still Failing After All These Years*, 83 FORDHAM L. REV. 731 (2014); Beermann, *supra* note 25. But he is not alone. See *supra* note 32.
35. Other criticisms of *Chevron* include the following: (1) *Chevron* is inconsistent with the APA, which directs courts to review and set aside unlawful agency actions; (2) *Chevron* mistakenly assumed that Congress intended to vest interpretive authority in agencies when Congress gave no thought to the matter; (3) the Court has manipulated the *Chevron* test whenever it does not like the result that *Chevron* would require by creating exceptions to its supposedly all-encompassing standard; (4) *Chevron* gives Members of Congress an unnecessary and undesirable incentive to punt to unelected agency officials the answers to important policy issues; and (5) *Chevron* encourages dishonesty by everyone involved—Members of Congress, agency officials, and the lower federal courts—because it enables each one to deceive the public that a policy dispute never the subject of a vote on the floor of the Senate or the House is actually a legal issue. For an entertaining example of how the *Chevron* doctrine can tie up in knots any effort to make sense of it, see Kenneth A. Bamberger & Peter L. Strauss, *Chevron’s Two Steps*, 95 VA. L. REV. 611 (2009); Mathew C. Stephenson & Adrian Vermeule, *Chevron Has Only One Step*, 95 VA. L. REV. 597 (2009); Cass Sunstein, *Chevron Step Zero*, *supra* note 20.
36. See, e.g., Lawson, *supra* note 32, at 1247–48.
37. See *United States v. Texas*, 136 S. Ct. 2271 (2016) (affirming the judgment below by an equally divided Court); *Friedrichs v. Cal. Teachers’ Ass’n*, 136 S. Ct. 1083 (2016) (same).
38. See *Zubik v. Burwell*, 136 S. Ct. 1557 (2016) (per curiam decision sending the case back to the lower federal courts and effectively telling the parties, in a manner of speaking, to “go work it out”).
39. See JACK SCHAEFFER, *SHANE* (1949).

40. See DR. SEUSS, *HORTON HATCHES THE EGG* (1940).
41. See *supra* text accompanying notes 33–34.
42. For readers unfamiliar with the national pastime, a “utility” infielder is a baseball player who is sufficiently skilled to play multiple positions in the infield (ordinarily, but not exclusively, second base, third base, or shortstop) but not a good enough hitter to be in the starting lineup. Think Luis Sojo, New York Yankees, 1996–1999 and 2000–2001.
43. Under *Erie R. Co. v. Tompkins*, the federal courts generally lack authority to create federal common law. They may do so only in connection with subjects of peculiarly federal interest, such as admiralty, federal sovereign immunity, the obligations of the federal government, and interstate disputes over geographic boundaries and water rights. See, e.g., *Nw. Airlines, Inc. v. Transp. Workers Union*, 451 U.S. 77, 95–98 (1981) (collecting cases).
44. See GUIDO CALABRESI, *A COMMON LAW FOR THE AGE OF STATUTES* (1985).
45. *S. Pac. Co. v. Jensen*, 244 U.S. 205, 221 (1917) (Holmes, J., dissenting).
46. Yes, the *Chevron* opinion does not use those terms explicitly, talking instead of a “presumption” that Congress delegated interpretive authority to an agency. But Justice Stevens pulled that presumption out of thin air because there is no more reason to presume that Congress delegated decision-making authority to an agency than there is to presume that Congress did not give the matter a moment’s thought. See Antonin Scalia, *Judicial Deference to Administrative Interpretations of Law*, 1989 DUKE L.J. 511, 517. The Court’s use in *Chevron* of a “presumption” of congressional intent was a “fictional, presumed intent.” *Id.* A wag might say that “legal fiction” is the term that courts use to label what, when spoken by others, courts call a “lie.”
47. See, e.g., *Udall v. Tallman*, 380 U.S. 1, 16 (1965) (“When faced with a problem of statutory construction, this Court shows great deference to the interpretation given the statute by the officers or agency charged with its administration. To sustain the Commission’s application of this statutory term, we need not find that its construction is the only reasonable one or even that it is the result we would have reached had the question arisen in the first instance in judicial proceedings.”) (citation and internal punctuation omitted). The difference between what the Court wrote in *Tallman* and in *Chevron* is like the difference between dusk and twilight.
48. See, e.g., *Power Reactor Dev. Co. v. Int’l Union of Elec., Radio & Mach. Workers, AFL–CIO*, 367 U.S. 396, 408 (1961) (“Particularly in this respect due when the administrative practice at stake involves a contemporaneous construction of a statute by the men charged with the responsibility of setting its machinery in motion; of making the parts work efficiently and smoothly while they are yet untried and new.”) (citation and internal punctuation omitted).
49. See, e.g., *FCC v. Pacifica Found.*, 438 U.S. 726, 737 (1978) (“Not only did the Federal Radio Commission so construe the statute prior to 1934; its successor, the Federal Communications Commission, has consistently interpreted the provision in the same way ever since.”).
50. See, e.g., *NLRB v. Bell Aerospace Co. Div. of Textron*, 416 U.S. 267, 289 (1974) (“In sum, the Board’s early decisions, the purpose and legislative history of the Taft–Hartley Act of 1947, the Board’s subsequent and consistent construction of the Act for more than two decades, and the decisions of the courts of appeals all point unmistakably to the conclusion that managerial employees are not covered by the Act. We agree with the Court of Appeals below that the Board is not now free to read a new and more restrictive meaning into the Act.”) (footnote and internal punctuation omitted).
51. See, e.g., *Nat’l Broad. Co. v. United States*, 319 U.S. 190, 219–20 (1943) (“Congress did what experience had taught it in similar attempts at regulation, even in fields where the subject-matter of regulation was far less fluid and dynamic than radio. The essence of that experience was to define broad areas for regulation and to establish standards for judgment adequately related in their application to the problems to be solved.”).
52. See, e.g., *FCC v. Nat’l Citizens Comm. for Broad.*, 436 U.S. 775, 795 (1978) (“[T]he physical scarcity of broadcast frequencies, as well as problems of interference between broadcast signals, led Congress to delegate broad authority to the Commission to allocate broadcast licenses in the public interest. And the avowed aim of the Communications Act of 1934 was to secure the maximum benefits of radio to all the people of the United States.”) (internal punctuation omitted).
53. 323 U.S. 134 (1944). *Skidmore* is mislabeled as a form of deference because, as the opinion makes clear, it states that a court should agree with an agency’s interpretation only insofar as it finds that opinion *persuasive*. *Id.* at 140 (quoted *infra* at text accompanying note 56). Under *Chevron* Step 2, an agency can receive deference even if a court is unpersuaded that the agency’s position is the one that the court would have adopted in the first instance. See 467 U.S. at 844 (“Sometimes the legislative delegation to an agency on a particular question is implicit rather than explicit. In such a case, a court may not substitute its own construction of a statutory provision for a reasonable interpretation made by the administrator of an agency.”) (footnote omitted).
54. Ch. 676, 52 Stat. 1060 (1938).
55. *Skidmore*, 323 U.S. at 139–40 (“There is no statutory provision as to what, if any, deference courts should pay to the Administrator’s conclusions. And, while we have given them notice, we have had no occasion to try to prescribe their influence.

The rulings of this Administrator are not reached as a result of hearing adversary proceedings in which he finds facts from evidence and reaches conclusions of law from findings of fact. They are not, of course, conclusive, even in the cases with which they directly deal, much less in those to which they apply only by analogy. They do not constitute an interpretation of the Act or a standard for judging factual situations which binds a district court's processes, as an authoritative pronouncement of a higher court might do. But the Administrator's policies are made in pursuance of official duty, based upon more specialized experience and broader investigations and information than is likely to come to a judge in a particular case. They do determine the policy which will guide applications for enforcement by injunction on behalf of the Government. Good administration of the Act and good judicial administration alike require that the standards of public enforcement and those for determining private rights shall be at variance only where justified by very good reasons. The fact that the Administrator's policies and standards are not reached by trial in adversary form does not mean that they are not entitled to respect. This Court has long given considerable and in some cases decisive weight to Treasury Decisions and to interpretative regulations of the Treasury and of other bodies that were not of adversary origin.”).

56. *Id.* at 140.

57. *See, e.g., Tallman*, 380 U.S. at 16 (quoted *supra* at note 47); *NLRB v. Hearst Publications*, 322 U.S. 111, 130–31 (1944) (“Undoubtedly questions of statutory interpretation, especially when arising in the first instance in judicial proceedings, are for the courts to resolve, giving appropriate weight to the judgment of those whose special duty is to administer the questioned statute.”).

58. That is, even the most intelligent person can make a mistake due to a brief lack of alertness or inattention. *See* EVEN HOMER NODS, OXFORD DICTIONARIES, http://www.oxforddictionaries.com/us/definition/american_english/even-homer-nods.

CHAPTER 11: Transparency and Accountability at the SEC and at FINRA

Thaya Brook Knight

We know that governments “deriv[e] their just powers from the consent of the governed”¹—but what happens when the governed have no means of providing, or withholding, their consent? Currently, those bodies that govern the country’s securities sector—in particular the Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA)—lack the structural safeguards necessary to ensure that they exercise their authority only with the consent of the American public. There are solutions to these problems. The solution for the SEC is easier than the solution for FINRA, but the first step is persuading both entities that there *is* a problem. This chapter outlines the problems of accountability and transparency that plague both entities, and provides recommendations for ameliorating these deficiencies.

THE SEC: ADMINISTRATIVE PROCEEDINGS

The SEC was established in 1934 amid the wave of new agencies created under the auspices of the New Deal. Like many of this new breed of federal agency, it has, from its inception, incorporated rule-making, investigatory, and adjudicatory functions. The mix of all three branches—legislative, executive, and judicial—in a single agency has always inspired some skepticism. Indeed, James Madison warned against such a mix of powers in the *Federalist Papers*, arguing that the “accumulation of all powers, legislative, executive, and judiciary, in the same hands, whether of one, a few, or many, and whether hereditary, self-appointed, or elective, may justly be pronounced the very definition of tyranny.”² The

inclusion of the adjudicatory power may pose the greatest threat to liberty.

When an agency’s adjudicatory power is limited, when it is used only to interpret the rules established by the agency itself and not to mete out punishment, the risk it poses is reduced. Unfortunately, the role of the Administrative Law Judge (ALJ), who presides over this function, has increased enormously at the SEC, and administrative adjudication has now in many respects overtaken the role carved out in the constitution for the judiciary. This increase in power represents a serious threat both to the liberty of individuals and companies brought before the SEC’s ALJs, as well as to the credibility of the system as a whole.

While the SEC has always had the power to conduct internal hearings, the ALJ did not

exist until somewhat later. The Administrative Procedure Act (APA), passed in 1946, provided some guidance on conducting internal adjudications.³ Amendments to the APA in 1966 established further procedural rules for hearings presided over by agency employees, then called “hearing examiners.”⁴ But it was not until 1978 that the corps of quasi-judicial employees was dubbed ALJs.⁵

In the nearly 40 years since ALJs were established, the role has seen a marked increase in power. Although SEC administrative hearings were for decades viewed as providing remedial, not punitive, relief, that view began to change in the 1980s.⁶ Between 1984 and 1990, the SEC’s enforcement power expanded to include the ability to seek monetary penalties for violation of the securities laws, the ability to bar directors and officers of public companies from serving in those roles as a consequence of having engaged in activity prohibited by the securities laws, and the authority to issue cease-and-desist orders, temporary restraining orders, and orders to disgorge ill-gotten gains.⁷ In the wake of the corporate scandals that dominated the beginning of the 21st century, the Sarbanes–Oxley Act of 2002 handed the SEC more authority still, creating new obligations for corporate executives and directors, and providing the SEC with the tools to enforce those rules. And in 2010, the Dodd–Frank Act gave the SEC the power to impose fines on individuals who had not previously been subject to SEC authority.⁸

The SEC is not unique among federal agencies in using administrative hearings presided over by ALJs. But not every administrative hearing is created equal. The vast majority of ALJs work for one agency: the Social Security Administration (SSA). That agency alone employs more than 1,500 of the roughly 1,800 ALJs employed by the federal government.⁹ The SEC, by comparison, employs only five. The types of cases the SSA hears, however, differ substantively from the type heard by the SEC. In the case of the SSA, the role of the ALJ is to determine whether a person is eligible to receive benefits.¹⁰ At the SEC, however,

it is not the individual appealing a decision to the agency, but the agency bringing an action *against* the individual. The individual, as a respondent, has no choice but to participate in the administrative hearing. Additionally, while the SSA hearings typically address whether the government must give benefits *to* the citizen who brought the appeal, the SEC hearings typically address whether the government will *take* fines or withhold licenses from the citizens brought before it.

Although the SEC’s enforcement power has grown over the past several decades, it has done so without an attendant examination of the agency’s administrative hearings. The role of administrative hearings within the SEC has become indistinguishable from the role of trials before federal judges. In fact, in most cases brought against a respondent by the SEC, there is concurrent jurisdiction between the agency and the court. That is, the case is one that could be heard by a federal judge in federal district court, but is instead brought before an ALJ within the SEC. It is not clear how these actions are distinguishable from the judicial power of the United States, which, according to the Constitution, is vested in the federal courts, not in the federal agencies. In fact, a number of respondents have recently challenged the SEC’s administrative hearing process, alleging that the hearings provide insufficient due process and that the appointment process for ALJs is unconstitutional.¹¹

There has also been concern that the SEC has an easier time prevailing in its own administrative proceedings. A recent article in *The Wall Street Journal* noted that the SEC enjoys a 90 percent success rate in administrative proceedings but prevails in only 69 percent of cases before federal judges.¹² It is possible that a portion of this discrepancy can be attributed to the agency’s internal selection process and that the cases brought in-house are for some reason those that would be easier for the SEC to win regardless of venue. But the perception of fairness is often as important to the integrity of an adjudicatory process as the actual existence of fairness,

and in this case the difference at least raises questions about whether individuals receive fair treatment.

The distinction between court and administrative proceedings is especially important because federal court proceedings include a number of protections for the benefit of the defendant that are lacking in administrative proceedings. Most important among these is the discovery phase of litigation. Broadly, discovery is the process by which the parties obtain information from each other about what evidence might be presented at trial.¹³ The process is highly formalized and includes both written and oral portions. In the written portion, parties exchange lists of questions to be answered under oath by the other party, and write requests for documents, which must be produced again under oath. Any failure by either party to comply with these written requests can be brought to the court. The oral portion includes depositions, in which potential witnesses provide hours of sworn testimony. The questions that can be posed during this process are wide-ranging and allow much greater leeway than is afforded at trial.

Although respondents in administrative hearings may request that certain documents be subpoenaed and that certain witnesses be called for the hearing, the process is limited when compared with the process permitted in federal court. The lack of discovery in administrative proceedings means that respondents and their counsel may go into settlement negotiations partially blind. Approximately 80 percent of all cases begun as administrative proceedings ultimately settle, making the fairness of settlement negotiations a key determinate of fairness overall.¹⁴ It is exceedingly difficult to know what a fair settlement is without knowing what evidence is likely to be presented in a hearing. And because the discovery process uncovers not only the evidence likely to be presented in support of the plaintiff's case, but also information that weakens the plaintiff's position, access to this information is crucial to a defendant's ability to leverage the weaknesses to obtain a more favorable deal.

The government, however, does not approach settlement blindly. The government has the authority to issue subpoenas for both documents and for witnesses to appear and give testimony in the course of its investigation, before the SEC has even decided to pursue charges. This testimony is typically provided in a closed session with just the SEC's lawyer, the witness, and the witness's lawyer present. The government also reviews thousands, or millions, of documents provided by the respondent and other individuals and firms. By the time the parties begin settlement negotiations, the SEC usually has a much clearer understanding of what would be presented at a hearing than the respondent does.

Administrative proceedings present other challenges as well. Because the hearing and investigation are conducted by the industry regulator, witnesses in the industry may be nervous about testifying in favor of a respondent. Of course, even in federal court a witness who works in the securities industry may be hesitant to testify against the SEC, but the court provides the added safeguard of being presided over by a federal judge. The experience of testifying before a judge or a jury in a courtroom is simply different from showing up on the doorstep of the SEC building to testify before an SEC employee. Finally, administrative hearings provide no option for a jury trial; the ALJ alone makes the final decision in the case, unless it is appealed.

ALJs do not, as has been noted, operate without certain checks on their authority. Any decision rendered by an ALJ can be appealed to the SEC itself.¹⁵ Even that decision can ultimately be appealed to a federal court. But recourse to either of these avenues depends on the respondent proceeding with a complete hearing instead of settling. As mentioned above, only 20 percent of cases proceed to hearing; the other 80 percent settle with no opportunity to appeal even to the full SEC.

This is a vitally important point. As discussed earlier, respondents and their lawyers go into settlement negotiations without a full command of the evidence. In the rare cases in

which a respondent proceeds to a full hearing, the respondent at least has the benefit of seeing the evidence against him or her and has an opportunity to respond to it. A respondent who instead opts for settlement may have no such opportunity.

Additionally, even when a case proceeds through a hearing, the available appeal is limited. In law, there are two types of findings that can be determined through trial: findings of fact, and findings of law. Findings of fact refer to the process of determining what actually happened: Did the defendant make a particular transaction? Did the respondent have certain knowledge? Did the defendant communicate with another person at a specific time? Findings of law refer to the process of determining whether those facts satisfy the elements of the case brought against the defendant: Was the information “material”? Was the communication “misleading”? Although the commissioners may hear an appeal, they typically give great deference to the ALJ’s findings of fact, in particular to the ALJ’s determination of witnesses’ credibility, “absent overwhelming evidence to the contrary.”¹⁶ If the respondent claims not to have said particular words during a telephone call, but the ALJ has found the respondent’s denial not credible, the commissioners will typically accept the ALJ’s finding. What the commissioners will review is whether those words constituted, for example, a misleading statement about a material fact. If the case is appealed to federal court, the court will grant the same deference, accepting as true the findings of fact made by the ALJ. This means that even in the 20 percent of cases that proceed through a full administrative hearing, and are not settled, there is no real opportunity to appeal the ALJ’s findings of *fact* even if it was the facts, not the law, that were in dispute. This does not differ from the practice in the judicial branch in that the findings of fact made at the trial court level are rarely disturbed by the appellate court, and appeals almost always turn only on the interpretation of the law and its application to the facts. But,

as discussed, defendants facing trial in court have the full discovery apparatus available to them, rendering the findings of fact more reliable than those determined by an ALJ.

Given the lack of discovery and the handicap it presents the respondent in making a case to the ALJ, and crucially in refuting evidence presented by the SEC attorneys, review of findings of law by the commission or a federal court is cold comfort. Especially as it is the commission that decides to bring charges against a respondent in the first place. This results in what is at base “a top-level, agency-wide decision to side with Enforcement and against the respondent, prior to any adversarial hearing on the merits.”¹⁷ An appeal to the very body that already sided against the respondent is not much of an appeal at all.

Although agencies do not conduct the full recruitment process for ALJs, they do select the individuals from a list presented to them by the Office of Personnel Management. And while there are certain practices designed to preserve the independence of the ALJs—they can be fired only for cause, and, at least in the SEC, their offices are physically segregated in the building from other employees—the ALJs are nonetheless employees of the agencies they serve and are on the agency’s payroll. This is not to impugn the integrity of any individual ALJ, nor of the entire corps, and yet such arrangement can elicit “fears of bias [which] can arise when—without the consent of the other parties—a man chooses the judge in his own cause.”¹⁸ Again, there is a distinction between the hearings held by agencies such as the SSA, and enforcement hearings such as those held by the SEC. This is clearly visible in the manner in which the agencies present their adjudications to the public. For example, the SEC often issues press releases touting the number of successful enforcement actions it has brought in the past year, congratulating its staff for their work in winning large penalties or settlements from defendants.¹⁹ In comparison, there is no political capital to be gained by trumpeting the number of applicants for Social Security benefits

who were turned away empty-handed each year. The incentives of the SSA in conducting its hearings are quite different from those of the SEC, resulting in a structural bias in favor of the SEC in its own administrative hearings.

The solution to the current problem is relatively simple: Give the respondent a choice of federal court or administrative proceeding. This is the choice that is always available to the SEC's enforcement attorneys and it is only fair to extend it to the respondent. In other areas of law with concurrent jurisdiction—when a case could be brought in state or federal court, for example—the parties are equally eligible to move for the case's removal to the other jurisdiction.

Those who support the use of administrative proceedings often tout their benefits to the respondent. For example, noting that the process is streamlined and therefore speedier, allowing the respondent to move on quickly without a cloud of suspicion hanging overhead. A quicker proceeding also means less attorney time and therefore a lower cost for the respondent. The ALJs, because they hear only securities cases, are typically more knowledgeable about the intricacies of securities regulation and can be a better arbiter than a federal judge who hears every kind of case under federal law with little opportunity to delve deeply into any. To the extent that these features are attractive to respondents, many may still choose to proceed through the administrative route. But these features are not universally attractive, as evidenced by the respondents suing for their rights to be heard in federal court. To the extent that a respondent would prefer the safeguards so precious to our concept of due process, the respondent should have the opportunity to elect them.

FINRA: A BIGGER PROBLEM

In addition to the SEC, there is another organization that regulates the securities industry. Neither fish nor fowl, it straddles the line between government and private entity, in many instances taking the worst from both worlds and offering a considerable lack

of transparency and accountability overall. FINRA is a non-governmental self-regulatory organization (SRO) that oversees firms and individuals operating in the securities industry. Organized as a private not-for-profit corporation, it, like the SEC, includes rule-making, enforcement, and arbitration functions all under one roof. It writes and issues rules that, with SEC approval, govern the securities industry. It administers the industry's licensing process, including writing and administering the relevant exams. It investigates the violation of its rules and conducts in-house enforcement actions, levying fines and barring individuals and firms from the industry in order to punish and deter wrongful conduct. It provides investor education to the public. And, it provides arbitration facilities for its members in order to mediate disputes between them. Like the SEC, compliance with its rules is compulsory for those in the securities industry. Unlike the SEC, its management is not answerable to, nor appointed by, an elected official.

The fact that FINRA is a non-governmental regulator is not, in itself, problematic. Although the federal securities laws date from the Great Depression, and state securities laws date from the turn of the 19th century, non-governmental regulation of the industry dates from just after the country's founding. In 1792, a group of brokers famously executed the Buttonwood Agreement, creating what is now known as the New York Stock Exchange (NYSE). While the NYSE has never been a government entity, it has always been a regulator. Although the terms of the Buttonwood Agreement were quite terse, the rules for trading on the NYSE expanded over time. By 1817, the rules already included a process for collecting fines, adjudicating disagreements, and ejecting members found to have engaged in fraud.²⁰ A hundred years later, by 1920, a disclosure regime was also firmly in place, with a number of monthly and other regular reports required by member firms.²¹ There is, in fact, much to be recommended in the private regulation of the industry. Indeed, it was the practice in this country for more than 100 years.

While FINRA did not come into being until 90 years after the NYSE was established, the framework for such a public-private structure was laid much earlier. In 1934, Congress passed the Exchange Act, which established the SEC and introduced government regulation of the securities exchanges. In 1938, the Maloney Act amended the Exchange Act to provide for the creation of self-regulatory organizations that would provide oversight of the over-the-counter (OTC) markets in a manner similar to the oversight provided for exchange trading by the exchanges themselves. These organizations were charged with “prevent[ing] fraudulent and manipulative acts and practices [and] promot[ing] just and equitable principles of trade.”²² Although the Maloney Act contemplated “national securities associations” (plural) only one such association, the National Association of Securities Dealers (NASD), ever materialized.

FINRA took on its current form in 2007 when the NASD merged with the regulatory arm of the NYSE.²³ One of the chief reasons for the merger was to consolidate the regulations governing broker-dealers, bringing the exchange and OTC oversight under one roof.²⁴ The merger was expected to streamline the regulatory burden by “eliminat[ing] unnecessarily duplicative regulation, including consolidating and strengthening what until now have been two different member rulebooks and two different enforcement systems.”²⁵ FINRA, like the NASD before it, is an SRO as defined by the Securities Exchange Act of 1934.

There are considerable advantages to industry self-regulation. One of the challenges of effective oversight is the risk that the overseers become detached from the industry and begin to create rules that are out of touch with the day-to-day realities of running a business. Done well, self-regulation draws on members’ experiences to establish best practices that promote both good governance and ethical policies. But these benefits are difficult to realize when the self-regulating organization

combines government power and entanglement with private ownership, as is the case with FINRA. Instead, it operates with nearly as much power as a government agency, but without essential checks on that power.

One of the reasons that checks on government power are so essential to liberty is that it is the nature of government regulation to be mandatory; there is no opt-out. When the NASD was first established, membership was voluntary. Beginning in 1945, however, membership became mandatory for principal and customer-facing employees of broker-dealers, and by 1983, it was mandatory for the entire industry, a requirement that has persisted with the creation of FINRA.²⁶ This has resulted in the creation of a quasi-governmental structure that lacks the safeguards that we insist upon for actual government institutions. Although FINRA’s rules must be approved by the SEC,²⁷ the SEC does not choose FINRA board members, nor does it appoint any executives or other employees of the organization. This means that, despite the broad power that FINRA exercises over the industry, there is no accountability to an elected official or even to an officer of the United States.²⁸ Instead the executives are chosen by a board of directors, and the executives and other managers select the remaining employees.

FINRA’s lack of accountability also means that it is at risk of providing poor protection to investors. While the SEC and other government actors are ultimately answerable to the investing public, FINRA faces no such scrutiny, and its officials risk no removal from office. There is therefore no direct political accountability to provide an incentive to FINRA officials to ensure that its rules are effective. Because investors have been encouraged to rely on the SEC and FINRA to enforce certain standards against the industry, they are likely to be lax in conducting their own due diligence in assessing the business practices of a broker.

FINRA also lacks the transparency that is required of government entities. It is not subject to the Freedom of Information Act

that requires government offices to release requested documents to the public.²⁹ It is not required to follow the lengthy rule-making process mandated by the Administrative Procedures Act, which ensures that any proposed regulation be subject to public notice and comment.³⁰ Nor is it subject to the Sunshine Act's provisions that require certain meetings be open to the public.³¹ Accompanying the lack of proper controls is the fact that, like the SEC, it houses multiple quasi-governmental functions, along with the attendant problems described in the previous section.

FINRA also lacks the checks on power and the considerable benefits that typically apply to private corporations. One of the great benefits of private enterprise is the discipline and push toward innovation that market forces supply. But because FINRA is a monopoly, it has no incentive to improve its structure to attract members. Because membership is compulsory, FINRA faces no risk that members will flee from unfair rules or enforcement. It has the freedom to establish compensation for its own employees at rates as high as its funds can support. And that compensation can be quite high. In 2015, FINRA's CEO earned nearly \$3 million; of the organization's top 10 executives, eight had compensation squarely in the seven figures, and the remaining two were close behind.³² While FINRA must compete with the private sector to attract and retain talent, and talented financial executives can command huge compensation in the private sector, it draws on the same talent pool used by other financial regulators, whose pay is not nearly so rich. For example, SEC commissioners earn just under \$250,000, and the Secretary of the Treasury earns less than \$200,000.³³ It is not clear why the FINRA CEO must earn 15 times the amount the Secretary of the Treasury does. In a truly private organization, which faces competitive pressures, compensation is held in check by the need to run the company efficiently. FINRA executives face no such countervailing force.

The means by which FINRA is funded creates its own conflicts, since FINRA's funding

derives from fees levied on members and from proprietary investments, including investments governed by FINRA's own rules. FINRA has attempted to temper some of this conflict, at least with regard to fees imposed for violation of FINRA rules. Such fees can be used only for capital expenditures or for programs promoting investor protection.³⁴ But money is fungible and therefore fees that support capital improvements free up other funds to be used for other purposes, including pay roll.

FINRA therefore exists in a kind of golden limbo. As a private entity, it is protected from the accountability and transparency required of government. As a quasi-governmental entity, it enjoys enormous power without being subject to the usual market forces. It also enjoys immunity from suit, at least when acting in its quasi-governmental role.³⁵

The solution to this problem is to withdraw FINRA's quasi-governmental authority and allow it to exist as a purely voluntary, private industry association. This will return accountability to its members, who will have the option of leaving if they are unsatisfied with its practices. FINRA would be able to continue to administer a certification exam, but would need to promote the value of this exam to investors and brokers alike, leading investors to seek out brokers who hold FINRA certification and leading brokers to be willing to sit for the exam. FINRA would be motivated to police the rigor of the exam because it would be valuable only if investors perceived it to demonstrate the broker's knowledge. FINRA would also be motivated to police its membership to ensure they meet the organization's standards, and members would be willing to submit to this oversight to communicate their trustworthiness and ability to clients. Additionally, without the government ties, entrance for new SROs would be easier, introducing competition and allowing refinement of rules and best practices. Finally, it would loosen the grip that FINRA currently has on members, requiring fairness and transparency in its disciplinary process.

Although private regulation can provide great benefits to an industry, many of those benefits are compromised when the regulator enjoys governmental authority. Likewise, governmental power without the essential checks on power we typically require risks tyranny. FINRA has the potential to improve the securities industry, protect investors, and promote the reputations of honest brokers. But, if it continues to operate unchecked and without needed transparency, it risks providing none of these.

CONCLUSION

Governmental power must be accountable to the electorate if it is to qualify as just. Accountability assumes transparency because the people cannot judge the government's actions if they cannot determine what the actions are. The SEC and FINRA both suffer in different ways from internal structures that obscure their activities and that prevent their accountability to the people whose lives and livelihoods they control. These problems must be addressed, or the powers these regulators wield must be deemed unjust.

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ENDNOTES

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21. Ashbel Green, “Instructions to New Members,” New York Stock Exchange, 1920, http://3197d6d14b5f19f2f440-5e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/papers/1920/1920_0101_NYSEInstructions.pdf (accessed October 6, 2016).
22. Securities and Exchange Act § 15A(b)(6) (2012).
23. The exchange itself incorporated and became a publicly traded company.
24. News release, “SEC Gives Regulation Approval for NASD and NYSE Consolidation,” Securities and Exchange Commission, July 26, 2007, <https://www.sec.gov/news/press/2007/2007-151.htm> (accessed October 6, 2016).
25. *Ibid.*
26. Hester Peirce, “The Financial Industry Regulatory Authority: Not Self-Regulation After All,” Mercatus Center *Working Paper*, January 2015, p. 6, <http://mercatus.org/sites/default/files/Peirce-FINRA.pdf> (accessed October 6, 2016).

27. Financial Industry Regulatory Authority, "FINRA Rulemaking Process," <http://www.finra.org/industry/finra-rulemaking-process> (accessed October 6, 2016).
28. The Constitution requires that officers of the United States be appointed by the President with the advice and consent of the Senate. Although officers themselves are not elected, they are nonetheless accountable to those who are elected.
29. 5 U.S. Code § 552.
30. 5 U.S. Code § 551 et seq.
31. 5 U.S. Code § 552b.
32. Financial Industry Regulatory Authority, "Management Compensation Committee Report," *FINRA 2015 Year in Review and Annual Financial Report*, 2016, p. 29, https://www.finra.org/sites/default/files/2015_YIR_AFR.pdf (accessed October 6, 2016).
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PART IV

Government- Preference Reforms

CHAPTER 12:

The Massive Federal Credit Racket

Diane Katz

The government is not a canny lender.

—Henry Hazlitt

Few Americans are aware that, collectively, they shoulder more than \$18 trillion in debt exposure¹ from loans, loan guarantees, and subsidized insurance provided by some 150 federal programs. While legions of regulators scrutinize the actions of private banks and financiers, there is sparse oversight of the government’s massive credit subsidies and their detrimental effects on the economy. This redistribution of taxpayers’ money erodes the nation’s entrepreneurial spirit, increases financial risk, and fosters cronyism and corruption. It is time to shut it down.

The government credit portfolio consists of direct loans and loan guarantees for housing, agriculture, energy, education, transportation, infrastructure, exporting, and small business, among other enterprises. Federal insurance programs cover bank and credit union deposits, pensions, flood damage, declines in crop prices, and acts of terrorism. Capital for mortgage lending by banks is provided by government-sponsored enterprises (GSEs), such as Fannie Mae and Freddie Mac.

Total outstanding loans and loan guarantees backed by taxpayers exceeded \$3.4 trillion at the end of fiscal year (FY) 2015.² Add in the exposure of Fannie Mae, Freddie Mac, the Federal Home Loan Banks (FHLBs), the Federal Deposit Insurance Corporation (FDIC), and the Pension Benefit Guaranty Corporation (PBGC), and the total swells to an estimated \$18 trillion.³

Researchers with the Federal Reserve Bank of Richmond, in their “Bailout Barometer,” estimate that 61 percent of *all* liabilities throughout the U.S. financial system are explicitly or implicitly backed by government (that is, taxpayers).⁴ But the actual liability is greater because federal accounting methods understate the costs. Nor do government balance sheets capture the economic distortions induced by credit subsidies.

Federal credit ballooned amid the 2008 financial crisis. Between November 2008 and March 2012, the government “invested” \$187.5 billion in Fannie Mae and Freddie Mac.⁵ Similarly, under the Troubled Asset Relief Program, the government⁶ purchased \$540 billion in stock from Ally Financial, Chrysler, General Motors, AIG, and dozens of banks to shift corporate financial risks to taxpayers.⁷ Despite the recession ending in June 2009, higher levels of subsidies have persisted.

Taxpayer Liabilities Added Each Year

IN BILLIONS OF DOLLARS



SOURCE: U.S. Department of the Treasury, *U.S. Government Receivables and Debt Collection Activities of Federal Agencies, FY 2014*, p. 3, Figure 2, <https://fiscal.treasury.gov/fsservices/gov/debtColl/pdf/reports/debt14.pdf> (accessed December 9, 2016).

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With some government loans extending 40 years, the ever-growing burden of federal credit will encumber generations to come—without their consent. Advocates insist that the subsidies are necessary to equalize opportunity, but a variety of other less destructive means of assistance are available.

Reform of government financing has not been a congressional priority. Few taxpayers are aware of the extent of the burden, and the subsidies have given rise to powerful constituencies of beneficiaries. And unconstrained spending, unfettered losses, and rampant cronyism are only part of the cost of the government's vast credit racket. Trillions of dollars of credit subsidies represent the commandeering of financial services by government and its escalating power over private enterprise.

DISTORTIONS

Proponents say that government lending is necessary in order to spur economic growth, or to mitigate “market imperfections,”⁸ such as gaps in available financing or

lack of competition (leading to unduly high credit costs). But government credit is a poor substitute for private financing. The purposes of the two are entirely different, as are the repercussions.

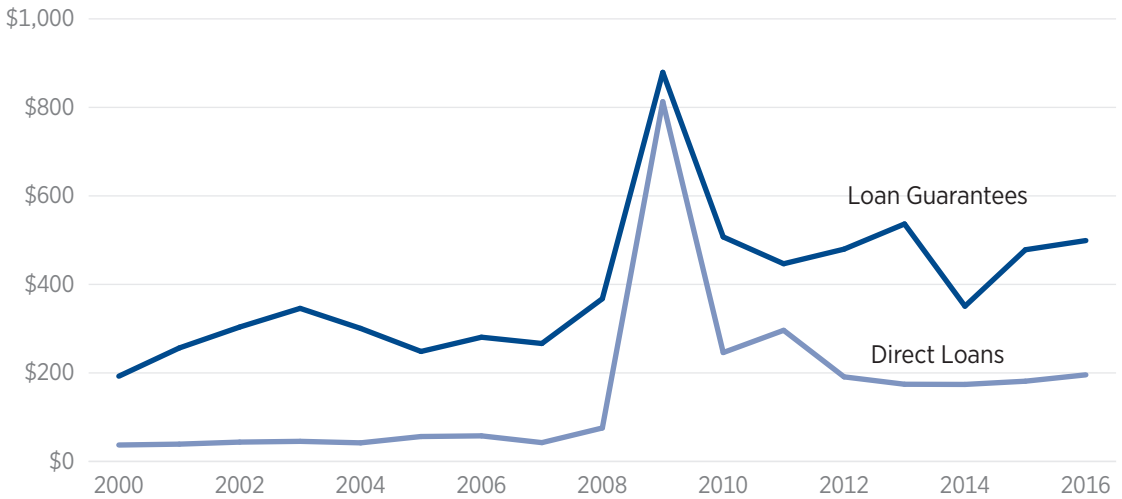
Private lenders offer credit to generate profit. The challenge they face is to minimize risk and maximize return—within ever-changing market conditions. Under threat of loss (and independent of government meddling), great care is taken in lending decisions.

In contrast, government financing is entirely detached from the profit motive (and its inherent discipline) because tax revenues provide an endless source of capital, and bureaucrats are largely protected from accountability. Losses are dispersed among millions of taxpayers, and are considered to be justified as a cost of reducing access inequities to capital. Consequently, default rates exceeding 20 percent are common among federal credit programs.⁹

The U.S. Department of Agriculture (USDA), for example, awarded 100 loans

Federal Direct Loans and Loan Guarantees

IN BILLIONS OF DOLLARS



SOURCE: Data from 2000-2009: U.S. Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2009*, 2008, p. 99, Table 7-5, <https://www.whitehouse.gov/sites/default/files/omb/budget/fy2009/pdf/spec.pdf> (accessed December 8, 2016). Data from 2010-2016: U.S. Office of Management and Budget, *Budget of the United States Government*, p. 327, Table 20-5, https://www.whitehouse.gov/sites/default/files/omb/budget/fy2016/assets/ap_20_credit.pdf (accessed December 8, 2016).

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totaling \$2 billion to deploy rural broadband service. A total of 18 loans defaulted and 25 others were rescinded. Only nine have been repaid. In its evaluation of the USDA’s Rural Utilities Service, the Government Accountability Office concluded that the agency “has not gathered information or performed analyses to better understand what might lead a project to default or otherwise make a project a poor candidate for receiving a loan.”¹⁰

Government financing programs are often sold to the public as economic imperatives, particularly during downturns. In reality, they are instruments of redistributive policies, such as “affordable” housing, protection of the “family farm,” and energy “independence.” In many instances, the biggest beneficiaries are those with the most political influence, not those with the greatest need.¹¹

Some subsidies exist largely to serve specific corporations, as is the case of the

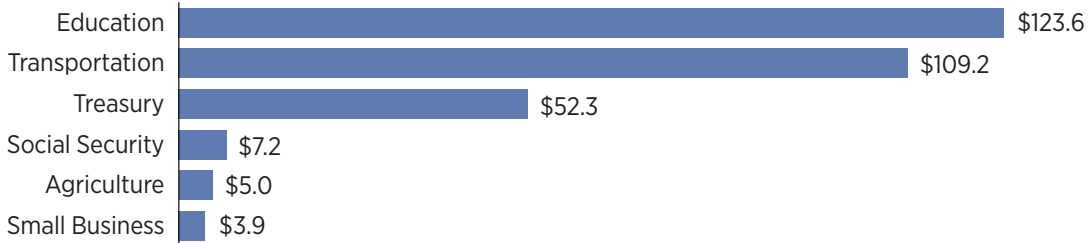
Export-Import Bank—widely known as “Boeing’s bank.” Ex-Im advocates claim that the finance subsidies are needed to fill gaps in financing for small businesses that cannot attract private capital. But the bank’s foremost beneficiary is Boeing,¹² the world’s largest aerospace company (with a market cap exceeding \$87 billion).

Well-intentioned or otherwise, there is abundant evidence that government financing produces more harm than benefit for the nation as a whole. For one thing, government credit represents a subsidy (either explicit or implicit). Because there is virtually no chance that the government will not cover a loss, federal credit is provided on more favorable terms than financing from a private lender, including:¹³

- Interest rates below commercial levels,
- Longer maturities than private loans,
- Deferral of interest,

Non-Tax Delinquencies: Top Six Creditor Agencies

AGENCIES WITH LARGEST DELINQUENT DEBT, IN BILLIONS OF DOLLARS, FY 2015



SOURCE: U.S. Department of the Treasury, *U.S. Government Receivables and Debt Collection Activities of Federal Agencies, FY 2015*, p. 8, Figure 11, <https://www.fiscal.treasury.gov/fsservices/gov/debtColl/pdf/reports/debt15.pdf> (accessed December 9, 2016).

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- Allowance of grace periods,
- Waiver or reduction of loan fees,
- Higher loan amount relative to the enterprise value than available from a private lender, and
- Availability of funds for purposes for which the private sector would not lend.

Whether government credit is provided as a loan or loan guarantee, it constitutes a risk borne by taxpayers for the benefit of a private party. That risk—multiplied by tens of thousands of transactions—carries direct and indirect consequences for the nation.

Indeed, when the government shifts credit risk to taxpayers, borrowers are largely relieved of the consequences of failure, and act accordingly. As noted by economist Henry Hazlitt,¹⁴

Responsibility follows risk. When an owner's risk in an enterprise has been minimized or eliminated because the government has supplied the funds which he otherwise would have to supply, then, speaking comparatively, the owner tends to feel no great pain from the failure of the enterprise. He would stand to gain by its success, of course,

and so he would tend to work for its success; but his position is an unbalanced one because he will not try desperately to prevent its failure.

When borrowers need not compete for private loans based on merit, productivity improvements and innovation become less important than political capital. Moreover, credit-worthiness also becomes less relevant to banks and mortgage lenders that act as pass-through agents for government financing.

When the Federal Housing Administration (FHA) loan program debuted in 1934, for example, a down payment approaching 50 percent of the purchase price was a common requirement. Last year, more than 72 percent of new FHA loans were financed with less than 5 percent down.

The result is a larger proportion of economic assets (in the form of both property and enterprise) that are inherently weaker than they otherwise would be if financed by private lenders instead of government (taxpayers).

Government financing also distorts the allocation of private lending. As noted by economist Jeffrey Lacker, president of the Federal Reserve Bank of Richmond, “These government lending programs, by targeting

particular market sectors, alter the allocation of credit across markets. Consequently, while some market segments benefit from reduced funding costs, others may actually see their costs rise as credit is diverted to those markets that have been targeted for support.”¹⁵

There is also a pernicious regulatory chain reaction when government engages in lending. As Hazlitt noted, “[When] the government provides the financing, the private property becomes public property instead and the government has the right to decide how, where, when, and by whom the property shall be used.”¹⁶

For instance, there are hundreds of procedures and rules of practice imposed upon depository institutions by the FDIC. Lawmakers devised government deposit insurance in 1933 to restore public confidence in the banking system. But their good intentions also dramatically increased government control of the financial system—sometimes to disastrous result.

Consider the 2008 financial crisis. In 2001, as part of micromanaging bank reserves, regulators assigned a lower risk weight to mortgage-backed securities than to individual (unsecuritized) mortgages. Therefore, banks that converted individual mortgages into mortgage-backed securities did not need to hold nearly as much capital in reserve to cover potential future losses. By freeing up capital, the banks could write more loans and generate more earnings.

No surprise, then, that demand for mortgage-backed securities surged (which also induced banks to increase mortgage lending by lowering standards). Meanwhile, the Clinton Administration pursued explicit homeownership goals, including quotas for lower-to-moderate-income buyers. All of these policies fed the unsustainable housing bubble with higher-risk mortgages—the collapse of which prompted the 2008 financial crisis.

PURPORTED BENEFITS

Proponents of government credit contend that the social goals for which the subsidies are employed justify—or at least offset—the

market distortions, regulatory onslaught, and taxpayer risk they produce.

Whether subsidized financing achieves the goals set by policymakers is dubious; there is very little measurement of program results, and abundant evidence of negative consequences. Under the Government Performance and Results Act of 1993, for example, Congress directed federal agencies to set goals and report on their progress. But the metrics largely measure only inputs (such as the number of loans awarded), not outcomes.

At the very least, any benefit derived from government credit is offset by handicapping enterprises that operate without subsidies.

TRACKING COSTS

The Federal Credit Reform Act (FCRA) of 1990 requires agencies to estimate the long-term costs (including subsidy costs) of loans and loan guarantees, and to “true up” those figures annually (after the end of the fiscal year) to reflect actual loan performance and to incorporate any changes in projections of future loan performance.

However, the methods required by law to do so produce imprecise results, and, consequently, faulty projections of budgetary gains and losses. There are also inconsistencies among agencies in scoring, and scarce oversight by Congress of payment errors and default rates.¹⁷

Under the FCRA, the subsidy cost of federal credit is calculated by first converting all future loan costs and revenue into a “net present value.”¹⁸ Because \$100 to be received a year from now is not worth as much as \$100 today (which could be invested now and grow larger over the next year), a discount rate is applied to future revenues when calculating the net present value. Under the FCRA, that discount rate is tied to the interest rate on U.S. Treasury securities.¹⁹

If the present value of estimated cash outflows exceeds cash inflows, there is a subsidy cost. If the present value of estimated cash inflows exceeds cash outflows, there is a negative subsidy cost, referred to as “subsidy income.”

However, as currently calculated, subsidy estimates consistently understate costs because of the nature of the discount rate applied when calculating net present value. Treasury yields are lower than private securities because there is virtually no risk that the government will default. This low rate does not account for the actual risks that government loans represent. Therefore, the government's accounting method produces artificially high estimates of future revenue. (In other words, the lower the discount rate, the higher the present value of future income.) The use of these artificially low discount rates makes government loans appear to generate income for the Treasury.

In some instances, the differences are substantial. For example, the Congressional Budget Office (CBO) estimates that the loan guarantees provided by the FHA for 2014 and 2015 will "save" \$16.4 billion. However, employing a more realistic discount rate to the calculation produces a cost to taxpayers of \$2 billion for the same set of loan guarantees.

As noted by economist Deborah Lucas, "If you use the price of Treasury securities to try to assign a price to a risky loan, you get nonsense."²⁰

Inaccurate budget estimates feed the propensity of government to minimize costs, and induce policymakers to expand federal credit rather than adopt other policy tools. All of which increases the risk to taxpayers.

Most agencies have been granted "permanent indefinite authority" to obtain additional funds from the Treasury to cover higher subsidy costs that result from annual re-estimates. That means the actual costs are largely hidden.

How should agencies calculate subsidy costs? The Financial Economists Roundtable recommends that subsidy costs be calculated using the same discount rates as private lenders. Those rates would be higher than Treasury rates, thereby reducing the present value of future income—and thereby providing a more accurate estimate of the costs to taxpayers.

According to Lucas, "Private-sector financial institutions are responsible for

reporting fair values [of loans and guarantees], so there is an entire infrastructure for providing these values."²¹

MAJOR CREDIT PROGRAMS

The following section describes several forms of government financing for which taxpayers are liable, either explicitly or implicitly. An expanded list of programs by agency can be found in the Appendix.

Federal Deposit Insurance Corporation.

- Deposit Insurance Fund Balance: \$72.6 billion
- FDIC Insured Deposits: \$6.4 trillion

Between 1930 and 1933, some 9,000 banks failed, prompting Congress to create the FDIC as an independent agency under the Glass-Steagall Act.²² The idea was to restore confidence in the banking system by offering government-guaranteed deposit insurance and requiring all state and federally chartered banks to carry coverage.

The FDIC covers the following individual accounts:

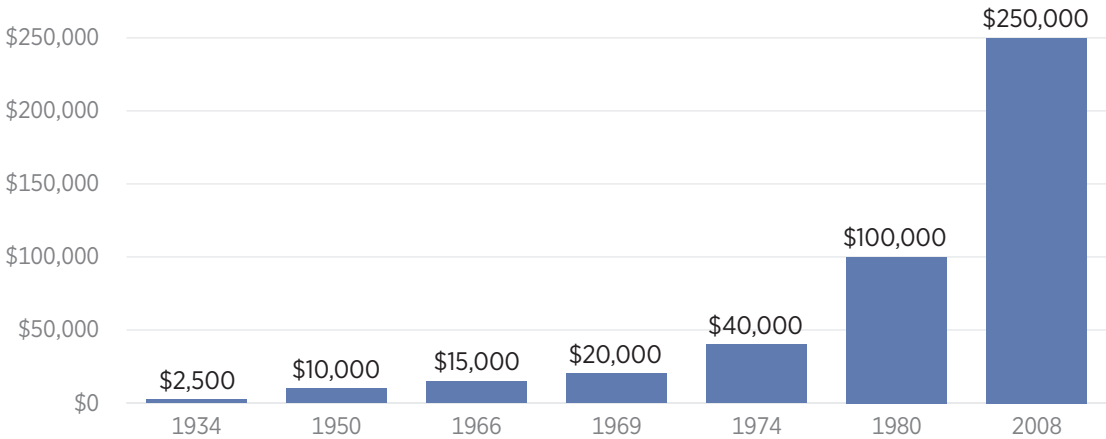
- Checking accounts;
- Money market/savings accounts;
- CD accounts;
- Revocable trust accounts;
- Irrevocable trust accounts;
- Employee benefit plan accounts;
- Corporation, partnership, or unincorporated association accounts; and
- Government accounts.²³

FDIC insurance does not cover stocks, bonds, mutual funds, life insurance policies, annuities, or securities.

Originally, deposits were insured for up to \$2,500 per depositor, per insured bank, for each account ownership category. That limit remained unchanged for some 16 years, and increased rapidly beginning in the 1970s.

The FDIC funds coverage by collecting premiums from banks and investing the funds in securities. It is also authorized to borrow from the U.S. Treasury.

FDIC Coverage per Depositor



SOURCE: Investopedia, “The History of the FDIC,” <http://www.investopedia.com/articles/economics/09/fdic-history.asp> (accessed December 9, 2016).

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When a bank fails, the FDIC reimburses depositors either by providing each with a new account at another insured bank in the amount allowed under coverage limits or by issuing checks to depositors.

The FDIC also functions as the receiver of the failed bank, and assumes responsibility for managing the assets and liabilities that remain. Depositors may recover a portion of uninsured funds from the sale of bank assets.

The FDIC’s fund balance totaled \$72.6 billion at the end of 2015, which constitutes a reserve ratio of 1.09 percent.²⁴ The Dodd-Frank Act raised the minimum Designated Reserve Ratio to 1.35 percent (from 1.15 percent), and removed the upper limit on the maximum reserve ratio (which had been capped at 1.5 percent).²⁵

There is no plausible scenario under which all insured banks would simultaneously fail and require a vastly larger fund. However, as noted in the FDIC’s 2015 annual report, “Projections for the [Deposit Insurance Fund] are subject to considerable uncertainty.” Higher interest rates, slower economic growth, and errors in earnings projections may stress the fund, potentially foisting another bailout on taxpayers.

The very design of the program is actuarially unsound. Flat-rate premiums are set by Congress without regard to an institution’s risk of failure. Likewise, coverage is provided regardless of bank management. Political pressure keeps premiums artificially low, which means that taxpayers are shouldering risk that ought to be covered by the banks. Moreover, the likelihood of failure is heightened by banks’ inclination to take more risks when potential losses will be covered by taxpayers.

Whether the nation needed the FDIC in 1933 is debatable,²⁶ but there certainly is little reason for it to exist today, when a variety of financial instruments are available to hedge banks’ risks. Good intentions notwithstanding, creation of the FDIC dramatically increased government control of the financial system to protect taxpayers’ liability.

To try to offset some of that risk, the FDIC plays a major role in bank regulation as a monitor, a supervisor, and an enforcer of hundreds of rules. These functions were expanded with the 2010 passage of Dodd-Frank, which extended the agency’s regulatory authority to bank holding companies with more than \$50

billion in assets and to non-bank financial companies that are designated as “systemically important” by the Financial Stability Oversight Council.

To the extent that the FDIC has assumed the role of guardian, banks have relied on regulatory requirements as safe harbors—despite the government’s dismal record on forecasting risk. For example, federal regulators have long imposed risk-based capital requirements on banks to mitigate potential losses. But as noted above, regulators contributed mightily to the 2008 financial crisis when they guessed wrong about the degree of risk relative to investments they deemed to be safe.

Pension Benefit Guaranty Corporation.

- Outstanding Obligations: \$108 billion
- Total Deficit: \$76.4 billion (2015)

Following the failure of several pension plans in the 1960s and 1970s,²⁷ Congress enacted the Employee Retirement Income Security Act (ERISA). The law granted tax benefits to employers who contribute to pensions, and exempted pension payments from workers’ calculation of taxable income.

ERISA also established the Pension Benefit Guaranty Corporation (PBGC) to insure the pension benefits of workers and retirees in defined-benefit pension plans. The PBGC operates two insurance programs: single-employer plans and multiemployer plans.²⁸ About 31 million people are covered under single-employer plans, and 10 million by plans in the multiemployer program.

In 2015, the maximum annual payment guaranteed under the single-employer program was \$60,136 for a retiree at age 65.

Taxpayers are not explicitly responsible for backing the pensions, but there is an implicit guarantee that the federal government (taxpayers) will intercede if insolvency threatens.

The PBGC’s total liability in FY 2015 hit \$108 billion, representing 4,706 single-employer pension plans that have “terminated” (plus five probable terminations), and \$54 billion for multiemployer obligations. The CBO

reports that multiemployer defined-benefit plans have committed to \$850 billion in benefits, but hold assets worth only \$400 billion.²⁹ The program is projected to become insolvent in 2025, and some analysts expect that to happen even sooner, particularly if pension failures exceed current estimates or the PBGC’s investment returns lag current forecasts.³⁰

In other bad news, the American Legislative Exchange Council recently reported that state and local governments have set aside only 35 cents for every dollar of pension promises—amounting to \$5.6 trillion in unfunded liabilities.³¹

Premiums for federal pension insurance are paid by participating companies, and supplemented by investment earnings and pension assets assumed by the PBGC. Unlike private insurers, federal law does not allow the PBGC to deny insurance coverage to a defined-benefit plan or to adjust premiums according to risk.

Both types of PBGC premiums—the flat rate (a per person charge paid by all plans) and the variable rate (paid by some underfunded plans) are set in statute—as are myriad exceptions that virtually guarantee underfunding. That means, of course, that taxpayers are shouldering risk that ought to be covered by unions and employers, and the likelihood of failure is heightened by their lack of accountability for failure.

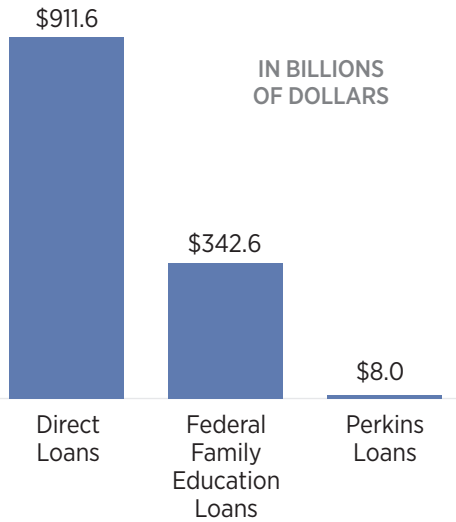
A major part of the problem is the tendency for pension plans to exaggerate investment earnings to project solvency. When those investments fail to deliver on the unrealistic returns, the liabilities shift to the PBGC. But the PBGC itself does not include a risk adjustment in its estimates of investment returns, meaning that it essentially assumes that the returns will match its estimates. The PBGC’s looming insolvency is prompting some lawmakers to propose a bailout—which is alarmingly predictable these days.

Education.

- Annual Loan Level: \$155 billion (2015)
- Loan Default Rate: 16 percent
- Delinquencies: \$123.6 billion

CHART 12-5

Federal Student Aid



NOTE: Figures include outstanding principal and interest balances. Figures are from Q3 2016. Data is run at the end of the corresponding federal fiscal year or at the end of each quarter listed by federal fiscal year. Each federal fiscal year begins October 1 and ends September 30. Q1 ends December 31, Q2 ends March 31, Q3 ends June 30, and Q4 ends September 30.

SOURCE: National Student Loan Data System, "Federal Student Aid Portfolio Summary," <https://studentaid.ed.gov/sa/about/data-center/student/portfolio> (accessed December 14, 2016).

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The single largest proportion of outstanding government credit is direct loans to students by the Department of Education. At a total of \$1.3 trillion, the loans are now the largest form of non-mortgage debt for U.S. households, according to a report by the Federal Reserve Bank of New York.³² In the third quarter of 2016, 16 percent of borrowers—and 10 percent of outstanding dollars—were in default.³³

The Department of Education administers three types of direct loans for higher education:³⁴ (1) Federal Direct Subsidized Stafford Loans; (2) Federal Direct Unsubsidized Stafford Loans; and (3) Federal Direct PLUS

Loans. The loans are distributed to more than 6,000 colleges and universities which, in turn, disburse the funds to students. In addition, some 1,500 schools participate in the Federal Perkins Loan Program, which serves students of "exceptional financial need." The school acts as lender and services the low-interest loans.

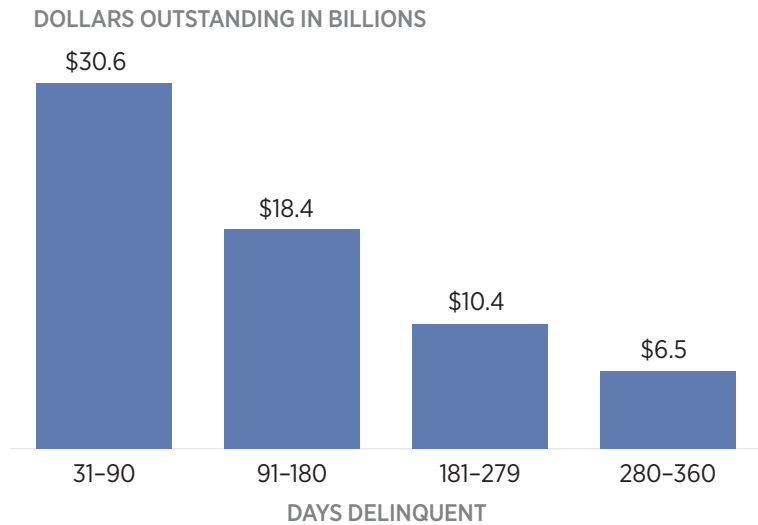
Interest rates on direct loans are adjusted annually based on Treasury rates, and the rate is fixed for the life of the loan. Repayment plans vary by type of loan and the borrower's income. The Obama Administration in 2011 capped monthly payments at 10 percent of discretionary income, down from 15 percent previously. Any balance remaining after 20 years is "forgiven," five years earlier than the time frame established by the Bush Administration.

Student lending more than doubled between 2001 and 2012, with some 90 percent of loans originating under federal student aid programs. No wonder: Federal law requires financial aid officers to encourage students to exhaust government borrowing before seeking a private loan. Loose eligibility standards and subsidized interest rates induce students to maximize their borrowing without careful consideration of the consequences the debt load will have on their future finances.

The surge in federal lending appears to drive up tuition disproportionately. When taxpayers subsidize the cost of higher education, colleges and universities need not worry as much about losing enrollment due to tuition costs. Indeed, average tuition rose 46 percent (in constant 2012 dollars) between 2001 and 2012, from \$6,950 to \$10,200.³⁵ As noted by economists with the Federal Reserve Bank of New York, the tuition hikes undermine the benefits of subsidized lending.

"While one would expect these [student aid] expansions to improve the recipients' welfare, for example, through lower interest payments and a relaxation of borrowing constraints, they may have actually resulted in lower welfare because of the sizable and offsetting tuition effect."³⁶

Delinquency Status of Direct Loans



NOTE: Figures include outstanding principal on interest balances of direct loan borrowers. Figures are from Q3 FY 2016.

SOURCE: National Student Loan Data System, “Federal Student Aid Portfolio Summary,” <https://studentaid.ed.gov/sa/about/data-center/student/portfolio> (accessed December 14, 2016).

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Housing. The federal government now dominates mortgage lending. Various agencies, including the FHA, the Department of Agriculture, and the Veterans Administration, provide mortgage assistance, while institutions such as Fannie Mae and Freddie Mac and the FHLBs influence the availability of mortgage credit in the market. Hundreds of regulations unleashed by Dodd–Frank dictate the terms and conditions of mortgage financing.

The Federal Housing Administration.

- Insurance Portfolio Total: \$1.1 trillion

The FHA insures mortgage loans, which translates into lower risk for lenders and thus lower loan costs for borrowers—and big subsidy costs for taxpayers. As of September 30, 2015, the FHA’s primary insurance portfolio included 7.6 million loans with an unpaid principal balance exceeding \$1.1 trillion.³⁷

The FHA insured nearly 22 percent of all single-family mortgages originating in 2015, with a dollar volume of \$233 billion.³⁸

The FHA loan guarantees are available for a variety of purposes beyond home purchase,

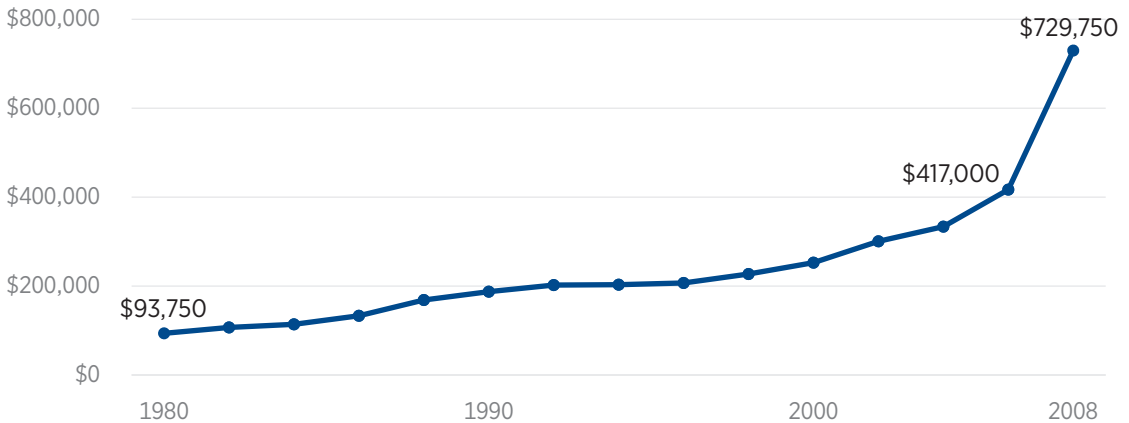
including home improvement, reverse mortgages, and loans for repair or construction of apartments, hospitals, and nursing homes.³⁹

Congress created the FHA under the National Housing Act of 1934 in response to the Depression-era collapse of the banking system. Its original mission was to stimulate home construction to create jobs, not to increase homeownership among low-income and moderate-income households as is generally believed.⁴⁰

Borrowers pay monthly fees to provide lenders with FHA loan-loss coverage. The premiums are based on the size of the mortgage, the term of the loan, and the down payment. Unlike private insurance, FHA fees do not represent the actual risk—and taxpayers are liable for the difference. In FY 2012, for example, the FHA required several billion dollars from taxpayers to cover deficits in the mortgage insurance fund.

There are no income eligibility standards for FHA assistance, which is contrary to basic economic principles that would normally guide lending decisions. More than 72 percent of new FHA loans last year were

Fannie Mae Loan Limits for Single-Family Homes



SOURCE: Fannie Mae, “Fannie Mae Historical Conventional Loan Limits,” December 31, 2011, p. 1, https://www.fanniemae.com/content/fact_sheet/historical-loan-limits.pdf (accessed December 9, 2016).

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financed with down payments of less than 5 percent, and as low as 3.5 percent of the purchase price. And, the amount of coverage is tied to the median home price in a region, not income, which can range from \$271,400 in Maine’s Hancock County to a high of \$721,500 in Honolulu.

The risk to taxpayers is supposedly mitigated by the statutory requirement that the FHA maintain a capital reserve—although the U.S. Treasury is obligated to cover losses that exceed the reserve. The required reserve is just 2 percent of outstanding liabilities—compared to the 4 percent minimum typically required of private insurers. As with other government finance programs, the FHA subsidies constitute a competitive disadvantage to private companies.

For all the costs to taxpayers and entrepreneurs, FHA assistance has not been found to contribute much to boosting homeownership rates. Instead, research indicates that it may accelerate home purchases by a few years. In other words, the FHA enables home purchases by people who could not afford it without taxpayers’ backing.⁴¹

Fannie Mae and Freddie Mac.

- Outstanding Debt and Securities Guarantees: \$5.1 trillion

Prior to 2008, Fannie Mae⁴² and Freddie Mac⁴³ operated as GSEs⁴⁴ whose mission was to provide liquidity for residential mortgage loans.⁴⁵ (Their missions were later expanded to include promotion of “affordable housing.”⁴⁶) Providing liquidity has entailed purchasing mortgages from banks and then bundling the loans for sale as securities, thus generating bank revenue for more mortgages. The GSEs finance the purchase of mortgages and mortgage portfolios through debt issued in the credit markets. The combined debt and guarantees for mortgage-backed securities held by Fannie Mae and Freddie Mac totaled \$5.1 trillion as of November 30, 2015.

Before 2008, Fannie Mae and Freddie Mac were not explicitly backed by the “full faith and credit” of the federal government (taxpayers). However, the GSEs held a line of credit with the U.S. Treasury, and most investors believed that Washington would not allow either one to become insolvent.

Consequently, investors and regulators alike deemed GSE debt and mortgage-backed securities to be virtually risk free, prompting their widespread use.⁴⁷

The perception of low risk also allowed Fannie Mae and Freddie Mac to borrow at lower interest rates than private investors. The lower cost of risk meant that the GSEs could purchase riskier mortgages—which, in turn, prompted lenders to write riskier mortgages.⁴⁸ These policies also diverted investment into the housing sector from other areas of the economy. By raising loan limits and offloading of risk to taxpayers, Fannie and Freddie created higher demand, thus helping to fuel a housing bubble.

At the peak of the housing market in 2006, the national Case-Shiller home price index was 84 percent above its long-term trend, according to Heritage Foundation financial analysts Nibert Michel and John Ligon.⁴⁹ As the market collapse ultimately proved, the dramatic increases were not sustainable.

When housing prices collapsed and millions of mortgages went bad, the two GSEs were forced into federal conservatorship by the Federal Housing Finance Agency (FHFA). In all, the taxpayer bailout totaled \$187 billion.

It is long past time for Fannie and Freddie to be privatized. However, as with most subsidies, special interests are loath to lose their government favors. Thus, homebuilders, bankers, and “affordable housing” advocates resist reform despite the onerous burden on taxpayers.

Agriculture.

- Annual Loan Level: \$10.6 billion (2015)
- Outstanding Receivables: \$111.6 billion
- Default Rates: <1 percent–75 percent
- Delinquencies: \$5 billion

U.S. agriculture policy is a multibillion-dollar tangle of subsidized loans, loan guarantees, and price supports. The outsized “safety net” is essentially an income guarantee. But dramatic changes in the agricultural landscape render Depression-era farm policies wholly obsolete.

The USDA administers more than 29 loan programs, including operating loans, ownership loans, microloans, guaranteed loans, targeted loans, youth loans, loans for minorities and women, tribal loans, loans for beginning farmers, specialty loans, emergency loans, and conservation loans. The loan guide for the Farm Service Agency alone runs 74 pages.

Farming is risky, to be sure, but so are many entrepreneurial endeavors. There also are rewards to balance the hardships. Government policies that cushion farmers invite risk-taking by shifting the costs of failure to taxpayers.

Advances in agronomy, biotechnology, pest control, and disease management have profoundly reduced risks and improved productivity. Yields per acre of staples, such as corn, soy, wheat, and cotton, have doubled, tripled, or quadrupled in a matter of decades. Farm-sector equity hit a record high of \$2.6 trillion in 2014, and is forecast to reach \$2.47 trillion this year.⁵⁰ Net farm income is expected to hit \$66.9 billion, down slightly from a record high in 2013.⁵¹ There is no justification for continuing to give tens of billions of dollars to the agriculture industry.

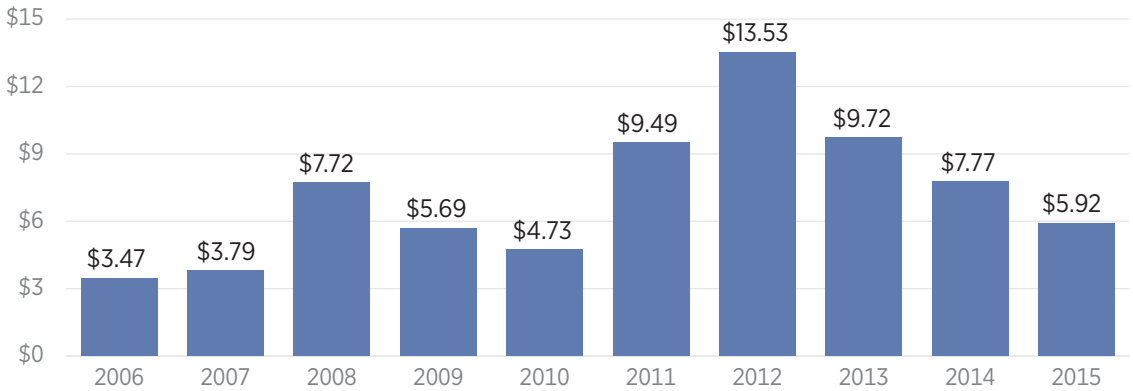
Farmers already have a variety of private-sector options to mitigate agriculture risks, including futures contracts and hedging, crop diversification, credit reserves, and private insurance. There could be even more options if Washington loosened its grip on agriculture and allowed entrepreneurs to create new products and services for managing risk.

Many people assume that farm assistance largely benefits “family farms.” While some smaller operations do receive major subsidies, the big winners are large agricultural enterprises. The top 15 percent of all farmers receive about 85 percent of all farm-subsidy payments, according to economist Vincent Smith.⁵² And, the subsidies collected by large enterprises make it more difficult for small farms to stay in business.

Farm subsidies produce a perverse double-whammy: Taxpayers are hit with underwriting the costs, and consumers are slammed with higher prices on groceries.

Crop Insurance Costs

IN BILLIONS OF DOLLARS



SOURCE: U.S. Department of Agriculture, “Crop Year Government Cost of Federal Crop Insurance,” June 27, 2016, <http://www.rma.usda.gov/aboutrma/budget/15cygovcost.pdf> (accessed December 9, 2016).

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Meanwhile, rather than stabilizing crop prices as proponents claim, subsidies promote overproduction and downward pressure on prices—thereby increasing subsidy payouts. Moreover, billions of dollars lavished on farmland conservation encourages overplanting on marginal lands that require more chemical management.

Crop Insurance. Federal crop insurance originated in the 1930s, when severe drought and erosion left farmers impoverished. But what started as a hedge against natural disaster has morphed into a huge taxpayer subsidy for wealthy farmers.

Insurable commodities include major field crops such as wheat, corn, soybeans, cotton, peanuts, and rice, as well as many specialty crops (including fruit, tree nut, vegetable, and nursery crops), pasture, rangeland, forage crops, and prices and operating margins of the livestock industry.⁵³

The CBO estimates that the cost to taxpayers for subsidizing crop insurance will reach \$8.8 billion per year over the next decade. Indeed, crop insurance is among the most heavily subsidized insurance schemes shouldered by taxpayers. Taxpayers subsidize a whopping

62 percent of the premiums for participating farmers.⁵⁴ Despite paying the bills, the public is prohibited from knowing which farms receive payouts.

Crop insurance policies cover individual farm losses in yield, crop revenue, or whole-farm revenue. Payouts do not require a disaster or catastrophic loss.⁵⁵ There are no limits on the indemnities that farmers can receive.

By law, crop insurance must be provided to all who apply. But shielding farmers from the consequences of their actions encourages risk-taking, including the cultivation of marginal acreage (requiring greater use of water and chemicals).

The insurance is administered by 18 banks designated by the government, which pays fees for servicing the coverage. The program is effectively a cartel in which the government controls the private crop-insurance market in collaboration with its approved companies. Any new insurance product must receive government approval.

As with other subsidies, crop insurance disproportionately benefits large agribusinesses. According to the Environmental Working Group, the top 10 percent of

commodity-payment recipients between 1995 and 2014 collected 77 percent of commodity payments.⁵⁶

In 1980, Congress greatly expanded the federal crop-insurance program in order to replace a standing disaster-payment program. The expansion of the federal crop-insurance program was seen as an alternative way to provide disaster protection for farmers, which would reduce costs and address moral hazard (parties taking on risky practices because they do not incur the risks). The program has been a complete failure, particularly when looking at costs: The disaster assistance that Congress deemed to be too costly in 1980 was replaced with a crop-insurance program that is six times greater in costs, adjusted for inflation.

The notion that subsidized crop-insurance protects farmers from serious unforeseen losses is largely a myth. In reality, the federal crop-insurance program does not require a disaster or even losses in yield for farmers to receive indemnities. Although promoted as an alternative to the costly disaster payment program, crop insurance subsidies have instead morphed into price supports.

Small Business Administration.

- Unpaid Principal 2016 (loan guarantees): \$118 billion
- Unpaid Principal 2016 (direct loans): \$145 million
- Unpaid Principal 2016 (disaster loans): \$6 billion
- Default Rates: 4.9 percent to 27.9 percent

The Small Business Administration (SBA) provides loan guarantees for starting, maintaining, and expanding small businesses. The SBA also provides direct loans to cover the uninsured costs of disaster recovery. Congress created the agency in 1953 to mitigate the supposed tendency of banks to withhold loans from small businesses presumed to pose high risks.

Whether small businesses actually lacked access to private capital at that time, it does not appear to be a problem now. The National

Federation of Independent Business reports that obtaining short-term or long-term loans rank among the 10 least-severe problems out of 75 choices.⁵⁷

On the other hand, the top three severest problems (out of 75) are the cost of health insurance, unreasonable government regulation, and federal taxes on business income. In other words, small businesses need tax and regulatory relief much more than they need subsidized loans.

The SBA subsidies are a poor substitute for private capital for at least two reasons: (1) they benefit only a fraction of small businesses, which means that other firms suffer a competitive disadvantage, and (2) SBA loan guarantees go primarily to businesses that have been judged to be poor risks by private investors, which means that taxpayers are subsidizing weak enterprises. Not every small business has the potential to succeed—which explains, in part, why the SBA default rates run high.

As is often the case with subsidies, the SBA has been sloppy in handling taxpayers' money. According to the SBA's Inspector General (IG), the agency needs to improve quality control in its loan centers, that is, verifying and documenting compliance with loan processing requirements. As the IG noted, "[I]mprovement is needed for SBA to continue to demonstrate that all elements of the program are being completed and that the program is effective at identifying and correcting material deficiencies."⁵⁸

The SBA guarantees 75 percent to 85 percent of the value of loans made under the flagship subsidy program, and these loans are widely regarded as a subsidy to banks. Borrowers apply to an SBA-certified bank. The banks then boost their earnings by selling the government-guaranteed portion of the loans on a secondary market. Ironically, the biggest banks do the most business through the SBA.

Export-Import Bank.

- Total Exposure: \$102.2 billion⁵⁹

The Ex-Im Bank was incorporated in 1934 by President Franklin D. Roosevelt to finance

trade with the Soviet Union. Congress later constituted the bank as an independent agency under the Export–Import Bank Act of 1945.

The bank provides loans and loan guarantees as well as capital and credit insurance to “facilitate” U.S. exports. The financing is backed by the “full faith and credit” of the U.S. government.

Multinational corporations have attracted the largest proportion of Ex–Im financing, including the construction and engineering firm Bechtel, ranked by *Forbes* as the fourth-largest privately held company by revenue, and Lockheed Martin, valued in excess of \$50 billion. But the bank’s foremost beneficiary is Boeing, the world’s largest aerospace company (with a market capitalization exceeding \$91 billion).

These and the other deals with titans of industry belie claims that the bank is necessary to fill “gaps” in financing—that is, bankrolling deals that supposedly pose too much political or economic risk to garner private capital. In fact, U.S. exports in 2014 set a record for the fifth consecutive year, reaching \$2.35 trillion—reflecting no shortage of private export capital.⁶⁰

Supporters say the bank carefully manages risk; its charter allows loans only to enterprises that demonstrate “a reasonable assurance of repayment.” However, Ex–Im’s IG has noted insufficient policies to prevent waste, fraud, and abuse. According to the IG, the bank has also exhibited “weaknesses in governance and internal controls for business operations.”

In another review, the Government Accountability Office reported that the bank appeared to rely on inappropriate risk modeling that could produce inaccurate estimates of both subsidy costs and potential losses.

These findings are not surprising. Ex–Im officials are not putting their own money at risk and thus have less of a stake in the outcome. It is an inevitable aspect of government intrusion into the finances of private enterprise.

Bank officials and advocates emphasize that Ex–Im financing creates jobs. In fact, the bank does not count jobs related to its projects but simply extrapolates numbers based

on national data. This formula does not distinguish among full-time, part-time, and seasonal jobs. It also assumes that average employment trends apply to Ex–Im clients (who may not be typical).

Most important, the bank does not account for what would occur in the absence of the subsidies. Ex–Im officials assume that the economic activity they subsidize would not occur absent bank financing. That is an absurd notion, but it is prevalent among bureaucrats who cannot fathom that business actually functions without them.

To the extent that Ex–Im does finance deals that the private sector supposedly snubs, taxpayers are justified in questioning whether they should be saddled with risk that private investors deem unacceptable. It is also difficult to reconcile bank officials’ assertions that they alone assist higher-risk exporters but still manage to offer competitive rates and generate profits.

National Flood Insurance.

- Outstanding Debt: \$23 billion
- Coverage in Force: \$1.2 trillion

Subsidized flood insurance is provided through the National Flood Insurance Program (NFIP), which is administered by the Federal Emergency Management Agency. The insurance is available to homeowners and businesses in communities that adopt and enforce prescribed floodplain management measures.

At the end of FY 2015, more than \$1.2 trillion in coverage (5.1 million policies) was in place across 22,100 communities. Private insurers sell and service the policies on behalf of the government and receive generous fees for doing so—fees that consume more than a third of all premiums.

Virtually all flood insurance is issued by the federal government under the National Flood Insurance Act of 1968. Intended to reduce federal disaster payouts, the subsidies have actually promoted development in flood zones and thus worsened the devastation of natural disasters.

Like most government giveaways—well-intended though it was—the NFIP is financially unsustainable, with a debt to taxpayers of \$24 billion and counting.

Five federal agencies recently issued a Joint Notice of Proposed Rulemaking to implement reforms adopted in the Biggert-Waters Flood Insurance Act of 2012. Among

other things, the act requires mortgage lenders to accept certain private flood-insurance policies rather than requiring coverage under the NFIP. The act also established a multiyear phase out of premium subsidies for commercial properties and vacation homes, and for primary residences after ownership changes.

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APPENDIX:

Federal Credit Programs by Agency

LOANS

Agriculture

- Agriculture Credit Insurance Fund
- Farm Storage Facility Loans
- Apple Loans
- Boll Weevil Eradication Loan Program
- Distance Learning, Telemedicine, and Broadband Loans
- Rural Electrification and Telecommunications Loans
- Rural Telephone Bank
- Rural Housing Insurance Fund
- Rural Economic Development Loans
- Rural Development Loan Program
- Rural Community Facilities Program
- Rural Business and Industry Program
- Rural Water and Waste Disposal Program
- Rural Community Advancement Program
- Public Law 480
- Title I Food for Progress Credits
- Multifamily Housing Revitalization Program
- Rural Microenterprise Investment Program

Commerce

- Fisheries Finance

Defense–Military Programs

- Military Housing Improvement Fund

Education

- Federal Direct Student Loan Program
- Temporary Student Loan Purchase Authority
- College Housing and Academic Facilities Loans
- Historically Black Colleges and Universities
- TEACH Grants

Energy

- Advanced Technology Vehicle Manufacturing Fund
- Title 17 Innovative Technology Fund

Health and Human Services

- Consumer Operated and Oriented Plan
- Consumer Operated and Oriented Plan Program Contingency Fund

Homeland Security

- Disaster Assistance

Housing and Urban Development

- Green Retrofit Program for Multifamily Housing

Interior

- Bureau of Reclamation Loans
- Bureau of Indian Affairs Direct Loans
- Assistance to American Samoa

State

- Repatriation Loans

Transportation

- Alameda Corridor Loan
- Transportation Infrastructure Finance and Innovation
- Railroad Rehabilitation and Improvement Program
- Highway Infrastructure Investment, Recovery Act

Treasury

- GSE Mortgage-Backed Securities Purchase Program
- Community Development Financial Institutions Fund
- Troubled Asset Relief Program Direct Loan
- Troubled Asset Relief Program Equity
- Small Business Lending Fund

Veterans Affairs

- Veterans Housing Benefit Program Fund
- Native American Veteran Housing
- Vocational Rehabilitation Loans

Environmental Protection Agency

- Abatement, Control, and Compliance

International Assistance Programs

- Foreign Military Financing
- U.S. Agency for International Development, Micro and Small Enterprise Development
- Overseas Private Investment Corporation, OPIC Direct Loans
- IMF Quota 4
- Loans to the IMF Direct Loan Program
- Debt Reduction

Small Business Administration

- Business Loans
- Disaster Loans

Other Independent Agencies

- Export–Import Bank Direct Loans
- Federal Communications Commission

LOAN GUARANTEES

Agriculture

- Agriculture Credit Insurance Fund
- Agriculture Resource Conservation Demonstration
- Biorefinery Assistance
- Commodity Credit Corporation Export Guarantees
- Rural Electrification and Telecommunications Loans
- Rural Housing Insurance Fund
- Rural Business and Industry Program
- Rural Community Facilities Program
- Rural Water and Waste Disposal Program
- Rural Community Advancement Program
- Rural Energy for America
- Rural Business Investment Program

Commerce

- Fisheries Finance
- Emergency Steel Guaranteed Loans
- Emergency Oil and Gas Guaranteed Loans

Defense–Military Programs

- Military Housing Improvement Fund
- Defense Export Loan Guarantee
- Arms Initiative Guaranteed Loan Program

Education

- Federal Family Education Loan Program

Energy

- Title 17 Innovative Technology Fund

Health and Human Services

- Health Center Loan Guarantees
- Health Education Assistance Loans

Housing and Urban Development

- Indian Housing Loan Guarantee
- Title VI Indian Guarantees
- Native Hawaiian Housing
- Community Development Loan Guarantees
- FHA-Mutual Mortgage Insurance
- FHA-General and Special Risk
- Guarantees of Mortgage-Backed Securities

Interior

- Bureau of Indian Affairs Guaranteed Loans
- Bureau of Indian Affairs Insured Loans

Transportation

- Maritime Guaranteed Loans (Title XI)
- Minority Business Resource Center

Treasury

- Air Transportation Stabilization Program
- Troubled Asset Relief Program
- Troubled Asset Relief Program, Housing Programs

Veterans Affairs

- Veterans Housing Benefit Fund Program

International Assistance Programs

- U.S. Agency for International Development
- Development Credit Authority
- Micro and Small Enterprise Development
- Urban and Environmental Credit
- Assistance to the New Independent States of the Former Soviet Union
- Loan Guarantees to Israel
- Loan Guarantees to Egypt
- Loan Guarantees to Middle East and North Africa
- Overseas Private Investment Corporation, OPIC Guaranteed Loans

Small Business Administration

- Business Loans

Other Independent Agencies

- Export-Import Bank Guarantees

ENDNOTES

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CHAPTER 13:

Reforming Last-Resort Lending: The Flexible Open-Market Alternative

George Selgin, PhD

The most fundamental of the Federal Reserve System's many responsibilities is that of serving as the U.S. financial markets' ultimate source of liquidity. Federal Reserve notes, along with account balances held by private depository institutions at the various Fed banks, are the U.S. economy's final means of payment, and hence its most liquid assets, the scarcity of which is a crucial determinant of the scarcity of other liquid assets.

A particular challenge facing the Fed and other central banks is that of avoiding liquidity shortages during financial emergencies, when private credit markets may malfunction. By what means, and according to which rules, should the Fed make additional credit available to financial (and perhaps nonfinancial) firms that might otherwise be rendered illiquid by such emergencies? Which emergency lending powers ought it to possess, and which facilities ought it to employ, beyond the powers it exercises, and the facilities it employs, in conducting its ordinary monetary policy operations? What kind of arrangements, if any, might allow the Fed to deal adequately with financial emergencies without contributing to the moral-hazard problem, or otherwise undermining the efficient allocation of credit?

This chapter draws on recent experience, both in the U.S. and elsewhere, to answer these questions, and to thereby suggest a plan for reforming the Fed's means for preserving

the liquidity of financial as well as nonfinancial firms and markets, especially during financial emergencies, but also in normal times.

Among other things, the proposed plan would:

- **Allow** a single Fed standing (as opposed to temporary) facility to meet extraordinary as well as ordinary liquidity needs as these arise, with no need for ad hoc changes in the rules governing the facility, or for special Fed, Treasury, or congressional action;
- **Make** Fed lending to insolvent, or potentially insolvent, institutions both unlikely and unnecessary, no matter how "systemically important" they may be, by allowing most financial enterprises to take part directly in the Fed's ordinary credit auctions;
- **Dispense with** any need for direct lending, including both discount window and 13(3) loans, whether aimed at particular institutions or at entire industries, and

otherwise radically simplify existing emergency lending provisions of the Federal Reserve Act;

- **Eliminate** any general risk of Fed mispricing or misallocation of credit, including such underpricing as might create a moral hazard;
- **Replace** the ad hoc and arbitrary use of open-market operations to favor specific firms or security markets with a “neutral” approach to emergency liquidity provision, by making the same facility and terms available to a wide set of counterparties possessing different sorts of collateral;
- **Enhance** the effectiveness of the Fed’s open-market purchases during periods of financial distress by automatically providing for extraordinary Fed purchases of less-liquid financial assets; and
- **Eliminate** uncertainty regarding the availability of emergency credit and the rules governing its provision.

AN UNHELPFUL DICHOTOMY

Conventional wisdom has it that, apart from regulatory responsibilities that may also be assigned to them, central banks must perform two fundamentally distinct duties. They are responsible, first of all, for implementing monetary policy, meaning that they must manage the aggregate supply of liquid reserves so as to reach various short-term and long-term macroeconomic targets. They must also serve as sources of last-resort credit when doing so prevents or contains financial crises.¹

This established dichotomy of central-bank duties has, in turn, informed a corresponding division of central-bank facilities, with one facility or set of facilities designated for the implementation of “ordinary” monetary policy, and the rest devoted to supplying last-resort credit. In the United States, until the recent crisis, ordinary monetary policy was implemented by means of both permanent and temporary open-market purchases and sales of Treasury securities, conducted with a limited set of counterparties, known as primary dealers.

Although the Federal Open Market Committee (FOMC) is responsible for determining the nature and objectives of the Fed’s open-market operations (OMOs), those operations are overseen by the manager of the System Open Market Account (SOMA) at the Federal Reserve Bank of New York, and conducted by the New York Fed’s Securities Trading Desk. The Trading Desk estimates the daily open-market purchases or sales needed to fulfill the FOMC’s general directive, and then conducts auctions with primary dealers according to that schedule, buying securities from those dealers offering the lowest prices, and selling securities to those offering the highest, using an auction system called FedTrade. Because primary dealers, though not banks themselves, have accounts at depository institutions known as clearing banks, in order to purchase securities from them, the Fed simply credits their clearing bank accounts, thereby increasing the banking system’s reserves. When it sells bonds, in contrast, the Fed debits dealers’ bank accounts, and so reduces total banking system reserves.²

The Fed’s permanent OMOs consist mainly of outright security purchases aimed mainly at accommodating long-run growth in the public’s demand for paper currency, which would otherwise result in a net reduction in bank reserves. Securities thus purchased are generally held until maturity in the New York Fed’s SOMA portfolio. The Fed’s temporary OMOs, in contrast, serve to accommodate general changes in the demand for liquidity, and to thereby meet the Fed’s short-run monetary policy targets. The Fed conducts these temporary operations by means of repurchase agreements (repos). In a repo, the Fed buys securities from a dealer who agrees to repurchase the securities from the Fed at a later date (frequently the next day). In effect, the transaction resembles a secured loan from the Fed to the dealer, with Treasury securities serving as collateral. In conducting “reverse” repos, the Fed sells securities to a dealer who agrees to buy them back at a later date. In this case, the dealer effectively makes a collateralized loan to the Fed.

By contrast, genuine secured loans, rather than repos, have been the traditional means by which the Fed has supplied last-resort credit to illiquid financial institutions using genuine secured loans as opposed to repos. Each of the 12 Federal Reserve Banks is responsible for making such “discount window” loans to eligible financial institutions operating in its region. Most deposit-taking institutions are eligible for discount-window loans, which can be secured using a wide range of private and public financial assets. Separate ordinary and last-resort liquidity-provision facilities have also been standard in other central-banking systems.

Although the recent crisis witnessed extraordinary modifications of central-bank liquidity-provision facilities, both in the U.S. and elsewhere, and although some of these modifications have been made permanent, the conventional dichotomy of duties and facilities has survived, if indeed it has not been reinforced. The most obvious consequence of the crisis consisted of the creation of various new, though mostly temporary, last-resort lending facilities, aimed at supplying emergency credit to institutions that could not or would not get it from established facilities. The new facilities were sometimes open to counterparties to which established facilities were closed; or they were prepared to accept collateral that those facilities would not. In some instances, such as the Fed’s Term Auction Facility (TAF), the new facilities dealt with the usual counterparties and collateral, but did so in a manner calculated to avoid the stigma attached to ordinary last-resort borrowing.

It would be wrong, however, to draw the lesson from recent experience that a permanent increase in the number of specialized last-resort lending facilities, or in the Fed’s authority to engage in bilateral lending of any sort, is needed if future crises are to be avoided. Instead, a review of the special steps that central bankers felt compelled to take during and since the crisis, heeding not so much those steps’ particulars as their general *drift*,

suggests a very different lesson. The lesson is not that the Fed and other central banks have lacked adequate *emergency* lending facilities and authority. It is that they have lacked *efficient arrangements for implementing ordinary monetary policy*. The special credit facilities established during and since the crisis, especially in the U.S. and the U.K., are, in other words, best understood as having served to rectify the shortcomings of established open-market frameworks. By reforming those frameworks, central banks might succeed in meeting both their monetary policy targets and extraordinary demands for liquidity, without having to make any use of either standing or temporary emergency lending facilities.

More fundamentally, recent experience suggests that the conventional dichotomy of “emergency” and “ordinary” central-bank liquidity provision, though it may have had some merit in the distant past, has outlived its usefulness. When implementing “ordinary monetary policy” meant little more than maintaining the gold standard, last-resort lending posed a separate, if not conflicting, challenge. A modern fiat-money-issuing central bank, in contrast, has but one fundamental duty to fulfill. That duty consists of supplying cash, meaning currency and bank reserves, in amounts sufficient to meet macroeconomic targets, and doing so *efficiently*, that is, so that newly created cash is assigned to those parties that can gain, and are therefore willing to pay, the most for it.

SPECIAL LAST-RESORT LENDING FACILITIES: INHERENTLY INEFFICIENT

Assuming that it is indeed possible to design a single open-market facility capable of supplying all the liquidity an economy may need, and of doing so efficiently, even during emergencies, discount windows and other dedicated emergency credit facilities serve, at best, to compensate for the absence of such a facility.

At worst, the tendency to suppose that central banks have not one, but two, duties

to perform, by encouraging them to employ separate facilities for each, makes the efficient allocation of both ordinary and emergency credit highly unlikely, if not impossible. This follows from the fact that, taking its “ordinary” monetary targets—and the amount of new reserve creation needed to achieve them—as given, a central bank operating multiple facilities, each catering to different sets of counterparties or dealing in different sorts of collateral and offering credit on different terms, must allot specific portions of the credit to be created among the various facilities. Some of these allotments may be negative, as when last-resort loans are “sterilized” by open-market sales. Such allocations are bound to be somewhat arbitrary, if not flagrantly so. Even if the allocations were somehow correct, the facilities themselves, in so far as they offer credit on implicitly (if not explicitly) distinct terms, would likely favor certain eligible counterparties over others. Finally, because counterparties do not all compete with one another for the same pool of funds, the ultimate allocation of those funds may be inefficient even when all face similar terms.³

In contrast, the understanding that central banks have but one overarching duty, which is to supply their economies’ most liquid assets, not just in adequate amounts but efficiently, points to the desirability of assigning as large a role as possible to the price mechanism as the means for allocating new central-bank credits among rival applicants. That goal is best accomplished, not by using multiple facilities, but by having all eligible counterparties compete on equal terms for central-bank credit auctioned off at one facility only. Under this arrangement, the central bank, once having set the terms of the auction, would have no other duty to perform save that of determining the aggregate amounts of credit to be auctioned. Last-resort lending, instead of being a distinct central-bank duty, would become an incidental counterpart of ordinary monetary policy, consisting of that part of auctioned credits taken up by liquidity-strapped counterparties that choose to take part in auctions

only as a last resort. Thus, while there would still be last-resort borrowers, there would be no last-resort lending operations as such.

ACHIEVING “FLEXIBLE” OPEN-MARKET OPERATIONS

So much for the theory. How can the ideal just sketched out be achieved in practice? Because the present Federal Reserve System is, in many respects, further removed from the ideal than either the European Central Bank (ECB) or the Bank of England, achieving it here is relatively difficult. Yet, even in the U.S. case, the steps involved in moving from existing arrangements for supplying last-resort credit to an ideal open-market framework, involving “flexible” OMOs, are relatively straightforward.

The first step is the primary dealer system—the system that confines the Fed’s ordinary open-market dealings to a small set of counterparties—should be abolished. That system can no longer be justified by appealing to its technological merits or to the claim that by dealing with primary dealers the Fed limits its counterparty exposure to “the soundest of the sound.”⁴

Indeed, during the recent crisis, primary dealers proved to be among the least sound of the unsound. For this reason, among others, the primary dealer system, “blocked, or seriously undermined the mechanism through which monetary policy influences the economy.”⁵ Consequently, as Donald Kohn observed at the time, when he was the Fed’s deputy governor,

The fact that primary dealers rather than commercial banks were the regular counterparties of the Federal Reserve in its open market operations, together with the fact that the Federal Reserve ordinarily extended only modest amounts of funding through repo agreements, meant that open market operations were not particularly useful during the crisis for directing funding to where it was most critically needed in the financial system.⁶

Although new names have replaced former ones on the Fed's list of primary dealers,⁷ the system remains fundamentally unchanged, in that it allows only a very small number of financial institutions to take part in the Fed's routine credit auctions. If the Fed's OMOs are to serve as a reliable source of liquidity both in ordinary times and during times of extreme financial distress, the outmoded primary dealer system must be scrapped. Instead, all commercial banks presently eligible for discount-window loans should be able to take part, along with presently designated primary dealers, in the Fed's routine credit auctions.⁸

Second, while continuing its traditional practice of confining outright or "permanent" open-market purchases to U.S. Treasury and agency securities, the Fed should stand ready to accept other sorts of collateral, including all collateral that is presently accepted as security for its discount-window loans, while assigning appropriate "haircuts" to riskier collateral, in its temporary open-market purchases or repos.

Third, the Fed should offer "term" (30-day or even 60-day) repos as well as the more usual overnight repos, as the former may prove especially helpful in tiding over liquidity-strapped firms during financial emergencies. Since, other things equal, such repos expose the Fed to a greater risk of losses stemming from a counterparty's failure, additional steps should be taken to guard against the extra risk, including arrangements for having counterparties supply additional collateral in the event that the market value of supplied collateral declines substantially during the life of a contract, and (perhaps) the application of haircut "add-ons" to collateral submitted by riskier counterparties, including non-banks and banks with high CAMELS ratings.⁹

Fourth, to allow counterparties to compete for credit using different sorts of collateral, the Fed should adopt a version of the "product mix" auction originally developed several years ago by Paul Klemperer, and employed since by the Bank of England in its indexed long-term repo operations (ILTRs).¹⁰ Klemperer's procedure allows bidders to submit

multiple mutually exclusive "sub" bids for a desired amount of credit, each offering different sorts and amounts of collateral. Then, as *The Economist* explains,

Having received a set of bids for different goods, at various prices and quantities, the auctioneer in Mr. Klemperer's set-up then conducts a proxy auction on bidders' behalf to see who should get what, and what the price should be. Because nothing is revealed to the bidders and they know they cannot influence this process, their best bet is to tell the truth. What is more, since the auctioneer has price information for a range of quantities, it is possible to see how prices change as supply does.¹¹

Participants' bids indicate the nominal quantity of funds they wish to purchase, the (positive) spread from the bank's policy rate that they are willing to pay, expressed in basis points, and the collateral they intend to provide. The bids are then ranked in descending order, with credit assigned to the higher-ranking bidders until the full amount has been allocated. When a qualifying bidder submits two or more sub-bids, rather than a single bid, the qualifying sub-bid that maximizes the bidder's value is accepted. Because of its commitment to uniform pricing, the Bank of England allows all successful bidders to pay the lowest rate accepted for the sort of collateral they offer. But discriminatory pricing, with bidders actually paying what each offers, is an option that might also be considered.

Further details concerning the conduct of product-mix auctions can be found in Klemperer's publications on the subject as well as in various Bank of England assessments of its own employment of his idea.¹² The bottom line, though, is (in *The Economist's* words again) that the auction design serves to "provide accurate information on individual banks' demand for liquidity and the prices they are willing to pay for it." What is more, the Bank of England has discovered that it can "use the

pattern of bids in each auction to assess the extent of stress in the market,” and to thereby “inform its decisions on the size and maturity of future operations.” In other words, flexible OMOs not only make last-resort lending facilities redundant, but help guide ordinary monetary policy, making it less likely that monetary authorities will err by incorrectly gauging the aggregate demand for liquidity, as federal officials did, with tragic results, in 2008.

Once flexible OMOs are established, the Fed should permanently close its discount window, which such operations will render redundant at best and a source of inefficient credit allocation at worst. Any institution that resorted to the discount window as a source of last-resort credit in the past will be able to participate in the Fed’s routine credit auctions using the same collateral it might have employed in securing a discount-window loan. However, instead of being guaranteed support, under pre-established terms, or having the Fed unilaterally determine to support it, it must secure funds by outbidding rival applicants. Thus the flexible OMO alternative improves upon bilateral Fed lending, not only by avoiding the stigma connected to the latter, but also by checking moral hazard.

Finally, Congress should improve oversight of the Fed’s broadened open-market operations, to assure that those operations are conducted in a manner consistent with efficient credit allocation, and especially with the avoidance of any implicit subsidization of risk-taking.

Although some authorities have treated the minimization of the Fed’s involvement in “credit” or “fiscal” policy as an ideal, while in turn equating that ideal with the complete avoidance of risky asset purchases, this view seems chimerical. As Willem Buiter has observed, “[T]here is an unavoidable fiscal dimension to a central bank’s activities.”¹³ The most obvious sense in which central banks, including the Fed, play a fiscal role is, indeed, precisely by acquiring relatively riskless Treasury securities, and then remitting the interest earned from them, net of their operating costs and losses, to the U.S. Treasury.

While confining the Fed to Treasury purchases may enhance its long-run contribution to government revenue, it cannot be said to minimize its fiscal footprint. On the contrary: It involves the Fed quite decidedly in the allocation of credit, albeit in a manner that favors the federal government over other parties.

Although the proposed broadening of the Fed’s open-market framework reduces the Fed’s fiscal footprint to the extent that it minimizes the Fed’s role in credit allocation, it also exposes the Fed to a greater degree of liquidity and credit risk. Whether these combined changes amount to a broadening or a reduction in the Fed’s overall involvement in “fiscal” or “credit” policy ultimately depends on the extent to which it succeeds in limiting its risk exposure by assigning proper haircuts to any risky securities it acquires.

Still, the fact that OMOs would not be entirely risk-free supplies grounds for subjecting them to occasional congressional scrutiny. The Dodd–Frank Wall Street Reform and Consumer Protection Act already goes some way toward addressing this need by requiring “ex-ante authorization of risky portfolio management decisions” as well as by providing some ex-ante accountability. But it should also be possible for the Government Accountability Office (GAO) to more generally assess the Fed’s administration of flexible OMOs, particularly when these involve substantial acquisitions of risky assets. Allowing the GAO’s inquiries and assessments to concern open-market procedures only, including the setting of haircuts and other rules for auctioning credit, but not the scale of those operations, should suffice to avoid any risk that the GAO’s enhanced authority would supply Congress with means for interfering any more than it has in the past with the Fed’s freedom to determine its policy stance.

FLEXIBLE OMOS AND THE EFFECTIVENESS OF MONETARY POLICY

Flexible OMOs would make the provision of last-resort credit to liquidity-stricken institutions a byproduct of the Fed’s

implementation of ordinary monetary policy, rather than a separate activity. This way, flexible OMOs would also enhance the *effectiveness* of the Fed's routine OMOs, and hence its ability to achieve its monetary policy targets by means of such operations, at times when conventional OMOs might be ineffective.

That conventional open-market purchases, meaning the exchange of central-bank funds for low-risk securities, and short-term sovereign debt especially, may cease to be effective during episodes of extreme financial distress was among the more striking lessons of recent experience. The crisis caused many private securities, especially asset-backed securities that had previously been reckoned good collateral for securing private-sector credit, to cease to be so regarded.¹⁴ The resulting collateral shortage had as its counterpart an extraordinary increase in the demand for short-term Treasury securities, with which illiquid firms were still able to secure private-sector credit. Central-bank open-market purchases of the usual sort, meaning swaps of their credits for short-term Treasury securities, were obviously incapable of relieving such a general liquidity shortage, and for that reason also proved far less effective than usual as means for achieving the central banks' monetary policy targets.¹⁵ By resorting to special facilities and programs aimed at swapping new reserves for less-liquid but still valuable securities, central banks hoped to more effectively combat the overall shortage of liquidity, not just directly but by increasing the effective liquidity of the securities in question, and hence their usefulness in securing private credit, and to thereby achieve greater success in meeting their general monetary policy goals. In effect, the central banks attempted to compensate, using special facilities established for the purpose, for the severe haircuts being applied by private-sector lenders to subprime-related securities by reducing those applied to other less-doubtful though formerly less-liquid private-sector securities.

In a flexible OMO system, the same result—an increased share of open-market purchases

of riskier and less-liquid collateral—would tend to be achieved automatically, because an exceptional demand for liquidity like that experienced recently would manifest itself in more aggressive and successful bidding for Fed funds by holders of relatively risky and illiquid but still valuable collateral. Also, because the holders of such collateral can succeed in securing credit with it *only* by offering to pay a relatively high price for it, the mechanism offers better protection against both moral hazard and adverse selection than might ad hoc alternatives.

Pointing to the potential monetary-policy advantages of flexible OMOs is not to suggest that having them would mean that repo financing of less-liquid securities would ordinarily play a substantial role of the Fed's monetary policy operations. Instead, those operations would, except on rare occasions, not differ substantially from the Fed's ordinary monetary policy operations in past times, with the Fed dealing mainly, if not exclusively, in Treasury securities, and with only a relatively small fraction of eligible counterparties taking part in its auctions.

FLEXIBLE OMOS AND CENTRAL-BANK DISCRETION

Superficially, the changes proposed in this chapter may appear to award the Fed more powers than it has enjoyed in the past by allowing more counterparties to engage in OMOs with it, using a widened range of collateral. But such an impression is mistaken for a number of reasons.

First, as noted, flexible OMOs are meant to render all emergency lending operations and facilities, whether actual or potential, redundant. That means that they eliminate the rationale, not just for ordinary discount-window lending, but also for lending targeted at specific banks deemed too “systematically important” to fail, as well as direct lending to non-banks under the Fed's current 13(3) authority. By opening access to the Fed's ordinary credit auctions to numerous counterparties, including all those institutions, whether

banks or non-banks, that play a prominent role in the payments system, flexible OMOs should make it possible for any of these counterparties that are for any reason unable to secure needed liquidity from private sources to apply directly to the Fed for it, and, by outbidding rival applicants, to get it. What is more, by dealing with the Fed's ordinary credit-creation facility, rather than with any facility explicitly devoted to last-resort or emergency credit provision, firms will avoid any risk of finding themselves stigmatized, and therefore worse off, than they might be if they refused central-bank credit altogether.

Second, by having all counterparties compete for credit offered through a single facility and on common terms, the reform eliminates opportunities for favoritism that arise when different counterparties must deal with different facilities operating under different rules.

Third, by eliminating distinct last-resort lending operations, flexible OMOs make it unnecessary for authorities responsible for such operations to coordinate their efforts with those of separate central-bank authorities charged with conducting ordinary monetary policy operations. The elimination of multiple authorities also reduces the risk of shirking, by placing responsibility for adequate aggregate liquidity provision firmly on the shoulders of a single decision-making authority—here, the FOMC.

Fourth, flexible OMOs should rule out any future resort to ad hoc emergency lending facilities, establishing instead a stable and predictable arrangement for central-bank liquidity provision, meant to meet both ordinary and extraordinary liquidity needs. The existence of fixed arrangements for liquidity assistance, combined with the competitive pricing of such assistance, allows prospective borrowers to prepare themselves for potential liquidity shocks, while ruling out moral hazard. This achievement alone would represent a considerable improvement upon past policy, for, as Thomas Humphrey has argued, one of the Fed's chief errors during the subprime crisis consisted of its "failure to specify and announce a

consistent LLR [lender of last resort] policy in advance...so that market participants [could] form stabilizing expectations." By generating uncertainty and otherwise confusing market participants, this "lack of a clearly laid-out LLR commitment" proved highly counterproductive to quelling the crisis.¹⁶

Fifth, and finally, flexible OMOs simplify central-bank decision making by reducing it to two components: (1) the determination of aggregate credit amounts to be auctioned, and (2) the setting, and occasional re-adjustment, of various auction parameters, including collateral haircuts. Credit allocation, including its allocation to solvent firms faced with a liquidity shortage that have sought funding from the Fed only as a last resort, is otherwise automatic. There would be no practical distinction between the Fed's conduct during episodes of financial distress and its conduct on other occasions. The only changes would be in the unusual counterparties taking part in the Fed's auctions, the wider range of collateral types offered, and the higher-than-usual interest rates implicit in winning bids.

The relatively automatic nature of last-resort credit provision under a system of flexible OMOs makes such a system a natural counterpart to rule-based, if not fully automatic, systems for determining the scale of central-bank aggregate credit creation, such as John Taylor's proposal for formally enshrining the rule bearing his name, and the proposals of Scott Sumner, David Beckworth, and others for targeting nominal gross domestic product.¹⁷

PRECEDENTS

Although the proposal in this chapter may seem radical, its various elements are far from being without precedent. As noted, the Bank of England already employs product-mix auctions to allocate funds, using its Indexed Long-Term Repo (ILTR) Facility, among competing bids involving different sorts of collateral. It has also established an Extended Collateral Term Repo (ECTR) Facility, to auction liquidity against a still-broader range of

collateral, identical to the range accepted by the Bank's Discount Window Facility, during emergencies.¹⁸ The bank's ordinary short-term repo operations have, on the other hand, been suspended since the crisis, while its Discount Window Facility (the analogue of the Fed's discount-window, though designed specifically to accommodate banks confronted with liquidity shocks between monthly ILTR operations), has been almost completely inactive since its inauguration in October 2008, owing in large part to banks' fear of being stigmatized if they resort to it.

In short, the bank's currently functioning facilities do not differ greatly from the single facility proposed here. Were the bank to follow recommendations made in a review of its liquidity framework that it commissioned, the difference would be even smaller. Among other things, the review recommends that the bank consider adding ECTR-eligible collateral to its ILTR, thereby allowing the latter facility to serve as a source of last-resort credit ("liquidity insurance") both in normal times and "in response to market-wide shocks originating in the banking sector."¹⁹

The ECB, for its part, has always accepted a relatively wide range of collateral in its ordinary (short-term) OMO; it also conducts those operations with numerous counterparties. The ECB was, for both of these reasons, able to cope with the first year of the financial crisis without having had to make any changes to its operational framework.²⁰

The Fed itself has, finally, occasionally and temporarily resorted to unorthodox OMOs, involving a larger number of counterparties, a wider range of securities, and different repurchase terms. To supply liquidity in connection with Y2K, it extended the term of its repurchase agreements, while also offering to purchase a wider range of securities. During the late 1990s and early 2000s, when confronted with what was then a looming shortage of Treasury securities, the Fed also gave serious thought to the possibility of permanently expanding the list of securities it might purchase, both in its repo operations and outright.

During the subprime crisis, the Fed established its Term Auction Facility (TAF)—a term repo facility to which all banks were given access, and at which all discount-window collateral could be financed. The TAF was intended to bypass the primary dealer system, while also avoiding the stigma attached to discount-window loans. The TAF proved far more successful than either the Fed's ordinary open-market operations or the discount-window at getting liquidity funds where they were most needed.²¹

Still more recently, in September 2013, the Fed established a special overnight reverse repo (ON-RRP) facility, through which it deals, not with its usual set of primary dealers, but with money market mutual funds, government-sponsored enterprises, and a broader set of commercial banks. More recently still, it began undertaking sizable term (as opposed to overnight) reverse repos using that facility.

What distinguishes the flexible-OMO plan from these precedents is that it envisions a single facility only, supplying both routine and emergency credit, and doing so in a way that relies to the fullest extent possible on market forces, rather than on decisions by bureaucrats, to achieve an efficient allocation of liquidity among competing applicants. By allowing a broad set of potential applicants, using a wide range of eligible collateral, to compete for available funds, not only in private markets, but, when necessary, at a single Federal Reserve facility, flexible OMOs *minimize* the Federal Reserve's credit footprint, and thereby prevent it from taking part in either deliberate or inadvertent credit-allocation exercises for which fiscal rather than monetary authorities ought to be responsible.

BACK TO BAGEHOT?

Because it dispenses altogether with facilities devoted exclusively to last-resort lending, or to bilateral central-bank lending (as opposed to auctioning of credit) of any sort, the reform proposed here may also seem inconsistent with received wisdom regarding

the principles of last-resort lending. But it is certainly far more faithful to that wisdom, particularly as formulated by Walter Bagehot, than existing arrangements. Consider Bagehot's seminal statement of now-conventional last-resort lending principles, as found in his 1873 book *Lombard Street*:

First. That [last-resort] loans should only be made at a very high rate of interest. This will operate as a heavy fine on unreasonable timidity, and will prevent the greatest number of applications by persons who do not require it. The rate should be raised early in the panic, so that the fine may be paid early; that no one may borrow out of idle precaution without paying well for it....

Secondly. That at this rate these advances should be made on all good banking securities, and as largely as the public ask for them. The reason is plain. The object is to stay alarm, and nothing therefore should be done to cause alarm. But the way to cause alarm is to refuse some one who has good security to offer.... No advances indeed need be made by which the Bank will ultimately lose.... If it is known that the Bank of England is freely advancing on what in ordinary times is reckoned a good security—on what is then commonly pledged and easily convertible—the alarm of the solvent merchants and bankers will be stayed. But if securities, really good and usually convertible, are refused by the Bank, the alarm will not abate, the other loans made will fail in obtaining their end, and the panic will become worse and worse.²²

Allowing for the trivial difference between repos and secured loans, there is very little difference after all between what Bagehot recommends and what flexible OMOs would accomplish, and accomplish far more reliably and consistently than existing Fed facilities. In particular, flexible OMOs would make for a more certain commitment to the principle of making last-resort credit both “largely” (that is, widely) available, and available only at suitably “high” (that is, penalty) rates, for the auction procedure itself assures that, in times of extraordinary need, high rates are bound to prevail. Owing to these considerations, and supposing Bagehot were both alive today and familiar with current, high-tech means for auctioning credit that were unavailable in Victorian times, it is tempting to speculate that it is not the reform proposed here, but the dizzying array of emergency lending facilities seen in the course of the recent crisis, with all the opportunities for inefficient credit allocation those facilities entailed, that would have struck him as odd.

CONCLUSION

To propose an alternative arrangement for last-resort lending is not necessarily to regard the proposed alternative as an ultimate solution to the problem of avoiding financial crises. On the contrary: The very need for last-resort lending is evidence of structural weaknesses in private-market financial arrangements, where such weaknesses are, in turn, more often than not, a result of misguided government interference in the free development of financial markets and institutions.²³ As desirable as it is to have effective and efficient arrangements for supplying additional liquidity during financial emergencies, a more fundamental goal of reform should be that of making such emergencies far less likely than they have been.

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ENDNOTES

1. In the Bank of England's publications and statements, this second duty is referred to as that of serving as a source of "liquidity insurance" to private-sector financial institutions.
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CHAPTER 14:

Simple, Sensible Reforms for Housing Finance

Arnold Kling, PhD

At the peak of the boom in 2006, over a third of all U.S. home purchase lending was made to people who already owned at least one house. In the four states with the most pronounced housing cycles, the investor share was nearly half—45 percent. Investor shares roughly doubled between 2000 and 2006. While some of these loans went to borrowers with “just” two homes, the increase in percentage terms is largest among those owning three or more properties. In 2006, Arizona, California, Florida, and Nevada investors owning three or more properties were responsible for nearly 20 percent of originations, almost triple their share in 2000.

—Andrew Haughwout et al., “Flip this House’: Investor Speculation and the Housing Bubble,” Federal Reserve Bank of New York *Liberty Street Economics*, December 5, 2011

Speculation played an important role in the sharp housing cycle that contributed to the 2008 financial crisis. Investors drove up prices during the speculative frenzy that

prevailed from 2004 to 2006. Because they do not occupy the homes that they purchase, investors are prone to default at higher rates than owner-occupants. Moreover, the attempt to alleviate the distress in housing markets by modifying mortgage terms was thwarted by the fact that loan modifications hold much less appeal for investors than for owner-occupants.

This chapter makes the case for simple, sensible reforms for housing finance. One obvious improvement would be to eliminate all government subsidies for mortgages to non-owner-occupants. It seems likely that this policy change alone could have greatly reduced the severity of the financial crisis or prevented it altogether.

Another reform would be to establish a national title database. Such a database would eliminate the expense of title search and prevent the sort of clerical errors that plagued the foreclosure process during the housing crash of 2007 to 2009. It could ultimately reduce the cost of home purchases.

Next, this chapter makes the case for eliminating government support for mortgages with low down payments as well as for refinancing loans that increase the mortgage debt of the

borrower. Such loans encourage households to take on debt rather than accumulate wealth, and they should not be subsidized or encouraged by any form of government support.

The last recommendation is to phase out the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Federal Housing Administration (FHA) altogether. This could be done by gradually reducing the maximum loan amounts that those agencies can purchase or guarantee.

NO MORE GOVERNMENT SUBSIDIES FOR INVESTOR LOANS

Investors purchase houses that they will not occupy for many legitimate reasons. Some investors want to own rental property to earn income. Others purchase run-down properties in order to rehabilitate them and earn a profit from the improvement. Still other investors purchase properties in neighborhoods where they see potential for housing values to appreciate.

There is no reason for government to step in to stop investors from buying properties or from obtaining mortgages to do so. However, for government to *subsidize* mortgages for investors serves no useful public purpose. On the contrary, to the extent that a goal of public policy is to encourage families to own their dwellings and in particular to purchase their first home, mortgage subsidies for investors are counterproductive. Such subsidies make it easier for investors to outbid families who would occupy homes as owners, thereby increasing the share of properties that are rented, and reducing the share of houses that are occupied by owners.

Currently, government subsidizes investor loans in two ways. First, the government-supported housing agencies purchase and guarantee such loans. Second, such loans are given favorable treatment along with other mortgage loans in risk-based capital regulations for banks.

Fannie Mae, Freddie Mac, the FHA, and the Federal Home Loan Banks should be

immediately forbidden from making purchases or guaranteeing investor loans. Any government subsidy for mortgages should at most be given to purchasers who intend to occupy their homes.

In addition, risk-based capital regulations should be modified to reflect the reality that investor loans default at higher rates than comparable mortgage loans to owner-occupants. The simplest approach would be to give investor loans a 100 percent risk weight for capital purposes.

Ideally, risk-based capital ratios would be eliminated altogether and replaced by a uniform capital requirement. Regulators are unable to out-smart banks when it comes to measuring risk.¹

Finally, regulators must be cognizant of the problem of occupancy fraud.² That is, knowing that owner-occupants can obtain mortgages on more attractive terms, investors occasionally fill out mortgage applications where they misrepresent their intentions by claiming to plan to occupy the home. Government-backed institutions should have policies and procedures for deterring and detecting occupancy fraud.³

A NATIONAL DATABASE OF PROPERTY TITLE INFORMATION

In the United States, property title information is contained in antiquated and fragmented systems. This directly raises the cost of housing transactions by forcing buyers to obtain “title insurance,” which is a waste of resources. It also makes the processes of selling mortgages in the secondary market and handling foreclosures more costly and subject to error.⁴

There is no reason for title insurance to exist. With any other purchase, whether of a durable good or a financial asset, once one pays for something and take possession, one owns it unquestionably. Only with real estate is the issue of ownership in such doubt that the buyer must pay for a title search and for “insurance” against the possibility that such a search has failed to uncover an existing lien on the property.

The need for title insurance can be eliminated by switching to a system whereby a new owner obtains definitive title at the time of purchase, as long as the property is purchased properly from the current owner of record. Some have suggested that new blockchain technologies might be helpful in this process.⁵ If an imperfection in the previous owner's title is subsequently discovered, any claim by an earlier lien-holder could be paid through compensation from a general fund, perhaps created by the state.

A national database of definitive title information could make title search less costly. It also could facilitate the sale of mortgage loans in the secondary market and reduce the costs and errors involved in foreclosure processing.

There is no ideological barrier to these reforms, which would lower the cost of buying a home, support the policy objectives of promoting home ownership, and help first-time homebuyers. However, Congress would have to overcome intense opposition from the title industry and housing attorneys who earn revenue under the current inefficient system.

NO SUBSIDIES FOR ZERO PERCENT EQUITY

Investors were not the only home purchasers engaged in speculation during the housing boom. Many owner-occupants were buying their homes with little or no money down. In addition, home owners were extracting equity from their homes, using cash-out refinances to treat their houses like automated teller machines to obtain money for consumer purchases.⁶

One reason to encourage home ownership is to foster the accumulation of wealth by families that purchase homes. Low down-payment loans and cash-out refinances do not serve that purpose.

Fannie Mae, Freddie Mac, and the FHA should stop purchasing mortgages where the borrower takes on a larger mortgage than the loan being refinanced. The agencies may continue to purchase "rate-and-term" refinances, meaning new loans that are obtained in order to reduce the interest rate or the duration of

the borrower's mortgage. The rule should be that the agency will only purchase refinances for amounts less than or equal to the size of the loan being refinanced.

There will always be borrowers who wish to refinance their mortgages by taking out larger loans. There is no need to outlaw such activity. However, no public policy purpose is served by government subsidizing these cash-out refinances. Such loans can be provided by the private sector.

With government subsidies no longer available, fewer home owners will find it attractive to extract equity from their homes. This change will encourage home owners to build equity and accumulate wealth instead.

Home purchases are more financially sound and less speculative when buyers make down payments of at least 10 percent. Until relatively recently, most home purchases were made with down payments of 20 percent or more. This practice helped to keep mortgage defaults low and to keep cyclical movements of house prices relatively mild.⁷

Loans with low down payments have not served anyone well, including the borrowers. The FHA in recent years became increasingly eager to finance nearly the entire purchase price for a home. Whereas in 1991, only about 5 percent of FHA-guaranteed mortgages had down payments of 3 percent or less, by 2003, such loans constituted a majority of its new business.⁸ When the housing boom ended, FHA loans were defaulting at several times their historical average. Even in relatively benign housing environments, the FHA's default rates have been unacceptably high. Too many families are being set up to fail when they purchase homes with little or no money down.

Government-backed mortgages with low down payments turn home purchasing into highly leveraged speculation. An individual who speculates in the stock market by buying on margin is required to put down at least 50 percent of the value of securities purchased. By encouraging people to speculate in real estate with little or no money down, Congress

puts families at risk and makes the entire housing market fragile.

There is a better way to encourage families to build wealth and reach home ownership. Instead of subsidizing high-risk mortgages, government could provide programs that enable families to save for a down payment. For example, housing economist Joseph Gyourko has proposed a tax-favored household savings program with the government contributing matching funds for families that are in the process of accumulating a 10 percent down payment.⁹ It is also likely that reforming the tax code so that savings are not taxed would encourage higher savings. Furthermore, eliminating all forms of government subsidies—including rental-market subsidies, such as Section 8 vouchers, which effectively set a price floor for rental units—would make housing more affordable in the first place.¹⁰ In housing, as in other areas, government tends to subsidize demand while restricting supply. This combination of policies only serves to raise prices.

PHASE-OUTS FOR FANNIE, FREDDIE, AND THE FHA

There is a good case to be made for phasing out the government's role in housing finance altogether. The United States has better uses for capital than to direct it toward heavy mortgage indebtedness that largely serves to drive up house prices. Despite all the government programs and guarantees, the U.S. homeownership rate is still essentially the same as it was in the late 1960s, when Fannie Mae became a government-sponsored enterprise (GSE). Taxpayer funds have better uses than to contribute to the privatized profits and socialized risks that are embedded in the agency mortgage markets.

Currently, there are ceilings on the size of loans eligible for purchase or guarantee by the agencies. One simple approach for phasing out the agencies would be to reduce these loan limits by 20 percent of their current amount each year for five years. At that point, the remaining servicing portfolios of the agencies could be sold to private companies.

Critics of turning mortgage lending back to the private sector might be concerned with two potential adverse consequences. One possibility is an increase in risky adjustable-rate mortgages. Another possibility is that ethnic minorities could face less credit availability or higher mortgage interest rates.

If government support were phased out, there might be a decline in the market share of 30-year fixed-rate mortgages. Such loans are difficult to finance safely. If they are funded by short-term deposits, a rise in interest rates can cause steep losses for lenders, as happened during the collapse of the Savings and Loans in the 1970s and 1980s. On the other hand, the use of long-term bonds raises the cost of funding mortgage assets, and it leaves the financial intermediary subject to prepayment risk: If interest rates fall sharply, the mortgage loans may be refinanced, leaving the intermediary with the long-term debt obligation and no high-yielding earning asset. The intermediary can hedge this prepayment risk by purchasing bond options or other derivatives, but this simply transfers the risk to another financial institution. For this reason, policies should ensure that financial firms can create the types of loans they need to best mitigate their risks.¹¹

Most other countries maintain very satisfactory rates of home ownership without the 30-year fixed-rate mortgage.¹² For example, Canada's housing market has performed very well on the basis of a five-year rollover mortgage. After five years, the borrower obtains a new mortgage at competitive rates. These loans provide a good balance between the risk borne by home owners and that borne by financial institutions.¹³

Of course, there is no certainty that the U.S. mortgage market would evolve toward the Canadian five-year rollover. Many riskier mortgages have been tried in recent years, including loans with negative amortization (meaning that the loan balance can increase over time) and loans with monthly adjustment periods. Should there start to be an increase in the share of these risky loans as the

agencies are phased out, a number of policy options are available. These include legislation or regulation that prohibits loans with risky rate-adjustment characteristics or that requires that lenders only offer such loans to borrowers with high income and net worth.

The other concern is that underserved markets could lose access to credit or find credit available only on adverse terms. Anti-discrimination laws offer some protection against this problem, but, ultimately, market competition is the best protection for consumers who meet standard underwriting guidelines to maintain access to credit. However, in the event that during the phase-out period regulators identify underserved markets in which competition for consumers' mortgage business is not robust, they might recommend maintaining a government agency to make competitive offers to borrowers who otherwise are not receiving access to loans even though they meet typical underwriting standards.

CONCLUSION

Housing finance was at the epicenter of the financial crisis of 2008. Simple, non-controversial reforms can prevent a repeat of that disaster. In particular, given the role that investor loans played in the housing boom and bust, and given that such loans do not promote the goal of home ownership, Congress

should immediately remove all government subsidies for investor loans.

Another reform that need not stir up partisan controversy would be to establish a national title database and to remove the need for buyers to obtain title insurance. This would contribute to the efficiency of the housing market, make it easier and less expensive to buy a home, and eliminate the costs and errors that cropped up during the foreclosure process.

Yet another simple reform would be to make cash-out refinances ineligible for purchase by government housing agencies. This would help underline that the goal of public policy is to encourage home ownership as a means for wealth accumulation, not for equity extraction.

Mortgage loans with low down payments are more conducive to speculation than to wealth accumulation. Congress should replace government guarantees and purchases of such loans with a program that helps households save for down payments.

Finally, Fannie Mae, Freddie Mac, and the FHA should be phased out while monitoring the mortgage market. Monitoring should focus on making certain that, as the mortgage market evolves, there is no surge in the riskiest forms of adjustable-rate mortgages, and that ethnic minorities do not lose access to fair, competitive mortgage offers.

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CHAPTER 15:

A Pathway to Shutting Down the Federal Housing Finance Enterprises

John L. Ligon

Over the past 80 years, Congress has assembled a system of federal housing finance enterprises (FHFEs), which have led to the long-term deterioration of credit underwriting standards, created moral hazard, and encouraged imprudent risk-taking in the housing finance system. Indeed, beginning with the New Deal-era housing policies of the 1930s, Congress has created an ever-growing apparatus of FHFEs that provides various forms of insurance and guarantees of residential home loans. The list of the FHFEs encompasses federal government agencies, the Federal Housing Administration (FHA), and the Rural Housing Service (RHS) authorized to provide mortgage insurance and guarantee coverage, as well as the Government National Mortgage Association (Ginnie Mae), which is authorized to guarantee the timely payment of pass-through income to investors of qualified mortgage-backed securities (MBS). In addition, the FHFEs include three government-sponsored enterprises (GSEs)—the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Federal Home Loan Banks (FHLBs)—each chartered by Congress to facilitate operations in the secondary market for mortgages and MBS.

As wholly owned agencies of the federal government, the financial viability of Ginnie Mae, the FHA, and the RHS is directly subsidized by federal taxpayers. The GSEs, on the other hand, were chartered as private financial corporations, though they have benefited from numerous federally financed subsidies not conferred to other corporations. Over the years, for example, these federal subsidies have included lines of credit with the U.S. Treasury, exemptions from regulatory filing requirements,¹ and various tax advantages. Because of the special privileges provided to these GSEs, financial market participants assumed, correctly, that these corporations have

the implicit guarantee of the federal government. This implied guarantee became explicit when Fannie Mae and Freddie Mac, after suffering devastating financial losses during the 2007–2009 housing crisis, were placed into conservatorship under the Federal Housing Finance Agency (FHFA) and, combined, received several hundred billion dollars in direct bailout terms set by the U.S. Treasury. Overall, federal taxpayers currently cover more than \$6 trillion (60 percent) of single-family residential housing mortgage debt.²

As these institutions increase in size and influence over the housing finance system, their market activities, including the vast

accumulation of debt, expose federal taxpayers to greater cost of bailouts during events of financial failure. Yet, Congress has repeatedly decided not to end the failed experiments, and has instead accomplished many reforms of the FHFES that have only further enmeshed federal taxpayers to the institutions. Nevertheless, there is a viable window for accomplishing federal policy reform that would shut down these institutions, thereby eliminating the distortions they create in the housing finance system. Congress can and should take the necessary steps to dissolve these FHFES, and allow the conditions for a vibrant free market in housing finance that can best provide individuals with durable and truly affordable homeownership opportunities over time.

ORIGINS OF THE FEDERAL HOUSING FINANCE ENTERPRISES

The Federal National Mortgage Association. Congress authorized the creation of national mortgage associations in the National Housing Act of 1934, and then in 1938, the government-owned Reconstruction Finance Corporation (RFC) used this authority to establish a subsidiary agency titled the National Mortgage Association of Washington, which soon became known as the Federal National Mortgage Association.³ Over the first decade of its existence, Fannie Mae predominantly purchased mortgages insured by the Federal Housing Administration, although Fannie Mae's purchases expanded in the 1940s to include mortgages insured through a program established for military veterans.⁴ The federal government reorganized in 1950, which included the transfer of Fannie Mae from the RFC to the control of the newly formed Housing and Home Finance Agency (predecessor to the Department of Housing and Urban Development).⁵ Then in 1954, Congress altered Fannie Mae's federal charter and provided it a means to raise private capital through the issuance of shares in common stock—although the federal government acquired shares of the preferred stock which established Fannie Mae's initial capitalization.

Indeed, Congress set a path toward privatization for Fannie Mae in the federal charter established by the Housing Act of 1954. This charter authorized Fannie Mae to remain a constituency division of the Housing and Home Finance Agency under the general control of the federal government.⁶ The federal legislation also authorized the federal government to provide the initial capitalization and acquire shares of preferred stock in Fannie Mae, while including provisions for the draw-down (retirement) of the government-held shares of preferred stock. The 1954 charter enacted a method for Fannie Mae to raise private capital over time, largely from required (and nonrefundable) contributions to a capital surplus account by mortgage lenders selling home loans to the corporation.⁷ Fannie Mae determined the issuance and distribution structure of common shares to mortgage lenders largely based on these contributions. In the secondary market, Fannie Mae was authorized to conduct operations and create liquidity for residential mortgages eligible (and, as amended) under the National Housing Act, and thus this activity was focused on home loans insured by the FHA and through the home loan program established for military veterans.

In 1968, Congress again reformed Fannie Mae, only this time chartering it as a government-sponsored private corporation, and partitioned a portion of its financial portfolio to the newly created Ginnie Mae.⁸ This legislative maneuvering amounted to shifting the debt portfolio for Fannie Mae off the official books of the federal government—a main impetus behind the passage of this section of the Housing and Urban Development Act of 1968—and provided some semblance of protection for federal taxpayers from liability for covering its debt.⁹ Indeed, the 1968 Housing Act gave Fannie Mae the ability to raise capital through the issuances of common shares of publicly traded stock,¹⁰ and for the corporation to continue to facilitate secondary mortgage market operations for mortgages authorized (and, as amended) under the National

Housing Act.¹¹ Fannie Mae’s secondary mortgage market operations therefore were concentrated to the government-insured home loan market until in 1970 Congress expanded Fannie Mae’s authority to include operations in the secondary conventional (non-government-insured) mortgage market.¹²

Until the mid-1980s, Fannie Mae’s business activity in the secondary mortgage market primarily consisted of the purchases of whole loans in the conventional and government-insured mortgage markets.¹³ Fannie Mae’s strategy of concentrating on the acquisition of whole mortgages resulted in negative interest rate margins (the difference between its income derived from interest payments and borrowing (interest) costs) that led to several years of severe financial losses during the 1980s.¹⁴ The General Accounting Office (now, the Government Accountability Office) reported that Fannie Mae suffered “cumulative net losses of over \$350 million in 1981, 1982, 1984, and 1985.”¹⁵ Fannie Mae was extended several privileges at federal taxpayers’ expense that included “regulator forbearance” (in other words, the problem was ignored) and a special tax provision that effectively allowed the corporation to forgo paying federal income taxes for up to 10 years.¹⁶ In the wake of these financial losses, Congress revised the degree of federal oversight required of the corporation (along with several other GSEs, including Freddie Mac), and in 1992, Fannie Mae was officially moved under the direct supervision of the Office of Federal Housing Enterprise Oversight, a division of the Department of Housing and Urban Development.¹⁷

During the early 1990s, Congress also established requirements for Fannie Mae related to the advancement of “affordable” housing policies—federal policies that were primarily aimed at subsidizing homeownership and rental housing assistance for low-income and moderate-income households.¹⁸ Over the next several decades, Fannie Mae committed an enormous amount of its overall business activity to its affordable-housing initiatives, including a pledge in 1994 that

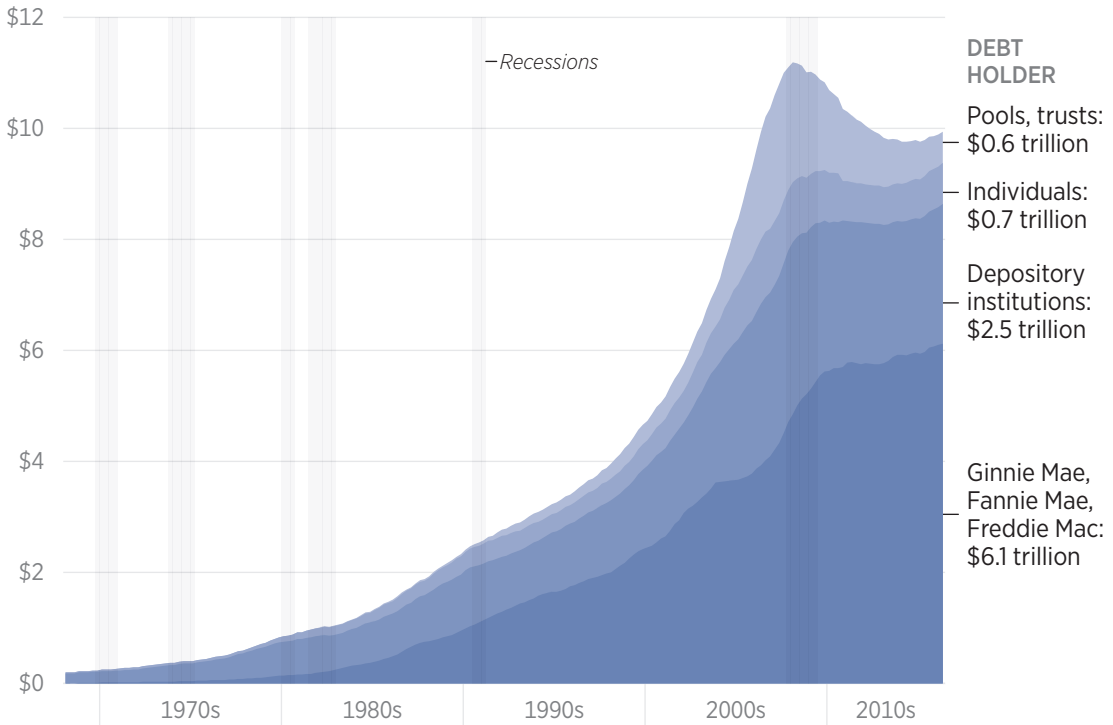
the corporation would purchase \$1 trillion in mortgage and mortgage-related securities associated with home loans to low and moderate income households.¹⁹ As has been documented by numerous housing policy experts, these federal affordable-housing policies beginning in the 1990s prompted a dramatic deterioration in underwriting standards for residential single-family homes, and represented some of the government policies that led to the 2007–2009 housing market collapse.²⁰ Fannie Mae, given its size and influence in the secondary mortgage market, was crucial to the systematic increase in mortgage credit (and high-risk mortgage lending) that contributed to the collapse in the housing market.

These so-called affordable-housing policies were central to the unraveling in the U.S. housing market between 2007 and 2009,²¹ as well as the severe decline in financial solvency of Fannie Mae. Indeed, as a result of significant and sudden increases in loan defaults and home foreclosures,²² Fannie Mae began to suffer devastating financial losses in 2008 and was placed into federal conservatorship. During the FHFA conservatorship, the federal government has effectively nationalized Fannie Mae, which includes bailout terms with the U.S. Treasury that have resulted in the federal government acquiring approximately \$140 billion worth of preferred and senior-preferred shares of stock in Fannie Mae and warrants to acquire 79.9 percent of the shares of common stock.²³ To make matters worse, Fannie Mae continues to hold significant influence in the housing finance system, covering more than \$3 trillion in outstanding single-family and multi-family housing residential mortgage debt. Federal taxpayers remain exposed to significant risk of covering any further financial losses given the scheduled depletion of Fannie Mae’s capital reserve account by 2018, and should there be any significant increase in interest rates or downturn in general conditions in the housing market.

The Government National Mortgage Association. Congress created Ginnie Mae in 1968 to function as a wholly owned corporate

Federal Enterprises Hold \$6 Trillion in Residential Mortgage Debt

TOTAL OUTSTANDING MORTGAGE DEBT OF SINGLE-FAMILY RESIDENCES



SOURCE: Data from the Board of Governors of the Federal Reserve System, retrieved via HaverAnalytics (accessed October 18, 2016).

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instrumentality of the U.S. government, and provided that it finances the guarantee of the timely payment of pass-through income to investors, to carry the full faith and credit of the U.S. government.²⁴ Ginnie Mae received authority to issue and guarantee pass-through income on MBS in 1968,²⁵ and this mortgage securities market officially took off in 1970.²⁶ There was a special emphasis between the Federal Home Loan Bank Board (FHLBB) and Ginnie Mae to coordinate the early issuances of the guaranteed MBS, and this market remained concentrated to those securities issued by Ginnie Mae and Freddie Mac until 1977 when Bank of America began to issue the

first private-label MBS.²⁷ Over the next several decades, Ginnie Mae’s total guarantee portfolio has steadily increased, and as of the end of the second quarter of 2016, it guaranteed approximately \$1.6 trillion (16 percent) in outstanding unpaid balances on single-family residential housing mortgages.

The Ginnie Mae MBS are almost entirely structured from government-insured mortgages, and the guarantee provides investors with the assurance of the timely payment on pass-through income. The pass-through income paid to investors is generally derived from a portion of the principal and interest payments in the mortgage pools that

comprise the MBS. Ginnie Mae has typically relied on financial institutions to both issue the MBS for purchase by investors and then to service the pass-through income on the securities, although in recent years it has implemented an option for these financial institutions to issue the securities and transfer the servicing rights to Ginnie Mae.²⁸ Ginnie Mae charges fees in return for the guarantee on the pass-through income, which shields investors from certain risks, primarily credit (default) risk, in these investment securities. Ginnie Mae is protected by the guarantee fees in addition to the viability of the financial institutions issuing and servicing the MBS.

Overall, Ginnie Mae provides liquidity for government-insured home loans in the housing finance system, which occurs as mortgage lenders sell home loans to financial institutions used in the structuring of the MBS. Ginnie Mae requires insurance coverage on the mortgages in the pools used for the MBS, and the mortgage insurance is almost entirely covered by direct federal government agencies.²⁹ The Ginnie Mae-guaranteed MBS almost entirely derive from pools of home loans insured by the FHA, and to a lesser extent those home loans covered by the U.S. Department of Agriculture's Rural Housing Service, the Department of Housing and Urban Development's Office of Public Indian Housing, and the single-family home loan guarantee program of the Department of Veterans Affairs. In fact, FHA-insured mortgages alone make up roughly 86 percent of the insured loans in the MBS pools, while only 5 percent of loans are covered in the conventional (non-government-insured) mortgage market.³⁰ These government insurance programs, particularly those of the FHA and the RHS, operate with comparatively high rates of default.³¹ Therefore, the overall liquidity created by the Ginnie Mae guarantee structure increases the level of government-subsidized mortgage credit and expands the federal government's influence in the housing finance system.

The Federal Home Loan Mortgage Corporation. Congress chartered the Federal Home Loan Mortgage Corporation in July 1970 with the general authority to purchase home loans that were originated in the government-insured and conventional markets in addition to the facilitation of MBS guaranteed by Ginnie Mae. The 1970 federal charter of Freddie Mac restricted ownership of shares in its common stock to the Federal Home Loan Banks. Throughout the 1970s, Freddie Mac and Ginnie Mae remained influential in the U.S. secondary-mortgage market, particularly the MBS market, which remained concentrated to these two institutions. In 1977, the private-label MBS market emerged with the first issuances structured by Bank of America.³²

Freddie Mac survived the interest rate volatility (spikes) during the 1980s largely because it did not concentrate its financial portfolio in the holding of long-term (debt) notes. Other financial institutions, such as the savings and loan institutions (S&Ls) and Fannie Mae assumed enormous interest rate risk and incurred financial losses because of the negative interest rate yields in their debt portfolios. Freddie Mac was able to get through this period by its focus on MBS that primarily allowed it to pass interest rate risk to investors in capital markets. In the late 1980s, Congress altered Freddie Mac's charter to allow the corporation to raise capital by issuing publicly traded shares of (voting) common stock, in addition to the shares of (non-voting) common stock restricted to ownership by the Federal Home Loan Banks.³³

Then, in the early 1990s, Freddie Mac was placed under general regulatory oversight of the federal government within the domain of the Office of Federal Housing Enterprise Oversight, a division within the Department of Housing and Urban Development. For nearly the next two decades, Freddie Mac (as was Fannie Mae) was used as an instrument to accomplish federal housing policies in the advancement of "affordable" housing, particularly geared toward single-family homeownership. Indeed, in the early

1990s, Congress took legislative steps that exposed Freddie Mac to the political whims of affordable-housing advocates by instituting requirements for the corporation to meet specified goals relating to the advancement of affordable-housing opportunities for underserved groups, particularly geared toward low-income and moderate-income households.³⁴ These federal affordable-housing policies, as discussed already, were indeed central to the deterioration of underwriting standards, the increase in high-risk mortgage lending, and the eventual mortgage credit bubble that resulted in the 2007–2009 housing market collapse.

Freddie Mac, given its exposure to the large number of poor-quality (high-credit-risk) mortgages, suffered significant losses during the downturn in the housing market between 2007 and 2009. In response, Congress authorized the transfer of the financially insolvent Freddie Mac in 2008, along with Fannie Mae, under the conservatorship oversight of the FHFA. During the FHFA conservatorship, the federal government has effectively nationalized Freddie Mac, which has included specific ownership terms accompanying the federal bailout by the U.S. Treasury. In the bailout process, the U.S. Treasury has acquired shares of senior preferred and preferred stock totaling nearly \$90 billion, and retains warrants to purchase up to 79.9 percent of the shares of common stock.³⁵ Overall, federal taxpayers remain in a vulnerable position to cover further financial losses incurred by Freddie Mac, which could likely occur given the scheduled depletion of the corporation's capital reserves, ongoing uncertainty in the housing market, and potential volatility (increases) in interest rates.

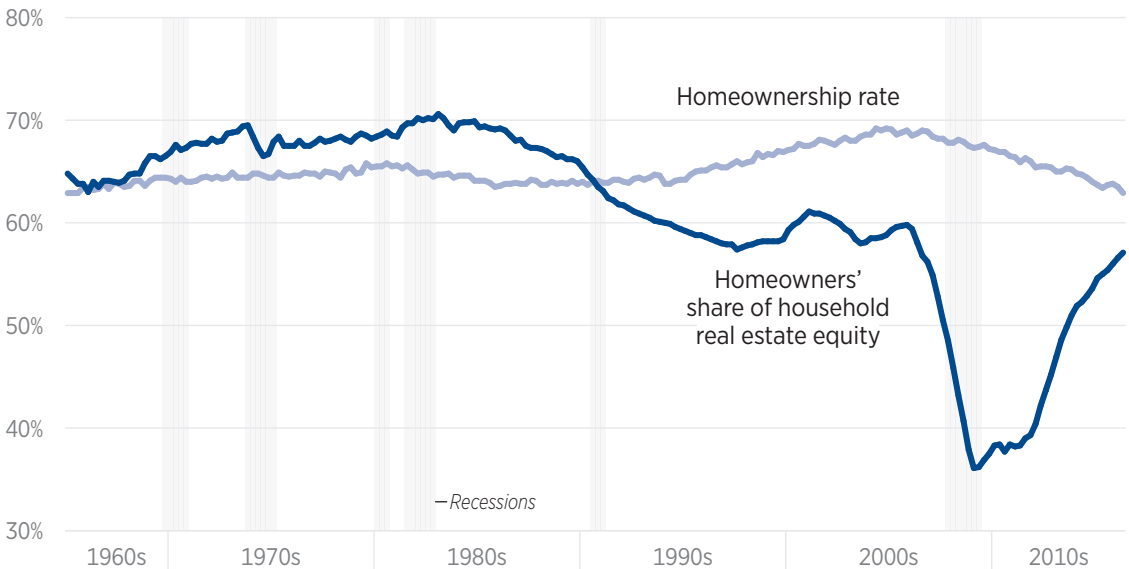
The Federal Home Loan Bank System. Congress passed legislation in 1932 that established 12 Federal Home Loan Banks, which were created with the intent to increase liquidity in the mortgage finance system by purchasing home loans from specialized mortgage lending institutions and life insurance companies. These purchases by the FHLBs afforded the specialized lenders

additional capacity in their respective portfolios to originate new home loans. To meet that goal, the 12 FHLBs funded these purchases by taking on debt, known as advances, so that they could provide loans to member financial institutions.³⁶ Until the late 1980s, membership in the FHLB system was predominantly restricted to the specialized thrift lending institutions (mostly S&Ls).

The FHLB system has evolved considerably over its more than 80 years of operation, with a significant pivot in 1990 when Congress expanded FHLB membership to include federally insured depository institutions in addition to the S&Ls.³⁷ When Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989, it authorized a bailout for the S&Ls, as well as new federal housing slush funds to advance so-called community and affordable-housing development. FIRREA required that 10 percent of the earnings retained by member institutions be used to pay the interest cost on bonds issued to finance the S&L bailout,³⁸ and that 10 percent of the FHLBs' retained earnings be used to finance affordable-housing and community-development initiatives. At present, FHLB membership is open to most financial institutions provided that residential home loans comprise at least 10 percent of their balance sheets.³⁹

The FHLB system currently consists of 11 regional FHLBs with commercial banks representing more than half of the member institutions in the consortium, and the Office of Finance serves as the FHLB system's fiscal agent, including the issuance of the advances.⁴⁰ Each of the regional FHLBs is a separate, government-chartered, mutual organization owned by its member financial institutions and, as such, can be required to cover the financial obligations of the other FHLBs.⁴¹ The FHLBs effectively function as wholesale purchasers of home loans issued by their member financial institutions. As of the end of 2015, the FHLBs combined had assets totaling \$969.6 billion (almost two-thirds in the form of loans called advances),⁴² and there

U.S. Homeownership and Real Estate Equity



SOURCES: Board of Governors of the Federal Reserve System, “Households; Owners’ Equity in Real Estate as a Percentage of Household Real Estate, Level,” <https://fred.stlouisfed.org/series/HOEREPHRE> (accessed October 12, 2016), and U.S. Census Bureau, “Homeownership Rate for the United States,” <https://fred.stlouisfed.org/series/RHORUSQ156N> (accessed October 11, 2016).

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were 7,235 member institutions (4,669 commercial banks) in the FHLB system.⁴³

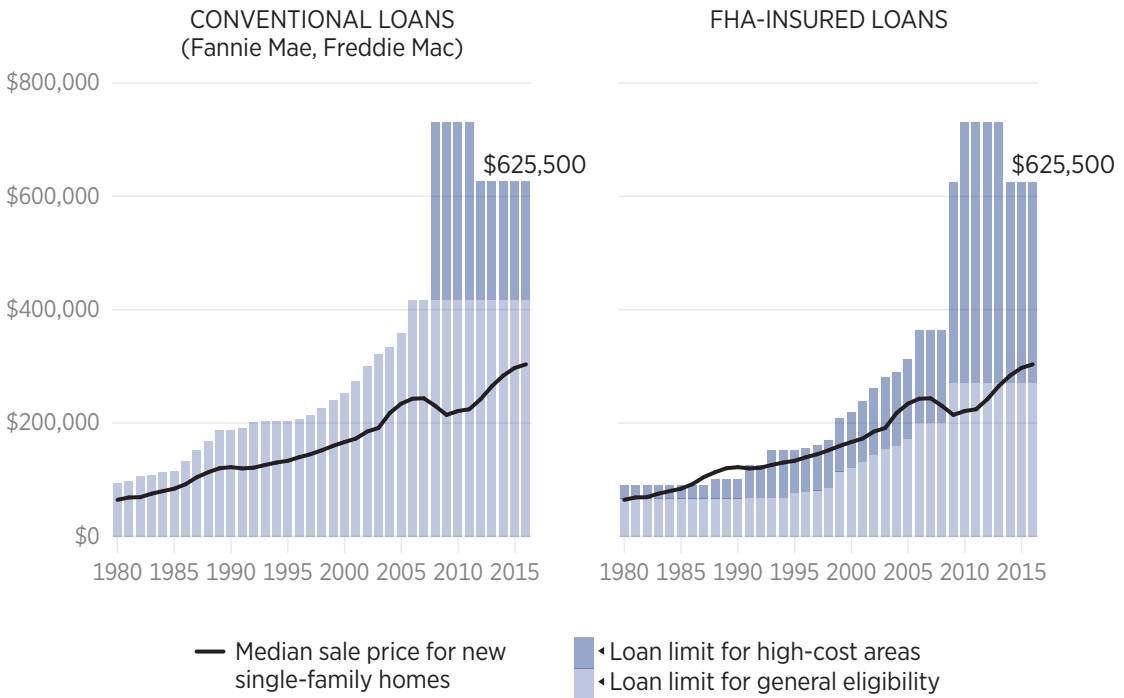
Similar to the other two housing GSEs, Fannie Mae and Freddie Mac, the FHLBs benefit from the implied guarantee of the federal government that is assumed by market participants given the various special privileges, including the exemption of certain taxes and regulatory requirements, as well as lines of credit to the federal government. The FHLBs fund the majority of their market activity through the issuance of debt, which in the event of significant financial failure could result in taxpayer bailouts, similar to the federal government’s intervention during the aftermath of the S&L crisis of the 1980s,⁴⁴ or the bailouts that occurred during the 2008 financial crisis with Fannie Mae and Freddie Mac. Thus, while the exact incentives may differ from other GSEs, the federal subsidies have led to higher levels

of debt liability at the FHLBs, and increases the risks to federal taxpayers of covering the cost of bailouts should the banks begin to experience severe financial losses.

THE INFLUENCE OF THE FHFES IN THE U.S. HOUSING FINANCE SYSTEM

The presence of the federal housing finance enterprises is antithetical to a free market in housing finance, and the FHFES’ interference in the housing finance system has led to less discipline by market participants. These FHFES create moral-hazard dilemmas for market participants that ultimately put homeowners, taxpayers, and private shareholders at greater risk of financial loss, all while increasing home prices relative to what they would be otherwise. Moreover, the FHFES have encouraged an explosion of mortgage debt over the past

Mortgage Limits Remain Far Above Median Home Prices



SOURCES: Fannie Mae, “Historical Conventional Loan Limits,” https://www.fanniemae.com/content/fact_sheet/historical-loan-limits.pdf (accessed September 23, 2016); Fannie Mae, “Loan Limits for Conventional Mortgages,” <https://www.fanniemae.com/singlefamily/loan-limits> (accessed October 7, 2016); U.S. Department of Housing and Urban Development, “FHA Mortgage Limits,” <https://entp.hud.gov/idapp/html/hicostlook.cfm> (accessed October 13, 2016); and U.S. Census Bureau, “Median Sales Price for New Houses Sold in the United States,” <https://fred.stlouisfed.org/series/MSPNHSUS> (accessed October 7, 2016).

several decades, while national homeownership is at the lowest rate since the mid-1960s. Homeownership can provide certain benefits to individual households, but this certainly does not mean that the federal government should interfere with the housing choices of individuals. The federal government would better serve citizens by getting out of the way of the market’s ability to guide individuals toward affordable and sustainable levels of mortgage debt when purchasing homes.

There are real costs associated with the federal government’s intervention in the housing finance system, which include the market-distorting subsidies that federal taxpayers

grant the FHFES. The federal subsidies have the effect of masking the risks involved with the financial management and governance of the FHFES, and alter incentives among market participants to reliably and prudently align with the interests of individuals looking to take on home mortgages. Too often there is tremendous motivation for politicians to use the FHFES as instrumentalities to advance federal housing policy, which has certainly included the “affordable” housing policies over the past several decades. Of course, when the errors lead to periods of financial insolvency at the FHFES, federal taxpayers too often step in to cover the cost burden of these failures.

The subsidies extended to the FHFES thus cost federal taxpayers during normal market periods, and certainly during episodes of federal bailouts as the FHFES have suffered financial insolvency.

As for any benefits, the FHFES appear to have done little more than provide borrowers with minimally lower interest rates on home loans. Economic research suggests that the benefit to borrowers is likely only on the order of 10 basis points (0.10 percentage points) in lower interest rates on mortgage loans, and that shareholders and management of the FHFES are likely to retain the majority of the benefits conferred by the taxpayer-financed subsidies.⁴⁵ To be sure, these estimates relate to the pass-through of the interest rate subsidy to borrowers of mortgages guaranteed by Fannie Mae and Freddie Mac. Separate academic research has also posited that removing this subsidy would enhance overall welfare and would likely improve economic outcomes in the housing market, especially for low-income and low-asset households.⁴⁶ Removing the interest rate subsidy would alter incentives for lower-income and lower-asset households in deciding when and how much mortgage debt to take up, and would likely encourage lower (more efficient) levels of home loan debt for these households.

Moreover, shutting down the FHFES would by no means leave individuals without financing options for purchasing homes. Indeed, winding down the FHFES would only prevent private financial corporations from issuing and purchasing government-insured mortgages, while removing government guarantees and insurance that currently crowd out private companies from providing such solutions. Private lending institutions already issue non-government-guaranteed home loans in the jumbo mortgage market (mortgages that exceed the loan limits in the conventional mortgage market), and to a lesser degree in the non-jumbo mortgage market (mortgages that would otherwise qualify for purchase by Fannie Mae or Freddie Mac). Nevertheless, if Congress were to shut down the FHFES, any

increase in interest rates due to the removal of the insurance and guarantee subsidies in the mortgage market would occur during a period of historically low interest rates.

TIME TO SHUT DOWN THE FEDERAL HOUSING FINANCE ENTERPRISES

Congress can create truly affordable and sustainable homeownership opportunities for Americans by establishing the conditions for a free enterprise housing finance system. To achieve this vision of a free market in housing finance, Congress should shut down the FHFES and relinquish the system of market-distorting housing subsidies it has constructed over more than 80 years.⁴⁷ To this end, Congress should initiate the dissolution of the FHFES, and in so doing, preclude the transfer of the FHFES' authority to another GSE or the federal government except for the limited powers essential for the disposition of the respective mortgage and financial portfolios.

Until the FHFES are shut down, Congress should implement policies that gradually reduce the market operations carried out by the FHFES, and thus encourage private capital to return to the housing finance system.

Initiate a Five-Year Wind Down of Fannie Mae and Freddie Mac. By the end of the five-year period, Congress should repeal the respective charters to both Fannie Mae and Freddie Mac,⁴⁸ and instruct the FHFA director to act as receiver in the dissolution of Fannie Mae and Freddie Mac,⁴⁹ which should include shutting down the common securitization platform and any subsidiary (joint) ventures formed by the corporations. In the interim period, Congress should decrease the conventional (conforming) loan limits for mortgages that are generally eligible for purchase by Fannie Mae and Freddie Mac.⁵⁰ Congress should also authorize increases in the guarantee fees Fannie Mae and Freddie Mac both charge on their respective operations in the secondary mortgage market.⁵¹ These intermediate reforms should occur irrespective to those scheduled changes for both Fannie Mae and Freddie Mac in current policy, which include

the reductions in the allowable limits for the mortgage investment portfolios and the requirements for the effective dissolution of the capital reserve accounts by January 2018.⁵²

Initiate a Five-Year Wind Down of Ginnie Mae, the FHA, and the RHS. Congress should shut down Ginnie Mae, the FHA, and the RHS, thereby eliminating their direct provision of taxpayer-financed insurance coverage and guarantees on mortgages and mortgage-related securities. Winding down the FHA and RHS in particular would also eliminate the various rental housing assistance subsidies and subsidized loans guaranteed in the construction of health care facilities subsidized by the agencies. During the process of shutting down the FHA and the RHS, Congress should increase the collateral requirements for insured loans, the guarantee premiums these institutions charge for risk adjustment, as well as the loan limits for mortgages eligible for insurance coverage. Moreover, during the process of shutting down all three federal entities, Congress should ensure that the respective dissolution processes preclude any new guarantee and investment portfolio activity.

Repeal Federal Affordable Housing Goals and Duty-to-Serve Rules. The federal government has pursued “affordable” housing policies by requiring that Fannie Mae, Freddie Mac, and the FHLB system meet specific goals—explicit quotas on the types of mortgages they finance—for low-income and moderate-income households. These so-called affordable-housing goals were fundamental to the collapse of the housing finance system between 2007 and 2009, and they have served mainly to increase consumer debt and inflate home prices. In addition to these affordable-housing goals, the FHFA has instituted an even broader and more nebulous regulatory apparatus that burdens the GSEs with a “duty to serve” specified markets deemed by the agency to lack sufficient access to mortgage credit.⁵³ Congress should repeal the mandatory

affordable-housing goals for the GSEs, including any affordable-housing trust funds, and eliminate the duty-to-serve regulatory rules required of Fannie Mae and Freddie Mac. In so doing, Congress should preclude the transfer of these regulatory systems to any other GSE or direct federal government agency.

Remove the Special Privileges for the FHLBs. The fact that the Federal Home Loan Banks did not require a taxpayer bailout on the scale of the one provided to Fannie Mae and Freddie Mac does not justify continuing the FHLB system as a GSE. The FHLB system could be legally allowed to continue operating as a mutual organization, owned by its member financial institutions, and without a line of credit from the U.S. Treasury. Any other special privileges given to GSEs, such as the exemption of certain taxes and regulatory requirements, should also be eliminated.

CONCLUSION

Since the New Deal-era federal housing policies of the 1930s, Congress has cobbled together a system of federal housing finance enterprises that today cover more than \$6 trillion (60 percent) of the outstanding single-family residential mortgage debt in the U.S. The federal government has used the federal housing finance enterprises to accomplish various policy goals—housing policies too often advanced under the notion of creating “affordable” homeownership opportunities for individuals. Over time, these policies have led to unsustainable levels of mortgage debt for millions of homeowners, and were central to several devastating downturns in the U.S. housing market. Overall, these policies have harmed American homeowners, cost federal taxpayers hundreds of billions of dollars in bailouts, and undermined the resilience of the housing finance system. It is time that Congress end these failed experiments of the federal government, and restore the conditions for a free market in housing finance by shutting down these federal housing finance enterprises.

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ENDNOTES

1. The federal bailout terms with the U.S. Treasury require Fannie Mae and Freddie Mac to file financial disclosure forms with the U.S. Securities and Exchange Commission. These reporting requirements were established in terms of the respective Senior Preferred Stock Purchase Agreements (SPSPAs) with each corporation in September 2008. Federal Housing Finance Agency, “Senior Preferred Stock Purchase Agreements,” <http://www.fhfa.gov/Conservatorship/Pages/Senior-Preferred-Stock-Purchase-Agreements.aspx> (accessed September 6, 2016).
2. By end of the second quarter of 2016, there was \$10 trillion in total outstanding mortgage debt for single-family residential housing and \$1.14 trillion in total outstanding mortgage debt for multi-family residential housing. Ginnie Mae guaranteed \$1.6 trillion in single-family residential housing mortgage debt, and \$96 billion in multi-family residential housing mortgage debt. Fannie Mae and Freddie Mac held \$2.81 trillion and \$1.7 trillion in single-family residential housing mortgage debt, and, respectively, \$210 billion and \$180 billion in multi-family residential housing mortgage debt. Federal Reserve Bank at St. Louis, “Board of Governors of the Federal Reserve System (US), Mortgage Debt Outstanding by Type of Holder,” <https://fred.stlouisfed.org/> (accessed October 4, 2016).
3. Congress established the Federal Housing Administration in 1934, and gave the agency the power to insure home loans that met the requirements specified in the National Housing Act of 1934. The National Housing Act of 1934 also provided the statutory foundation for the creation of federally chartered National Mortgage Associations. The National Housing Act of 1934, P.L. 479–73D §§ 1–5, 201–209 and 301–308, https://fraser.stlouisfed.org/scribd/?item_id=457156&filepath=/docs/historical/martin/54_01_19340627.pdf (accessed August 29, 2016).
4. The federal Veterans home loan program was authorized in the Serviceman’s Readjustment Act of 1944. In 1946, the Reconstruction Finance Corporation, and its subsidiary, the Federal National Mortgage Association, received authorization to facilitate mortgage purchases that were guaranteed through the Serviceman’s Readjustment Act, a function which lapsed in 1947. Then, in 1948, Congress re-authorized the Federal National Mortgage Association to purchase insured mortgages as provided under the 1944 Serviceman’s Readjustment Act. Serviceman’s Readjustment Act of 1944, P.L. 346, June 22, 1944, with amendments prior to August 11, 1948, pp. 16–23, 42–43, and 47–50, <https://babel.hathitrust.org/cgi/pt?id=umn.31951d035692831;view=1up;seq=1;size=150> (accessed September 26, 2016); and U.S. Department of the Treasury, *Final Report on the Reconstruction Finance Corporation: Pursuant to Section 6(c) Reorganization Plan No. 1 of 1957*, 1959, pp. 94–95, https://fraser.stlouisfed.org/scribd/?title_id=134&filepath=/docs/publications/rfc/rfc_19590506_finalreport.pdf (accessed September 22, 2016).
5. Fannie Mae was reorganized under the Housing and Home Finance Agency, a predecessor agency to the Department of Housing and Urban Development, in 1950. The Housing and Home Finance Agency was established in 1947 as part of a national reorganization plan. Reorganization Plan No. 3 of 1947, 12 *Federal Register* 4981, 61 Stat. 694, July 27, 1947, <http://uscode.house.gov/view.xhtml?req=granuleid:USC-prelim-title5a-node83-leaf95&num=0&edition=prelim> (accessed September 26, 2016); *Reorganization Plan No. 22 of 1950*, 15 *Federal Register* 3177, 64 Stat. 1269, May 24, 1950, <https://www.gpo.gov/fdsys/pkg/USCODE-2011-title5/html/USCODE-2011-title5-app-reorganiz-other-dup40.htm> (accessed September 15, 2016); and U.S. Department of the Treasury, *Final Report on the Reconstruction Finance Corporation*, pp. 93–96.
6. Housing Act of 1954, P.L. 560 § 201, <https://www.gpo.gov/fdsys/pkg/STATUTE-68/pdf/STATUTE-68-Pg590.pdf> (accessed September 12, 2016).
7. The National Housing Act of 1954 (also referred to as the Federal National Mortgage Association Charter Act of 1954) authorized that Fannie Mae could issue shares of common stock to mortgage lenders that sold home loans to the corporation and made required contributions to its retained capital account. Also, Fannie Mae could retire the shares in preferred stock that the federal government had acquired by using surplus funds it had accrued in the retained capital surplus account. There was no authorized schedule established for the retirement of the government-held stock. Housing Act of 1954, P.L. 560 § 201.
8. Housing and Urban Development Act of 1968, P.L. 90–448 § 801, <https://www.gpo.gov/fdsys/pkg/STATUTE-82/pdf/STATUTE-82-Pg476.pdf> (accessed August 29, 2016).
9. The federal government maintained a significant level of control over the quasi-private Fannie Mae. This included, for example, requirements that the U.S. President nominate one-third of the corporation’s board of directors and that the U.S. Secretary of the Treasury approve the securities (mortgage-backed securities) facilitated by Fannie Mae, and that these securities carry the same exemptions as direct and guaranteed obligations of the U.S. government from the laws administered by the U.S. Securities and Exchange Commission. Housing Act of 1968, P.L. 90–448 §§ 802(y)(7) and 804(a).
10. In 1968, Congress provided Fannie Mae with the authority to issue shares in common stock for public ownership (any person, firm, corporation, or other entity), and these shares each carried a voting right (cumulative for each share held) in the election of directors to Fannie Mae. Financial institutions responsible for servicing mortgages held by Fannie Mae were required to hold a minimum amount of common stock at all times. Housing Act of 1968, P.L. 90–448 §§ 802(h)–(m).

11. The Housing and Urban Development Act of 1968 authorized Fannie Mae to lend on securities as amended under section 302(b), and to facilitate certain secondary market functions related to investment activities in mortgages and mortgage-related securities. Housing Act of 1968, P.L. 90-448 §§ 802(d) and 804(a).
12. Fannie Mae's authority in the secondary mortgage market was later expanded in 1970 to include conventional mortgages. Emergency Home Finance Act of 1970, P.L. 91-351 § 201, <https://www.gpo.gov/fdsys/pkg/STATUTE-84/pdf/STATUTE-84-Pg450.pdf> (accessed September 26, 2016).
13. Fannie Mae started to issue MBS in 1981, though it had been involved in the mortgage-backed bond market prior to these MBS issuances. Beginning in the mid-1980s, Fannie Mae began to shift its portfolio toward mortgage-backed securities, and its mortgage portfolio activity in these securities has steadily increased since then. Fannie Mae, *Prospectus for the Guaranteed Mortgage Pass-Through Certificates*, November 1, 1981, p. 4, http://www.fanniemae.com/syndicated/documents/mbs/mbspros/November_1_1981.pdf (accessed September 23, 2016).
14. Fannie Mae, *Prospectus for the Guaranteed Mortgage Pass-Through Certificates*, November 27, 1985, p. B2, http://www.fanniemae.com/syndicated/documents/mbs/mbspros/November_27_1985.pdf (accessed September 23, 2016).
15. U.S. General Accounting Office, "Government-Sponsored Enterprises: The Government's Exposure to Risks," August 1990, p. 9, <http://www.gao.gov/assets/150/149461.pdf> (accessed September 30, 2016).
16. In 1982, Congress passed a law that extended provisions for Fannie Mae to carry back (or carry forward) certain losses for federal tax purposes. U.S. General Accounting Office, "Government-Sponsored Enterprises: The Government's Exposure to Risks," p. 9, and Miscellaneous Revenue Act of 1982, P.L. 97-362 § 102, <https://www.gpo.gov/fdsys/pkg/STATUTE-96/pdf/STATUTE-96-Pg1726.pdf> (accessed September 30, 2016).
17. Housing and Community Development Act of 1992, P.L. 102-550 §§ 1321-1328, 1331-1338, 1341-1349, 1361-1369 and 1381-1383, https://fraser.stlouisfed.org/scribd/?title_id=1106&filepath=/docs/historical/congressional/housing-community-development-1992.pdf (accessed September 12, 2016).
18. Housing and Community Development Act of 1992, P.L. 102-550 §§ 1331-1338, and The National Affordable Housing Act of 1990, P.L. 101-625, <https://www.congress.gov/bill/101st-congress/senate-bill/566/text> (accessed September 15, 2016).
19. James R. Hagerty, *The Fateful History of Fannie Mae: New Deal Birth to Mortgage Crisis Fall* (Mt. Pleasant, SC: The History Press, 2012), pp. 93-105, and Peter J. Wallison, *Hidden in Plain Sight: What Really Caused the World's Worst Financial Crisis and Why It Could Happen Again* (New York: Encounter Books, 2015), pp. 161-163.
20. Fannie Mae worked to meet the federal "affordable" housing goals through purchases in whole loans as well as its activity in the MBS market, including purchases of private-label MBS that met the affordable-housing requirements. Norbert J. Michel and John L. Ligon, "Fannie and Freddie: What Record of Success?" Heritage Foundation *Backgrounder* No. 2854, November 7, 2013, <http://www.heritage.org/research/reports/2013/11/fannie-and-freddie-what-record-of-success>.
21. Wallison, *Hidden in Plain Sight*, pp. 125-233.
22. As of June 2008, Fannie Mae and Freddie Mac combined balance sheets retained almost 11 million mortgages that had default rates between 13.8 percent and 17.3 percent. *Ibid.*, pp. 201-202.
23. The U.S. Treasury has acquired \$117.1 billion in senior preferred stock and \$19.1 billion in preferred stock of Fannie Mae, and it retains warrants to purchase up to 79.9 percent of the common stock of the corporation. Moreover, under the senior preferred stock purchase agreements, Fannie Mae is required to disburse dividend payments on the senior preferred shares held by the Treasury. The disbursements of dividends do not, however, represent any notion of repayment on the capital infusions financed by the Treasury. Federal Housing Finance Agency, "Senior Preferred Stock Purchase Agreements," Federal Housing Finance Agency, *2015 Annual Report to Congress*, June 2016, pp. 84 and 101, http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/FHFA_2015_Report-to-Congress.pdf (accessed October 4, 2016); and Fannie Mae, "Form 10-Q: Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934," pp. 9-10 and 69-73, <http://www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2016/q22016.pdf> (accessed September 9, 2016).
24. Ginnie Mae is required to operate under the requirements codified in federal law for government corporations, and the guarantee provided on the timely payment of pass-through income on qualified mortgage-backed securities holds the full faith and credit of the U.S. government. U.S. Code Title 31, Subtitle VI, Sections 9101-9110, <https://www.gpo.gov/fdsys/pkg/USCODE-2009-title31/html/USCODE-2009-title31-subtitleVI.htm> (accessed September 27, 2016).
25. Ginnie Mae, *Government National Mortgage Association Statutory Authority*, pp. 3, 6, and 11, http://www.ginniemae.gov/about_us/what_we_do/Documents/statutes.pdf (accessed September 28, 2016).
26. Soon after Ginnie Mae's first issuances of MBS in 1970, Freddie Mac started to issue and sell MBS in addition to the mortgage-backed bonds it was already selling to investors.

27. U.S. Securities and Exchange Commission, *A Staff Report of the Task Force on Mortgage-Backed Securities Disclosure: Enhancing Disclosure in the Mortgage-Backed Securities Market*, January 2003, p. 7, <https://www.treasury.gov/resource-center/fin-mkts/Documents/disclosure.pdf> (accessed September 23, 2016); “Clarke Discusses Secondary Mortgage Markets,” *The Journal of the Federal Home Loan Bank Board*, Vol. 3., Nos. 1 & 2 (January/February 1970), p. 4, <https://babel.hathitrust.org/cgi/pt?id=uc1.c3427024;view=lup;seq=1> (accessed October 3, 2016); and “Board Actions on Friend Study Recommendations,” *The Journal of the Federal Home Loan Bank Board*, Vol. 3, No. 9 (September 1970), p. 7, <https://babel.hathitrust.org/cgi/pt?id=uc1.c3427024;view=lup;seq=37> (accessed September 27, 2016).
28. In recent years, Ginnie Mae has started a program that allows the immediate transfer of the servicing rights on the pools from financial institutions to Ginnie Mae itself. Participation in the program, the Pools Issued for Immediate Transfer (PIIT) program, has increased in recent years, which exposes Ginnie Mae to different risks than it would be otherwise. Ginnie Mae, *2015 Annual Report*, p. 13, http://www.ginniemae.gov/about_us/who_we_are/budget_performance/Annual_Reports/annual_report15.pdf (accessed October 4, 2016).
29. The 1968 Housing and Community Development Act provided that mortgages insured by the Farmers Home Administration as authorized under Title V of the 1949 Housing Act were included in the initial guarantee authority for Ginnie Mae. Ginnie Mae’s secondary market functions later expanded to include certain public health service loans (1970), and then again to qualified loans to Indian families and Indian housing authorities (1996). Ginnie Mae, “Government National Mortgage Association Statutory Authority,” pp. 3 and 10.
30. Ginnie Mae, *2015 Annual Report*, pp. 66–67.
31. The FHA and the RHS crowd out private (non-government-insured) mortgages by subsidizing lower-cost mortgage insurance options for comparatively high-risk borrowers. Both federal agencies can accomplish these objectives by relaxing underwriting standards required for take-up in their respective insurance and guarantee programs. In the FHA’s single-family housing mortgage insurance program, there has indeed been a long-term degradation of credit underwriting standards in the single-family home loans insured by the FHA. Since 1990, for example, the share of FHA-insured single-family mortgage loans with down payments of 5 percent or less has increased from 34 percent to 75 percent of the agency’s portfolio. The RHS tends to insure even higher risk single-family home loans than the FHA, the majority of which are assumed by borrowers that do not even reside in a rural area. For more information on the history of these two federal housing agencies, see John L. Ligon and Norbert J. Michel, “Federal Housing Administration: What Record of Success?” Heritage Foundation *Backgrounder* No. 3006, May 11, 2015, <http://www.heritage.org/research/reports/2015/05/the-federal-housing-administration-what-record-of-success>, and John L. Ligon, “Time to Shut Down the Rural Housing Service,” Heritage Foundation *Backgrounder* No. 3097, March 23, 2016, <http://www.heritage.org/research/reports/2016/03/time-to-shut-down-the-usdas-rural-housing-service>.
32. U.S. Securities and Exchange Commission, *A Staff Report of the Task Force on Mortgage-Backed Securities Disclosure*, p. 7.
33. The 1970 federal charter for the Federal Home Loan Mortgage Corporation restricted shareholder ownership of the corporation to the 12 federal home loan banks. Later, in 1989, Congress amended the charter such that the corporation could raise capital through non-voting common stock and voting common stock. Ownership of the non-voting common stock was required for the federal home loan banks, and the voting common stock was tradable and publicly owned. Emergency Home Finance Act of 1970, P.L. 91-351 §§ 301-310, July 24, 1970, <https://www.gpo.gov/fdsys/pkg/STATUTE-84/pdf/STATUTE-84-Pg450.pdf> (accessed September 23, 2016), and Financial Institutions Reform, Recovery, and Enforcement Act of 1989, P.L. 101-73 § 731(d), August 9, 1989, https://fraser.stlouisfed.org/scribd/?title_id=1046&filepath=/docs/historical/congressional/financial-institutions-reform-1989.pdf (accessed September 23, 2016).
34. Wallison, *Hidden in Plain Sight*, pp. 125–233.
35. The U.S. Treasury holds \$72.4 billion worth of senior-preferred shares and \$14.1 billion in preferred shares of stock in Freddie Mac, and the corporation is required under the stock purchase agreement to disburse dividends on the senior-preferred shares held by the U.S. Treasury. Freddie Mac, “Form 10-Q: Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934,” pp. 3 and 71, http://www.freddie.com/investors/er/pdf/10q_2q16.pdf (accessed October 5, 2016), and Federal Housing Finance Agency, “Senior Preferred Stock Purchase Agreements.”
36. David C. Wheelock, “The Federal Response to the Home Mortgage Distress: Lessons from the Great Depression,” Federal Reserve Bank of St. Louis *Review* (May/June PART 1 2008), pp. 139–141, <https://research.stlouisfed.org/publications/review/08/05/Wheelock.pdf> (accessed October 27, 2016).
37. In 1998, Congress eliminated the requirement that S&Ls hold membership in the FHLB system. The FHFA has more recently authorized membership to certain non-depository institutions provided that they are “certified by the Treasury Department’s [Community Development Financial Institutions] Fund, such as community development loan funds.” Federal Housing Finance Agency, *2015 Annual Report to Congress*, p. 52.

38. Mark J. Flannery and W. Scott Frame, "The Federal Home Loan Bank System: The 'Other' Housing GSE," Federal Reserve Bank at Atlanta *Economic Review*, Third Quarter 2006, pp. 33–34, https://www.frbatlanta.org/-/media/Documents/research/publications/economic-review/2006/vol9Ino3_flannery-frame.pdf?la=en (accessed September 1, 2016).
39. Federal Housing Finance Agency, "Members of the Federal Home Loan Banks; Proposed Rule," *Federal Register*, Vol. 79, No. 177, September 12, 2014, <https://www.gpo.gov/fdsys/pkg/FR-2014-09-12/pdf/2014-21114.pdf> (accessed September 01, 2016).
40. Since the late 1990s, FHLBs have been permitted to expand business activity to include not only the purchase of residential home loans but also investment securities backed by home loans, including mortgages in the conventional mortgage market. Consequently, some of the FHLBs suffered financial losses in recent years and were not immune to financial setbacks during the recent housing crisis as their MBS portfolios suffered severe declines in valuation. Federal Housing Finance Agency, *2014 Annual Report to Congress*, p. 39, http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/FHFA_2014_Report_to_Congress.pdf (accessed September 8, 2016), and Federal Housing Finance Agency, *2015 Annual Report to Congress*, pp. 20–42.
41. The federal home loan banks operate within a cooperative (joint and several) ownership structure—each bank has an independent business portfolio with distinct operational management structure and shareholder (ownership) guidance. Each FHLB is liable, though, for financial losses incurred by the other FHLBs. The shares of capital stock are structured generally in the following way: There are two classes of capital stock issued within the FHLB system, and member financial institutions outside of the 11 FHLBs can purchase. Class B shares are redeemable at par value after a five-year holding period, and class A shares are redeemable after a six-month holding period. The shares between the different classes (and subclasses) of Class A and Class B stock carry different voting (activity) rights and dividend payment rates. When a bank is deemed undercapitalized by the FHFA, there are certain restrictions on how shares held may be redeemed, and FHLBs are restricted from disbursing dividend payments. The FHLBs must each hold a minimum level of *risk capital*, *regulatory capital*, and *leverage capital* in order to meet the capitalization requirements. Office of Finance, *2015 Annual Report for the Federal Home Loan Bank System*, pp. 8–11, http://www.fhlb-of.com/ofweb_userWeb/resources/2015Q4CFR.PDF (accessed September 8, 2016), and Flannery and Frame, "The Federal Home Loan Bank System: The 'Other' Housing GSE," pp. 38–43.
42. The FHLB Office of Finance issues advances (debt) to the respective federal home loan banks, which is the primary means that the banks use to fund their overall market activity related to the purchasing of residential loans from member financial institutions.
43. Federal Housing Finance Agency, *2015 Annual Report to Congress*, pp. 20–22.
44. As of 2004, the direct cost to federal taxpayers in the resolution of the savings and loan crisis of the later 1980s was \$124 billion, an estimate that excludes the tens of billions of dollars taxed to financially solvent member FHLB lending and bank institutions during the federal resolution. Bert Ely, "Savings and Loan Crisis," *The Concise Encyclopedia of Economics*, 2008, <http://www.econlib.org/library/Enc/SavingsandLoanCrisis.html> (accessed September 16, 2016).
45. Wayne Passmore, Shane M. Sherlund, and Gillian Burgess, "The Effect of Housing Government-Sponsored Enterprises on Mortgage Rates," *Real Estate Economics*, Vol. 33, No. 3 (September 2005), pp. 427–463, and Alex Kaufman, "The Influence of Fannie and Freddie on Mortgage Loan Terms," *Real Estate Economics*, Vol. 42, No. 2 (2014), pp. 472–496.
46. Karsten Jeske, Dirk Krueger, and Kurt Mitman, "Housing, Mortgage Bailout Guarantees, and the Macro Economy," Preprint submitted to *Journal of Monetary Economics*, September 6, 2013, <http://economics.sas.upenn.edu/~dkrueger/research/JKMSub.pdf> (accessed September 1, 2016).
47. These reforms assume that there are no qualified mortgage (QM) requirements, and no qualified residential mortgage (QRM) requirements, or any other federal regulations relating to requirements for mortgages in the (current) conventional mortgage finance system. In other words, should these federal reforms be implemented, one should assume that Congress will also accomplish similar free-market reforms in housing finance that would repeal broad elements of the 2010 Dodd–Frank Act. Norbert J. Michel ed., *The Case Against Dodd–Frank: How the "Consumer Protection" Law Endangers Americans* (Washington, DC: The Heritage Foundation, 2016.)
48. Fannie Mae and Freddie Mac have respectively acknowledged the possibility that they each would be placed into receivership, particularly under the circumstance that the corporations could face a negative net financial worth in future years. The likely occurrence of this event will certainly increase in the coming years as Fannie Mae is required under current policy in the Senior Preferred Stock Purchase Agreements to deplete its capital reserves by January 2018. Fannie Mae, "Single-Family MBS Prospectus: Guaranteed Mortgage Pass-Through Certificates," June 1, 2016, pp. 33–35, http://www.fanniemae.com/syndicated/documents/mbs/mbspros/SF_June_1_2016.pdf (accessed September 23, 2016); Freddie Mac, "Mortgage Participation Certificates," July 19, 2016, pp. 3–7, http://www.freddie.com/mbs/docs/pcoc_071916.pdf (accessed September 23, 2016); and James L. Gattuso, "Taking Stock: Shareholder Lawsuits No Barrier to GSE Dissolution," Heritage Foundation *Issue Brief* No. 4225, May 19, 2014, <http://www.heritage.org/research/reports/2014/05/taking-stock-shareholder-lawsuits-no-barrier-to-gse-dissolution>.
49. The 2013 Protecting American Taxpayers and Homeowners Act of 2013 took a similar approach and can be used as a guide to formulate new legislation. Protecting American Homeowners and Taxpayers Act of 2013, H.R. 2767, July 22, 2013,

<https://www.congress.gov/bill/113th-congress/house-bill/2767> (accessed September 16, 2016), and New Fair Deal Banking and Housing Stability Act of 2013, H.R. 3550, November 20, 2013, <https://www.govtrack.us/congress/bills/113/hr3550/text/ih> (accessed September 8, 2016).

50. Housing and Economic Recovery Act of 2008, P.L. 110–89 § 1124, <https://www.gpo.gov/fdsys/pkg/PLAW-110publ289/html/PLAW-110publ289.htm> (accessed October 11, 2016), and news release, “FHFA Announces 2015 Conforming Loan Limits: Unchanged in Most of the U.S.,” Federal Housing Finance Agency, November 24, 2016, <http://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Announces-2015-Conforming-Loan-Limits-Unchanged-in-Most-of-the-U-S.aspx> (accessed October 11, 2016).
51. Congress authorized the FHFA to conduct an “on-going study” of the fees charged by Fannie Mae and Freddie Mac for the guarantees that the corporations respectively provide on mortgages. The FHFA is required to submit an annual report to Congress related to its “on-going study” of the likely impacts of these guarantee fees. The FHFA director has the discretion to determine the adjustment to the guarantee fees. Housing and Economic Recovery Act of 2008, P.L. 110–80 § 1601, <https://www.gpo.gov/fdsys/pkg/PLAW-110publ289/html/PLAW-110publ289.htm> (accessed October 11, 2016), and Federal Housing Finance Agency, “Fannie Mae and Freddie Mac Single-Family Guarantee Fees in 2015,” <http://www.fhfa.gov/AboutUs/Reports/Pages/Single-Family-Guarantee-Fees-in-2015.aspx> (accessed October 11, 2016).
52. As amended, the respective Senior Preferred Stock Purchase Agreements (section 5.7) between the U.S. Treasury and the GSEs Fannie Mae and Freddie Mac require the reduction in the allowable mortgage investment portfolio for the corporation. These amendments to the GSEs’ respective SPSPAs cap the decreases in the allowable mortgage investment portfolio for the corporation at no less than \$250 billion.
53. Congress authorized in the Housing and Economic Recovery Act (HERA) of 2008 for Fannie Mae and Freddie Mac to carry out duty-to-serve requirements that function as a redistributive credit system. The proposed rule by the FHFA specifically targets very low-income, low-income, and moderate-income families in the manufactured housing market, the affordable-housing preservation market, and the rural housing market. Housing and Economic Recovery Act of 2008, P.L. 110–80 § 1129, <https://www.gpo.gov/fdsys/pkg/PLAW-110publ289/html/PLAW-110publ289.htm> (accessed October 11, 2016), and Federal Housing Finance Agency, “Update on FHFA’s Proposed Rule on Duty to Serve Underserved Markets,” July 21, 2016, <http://www.fhfa.gov/Media/Blog/Pages/Update-on-FHFAs-Proposed-Rule-on-Duty-to-Serve-Underserved-Markets.aspx> (accessed October 25, 2016).

CHAPTER 16:

Fixing the Regulatory Framework for Derivatives

Norbert J. Michel, PhD

Many policymakers have strong opinions on the risks of derivatives, but there is no objective economic reason to regulate derivatives as a unique product. To the contrary, it is best to avoid regulating derivatives as a unique product because doing so is bound to result in a complex set of rules filled with special exemptions for select users. Prior to the 2008 financial crisis, derivatives were not regulated as a unique product. Instead, most derivatives—including credit default swaps (CDSs) and other over the counter (OTC) derivatives—were regulated based on who used them and, necessarily, for what purpose. Banks, for instance, were required to account for their derivative exposure within their existing regulatory capital framework, just as they were required to account for loans, repurchase agreements (repos), and other financial risks.

The main problem with the pre-crisis regulatory structure for derivatives and repos was that the bankruptcy code included special exemptions (safe harbors) for derivatives and repos. These safe harbors from core bankruptcy provisions distorted financial markets leading up to the 2008 crisis because they gave derivative and repo users preferred positions relative to other types of creditors. The safe harbors were justified on the grounds that they would prevent systemic financial problems, a theory that proved false in 2008. Nonetheless, the 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act largely ignored these harmful provisions in the bankruptcy code, and implemented a new regulatory framework that regulates OTC derivatives as a unique product. Removing these safe harbors and eliminating the Dodd–Frank

framework would improve capital markets by properly incentivizing market participants to account for their financial risks.

OVERVIEW OF DERIVATIVES MARKETS

Derivatives securities are essentially contracts between buyers and sellers (commonly referred to as counterparties), but there are many different types of derivatives. Broadly speaking, these typically long-lived contracts bind the counterparties to buy or sell some asset at a future date at a certain price. The value of the contract—the derivative itself—is therefore tied to some underlying asset, such as a corporate bond. In general, the counterparties buy and sell these contracts so that they can lower their exposure to uncertain future price movements.¹ While there is no

doubt that some investors use derivatives for purely speculative purposes, the primary use of derivatives is to reduce financial risk.

Three of the more common types of derivatives are futures, forwards, and swaps. Futures are derivatives contracts used so commonly that they are standardized financial instruments, a feature that allows them to trade on exchanges, much like stocks.² The Chicago Mercantile Exchange, for instance, provides a market where counterparties can buy and sell standardized futures contracts on commodities, such as butter, lumber, cattle, foreign currencies, and even stock market indices. Forwards, on the other hand, are most often specialized contracts between two financial firms or between a financial firm and its customer. Internationally active corporations regularly enter into forward contracts to hedge against losing money on future changes in exchange rates.³

Whereas futures contracts typically do not require the physical delivery of an asset at maturity, forward contracts normally do require delivery. Swaps are similar to forward contracts but they require counterparties to make a *series* of future payments, whereas forward contracts require only one future payment. Swap contracts can, therefore, be viewed as a series of forward contracts. The most commonly used swaps are those that hedge against interest-rate risk, but market participants use many different types of swap contracts.⁴ Historically, most swaps have been negotiated directly (bilaterally) between large banks and other institutional investors—such as insurance companies, pension funds, and mutual funds—on the OTC market rather than purchased on exchanges. Standardized financial instruments typically trade on exchanges, whereas nonstandard financial products, such as highly customized CDSs, tend to trade in OTC markets.

Typically, as particular financial products become more widespread, they become more standardized, and their trading slowly migrates to exchanges.⁵ In terms of overall volume, the OTC market is more than 10 times the size

of the exchange-traded derivatives market.⁶ Furthermore, while all sorts of nonfinancial companies use OTC derivatives, the bulk of the OTC derivatives market consists of interest-rate and foreign-exchange swaps that are heavily concentrated among commercial banks.⁷ Thus, banking regulators have for years been the main regulators of financial risks concerning the bulk of the derivatives market.⁸

RISK AND THE OTC DERIVATIVES MARKET

Many commentators have pointed to the enormous *notional* size of the OTC derivatives markets—approximately \$700 trillion—as an ominous indicator of the systemic risk that derivatives create.⁹ This statistic is misleading for several reasons. To begin, the notional size of the market obscures the fact that derivatives, such as CDSs, improve firms' ability to diversify and reduce their risks. In fact, derivatives securities, such as OTC market CDSs, do not create any new risk. Instead, a CDS merely provides protection to end users by shifting *existing* risks to other firms that are more willing and able to risk their capital. The notional amount of a derivatives contract does not accurately reflect even the amount of capital at risk.

The notional size of an OTC contract merely represents the maximum amount to which a counterparty *could* be exposed, depending on a number of factors.¹⁰ Moreover, firms that sell CDS contracts typically protect their own financial exposure by purchasing separate CDS contracts. JP Morgan, for instance, can buy a CDS contract from Deutsche Bank to protect itself from having to pay on a CDS it sold to American Airlines. Then, Deutsche Bank can buy a new CDS from Goldman Sachs to protect itself from having to pay JP Morgan, and so on. Thus, while instructive at some level, the notional amount does not accurately reflect either the underlying risk or the amount of that risk to which the counterparties are exposed.

A better measure of the risk that OTC-derivative counterparties take on is the amount of *credit risk* they face. Credit risk, in turn, is

the risk that a counterparty may be unable to make the payments to which it agreed in the original contract. The Bank for International Settlements (BIS) estimates total credit risk in the OTC derivatives market with a measure called *gross market value*. The BIS reports that as of December 2015, global OTC derivatives markets contained a gross market value of \$14.5 trillion based on a notional amount of \$493 trillion.¹¹ Even this measure, however, fails to account for *netting* among counterparties as well as *collateral*, both of which further reduce counterparties' exposure on derivatives contracts.

The process of netting essentially offsets gains and losses so that OTC counterparties cannot simultaneously default on one contract while accepting payment on another—the *net* difference has to be paid (or received).¹² This practice is standard in the International Swaps and Derivatives Association (ISDA) master agreement, and it binds a defaulting counterparty to offset defaulting (negatively valued) contracts with non-defaulting (positively valued) contracts.¹³ Many of the large institutional investors in the OTC derivatives market have multiple contracts with each other, so applying netting to the gross market value in the OTC market reduces aggregate credit exposure even further. In 2013, the ISDA estimated that netting reduced credit exposure in OTC derivatives to less than \$4 trillion, a large amount, but far less than \$700 trillion.¹⁴ Similarly, the Office of the Comptroller of the Currency (OCC) estimates that U.S. commercial banks and savings associations netted more than 90 percent of their derivatives exposure between 2009 and 2012.¹⁵

Collateral is property that borrowers provide to lenders as a form of protection in case the borrower fails to pay back what is owed, and derivatives counterparties typically use cash or U.S. Treasury securities for collateral. Counterparties typically post collateral (margin) when they initiate a contract, and also may provide additional collateral (variation margin) as market conditions change. The ISDA estimated that accounting for both

netting and collateral reduced the credit exposure in OTC derivatives to \$1 trillion in 2013.¹⁶ This figure represents less than 0.5 percent of the notional amount outstanding, and the exposure is roughly consistent with data from both 2011 and 2012 as well.¹⁷ Regulators have to consider all of these issues when developing rules for regulating OTC derivatives.¹⁸

PRE-DODD-FRANK REGULATORY FRAMEWORK FOR OTC DERIVATIVES

Prior to the 2010 Dodd-Frank Act, OTC swaps were not separately regulated by either the Commodity Futures Trading Commission (CFTC) or the Securities and Exchange Commission (SEC), but the overwhelming majority of these swaps were regulated by state and federal banking regulators.¹⁹ Historically, large banks have always been the heaviest users of interest-rate swaps, the type of swap that accounts for more than 80 percent of the OTC derivatives market. Thus for the bulk of the OTC derivatives market, it is completely false to say that OTC derivatives were unregulated. Federal banking regulators, including the Federal Reserve and the OCC, constantly monitor banks' financial condition, especially the banks' swaps exposure.²⁰

The main method that banking regulators used to regulate banks' swap exposure was to ensure that banks accounted for OTC derivatives when calculating their regulatory capital. Even the very first iteration of the Basel capital requirements, which were implemented in the late 1980s, required banks to account for their swaps when calculating capital ratios. In particular, banks had to hold capital against the *credit-risk equivalent* to their swaps, a method that essentially treated derivatives as a type of loan in banks' risk-adjusted assets.²¹ Simply put, none of these derivatives transactions took place outside bank regulators' purview, and there is no shortage of public acknowledgements attesting to this fact. For instance, a 1993 Boston Federal Reserve paper notes that “[b]ank regulators have recognized the credit risk of swaps and instituted

capital requirements for them and for other off-balance-sheet activities, as part of the new risk-based capital requirements for banks.”²²

As a result, OTC derivatives were not regulated as a specific product in the way that, for example, gasoline is regulated. Instead, OTC derivatives were regulated on the basis of who used them and, necessarily, for what purpose. If, for example, American Airlines negotiated an OTC derivative contract with Wells Fargo, federal banking regulations would require Wells Fargo to account for that contract within its normal regulatory capital framework. In other words, Wells Fargo was required to account for its OTC derivatives exposure within the same framework it was required to account for loans and other financial risks. Although American Airlines was not regulated by banking regulators, the company had to disclose the financial risks associated with its derivatives contracts based on standards adopted by the Financial Accounting Standards Board (FASB).²³

Ideally, the regulatory framework for derivatives would focus exclusively on fostering accurate disclosure of relevant information, even by financial companies.²⁴ However, given that banks—not commercial companies, such as American Airlines—in the pre-Dodd-Frank era were regulated with a risk-based capital framework, the older approach made perfect sense. Then, as now, there was nothing particularly unique about OTC derivatives requiring special product-based regulations for all users. Indeed, it is best to avoid regulating OTC derivatives as a unique product because that type of regulation invites rules that favor certain users over others. Nonetheless, the Dodd-Frank Act imposed product-based regulations on much of the OTC derivatives market.

Title VII of Dodd-Frank imposes a requirement to clear more OTC derivatives through central counterparties (CCPs), and also gives the CFTC and the SEC explicit authority to regulate the OTC swaps markets and market participants.²⁵ Many commercial users of derivatives have exemptions from the new rules, but banking regulators remain responsible for certifying that banks are meeting their

regulatory capital ratios when they use OTC swaps. Title VII did virtually nothing to fix the problems that contributed to the 2008 financial crisis, and the new rules—particularly the clearing mandate—have likely further concentrated financial risks in U.S. markets.

The Dodd-Frank framework is also harmful because it ignores particularly damaging derivatives exemptions in the bankruptcy code. In fact, Dodd-Frank ignores similarly risky bankruptcy provisions for repos.²⁶ Both derivatives and repos, a type of short-term loan secured with collateral, share special bankruptcy provisions that favor their users relative to other creditors.²⁷ This special treatment contributed to major market distortions leading up to the 2008 financial crisis because it gave repo and derivatives counterparties preferred positions over other creditors.

OVERVIEW OF KEY PROVISIONS IN BANKRUPTCY

Dodd-Frank took a misguided approach to actively regulating OTC derivatives and, perhaps worse, failed to address special bankruptcy provisions that favor OTC derivative and repo users relative to ordinary creditors. The current bankruptcy code was enacted in 1978, and Congress has steadily expanded safe harbors for derivatives and repos, as well as other financial contracts.²⁸ A brief overview of the bankruptcy process highlights how this special treatment can distort financial markets by favoring certain counterparties over other creditors.²⁹

A firm (the debtor) typically files for bankruptcy protection under Chapter 11 of the U.S. Code, meaning that it seeks protection from creditors who may seek control of the firm’s assets because they fear nonpayment. A main goal of this protection is to enable the debtor to remain in business and pay its creditors what they are owed over time. When a Chapter 11 bankruptcy filing begins, the court creates an “estate” that consists of virtually all of the debtor’s assets as of the petition date.³⁰ To ensure that the estate remains a viable business, the bankruptcy filing triggers a

provision known as the *automatic stay*, a kind of financial time-out.³¹

The stay remains in effect until a bankruptcy judge—sort of a referee in the process—says otherwise, at which time the debtor and the creditors begin a coordinated effort to resolve the debtor’s financial situation equitably across similar creditors. In general, the bankruptcy filing strips creditors of many contractual rights they would normally have. For instance, when the debtor files bankruptcy, the stay immediately and automatically prohibits creditors from suing the debtor, or taking any other action to collect what they are owed. The stay even prohibits secured creditors from selling or seizing the collateral (cash or securities) they hold. This process is meant to protect the debtor from a mad rush of creditors trying to obtain what they are owed before anyone else.

The bankruptcy code provides several other protections to help ensure that similarly situated creditors are treated in an equitable manner (meaning that they share any losses in an equitable manner). For example, creditors generally have to seek the court’s permission to *set off* what they owe the debtor against any amounts the debtor may owe them.³² Additionally, the debtor (or a court-appointed trustee) can generally force creditors to return any *preferential transfers*.³³ For instance, a creditor may have to return a payment made within 90 days of bankruptcy if that payment would have made the creditor better off than had the transfer not been made. The amount would have to be returned to the estate so that it would improve the collective position of the creditors.

Similarly, the debtor generally has the power to avoid fraudulent conveyances.³⁴ For instance, sales or transfers of assets at less than fair value within two years of the filing date can be reversed to benefit *all* creditors. More broadly, creditors generally cannot terminate their contracts with the debtor simply because the firm filed for bankruptcy protection. In fact, even if a contract includes a clause that makes the debtor’s bankruptcy

a default (an *ipso facto* clause) the clause is generally not enforceable.³⁵ However, debtors can generally choose which uncompleted contracts (those which have elements of both assets and liabilities for the estate) to reject.³⁶

Distortions arise because the bankruptcy code provides derivatives and repo users with safe harbors that leave them in a preferred position relative to ordinary creditors. Based on what occurred during the 2008 financial crisis (discussed below), these safe harbors have at least partially defeated the main purpose of bankruptcy protection. In particular, these safe harbors prevented firms from using the bankruptcy code to reorganize and continue operating because they encouraged certain creditors to individually seek payments outside a collective bankruptcy proceeding rather than negotiate with debtors inside bankruptcy.³⁷

SAFE HARBORS FOR DERIVATIVES AND REPOS

The 2005 Bankruptcy Abuse Prevention and Consumer Protection Act expanded several key safe harbors largely by defining the term *swap agreement* to include effectively all derivatives contracts.³⁸ In particular, this change extended safe harbors to virtually all derivatives users such that the entire market was exempt from the automatic stay and preference provisions. The 2005 act also expanded the definition of *repurchase agreement* to include “mortgage related securities...mortgage loans, interests in mortgage related securities or mortgage loans,” as well as several additional items.³⁹ Thus, since 2005, the bankruptcy code exempted derivatives and repos from two core provisions of bankruptcy: the automatic stay and preference protections.⁴⁰

The code also exempts these contracts from bankruptcy’s anti-*ipso facto* rules, the trustee’s power to avoid fraudulent conveyances,⁴¹ and even from limitations on a non-debtor’s ability to set off obligations owed to the debtor. Unlike ordinary creditors, derivatives counterparties can automatically terminate their contracts as soon as a debtor files for bankruptcy protection.⁴² The fact that the

debtor's counterparties can seize collateral free from preference protections was a feature that proved especially harmful during the 2008 crisis. Collectively, these safe harbors mean that all derivatives and repo users are—as they were prior to the 2008 crisis—protected parties relative to ordinary creditors.

Weak Justification for Safe Harbors.

These safe harbors have been justified on various grounds, most of which relate in some way to systemic crises.⁴³ For instance, in the early 1980s, industry advocates argued that derivatives markets were too complex to treat counterparties like other creditors, and that if safe harbors were not provided “the whole system would become paralyzed” in a bankruptcy.⁴⁴ Similarly, in 1983, Fed Chair Paul Volcker suggested a safe harbor was necessary to protect the repo market given that repos were a main tool of monetary policy. Volcker also argued that limiting these special protections to repo transactions of \$1 million or more would suffice, thus avoiding the need to provide broad exceptions to existing bankruptcy laws.⁴⁵

A common argument for safe harbors is that subjecting derivatives counterparties to the automatic stay could cause multiple firms to fail, thus leading to a financial crisis, a recession, or both. A bankruptcy filing could, for instance, cause the firm's counterparties to “run,” quickly closing out their positions and selling collateral to avoid being subjected to an automatic stay. This run could result in rapidly declining asset prices, thus destabilizing financial markets. Similarly, proponents of these special exemptions argue that safe harbors allow counterparties to quickly cancel contracts and enter new hedges (with other counterparties), thus ensuring their financial health and avoiding financial market distress.⁴⁶

Aside from whether safe harbors can actually mitigate systemic risk, systemic concerns do not justify blanket exemptions from core bankruptcy provisions. By definition, systemic risk concerns could only justify, at most, exemptions for the largest or most systemically important derivatives counterparties. Identifying such institutions—even using broad

guidelines such as those in Dodd–Frank—is far from an objective exercise, a problem which highlights that such safe harbors necessarily provide preferential treatment to certain creditors over others. For this reason alone, providing these safe harbors requires an overwhelmingly compelling justification. This justification simply does not exist, and the 2008 financial crisis provides evidence that safe harbors worsen, rather than mitigate, systemic risk.

Safe Harbors Increase Risk of Financial Turmoil.

The 2008 crisis showed that most of these arguments for giving special exemptions to derivatives counterparties are deeply flawed. First, the notion that the automatic stay safe harbor would prevent a run proved to be incorrect. Bear Stearns's counterparties ran before Bear was even considering bankruptcy.⁴⁷ Lehman Brothers's problems were also exacerbated by safe harbors. Immediately before the firm collapsed, JP Morgan seized \$17 billion in securities and cash (Lehman's collateral) and demanded an additional \$5 billion payment.⁴⁸ Lehman effectively had no choice but to come up with the additional collateral, thus worsening its liquidity position.

Lehman could not file bankruptcy to prevent Morgan from selling the collateral because of the safe harbors, and Lehman had no reason to expect that it could retrieve the payment as a special preference if it did file for bankruptcy. Furthermore, the lead attorney in the Lehman bankruptcy case testified to Congress that the lack of an automatic stay contributed to confusion at the outset of the filing.⁴⁹ The safe harbors also encouraged Lehman's accounting manipulation known as Repo 105, an end-of-quarter transaction used to disguise the company's true leverage. Had repos been treated as secure loans without the safe harbors—as the economic structure of a repo actually justifies—it is unlikely that Lehman could have conducted the Repo 105 transaction.⁵⁰

The safe harbors also played a negative role in the near failure of American International Group (AIG).⁵¹ The company's counterparties

increasingly demanded additional collateral for its large CDS portfolio, thus threatening to bankrupt the company. As with Lehman, AIG would have been able to refuse the collateral demands and expect protection had there been no safe harbors for the CDSs.⁵² Even if the safe harbors only partly contributed to the runs on these counterparties, it is clear that the safe harbors did not prevent the type of systemic problems that advocates suggested they would.

Aside from the added incentive to run, the safe harbors likely induced firms to rely more heavily on derivatives and repos than they would have in absence of the special protections. For instance, Bear Stearns's liabilities consisted of only 7 percent repos in 1990, but by 2008 they consisted of 25 percent repos.⁵³ Data also show that the portion of *total investment bank* assets financed by repos doubled between 2000 and 2007.⁵⁴ Whether the growing market led to legislative action to further support the market, or whether the legislative amendments to the bankruptcy code led to the growing market is irrelevant. Either way, the market would not have supported such high increases in leverage without the special protections, which is precisely why the safe harbors should not be provided.

The safe harbors also lead to more subtle adverse effects, such as diminishing the incentive to monitor counterparties and to prepare (or even file) for bankruptcy.⁵⁵ It is certainly true that eliminating these safe harbors may cause firms to rely less on these short-term debt instruments, and to price in higher risks than they do currently. However, this outcome is not a market failure: It is precisely how markets function when the participants have the proper incentives to monitor their risks.

The fact that the Federal Deposit Insurance Corporation (FDIC) has for decades implemented a special failure-resolution process for banks that imposes a one-day stay on a bank's derivative and repo counterparties makes the case for economy-wide safe harbors even less compelling.⁵⁶ This temporary stay for banks provides additional evidence

that the safe harbors exacerbated the 2008 crisis because markets froze in the *nonbanking* sector where there were safe harbors, not in the banking sector where a temporary stay was in effect. Rather than relying on contracting and special rules to prevent excessive financial risks, Congress should enact reforms that expose financial market participants to more market discipline.

HOW REGULATORS SHOULD ACCOUNT FOR OTC DERIVATIVES

There is no objective economic reason to treat derivatives users preferentially relative to any other set of creditors in a bankruptcy case. Thus, a key component of reforming the regulatory framework for derivatives and repos is to remove their bankruptcy safe harbors. Some scholars have argued for a more cautious approach, such as implementing an automatic stay that lasts for 48 hours or 72 hours, and recent bankruptcy-reform legislation includes a 48-hour automatic stay for derivatives and repos that would apply to counterparties of certain large financial institutions.⁵⁷

Similarly, some have argued that *most* of the safe harbors should be eliminated, but that an automatic-stay safe harbor should remain in place for *cash-like* collateral used in repo transactions.⁵⁸ This type of proposal is justified on the grounds that repo markets are volatile and their values can change dramatically over very short time periods, with counterparties constantly recalibrating margin and collateral requirements. Economically, though, these market attributes alone provide no justification for bankruptcy safe harbors—they merely describe factors that counterparties would price differently were there no safe harbors.⁵⁹ In other words, removing all of the safe harbors would all but certainly impact the market because counterparties would have to account for more risk, an outcome which should be applauded.

There is also no objective economic reason to regulate derivatives as a unique product. The Dodd–Frank Act took such an approach, and imposed product-based regulations on

much of the OTC derivatives market. The outcome of these Dodd–Frank changes is more highly concentrated financial risks, and an incredibly complex set of rules filled with special exemptions and safe harbors. This is exactly the wrong approach because it creates a framework that invites special-interest lobbying for rules that favor certain market participants over others. Ideally, the regulatory framework should provide no special protections for derivative or repo counterparties and focus exclusively on fostering accurate disclosure of relevant information. In an optimal regulatory framework, this disclosure focus could even be applied to banking institutions.

Though the current framework is far from ideal, bringing more market discipline and less taxpayer backing to the banking industry would lessen the need for statutory capital requirements and complex derivatives rules. Even outside that ideal framework, there are many ways that regulatory capital rules for derivatives can be simplified, thus moving toward greater reliance on disclosure. For instance, regulatory relief could be provided to banks that choose to meet a higher capital requirement that accounts for derivatives exposure in a straightforward, transparent manner. This type of leverage ratio (referred to as a regulatory off-ramp) could, for example, include net credit exposure from derivatives and a flat percentage of notional derivative contracts in a bank's total assets.⁶⁰ Accounting for derivatives exposure in this type of straightforward, transparent manner would introduce much-needed market discipline to banks and derivatives counterparties.

Congress should implement the following changes to move the U.S. regulatory framework for derivatives toward an ideal system:

- **Repeal Title VII of Dodd–Frank.** Title VII of Dodd–Frank imposes a requirement to clear more OTC derivatives through central counterparties (CCPs), and also gives the CFTC and the SEC explicit authority to regulate the OTC swaps markets and market participants. Title VII is based
- **Simplify derivatives regulation for banks.** Banks are regulated differently than most companies largely because taxpayers back FDIC deposit insurance and loan guarantees, as well as (ultimately) Federal Reserve emergency lending. These forms of taxpayer support have to be removed in order for the U.S. framework to fully utilize market-based regulations that rely mainly on disclosure. In the meantime, Congress can provide regulatory off-ramps to banks that elect to meet higher, simpler capital standards, similar to the approach taken in the Financial CHOICE Act. While many other reforms are needed to bring more market discipline to bear on banks and derivatives counterparties, accounting for banks' derivatives exposure in a straightforward, transparent manner (in a regulatory off-ramp requirement) would partly accomplish this goal. Any off-ramp leverage ratio could, for example, include net credit exposure and a flat percentage of notional derivative contracts (both commonly reported already) in total assets. Such a reform would eventually lower the reliance on complex, opaque rules that favor those banks most heavily involved in derivatives markets.
- **Remove safe harbors for repos and derivatives.** The bankruptcy code should be amended so that repo and derivatives counterparties no longer have safe harbors that position them as preferred creditors. Specifically, safe harbors from the

automatic stay, anti-*ipso facto* rules, and preference and fraudulent conveyances rules should all be eliminated. A temporary automatic stay (for all derivatives and repos) of 48 hours to 72 hours is a good intermediate step, but any such temporary stay should automatically sunset after several years so that the safe harbor is completely eliminated. These safe harbors should be removed for CCPs as well. Even if systemic risk concerns were valid, they would not justify blanket exemptions from core bankruptcy provisions. By definition, systemic risk concerns could only justify, at most, exemptions for the largest or most systemically important derivatives counterparties. Providing safe harbors in this manner would blatantly provide special financial protection to a small group of financial firms. Regardless, safe harbors actually worsened credit market turmoil during the 2008 crisis, while safe harbor advocates had claimed the special exemptions would avoid such problems.

CONCLUSION

There is nothing particularly unique about derivatives that would require them to have special product-based regulations. Indeed, it is best to avoid regulating derivatives as a unique product because that type of regulation invites rules that favor certain users over

others. Ideally, the regulatory framework for derivatives would focus exclusively on fostering accurate disclosure of relevant information, even by financial companies. The U.S. regulatory framework has gone in exactly the wrong direction for decades, providing special exemptions to an increasingly complex set of rules and, as of 2010, regulating derivatives as specific products. Derivatives themselves should no longer be regulated as a distinct product, and the changes implemented by Title VII of the 2010 Dodd-Frank Act should be repealed.

Another main problem with the existing framework—which Dodd-Frank barely addressed—is that the bankruptcy code provides derivatives and repo users with exemptions that leave them in a preferred position relative to ordinary creditors. The turmoil in financial markets during the 2008 crisis shows that the main arguments for giving safe harbors to derivatives and repo counterparties are deeply flawed. Rather than mitigate systemic risk, the safe harbors increased reliance on derivatives and repos, provided higher incentives to run on counterparties, and decreased the incentive to monitor counterparties, as well as to prepare (or even file) for bankruptcy. All such safe harbors should be removed from the bankruptcy code to eliminate disparate treatment for similarly situated creditors.

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APPENDIX

The following, quoted, text compares the legal definitions of *repurchase agreement* and *swap agreement* before and after the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act was enacted.

*Repurchase Agreement as defined in U.S. Code prior to the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.*⁶¹

“repurchase agreement” (which definition also applies to a reverse repurchase agreement) means an agreement, including related terms, which provides for the transfer of certificates of deposit, eligible bankers’ acceptances, or securities that are direct obligations of, or that are fully guaranteed as to principal and interest by, the United States or any agency of the United States against the transfer of funds by the transferee of such certificates of deposit, eligible bankers’ acceptances, or securities with a simultaneous agreement by such transferee to transfer to the transferor thereof certificates of deposit, eligible bankers’ acceptances, or securities as described above, at a date certain not later than one year after such transfers or on demand, against the transfer of funds.

*Repurchase Agreement as defined in U.S. Code after the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.*⁶²

The term “repurchase agreement” (which definition also applies to a reverse repurchase agreement)—(A) means—

(i) an agreement, including related terms, which provides for the transfer of one or more certificates of deposit, mortgage related securities (as defined in section 3 of the Securities Exchange Act of 1934), mortgage loans, interests

in mortgage related securities or mortgage loans, eligible bankers’ acceptances, qualified foreign government securities (defined as a security that is a direct obligation of, or that is fully guaranteed by, the central government of a member of the Organization for Economic Cooperation and Development), or securities that are direct obligations of, or that are fully guaranteed by, the United States or any agency of the United States against the transfer of funds by the transferee of such certificates of deposit, eligible bankers’ acceptances, securities, mortgage loans, or interests, with a simultaneous agreement by such transferee to transfer to the transferor thereof certificates of deposit, eligible bankers’ acceptance, securities, mortgage loans, or interests of the kind described in this clause, at a date certain not later than 1 year after such transfer or on demand, against the transfer of funds;

(ii) any combination of agreements or transactions referred to in clauses (i) and (iii);

(iii) an option to enter into an agreement or transaction referred to in clause (i) or (ii);

(iv) a master agreement that provides for an agreement or transaction referred to in clause (i), (ii), or (iii), together with all supplements to any such master agreement, without regard to whether such master agreement provides for an agreement or transaction that is not a repurchase agreement under this paragraph, except that such master agreement shall be considered to be a repurchase agreement under this paragraph only with respect to each agreement or transaction under the master agreement that is referred to in clause (i), (ii), or (iii); or

(v) any security agreement or arrangement or other credit enhancement related to any agreement or transaction referred to in clause (i), (ii), (iii), or (iv), including any guarantee or reimbursement obligation by or to a repo participant or financial participant in connection with any agreement or transaction referred to in any such clause, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with section 562 of this title; and (B) does not include a repurchase obligation under a participation in a commercial mortgage loan.

*Swap Agreement as defined in U.S. Code prior to the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.*⁶³

“swap agreement” means—

(A) an agreement (including terms and conditions incorporated by reference therein) which is a rate swap agreement, basis swap, forward rate agreement, commodity swap, interest rate option, forward foreign exchange agreement, spot foreign exchange agreement, rate cap agreement, rate floor agreement, rate collar agreement, currency swap agreement, cross-currency rate swap agreement, currency option, any other similar agreement (including any option to enter into any of the foregoing);

(B) any combination of the foregoing; or

(C) a master agreement for any of the foregoing together with all supplements.

*Swap Agreement as defined in U.S. Code after the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.*⁶⁴

The term “swap agreement”—

(A) means—

(i) any agreement, including the terms and conditions incorporated by reference in such agreement, which is—

(I) an interest rate swap, option, future, or forward agreement, including a rate floor, rate cap, rate collar, cross-currency rate swap, and basis swap;

(II) a spot, same day-tomorrow, tomorrow-next, forward, or other foreign exchange, precious metals, or other commodity agreement;

(III) a currency swap, option, future, or forward agreement;

(IV) an equity index or equity swap, option, future, or forward agreement;

(V) a debt index or debt swap, option, future, or forward agreement;

(VI) a total return, credit spread or credit swap, option, future, or forward agreement;

(VII) a commodity index or a commodity swap, option, future, or forward agreement;

(VIII) a weather swap, option, future, or forward agreement;

(IX) an emissions swap, option, future, or forward agreement; or

(X) an inflation swap, option, future, or forward agreement;

(ii) any agreement or transaction that is similar to any other agreement or transaction referred to in this paragraph and that—

(I) is of a type that has been, is presently, or in the future becomes, the subject of recurrent dealings in the swap or other

derivatives markets (including terms and conditions incorporated by reference therein); and

(II) is a forward, swap, future, option, or spot transaction on one or more rates, currencies, commodities, equity securities, or other equity instruments, debt securities or other debt instruments, quantitative measures associated with an occurrence, extent of an occurrence, or contingency associated with a financial, commercial, or economic consequence, or economic or financial indices or measures of economic or financial risk or value;

(iii) any combination of agreements or transactions referred to in this subparagraph;

(iv) any option to enter into an agreement or transaction referred to in this subparagraph;

(v) a master agreement that provides for an agreement or transaction referred to in clause (i), (ii), (iii), or (iv), together with all supplements to any such master agreement, and without regard to whether the master agreement contains an agreement or transaction that is not a swap agreement under this paragraph, except that the

master agreement shall be considered to be a swap agreement under this paragraph only with respect to each agreement or transaction under the master agreement that is referred to in clause (i), (ii), (iii), or (iv); or

(vi) any security agreement or arrangement or other credit enhancement related to any agreements or transactions referred to in clause (i) through (v), including any guarantee or reimbursement obligation by or to a swap participant or financial participant in connection with any agreement or transaction referred to in any such clause, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with section 562; and

(B) is applicable for purposes of this title only, and shall not be construed or applied so as to challenge or affect the characterization, definition, or treatment of any swap agreement under any other statute, regulation, or rule, including the Gramm–Leach–Bliley Act, the Legal Certainty for Bank Products Act of 2000, the securities laws (as such term is defined in section 3(a)(47) of the Securities Exchange Act of 1934) and the Commodity Exchange Act.

ENDNOTES

1. John Hull, *Options, Futures, and Other Derivatives*, 3rd ed. (Upper Saddle River, NJ: Prentice-Hall, 1997).
2. *Ibid.* Historically, the exchanges have set the rules and procedures for standardization of futures contracts.
3. *Ibid.*, and Roberta Romano, “A Thumbnail Sketch of Derivative Securities and Their Regulation,” *Maryland Law Review*, Vol. 55, No. 1 (1996), http://digitalcommons.law.yale.edu/cgi/viewcontent.cgi?article=2985&context=fss_papers (accessed June 22, 2015). Also see Bruce Tuckman, “In Defense of Derivatives: From Beer to the Financial Crisis,” Cato Institute *Policy Analysis* No. 781, September 29, 2015, <http://object.cato.org/sites/cato.org/files/pubs/pdf/pa781.pdf> (accessed July 26, 2016).
4. As of June 2013, the International Swaps and Derivatives Association reported that interest-rate swaps accounted for more than 80 percent of the OTC derivatives market. See International Swaps and Derivatives Association, “The Value of Derivatives,” 2014, <http://www2.isda.org/about-isda> (accessed June 22, 2015).
5. Darrell Duffie, “Futurization of Swaps,” Bloomberg, January 28, 2013, p. 2, http://www.darrellduffie.com/uploads/policy/DuffieBGOV_FuturizationOfSwaps.pdf (accessed July 28, 2015). For more on the OTC markets, see Darrell Duffie, *Dark Markets: Asset Pricing and Information in Over-the-Counter Markets* (Princeton, NJ: Princeton University Press, 2012), pp. 1–9.
6. As of December 2015, globally, there was more than \$25 trillion in notional principal outstanding for all exchange-traded futures, and roughly \$38 trillion for all exchange-traded options. Historically, these two derivatives make up the bulk of the exchange-traded derivatives market. See Bank of International Settlements, “Exchange-Traded Futures and Options, by Location of Exchange,” Table D1, <http://www.bis.org/statistics/d1.pdf> (accessed July 26, 2016). In contrast, the total notional principal outstanding in the OTC market was nearly \$700 trillion as of June 2013. See International Swaps and Derivatives Association, “The Value of Derivatives.”
7. The largest five banks account for roughly 95 percent of all swaps among the largest 25 commercial banks. Comptroller of the Currency, “OCC’s Quarterly Report on Bank Trading and Derivatives Activities Third Quarter 2012,” Table 1, Quarter 3, 2012, <http://www.occ.treas.gov/topics/capital-markets/financial-markets/trading/derivatives/dq312.pdf> (accessed October 7, 2015). Similar concentration appears globally; see Duffie, “Futurization of Swaps.”
8. It is true that OTC swaps were not regulated by either the CFTC or the SEC, but the overwhelming majority of these swaps were regulated by state and federal banking regulators. See Norbert J. Michel, “Fixing the Dodd–Frank Derivatives Mess: Repeal Titles VII and VIII,” Heritage Foundation *Backgrounder* No. 3076, November 16, 2015, <http://www.heritage.org/research/reports/2015/11/fixing-the-doddfrank-derivatives-mess-repeal-titles-vii-and-viii?ac=1> (accessed July 26, 2016).
9. International Swaps and Derivatives Association, “The Value of Derivatives.”
10. Notional amounts for interest-rate swaps, for example, have a very different use and meaning than they have for CDS contracts. Notional amounts for interest-rate swaps are not traded, and the notional size is essentially a hypothetical amount upon which interest-rate payments are based. See International Swaps and Derivatives Association, “Interest Rate Swap Example,” 2004, <http://www.isda.org/educat/pdf/IRS-Diagram1.pdf> (accessed August 17, 2016). Also see Nicholas Vause, “Counterparty Risk and Contract Volumes in the Credit Default Swap Market,” *BIS Quarterly Review*, December 2010, p. 61, http://www.bis.org/publ/qrpdf/r_qt1012g.pdf (accessed September 7, 2015).
11. Bank for International Settlements, “OTC Derivatives Statistics at end-December 2015,” May 2016, http://www.bis.org/publ/otc_hy1605.pdf (accessed July 26, 2016).
12. Darryll Hendricks, “Netting Agreements and the Credit Exposure of OTC Derivatives Portfolios,” Federal Reserve Bank of New York *Quarterly Review* (Spring 1994), http://www.newyorkfed.org/research/quarterly_review/1994v19/v19n1article2.pdf (accessed June 22, 2015).
13. Participants in the OTC derivatives markets have long relied on their private trade association, the ISDA; the ISDA master agreement is the contract under which virtually all OTC derivative transactions take place. See Geoff Chaplin, *Credit Derivatives: Trading, Investing, and Risk Management*, 2nd ed. (United Kingdom: John Wiley and Sons, 2010), pp. 60–61.
14. International Swaps and Derivatives Association, “The Value of Derivatives.” See also David Mingle, “The Importance of Close-Out Netting,” ISDA *Research Notes*, No. 1, 2010, <http://www.isda.org/researchnotes/pdf/Netting-ISDAResearchNotes-1-2010.pdf> (accessed June 22, 2015).
15. *Ibid.*, and Comptroller of the Currency, “OCC’s Quarterly Report on Bank Trading and Derivatives Activities Third Quarter 2012,” Graph 5B.
16. International Swaps and Derivatives Association, “The Value of Derivatives.”
17. Some of these individual measures, even after accounting for netting and collateral, can still fail to provide a complete picture of system-wide risk because some OTC derivatives participants rely on a process called clearing, whereby a central counterparty (CCP) assumes the risks of the original counterparties to derivatives contracts. See Chaplin, *Credit Derivatives: Trading, Investing,*

and Risk Management, pp. 350–352, and Craig Pirrong, “The Economics of Central Clearing: Theory and Practice,” ISDA Discussion Papers Series No. 1, May 2011, <http://www2.isda.org/news/isda-publishes-the-economics-of-central-clearing-theory-and-practice-a-discussion-paper-on-clearing-issues> (accessed July 26, 2016).

18. Historically, exchange-traded derivatives have been regulated by the exchanges (such as the Chicago Mercantile Exchange and the New York Stock Exchange) on which they trade and the respective regulator of the exchange. In the U.S., these regulatory functions are typically carried out by a self-regulatory organization and either the SEC or the CFTC. See Edward Murphy, “Who Regulates Whom and How? An Overview of U.S. Financial Regulatory Policy for Banking and Securities Markets,” Congressional Research Service Report 7-5700, January 30, 2015, <https://www.fas.org/sgp/crs/misc/R43087.pdf> (accessed July 27, 2016). Dodd–Frank altered this framework; it encourages more exchange trading of OTC derivatives and institutes additional regulation for these types of trades. See Michel, “Fixing the Dodd–Frank Derivatives Mess: Repeal Titles VII and VIII.”
19. The first federal statute regulating futures, the Grain Futures Act of 1922, was enacted in the wake of declining crop prices after European agricultural production recommenced post World War I. The U.S. Department of Agriculture regulated the futures market until 1974 when, soon after newspaper reporters blamed a steep increase in food prices on speculative trading, Congress created the Commodity Futures Trading Commission (CFTC). See Romano, “A Thumbnail Sketch of Derivative Securities and Their Regulation.”
20. See Norbert Michel, “The Myth of Financial Market Deregulation,” Heritage Foundation *Backgrounders* No. 3094, April 28, 2016, <http://www.heritage.org/research/reports/2016/04/the-myth-of-financial-market-deregulation>.
21. Katerina Simons, “Interest Rate Structure and the Credit Risk of Swaps,” Federal Reserve Bank of Boston, *New England Economic Review* (July/August 1993), <https://www.bostonfed.org/economic/neer/neer1993/neer493b.pdf> (accessed June 22, 2015).
22. *Ibid.* For similar statements from the OCC, see Office of the Comptroller of the Currency, “Credit Derivatives,” *OCC Bulletin* 1996-43, August 12, 1996, <http://www.occ.gov/news-issuances/bulletins/1996/bulletin-1996-43.html> (accessed July 27, 2016), and Comptroller of the Currency Administrator of National Banks, “OCC’s Quarterly Report on Bank Derivatives Activities, First Quarter 2006,” <http://www.occ.gov/topics/capital-markets/financial-markets/derivatives/dq106.pdf> (accessed July 27, 2016).
23. Financial Accounting Standards Board, “Summary of Statement No. 133: Accounting for Derivative Instruments and Hedging Activities (Issued 6/98),” <http://www.fasb.org/summary/stsum133.shtml> (accessed July 27, 2016).
24. Currently, the SEC regulates the activities and capital structures of many nonbank financial firms—such as mutual funds, exchange-traded funds, and closed-end funds—under the Investment Company Act of 1940, as amended, 15 U.S. Code 80a. The SEC recently proposed a rule to “provide an updated and more comprehensive approach to the regulation of funds’ use of derivatives.” See Securities and Exchange Commission, “Use of Derivatives by Registered Investment Companies and Business Development Companies,” Proposed Rule, December 28, 2015, *Federal Register*, Vol. 80, No. 248, pp. 80883–80996, <https://www.gpo.gov/fdsys/pkg/FR-2015-12-28/pdf/2015-31704.pdf> (accessed August 26, 2016).
25. Section 701, Subtitle A (Regulation of the Over the Counter Swaps Markets), U.S. Code Title 15, Chapter 109, Subchapter I. For more on Dodd–Frank’s regulatory approach, see Michel, “Fixing the Dodd–Frank Derivatives Mess: Repeal Titles VII and VIII.”
26. A repo agreement is a contract where one party agrees to sell securities for cash and repurchase the same securities later at a higher price (frequently the next day). Thus, a repo is essentially a secured short-term loan: One party borrows cash from another and provides securities for collateral (which are kept in the event of nonpayment). See Norbert J. Michel, “Federal Reserve’s Expansion of Repurchase Market Is a Bad Idea,” Heritage Foundation *Issue Brief* No. 4261, August 14, 2014, <http://www.heritage.org/research/reports/2014/08/federal-reserves-expansion-of-repurchase-market-is-a-bad-idea>.
27. For financial disclosure rules on repos and derivatives that apply to nonfinancial companies, see Financial Accounting Standards Board, “Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures,” *Accounting Standards Update* No. 2014-11, June 2014, http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176164126488&acceptedDisclaimer=true (accessed August 4, 2016), and Financial Accounting Standards Board, “Derivatives and Hedging (Topic 815): Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes,” *Accounting Standards Update* No. 2013-10, July 2013, <http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175827352325&blobheader=application/pdf&blobcol=urldata&blobtable=MungoBlobs> (accessed August 4, 2016). Capital adequacy for banks’ repo transactions was included even in the first iteration of the Basel Capital Accords dating to the late 1980s. See Ralph de Haas and Thomas Keijser, “Repo-Style Transactions and Capital Adequacy Requirements Collateral, Capital Adequacy Requirements, and Supervisory Policies,” Netherlands Central Bank, *Research Series Supervision Paper* No. 37, 2001, http://www.dnb.nl/binaries/ot037_tcm46-146050.pdf (accessed August 4, 2016), and Peter Rose and Sylvia Hudgins, *Bank Management & Financial Services*, 7th ed. (New York: McGraw–Hill, 2008), pp. 423–495.
28. Mark Roe, “The Derivatives Market’s Payment Priorities as Financial Crisis Accelerator,” *Stanford Law Review*, Vol. 63 (2011), p. 552. Roe notes that “Congress added derivatives priorities to the Code over the last three decades, expanding them in 1982, 1984, 1994, 2005, and 2006.”

29. One of the earliest works to make such an argument was Franklin Edwards and Edward Morrison, "Derivatives and the Bankruptcy Code: Why the Special Treatment?" *Columbia Law and Economics Research Paper* No. 258, August 16, 2004, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=589261 (accessed July 27, 2016).
30. The estate effectively owns all of the proceeds, rents, or profits from these assets as well; see Title 11 U.S. Code § 541.
31. 11 U.S. Code § 362(a).
32. 11 U.S. Code § 362(a)(7).
33. 11 U.S. Code § 547.
34. 11 U.S. Code § 548.
35. 11 U.S. Code § 365(e)(1) and 11 U.S. Code § 541(c)(1). In general, the debtor's right to contract belongs to the estate.
36. These contracts are typically referred to as executory contracts, and defined as "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other." See David Skeel and Thomas Jackson, "Transaction Consistency and the New Finance in Bankruptcy," *Columbia Law Review*, Vol. 112 (2012), http://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=1345&context=faculty_scholarship (accessed July 27, 2016). Many of the original sources in this chapter are found in Skeel and Jackson, "Transaction Consistency and the New Finance in Bankruptcy."
37. There are several exemptions unrelated to derivatives and repos; 11 U.S. Code § 362(b) lists more than 20 exemptions from the automatic stay provision, related to obligations such as taxes, domestic support, and medical bills. Additionally, the automatic stay cannot preclude criminal prosecution.
38. Edward Morrison and Joerg Riegel, "Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankrupt Debtors and Bankruptcy Judges," *Columbia Law School Working Paper* No. 291, January 25, 2006, p. 4, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=878328 (accessed July 27, 2016).
39. The appendix to this chapter compares the legal definitions of *repurchase agreement* and *swap agreement* before and after the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act was enacted. The definitions are codified at 11 U.S. Code §101 (47) and 11 U.S. Code §101 (53B), respectively.
40. Repurchase agreements (repos) and swaps are among the financial contracts that receive exemption from certain core provisions in the Bankruptcy Code. The other main types of financial contracts receiving special protection are forwards, commodity contracts, and securities contracts. Collectively, these five types of contracts are often referred to as qualified financial contracts (QFCs) although the term is not neatly defined in bankruptcy law. See Darrell Duffie and David Skeel, "A Dialogue on the Costs and Benefits of Automatic Stays for Derivatives and Repurchase Agreements," in Kenneth Scott and John Taylor, eds., *Bankruptcy Not Bailout: A Special Chapter 14* (Stanford, CA: Hoover Institution Press, 2012).
41. The code even exempts derivative users from so-called *constructive* fraudulent conveyances, whereby assets are transferred for something less than reasonably equivalent value (see 11 U.S. Code § 548(a)(1)(B)(i)).
42. The contractual right to liquidate, terminate, or accelerate a repo is codified at 11 U.S. Code § 559. The contractual right to liquidate, terminate, or accelerate a *swap* is codified at 11 U.S. Code § 560 and (for a contract under a master netting agreement) at 11 U.S. Code § 561(a). Collectively, these safe harbors are found in the following sections of the code: 11 U.S. Code § 559, 560, 561(a), § 362(b)(7), § 362(b)(17), § 546(g), and § 548(d)(2)(D).
43. For more on these issues, see Skeel and Jackson, "Transaction Consistency and the New Finance in Bankruptcy"; Duffie and Skeel, "A Dialogue on the Costs and Benefits of Automatic Stays for Derivatives and Repurchase Agreements"; Edwards and Morrison, "Derivatives and the Bankruptcy Code: Why the Special Treatment?"; and Bruce Tuckman, "Amending Safe Harbors to Reduce Systemic Risk in OTC Derivatives Markets," Center for Financial Stability *Policy Paper*, April 22, 2010, <http://www.centerforfinancialstability.net/research/Safe-Harbor-Systemic-Risk-20100422.pdf> (accessed July 27, 2016).
44. This phrase quotes a lawyer representing two clearing associations during a 1981 congressional hearing. Skeel and Jackson, "Transaction Consistency and the New Finance in Bankruptcy," p. 160.
45. Skeel and Jackson, "Transaction Consistency and the New Finance in Bankruptcy," p. 160, footnote 34.
46. Another argument is that safe harbors are necessary to prevent *cherry picking*, whereby a debtor can choose which contracts to reject and which to assume, thus destroying the benefits of *netting* and further destabilizing markets. This fear is misguided because all contracts under a master agreement, such as the standard ISDA agreement, are treated as mutual obligations. *Ibid.*, pp. 161–162 and 186–189, and Stephen Lubben, "Derivatives and Bankruptcy: The Flawed Case For Special Treatment," University of Pennsylvania *Journal of Business Law*, Vol. 12 (2009), [https://www.law.upenn.edu/journals/jbl/articles/volume12/issue1/Lubben12U.Pa.J.Bus.L.61\(2009\).pdf](https://www.law.upenn.edu/journals/jbl/articles/volume12/issue1/Lubben12U.Pa.J.Bus.L.61(2009).pdf) (accessed July 27, 2016).
47. Kate Kelly, "Fear, Rumors Touched Off Fatal Run on Bear Stearns," *The Wall Street Journal*, May 28, 2008, <http://www.wsj.com/articles/SB121193290927324603> (accessed August 4, 2016).

48. Iain Dey and Danny Fortson, "JP Morgan 'Brought Down' Lehman Brothers," *The Sunday Times*, October 5, 2008, <http://www.thesundaytimes.co.uk/sto/business/article240146.ece> (accessed August 4, 2016). Also see Darrell Duffie, "The Failure Mechanics of Dealer Banks," *Journal of Economic Perspectives*, Vol. 24, No. 1 (2010), pp. 51–72, <http://www.darrellduffie.com/uploads/pubs/DuffieFailureMechanicsDealerBanks2010.pdf> (accessed August 4, 2016).
49. The lead attorney, Harvey Miller, testified: "Lacking the full benefit of a 'breathing space' within the contours of the bankruptcy code, the days that followed were a period of perpetual crisis." Harvey R. Miller, written testimony to the Subcommittee on Commercial and Administrative Law, Committee on the Judiciary, U.S. House of Representatives, 111th Cong., 1st Sess., for hearings on *Too Big to Fail: The Role for Bankruptcy and Antitrust Law in Financial Regulation Reform*, October 22, 2009, p. 9, https://judiciary.house.gov/_files/hearings/pdf/Miller091022.pdf (accessed July 27, 2016).
50. Skeel and Jackson, "Transaction Consistency and the New Finance in Bankruptcy," pp. 164–165.
51. Safe harbors were surely not the only cause of AIG's downfall. See Hester Peirce, "Securities Lending and the Untold Story in the Collapse of AIG," Mercatus Center *Working Paper* No. 14-12, May 1, 2014, http://mercatus.org/sites/default/files/Peirce_SecuritiesLendingAIG_v2.pdf (accessed August 24, 2016).
52. The federal government even invoked the possibility of a mass termination of CDS contracts as a main reason for arranging the AIG bailout. Fed Chairman Ben Bernanke testified to the U.S. House of Representatives that AIG's failure would have "posed unacceptable risks for the global financial system" due in part to the large CDS exposures. See Office of the Special Inspector General for the Troubled Asset Relief Program, "Factors Affecting Efforts to Limit Payments to AIG Counterparties," SIGTARP-10-003, November 17, 2009, p. 9, https://www.sig tarp.gov/Audit%20Reports/Factors_Affecting_Efforts_to_Limit_Payments_to_AIG_Counterparties.pdf (accessed July 27, 2016).
53. Roe, "The Derivatives Market's Payment Priorities as Financial Crisis Accelerator," p. 552. Roe notes that Congress expanded derivatives priorities in 1982, 1984, 1994, 2005, and 2006.
54. *Ibid.*
55. Skeel and Jackson identify five adverse effects that the safe harbors for derivatives and repos have on financial markets: Skeel and Jackson, "Transaction Consistency and the New Finance in Bankruptcy," pp. 166–168.
56. Historically, the view was that only banks needed a special resolution process to avoid systemic economic problems, but that belief has expanded to include the nonbanking sector. Dodd–Frank introduced new resolution rules for these nonbanking firms, and the one-day automatic stay now applies to derivative and repo contracts held by banks, large bank holding companies, and specially designated (systemically important) nonbank financial companies. Derivatives CCPs are exempt from some aspects of the stay. See Duffie and Skeel, "A Dialogue on the Costs and Benefits of Automatic Stays for Derivatives and Repurchase Agreements," p. 141. The one-day automatic stay (until 5:00 p.m. on the next business day) for banks' counterparties in the FDIC resolution process is codified at 12 U.S. Code §1821(e)(10)(B)(i).
57. The Financial Institution Bankruptcy Act of 2016, H.R. 2947, passed the U.S. House by voice vote on April 12, 2016. Section 1188, Treatment of Qualified Financial Contracts and Affiliate Contracts, implements the automatic stay for QFCs. Essentially the same legislative language is also included in the Financial CHOICE Act, a broader regulatory reform bill introduced in the House in June 2016. Another option is to narrow the safe harbors for derivatives only to those contracts which are cleared (defined as third-party pricing and collateral management). See Tuckman, "Amending Safe Harbors to Reduce Systemic Risk in OTC Derivatives Markets."
58. Skeel and Jackson, "Transaction Consistency and the New Finance in Bankruptcy," pp. 156–157.
59. Typically, the value of a secured creditor's collateral is fixed as of the date of the bankruptcy filing, and the Code (11 U.S. Code § 361 and 11 U.S. Code § 362(d)(1)) provides such a creditor *adequate protection* for the value of the collateral. See Skeel and Jackson, "Transaction Consistency and the New Finance in Bankruptcy," pp. 169–170.
60. This approach is similar to the one taken in the Financial CHOICE Act. See Norbert J. Michel, "Money and Banking Provisions in the Financial CHOICE Act: A Major Step in the Right Direction," Heritage Foundation *Backgrounder* No. 3152, August 31, 2016, <http://www.heritage.org/research/reports/2016/08/money-and-banking-provisions-in-the-financial-choice-act-a-major-step-in-the-right-direction>.
61. See 11 U.S. Code §101 (47) as of 2000, <http://uscode.house.gov/view.xhtml?hl=false&edition=2000&path=%2Fprelim%40title11%2Fchapter1&req=granuleid%3AUSC-prelim-title11-chapter1&num=0> (accessed July 30, 2016).
62. See current edition of 11 U.S. Code §101 (47), <http://uscode.house.gov/view.xhtml?path=/prelim@title11/chapter1&edition=prelim> (accessed July 30, 2016).
63. 11 U.S. Code §101 (53B) as of 2000, <http://uscode.house.gov/view.xhtml?hl=false&edition=2000&path=%2Fprelim%40title11%2Fchapter1&req=granuleid%3AUSC-prelim-title11-chapter1&num=0> (accessed July 30, 2016).

64. See current edition of 11 U.S. Code §101 (53B), <http://uscode.house.gov/view.xhtml?path=/prelim@title11/chapter1&edition=prelim> (accessed July 30, 2016).

PART V

Protecting the Integrity of Finance

CHAPTER 17:

Designing an Efficient Securities-Fraud Deterrence Regime

Amanda M. Rose

In order for capital markets to function well, investors need accurate information about securities. If investors do not trust firms' disclosures, they will discount what they are willing to pay for securities, increasing the cost of capital and thereby making it more difficult, even for honest firms, to fund productive endeavors. Moreover, investment decisions based on inaccurate information distort the efficient allocation of resources in an economy. As it has artfully been put, "A world with fraud...is a world with too little investment, and in the wrong things to boot."¹ Deterring fraud in the capital markets should therefore be a government priority.²

But the devil, as is so often the case, is in the details. If poorly constructed, a deterrence regime can produce the very harms it is meant to prevent: Just as securities fraud increases the cost of capital and reduces allocative efficiency, so, too, can misguided enforcement. This happens when firms, fearing erroneous prosecution and legal error, choose not to disclose information that may be helpful to investors, out of fear it will be deemed misleading, or, conversely, bury investors in an avalanche of trivial information, out of fear that its omission will give rise to liability. With less useful information to guide their decisions, investors will again discount what they pay for securities and may end up investing in the wrong things. Misguided enforcement also imposes a variety of other deadweight costs on firms and, ultimately, their shareholders, operating as a drag on economic growth.³

The goal of a securities-fraud deterrence regime should be to minimize the sum of the

costs that securities fraud produces and the costs that the deterrence regime itself produces—both direct enforcement costs and the over-deterrence costs that result when companies fear inaccurate prosecution and legal error. It is, of course, difficult to observe and measure these costs, and thus to empirically prove that a regime has achieved or failed to achieve this goal. But where empirics fail theory can still offer guidance. This chapter discusses the fundamental design choices that policymakers must confront when attempting to construct an optimal securities-fraud deterrence regime, and offers what theory suggests is the best approach to each. The analysis reveals that the United States's current approach to securities-fraud deterrence falls far short of the ideal.

THE BUILDING BLOCKS

If policymakers were designing a securities-fraud deterrence regime from scratch,

they would necessarily confront several basic questions. These include: Should civil or criminal penalties be imposed? On whom? By whom? This part briefly discusses these choices and the impact they can have on the ultimate efficiency of a deterrence regime.

Should Securities Fraud Carry Criminal or Civil Penalties? A threshold question that must be addressed in designing any deterrence regime is whether to impose criminal or civil penalties on offenders. In modern practice, the civil–criminal divide has become increasingly blurred—civil enforcement agencies often pursue remedies that appear designed to punish, while criminal enforcement agencies often impose fines for regulatory offenses that lack a *mens rea* requirement.⁴ But at a theoretical level, a clear distinction can be drawn: Regardless of how they are labeled or who enforces them, civil penalties can be thought of as those meant to “price” behavior, whereas criminal penalties can be thought of as those meant to “sanction” behavior.⁵ Under this conception, civil penalties should be set at a level designed to force potential defendants to internalize the costs their activities impose on society, much like a Pigouvian tax;⁶ criminal penalties, by contrast, should be set high enough to deter the behavior unconditionally.⁷

It follows that criminal penalties should be reserved for conduct that has no redeeming social value—a category that securities fraud surely falls within. Criminal sanctions would not be appropriate, however, if the conduct sought to be regulated is not securities fraud itself, but company-level efforts to prevent fraud within the organization. Clearly, companies should not spend unlimited amounts on such efforts; rather, they should invest in them only so long as the social benefits produced exceed the marginal cost—something that civil (but not criminal) penalties encourage of companies.

Even when limited to the direct perpetrators of fraud, criminal penalties must be deployed with caution. Because they are by design severe, criminal penalties raise serious over-deterrence concerns to the extent that inaccurate prosecution and legal error

are risks. How severe of a problem this proves to be will depend on other features of the liability regime. For example, the scope of the substantive fraud prohibition will make a difference, as will procedural issues, such as the burden of proof—the vaguer the boundaries of the law, and the easier it is to establish culpability, the more likely that honest individuals will distort their disclosure choices to avoid mistakenly getting caught in the law’s web.⁸ Perhaps the most important factor that will influence the level of over-deterrence, however, is the identity of the enforcer, a topic discussed more fully below.

To Whom Should Liability Attach? The best way to deter a scienter-based offense like securities fraud is to credibly threaten the individuals who would commit it with criminal penalties.⁹ The criminal penalties threatened should include imprisonment, but need not be so limited. As explained above, what makes a penalty “criminal” is that it is severe enough to discourage the activity unconditionally. Monetary fines and orders barring defendants from working for public companies or in the securities industry can fit this definition, as well, if they impose expected costs on individuals that exceed any possible expected benefits from committing fraud.

When the individuals who would commit fraud are acting as corporate agents, a case can sometimes be made for also threatening the corporation with civil (but not criminal) penalties.¹⁰ Forcing corporations to internalize the costs imposed on society by the frauds committed by their agents, the argument goes, creates incentives for corporations to invest efficiently in internal controls to deter it.¹¹ Of course, a corporation is a legal fiction, one characterized by a separation of ownership from control. As its residual claimants, it is ultimately the shareholders of the corporation who bear the cost of corporate-level liability. A more precise statement of what corporate-level liability is meant to do, then, is to incentivize shareholders to use the tools available to them to push corporate managers to take efficient steps to deter fraud within the organization. It

thus assumes that shareholders do not already have natural incentives to do so.

This assumption is probably not true of the institutions who own the majority of U.S. public company stock.¹² Institutional investors like mutual funds and pension funds are among the primary victims of securities fraud, so they have natural incentives to prevent it.¹³ Indeed, most scholars today view securities fraud by public companies as primarily a species of agency cost—corporate managers commit fraud in order to hide their poor performance, thus allowing them to game incentive compensation programs and avoid other forms of shareholder discipline.¹⁴ Imposing liability on public companies when managers commit fraud is thus akin, as one commentator has observed, “to punishing the victims of burglary for their failure to take greater precautions.”¹⁵

Who Should Enforce the Prohibition?

Another important decision that policymakers must make when designing a deterrence regime is to whom to assign enforcement authority. As a general matter, public enforcement is to be preferred over profit-driven private enforcement. This is especially so with respect to criminal penalties. Even a small risk of inaccurate prosecution and legal error can produce significant over-deterrence costs when criminal penalties are threatened, and this risk is likely to be higher under a regime of private enforcement than public enforcement. Profit-driven private enforcers are likely to bring all cases that have a positive net present value to them, even if of borderline merit, and to ignore those that do not. A public enforcer, by contrast, is more likely to consider the broader social impact of its enforcement choices—including both the fraud its choices might deter and the costs they might produce. To be sure, public enforcement agencies are far from perfect, and may sometimes base enforcement decisions on undesirable criteria. Nevertheless, it is usually easier to monitor, control, and discipline public servants than it is to force the alignment of private incentives with the social goal of optimal fraud deterrence. It is not surprising, then, that throughout the

developed world the enforcement of criminal law is entrusted to public authorities.¹⁶

Private enforcement of civil penalties can be problematic, as well. Although less severe than criminal penalties, civil penalties can likewise produce over-deterrence costs to the extent that individuals fear inaccurate prosecution and legal error—something that, again, is more likely under a regime of private enforcement. In addition, it can be difficult to craft accurate and stable civil penalties under a regime of private enforcement, given that penalty levels can be expected to drive the amount of private enforcement activity.¹⁷

This is not to say that private parties should be denied traditional compensatory remedies if they find themselves the victim of securities fraud. To the contrary, the prospect of being able to recover one’s losses in the event of fraud encourages participation in the capital markets, and discourages inefficient investments in precautions.¹⁸ Meanwhile, the traditional common-law restrictions on private fraud claims—such as the need to prove actual reliance and damages—serve to limit the over-deterrence risk these types of lawsuits present.¹⁹

With respect to the allocation of enforcement authority as between the federal government and state governments, the federal government should have the leading role in policing fraud in the national capital markets, whereas state enforcers should focus on intrastate frauds. No individual state would fully capture the benefits of deterring fraud in the national capital markets, as those benefits would spill over to the national economy; thus, states might predictably underinvest in the effort. Conversely, states “might use their authority aggressively to impose monetary sanctions on offenders to generate revenue for their state, without fully internalizing the potential over-deterrence costs of their actions.”²⁰

HOW THE CURRENT SYSTEM MEASURES UP

The straightforward tenets outlined above counsel in favor of a securities-fraud deterrence regime that bears little resemblance to

the one that exists in the United States today. To recap: Theory suggests that the individuals who would commit securities fraud should be threatened with criminal penalties, enforceable by a federal public enforcer when the conduct implicates the national capital markets. Corporate-level liability for securities fraud may also make sense with respect to firms that are closely held, but is difficult to justify with respect to public companies. And when corporate-level liability is warranted, the penalties threatened should be civil—never criminal. Finally, private enforcement is best limited to traditional common-law compensatory remedies or close analogues.²¹

Now compare the U.S. system. Public companies routinely face corporate-level liability for securities fraud committed by their agents, while the responsible agents often escape punishment entirely. This is almost always true in private securities fraud litigation.²² The Securities and Exchange Commission (SEC) and Department of Justice impose penalties on individual defendants with greater frequency, but have also been criticized for favoring headline-grabbing high-dollar settlements with public companies, to the ultimate detriment of innocent shareholders, over pursuit of actual individual wrongdoers.²³

Moreover, public companies face not just civil penalties for securities fraud but criminal penalties, as well. This is true both in the formal sense that they may be pursued by the criminal division of the Justice Department, and in the functional sense that the penalties with which they are threatened (by both the Justice Department and the SEC) often seem calibrated to “sanction” rather than to “price.”²⁴ Worse yet, public companies also face criminal penalties (in the functional sense) at the hands of profit-driven private enforcers. Fraud-on-the-market class actions brought under SEC Rule 10b-5 retain the out-of-pocket measure of damages associated with a common-law fraud action, but they are not subject to other

traditional limitations on common-law fraud suits, such as the need to prove actual reliance.²⁵ As a result, all investors who purchased stock in a public company on the secondary market at a price affected by an alleged misstatement or omission are included in the plaintiff class, and stand to recover the full amount of their losses with no offset for the gains to the counterparties to their trades. Fraud-on-the-market class actions therefore threaten public companies with truly enormous damage awards—awards that likely far exceed what might be necessary to force them to internalize the social costs of their agents’ frauds.²⁶

Finally, while, as a general matter, the federal government focuses on fraud in the national capital markets and state governments focus on intrastate frauds, states are free to pursue national frauds without any need to notify or coordinate with the federal government.²⁷ This has occasionally led to duplicative, follow-on state enforcement actions against public companies that have already reached a settlement with federal authorities.²⁸ Such actions generate revenue for the enforcing state but fail to produce meaningful deterrence benefits.

CONCLUSION

The securities-fraud deterrence regime that exists in the United States today deviates in significant ways from what theory suggests is optimal. If writing on a clean slate, policymakers would be well-advised to design a system that: (1) places more emphasis on individual liability; (2) eschews corporate criminal penalties entirely; (3) focuses the imposition of corporate civil penalties on companies whose shareholders would otherwise have poor incentives to adopt internal control systems to deter fraud; (4) limits private enforcement to traditional common law remedies or other compensatory remedies possessing similar safeguards against over-deterrence; and (5) better delineates and coordinates the authority of federal and state securities fraud enforcers.

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ENDNOTES

1. Frank H. Easterbrook and Daniel R. Fischel, “Mandatory Disclosure and the Protection of Investors,” *Virginia Law Review*, Vol. 70 (1984), pp. 669 and 673. For a more in-depth discussion of the social costs of securities fraud and, conversely, the social benefits of accurate disclosure, see Merritt B. Fox, “Civil Liability and Mandatory Disclosure,” *Columbia Law Review*, Vol. 109 (2009), pp. 237 and 252–268, and sources cited therein.
2. A legal rule against fraud is likely more efficient than exclusive reliance on market-based solutions. See Easterbrook and Fischel, “Mandatory Disclosure and the Protection of Investors,” pp. 674–677.
3. The costs of producing and verifying information can be considerable. If companies fear mistaken liability, they may overinvest in this effort. If this fear extends to the third parties who assist corporations in the disclosure process, such as auditors and investment banks, they will charge more for their services. Fear of erroneous fraud liability might also distort companies’ financing choices.
4. Crimes have traditionally required a showing of mens rea—that is, “a guilty mind: a guilty or wrongful purpose; a criminal intent.” *Black’s Law Dictionary*, 6th ed. (1990), p. 985.
5. This terminology traces its origin to Robert Cooter, “Prices and Sanctions,” *Columbia Law Review*, Vol. 84 (1984), p. 1523. For a more detailed theoretical account of the civil-criminal divide, see Amanda M. Rose, “Public Enforcement: Criminal versus Civil,” *The Oxford Handbook of Corporate Law and Governance* (2014).
6. “A Pigouvian tax is a tax equal to the harm that the firm imposes on third parties. For example, if a manufacturer pollutes, and the pollution causes a harm of \$100 per unit of pollution to people who live in the area, then the firm should pay a tax of \$100 per unit of pollution. This ensures that the manufacturer pollutes only if the value of the pollution-generating activities exceeds the harm, such that the social value of those activities is positive.” Jonathan S. Masur and Eric A. Posner, “Toward a Pigouvian State,” *University of Pennsylvania Law Review*, Vol. 164 (2015), pp. 94–95. Because the likelihood of imposition is less than 100 percent, civil penalties should be set higher than the net social costs of the conduct to reflect the probability of non-detection. See Steven Shavell, *Foundations of Economic Analysis* (Cambridge, MA: Belknap Press, 2004), p. 483.
7. Steven Shavell, “Criminal Law and the Optimal Use of Nonmonetary Sanctions as a Deterrent,” *Columbia Law Review*, Vol. 85, No. 6 (October 1985), pp. 1232 and 1234, and Richard A. Posner, “An Economic Theory of the Criminal Law,” *Columbia Law Review*, Vol. 85, No. 6 (October 1985), pp. 1193 and 1215. This does not mean that criminal sanctions should always be set as high as possible. Concerns about marginal deterrence, as well as other factors, counsel against this. *Ibid.*, p. 1207 (“If robbery is punished as severely as murder, the robber might as well kill his victim to eliminate a witness.”), and Reinier Kraakman, “The Economic Functions of Corporate Liability,” in Klaus J. Hopt and Gunther Teubner, eds., *Corporate Governance and Directors’ Liabilities* (Berlin: De Gruyter, 1985) (discussing other practical and moral limitations on the magnitude of sanctions).
8. For a more fulsome discussion of these issues, see Amanda M. Rose, “The Multienforcer Approach to Securities Fraud Deterrence: A Critical Analysis,” *University of Pennsylvania Law Review*, Vol. 158 (2010), pp. 2183–2192.
9. Scierter-based offenses are those that require proof of an intentional mental state. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).
10. V. S. Khanna, “Corporate Criminal Liability: What Purpose Does It Serve?” *Harvard Law Review*, Vol. 109, No. 7 (1996), p. 1477 (challenging the social desirability of corporate criminal liability).
11. The possibility of judgment-proof defendants is one oft-cited reason for supplementing individual liability with corporate liability. For an overview of this and other arguments for corporate liability, and a survey of the literature, see Amanda M. Rose and Richard Squire, “Intraportfolio Litigation,” *Northwestern University Law Review*, Vol. 105 (2011), pp. 1682–1687. The optimal design of a corporate liability regime is a complex issue that is outside the scope of this chapter. For an introduction to the topic, see Jennifer Arlen and Reinier Kraakman, “Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes,” *New York University Law Review*, Vol. 72, No. 4 (October 1997), p. 687.
12. Ronald G. Gilson and Jeffrey N. Gordon, “The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights,” *Columbia Law Review*, Vol. 113 (2013), pp. 874–886 (detailing how changes in the financing of retirement security in the United States has led to the concentration of record ownership of U.S. public equities in the hands of institutional investors).
13. Among other things, the specter of fraud increases bid-ask spreads, which makes portfolio adjustments more expensive.
14. See, for instance, Jennifer Arlen and William Carney, “Vicarious Liability for Fraud on the Securities Markets: Theory and Evidence,” *University of Illinois Law Review* (1992), p. 691; Jonathan Macey, “Agency Theory and the Criminal Liability of Organizations,” *Boston University Law Review*, Vol. 71 (1991), p. 315; and A. C. Pritchard, “Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers,” *Virginia Law Review*, Vol. 85 (1999), p. 925. For an alternative account of securities fraud, see Donald C. Langevoort, “Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms),” *University of Pennsylvania Law Review*, Vol. 146 (1997), p. 101.

15. John C. Coffee, "Reforming the Securities Class Action: An Essay on Deterrence and its Implementation," *Columbia Law Review*, Vol. 106 (2006), pp. 1534 and 1562.
16. For a more nuanced discussion of the choice between public and private enforcement, see Rose, "The Multienforcer Approach," pp. 2200–2203, and Amanda M. Rose, "Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10b-5," *Columbia Law Review*, Vol. 108 (2008), pp. 1330–1349.
17. *Ibid.*, pp. 1326–1328, and sources cited therein. To the extent that private parties have superior access to information about securities fraud than government enforcers, they can be encouraged to report to public authorities through the payment of whistleblower awards. If public authorities were to systematically under-enforce, it might justify granting private parties a limited right to sue to recover civil penalties, but only subject to continued government oversight and control to prevent abuse. For a more fulsome discussion of the circumstances under which private enforcement might be justified, and how it might be structured, see Rose, "The Multienforcer Approach," pp. 2210–2227; Rose, "Reforming Securities Litigation Reform," pp. 1354–1358; and Amanda M. Rose, "Better Bounty Hunting: How the SEC's New Whistleblower Bounty Program Changes the Securities Fraud Class Action Debate," *Northwestern Law Review*, Vol. 108 (2014), pp. 1290–1300.
18. See, for instance, Pritchard, "Markets as Monitors," p. 939, and Paul G. Mahoney, "Precaution Costs and the Law of Fraud in Impersonal Markets," *Virginia Law Review*, Vol. 78 (1992), pp. 630–632.
19. Richard B. Stewart and Cass R. Sunstein, "Public Programs and Private Rights," *Harvard Law Review*, Vol. 95 (1982), pp. 1298–1300.
20. Rose, "The Multienforcer Approach," p. 2206. For a more nuanced analysis of the choice between federal and state enforcement, as well as the desirability of hybrid models, see Amanda M. Rose, "State Enforcement of National Policy: A Contextual Approach (with Evidence from the Securities Realm)," *Minnesota Law Review*, Vol. 97 (2013), p. 1343.
21. Additionally, under limited circumstances private enforcement of civil penalties might be warranted if under-enforcement by public authorities is a concern. See note 17 and sources cited therein.
22. See, for instance, Michael Klausner et al., "How Protective Is D&O Insurance in Securities Class Actions? An Update," *Professional Liability Underwriting Society*, Vol. 26 (2013) (empirical study of securities class actions filed between 2006 and 2010 finding that outside directors contributed in none of the settled cases, and officers contributed in only 2 percent).
23. Judge Jed Rakoff of the District Court for the Southern District of New York highlighted this issue when he initially rejected an SEC-proposed settlement with Bank of America in 2009. *SEC v. Bank of Am. Corp.*, 653 F. Supp. 2d 507, 509 (S.D.N.Y. 2009). See also Jed S. Rakoff, "The Financial Crisis: Why Have No High-Level Executives Been Prosecuted?" *New York Review of Books*, January 9, 2014, <http://www.nybooks.com/articles/2014/01/09/financial-crisis-why-no-executive-prosecutions/> (accessed October 11, 2016). The Department of Justice has also taken note, recently instructing its attorneys on the importance of individual accountability. Sally Quillian, "Individual Accountability for Corporate Wrongdoing," Department of Justice *Memorandum*, September 9, 2015, <https://www.justice.gov/dag/file/769036/download> (accessed October 11, 2016). See also Mary Jo White, "Opening Remarks at the 21st Annual International Institute for Securities Enforcement and Market Oversight," U.S. Securities and Exchange Commission, November 2, 2015, <https://www.sec.gov/news/statement/remarks-21st-international-institute-for-securities-enforcement.html> (accessed October 11, 2016), similarly stressing the importance of individual liability.
24. The Justice Department and SEC have considerable leverage in settlement negotiations, both to demand the payment of large fines and to insist on what can be invasive corporate governance reforms, given that a litigated adverse judgment can have severe direct, as well as collateral, consequences for a public company.
25. Amanda M. Rose, "Form vs. Function in Rule 10b-5 Class Actions," *Duke Journal of Constitutional Law and Public Policy*, Vol. 10 (2015), pp. 58–60 (discussing the differences between Rule 10b-5 class actions and common law fraud actions).
26. See, for instance, Janet Cooper Alexander, "Rethinking Damages in Securities Class Actions," *Stanford Law Review*, Vol. 48, No. 6 (July 1996), p. 1497 ("It seems likely that the true social costs of any particular violation are significantly less than the tens or hundreds of millions of dollars represented by potential class-based damages."); Donald C. Langevoort, "Capping Damages for Open-Market Securities Fraud," *Arizona Law Review*, Vol. 38 (1996), p. 646 (arguing that "full out-of-pocket compensation in open-market cases is systematically excessive and dysfunctional"); and William W. Bratton and Michael L. Wachter, "The Political Economy of Fraud on the Market," *University of Pennsylvania Law Review*, Vol. 160 (2011), p. 72 (observing that the "consensus view" amongst academics is that the fraud-on-the-market class action "just doesn't work").
27. Sara Sun Beale, "What Are the Rules if Everybody Wants to Play?" in Anthony S. Barkow and Rachel E. Barkow, eds., *Prosecutors in the Boardroom: Using Criminal Law to Regulate Corporate Conduct* (New York: New York University Press, 2011) ("At present there are no formal mechanisms to preclude duplicative or dueling prosecutions in different jurisdictions, require prosecutors in such cases to cooperate, or sequence the cases to avoid conflicts"). While the National Securities Markets Improvement Act of 1996 prohibits states from applying mandatory disclosure and offering rules to nationally traded firms, state regulators remain free to bring enforcement actions against such firms with respect to fraud or deceit. Rose, "The Multienforcer Approach," p. 1377.

For an empirical examination of state securities-fraud enforcement efforts, see Amanda M. Rose and Larry J. Leblanc, "Policing Public Companies: An Empirical Examination of the Enforcement Landscape and the Role Played by State Securities Regulators," *Florida Law Review*, Vol. 65 (2013), p. 395.

28. Rose, "The Multienforcer Approach," pp. 1402–1406 (describing numerous such actions brought by the State of West Virginia).

CHAPTER 18:

Financial Privacy in a Free Society

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Privacy, both financial and personal, is a key component of life in a free society. Unlike in totalitarian or authoritarian regimes, individuals in free societies have a private sphere free of government involvement, surveillance, and control. The United States Constitution's Bill of Rights, particularly the Fourth, Fifth, and Ninth Amendments, together with structural federalism and separation of powers protections, is designed to further that end by protecting individual rights. The current financial regulatory framework is inconsistent with these principles.

In general, individuals should have control over who has access to information about their personal and financial lives. Individuals should be free to lead their lives unmolested and un surveilled by government unless there is a reasonable suspicion¹ that they have committed a crime or conspired to commit a crime. Any information-sharing regime must include serious safeguards to protect the privacy of individuals and businesses. Financial privacy is especially vital because it can be the difference between survival and systematic suppression of an opposition group in a country with an authoritarian government. Many businesses, dissidents, and human rights groups maintain accounts outside the countries where they are active for precisely this reason.

Financial privacy can allow people to protect their life savings when a government tries to confiscate its citizens' wealth, whether for political, ethnic, religious, or "merely"

economic reasons. Businesses need to protect their private financial information, intellectual property, and trade secrets from competitors in order to remain profitable. Financial privacy is of deep and abiding importance to freedom, and many governments have shown themselves willing to routinely abuse private financial information.

Many government agencies, in both the U.S. and other countries, are currently involved in collecting and disseminating private individuals' information for the purpose of conducting their national security, law enforcement, and tax administration functions. The unique requirements for fulfilling each of these purposes dictate certain policy choices for designing an optimal financial-privacy regime. The current U.S. framework is overly complex and burdensome, and its ad hoc nature has likely impeded efforts to combat terrorism, enforce laws, and collect taxes.

Efforts to improve the existing framework must focus on protecting individuals' privacy rights while improving law enforcement's ability to apprehend and prosecute criminals and terrorists.

Reform efforts also need to focus on costs versus benefits. The current framework, particularly the anti-money laundering (AML) rules, is clearly not cost-effective. As demonstrated below, the AML regime costs an estimated \$4.8 billion to \$8 billion annually. Yet, this AML system results in fewer than 700 convictions annually, a proportion of which are simply additional counts against persons charged with other predicate crimes. Thus, each conviction costs approximately \$7 million, potentially much more.² This chapter recommends several major reforms for fixing the U.S. financial privacy framework, such as eliminating burdensome reporting requirements, raising certain reporting thresholds, exempting crowdfunding from AML rules, and instituting federal preemption of state regulation of money-transmission businesses. In addition, the Senate should not ratify the Protocol Amending the Multilateral Convention on Mutual Administrative Assistance in Tax Matters.

THE CURRENT SYSTEM: COMPLEX, COSTLY, OVERLAPPING, AND DUPLICATIVE

The list of national and international agencies, and national laws and international agreements, governing financial information exchange and reporting has grown preposterously long. For instance, there are more than 100 foreign financial intelligence units (FIUs) around the world, a role filled in the United States by the Treasury Department's Financial Crimes Enforcement Network (FinCEN).³ FIUs typically exchange financial information with their international counterparts based on national legislation and regulations. Private entities are required to collect and report voluminous information under the Bank Secrecy Act reporting provisions designed to enforce the AML laws and the know-your-customer (KYC) requirements.

Over 90 countries participate in either the original or amended Multilateral Convention on Mutual Administrative Assistance in Tax Matters.⁴ The U.S. has bilateral income tax treaties, protocols, and tax-information-exchange agreements with approximately 70 countries.⁵ In addition, private entities must provide a wide variety of information to the Internal Revenue Service (IRS) with respect to both domestic and foreign operations. In fiscal year (FY) 2015, more than 2.6 billion information returns were filed with the IRS.⁶ Both U.S. and foreign financial institutions must report on the financial activities of their U.S. customers under both the Foreign Account Tax Compliance Act (FATCA)⁷ and the qualified intermediary rules.⁸

In addition, the terrorism-related Information Sharing Environment, a center within the Office of the Director of National Intelligence, involves approximately 18,000 federal, state, local, and tribal government agencies.⁹ The Federal Bureau of Investigation Criminal Justice Information Services Division operates a National Data Exchange and other programs.¹⁰ Interpol maintains various information-sharing databases that are made available to its 190 members.¹¹

The current system's mind-numbing complexity and ad hoc nature impedes the effectiveness of governments' efforts to combat terrorism, enforce the laws, and collect taxes, and it imposes substantial costs on the private sector. For instance, the current framework requires financial firms to file millions of reports each year even though records show that there are only approximately 2,000 AML investigations per year. Similarly, the wide discretion given to FinCEN to change reporting thresholds and requirements predisposes financial institutions to err on the side of filing too many reports rather than risk legal liability. The current approach, essentially focused on collecting as much information as possible, has led to the creation of multiple, expensive, and overlapping national and international bureaucracies. There is little doubt that the current system pays inadequate attention to

the core values that underpin all free societies or to the cost-effectiveness of ever-increasing demands for more information reporting.

RE-EVALUATING UNCRITICAL INFORMATION EXCHANGE

The first business of government is to protect the life, liberty, and property of its citizens.¹² Accordingly, international information sharing directed at preventing terrorism, crime, and fraud is an important and appropriate function of government. However, all governments cannot be trusted to share the goals of protecting life, liberty, and property and upholding the rule of law, so U.S. policymakers must be careful about deciding with whom to share information. Corruption and ideology make information sharing with some governments highly problematic. Shared information can be used to oppress political opponents, to support terrorism, to identify kidnapping targets, to facilitate financial fraud, to enable identity theft, to further industrial espionage, or for other nefarious purposes. The ongoing abuse of Interpol Red Notices for political purposes by authoritarian governments provides a stark lesson in the dangers of the uncritical reliance on institutions created to promote information sharing.¹³

Information sharing for law enforcement purposes should be limited to actions that a liberal democratic state would regard as criminal. Terrorism, violent crime, and fraud would clearly meet this test, while speaking out against one's government, peaceful political or labor organizing, gambling, homosexual behavior, and tax evasion would not.¹⁴ No liberal democratic government should share, or be required to share, information for the purposes of enforcing laws that criminalize behavior that is not illegal under the laws of the government from which the information is being requested. This is sometimes known as the principle of dual criminality, and it should be adhered to in any information-sharing arrangement.

It is also true that many governments exploit (or are complicit in exploiting)

information-sharing arrangements for inappropriate commercial purposes, such as industrial espionage or to further government confiscation or extortion.¹⁵ Therefore, any information-exchange regime must limit this risk and protect the commercial interests of participating countries. Any information-sharing regime needs to include serious safeguards to protect the privacy of both individuals and businesses.¹⁶ Currently, these safeguards are lax at best, and the U.S. should take the lead internationally to strengthen protections rather than succumb to international bureaucracies' efforts to weaken privacy rights. A separate type of information sharing deals with cross-country agreements to share tax information.

TAX INFORMATION SHARING

One reason that tax-sharing agreements pose a unique set of challenges is that tax evasion is not a crime in many liberal democratic states. Instead, tax evasion is often treated as a civil violation. Naturally, the public benefit of preventing terrorist attacks or violent crime is greater than the benefit of preventing a civil violation, such as tax evasion. Therefore, the willingness to impose costs on the private sector and to violate the privacy interests of ordinary people should be less in the case of information sharing for tax purposes than for the purposes of preventing terrorism or crime.

Moreover, tax-information-sharing programs are quite often a veiled attempt to stifle tax competition from low-tax jurisdictions. Tax competition is salutary and limits the degree to which governments can impose unwarranted taxation.¹⁷ Furthermore, poorly constructed tax-sharing agreements put Americans' private financial information at risk, and the risk is highest for internationally active American businesses.

To safeguard citizens' rights, U.S. tax-return information under current law may only be lawfully disclosed to a foreign government pursuant to a ratified treaty authorizing the information exchange.¹⁸ The U.S. is currently party to a network of bilateral tax treaties

and tax-information-exchange agreements,¹⁹ and the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, a treaty agreed to on January 25, 1988, and entered into force in 1995.²⁰

Article 4 of the original convention states: “The Parties shall exchange any information, in particular as provided in this section, that is foreseeably relevant to...the assessment and collection of tax, and the recovery and enforcement of tax claims.” However, Article 5 provides that this obligation must be fulfilled only upon request by a government “for information referred to in Article 4 which concerns particular persons or transactions.” (Emphasis added.) Article 6 permits but does not require automatic exchange of information. Article 22 contains provisions designed to protect the privacy of the information exchanged by the contracting states.²¹

Separately, countries around the world have entered into more than 500 bilateral tax-information-exchange agreements modeled on the Organization for Economic Cooperation and Development’s (OECD’s) model Agreement on Exchange of Information on Tax Matters.²² This model agreement, released in 2002, is a nonbinding instrument meant to serve as a standard of “effective exchange of information for the purposes of the OECD’s initiative on harmful tax practices.”²³ Article 5 of the model agreement makes it clear that the information must be provided only upon request and that automatic provision of the information is not required.²⁴ Article 8 of the OECD model contains privacy protections.

Recent Sharing Proposals Endanger Financial Privacy. The U.S. Senate is currently considering the “Protocol Amending the Multilateral Convention on Mutual Administrative Assistance in Tax Matters,” which would impose a wide variety of new information-reporting requirements on financial institutions to help foreign governments collect their taxes.²⁵ A second treaty—worse than this protocol—is the follow-on OECD treaty known as the “Multilateral Competent Authority Agreement on Automatic Exchange of

Financial Account Information.” This follow-on treaty implements both the protocol and the 311-page OECD “Standard for Automatic Exchange of Financial Account Information in Tax Matters.”²⁶ Together, the protocol, the Multilateral Competent Authority Agreement, and the OECD Standard constitute the three main parts of a new automatic information-exchange regime being promoted by the OECD and international tax bureaucrats.

If the U.S. ratifies the protocol and implements the new OECD standard, Washington would automatically, and in bulk, ship private financial and tax information—including Social Security and other tax identification numbers—to Argentina, China, Colombia, Indonesia, Kazakhstan, Nigeria, Russia, and nearly 70 other countries. In other words, foreign governments that are hostile to the U.S., corrupt, or have inadequate data safeguards, would automatically have access to private financial (and other) information of some U.S. taxpayers and most foreigners with accounts in the U.S.²⁷ This new regime would also add yet another layer to the voluminous compliance requirements imposed on financial institutions, hitting small banks and broker-dealers especially hard.

COMPLIANCE BURDEN FOR BANKS AND FINANCIAL INSTITUTIONS

Financial privacy necessarily deals with financial transaction data, so many federal rules deal with firms transferring money. These rules, which often impose heavy compliance costs on companies, are spread throughout several sections of the U.S. code but they generally apply to financial institutions as defined by Title 31 U.S. Code § 5312. Most of these regulations are AML and KYC rules, and they are primarily enforced by FINCEN.²⁸ Other than banks (broadly defined), securities dealers, and insurance companies, the U.S. Code now identifies many non-financial firms as “financial institutions,” including government agencies, casinos, pawnbrokers, jewelry shops, travel agencies, car dealers, and real estate companies.²⁹ Broker-dealers

must also comply with the Financial Industry Regulatory Authority Rule 3310, which sets forth minimum standards for a firm's written AML compliance program.³⁰

Title 18 of the U.S. code prohibits the operation of an unlicensed money-transmitting business, and also prohibits the knowing transfer of funds derived from (or intended for) criminal activity.³¹ Title 18 considers a business unlicensed if it fails to comply with federal "money transmitting business registration requirements," or if it operates without a state license if one is required. Additionally, Title 31 of the U.S. Code requires money-transmitting businesses to register with the U.S. Secretary of the Treasury.³² Banks and other financial institutions are also required to comply with a complex set of tax information-reporting requirements administered by the IRS.³³ According to a search of the Legal Information Institute's version of the U.S. Code and the Code of Federal Regulations (CFR), the term "money laundering" occurs 72 times in the code and 185 times in the CFR.³⁴

Many of these rules have their genesis in the Bank Secrecy Act (BSA) of 1970, an act originally aimed at deterring foreign banks from laundering criminal proceeds and helping people evade federal income taxes.³⁵ The BSA was little used until it was amended by the Money Laundering Control Act of 1986, an explicit component of the federal war on drugs and organized crime.³⁶ In the wake of 9/11, the USA PATRIOT Act levied new rules on an expanded list of "financial institutions," and also imposed stricter due-diligence and AML requirements. Essentially, the BSA/AML rules ensure that firms cannot legally transfer any money without knowing who the customer is and having some idea of where the money came from.³⁷

The BSA gave banks an affirmative duty to report to the Department of the Treasury cash transactions of more than \$10,000, and it criminalized the failure to report such transactions.³⁸ Adjusted for inflation to 2015 dollars, this amount represents more than \$60,000, but the threshold has never been

adjusted for inflation. Banks must electronically file a currency transaction report (CTR) for any "deposit, withdrawal, exchange, or other payment or transfer of more than \$10,000 by, through, or to the bank."³⁹ Financial institutions are also required to report multiple currency transactions conducted "by, or on behalf of, one person" that aggregate to more than \$10,000 in any single day.⁴⁰

Aside from the fact that FinCEN has the discretion to lower the \$10,000 threshold, the regulations go well beyond the basic \$10,000 threshold CTRs.⁴¹ Banks, for instance, have a \$5,000 threshold for filing suspicious activity reports (SARs). Other financial institutions, such as casinos, also have the \$5,000 SAR threshold, and most money-service businesses (MSBs) have a \$2,000 SAR threshold.⁴² Additionally, some states have extended AML rules and have given casinos a \$3,000 multiple transaction log (MTL) threshold.⁴³ Moreover, all financial institutions regarded as MSBs⁴⁴ must obtain and record specific information for all transfers of at least \$3,000, and all currency exchangers must track any exchange that exceeds \$1,000 in either domestic or foreign currency.⁴⁵

Federal regulators also require financial institutions to institute formal compliance programs for the BSA/AML rules, and regulators heavily micromanage this process. For guidance, the Federal Financial Institutions Examination Council publishes a 442-page examination manual that outlines procedures and requirements for a BSA/AML compliance program.⁴⁶ The manual includes an overview of, for example, an appropriate customer identification program (CIP) as well as customer due-diligence (CDD) "policies, procedures, and processes."⁴⁷ Section 326 of the USA PATRIOT Act requires each bank to have a written CIP that is "appropriate for its size and type of business and that includes certain minimum requirements."⁴⁸

The CIP is mandated to enable banks to form a "reasonable belief" that they know the true identity of each customer.⁴⁹ Effective CDD programs, on the other hand, are meant to enable banks to "comply with regulatory

requirements and to report suspicious activity.”⁵⁰ Additionally, Section 1073 of the Dodd–Frank Wall Street Reform and Consumer Protection Act gave the Consumer Financial Protection Bureau (CFPB) certain regulatory responsibilities for remittance transfers.⁵¹ Specifically, Dodd–Frank amended the Electronic Fund Transfer Act “to create a new comprehensive ‘consumer protection regime’ for remittance transfers sent by consumers in the United States to individuals and businesses in foreign countries.”⁵² Combined, these rules impose large costs on financial institutions, many of which have decided to stop offering certain services rather than deal with the additional compliance burden or risk being held liable for criminal activity.⁵³

COST AND BENEFITS OF BSA/AML RULES

The original goal of the BSA/AML rules was to reduce predicate crimes, such as illegal drug distribution, rather than money laundering itself. Judged by this standard, very little empirical evidence suggests that the rules have worked as designed.⁵⁴ In fact, even though BSA/AML rules have been expanded consistently throughout the past four decades, it remains difficult to discern any net benefit of the overall BSA/AML regulatory framework.⁵⁵ Even though there is no clear evidence that the rules materially reduce crime, the BSA/AML bureaucracy began relentlessly expanding *internationally*—primarily through the Financial Action Task Force (FATF)—more than two decades ago.⁵⁶

One comprehensive study reports that even though the FATF proceeds as if these rules have produced only public benefits, “[t]o date there is no substantial effort by any international organization, including the International Monetary Fund, to assess either the costs or benefits of” this regulatory framework.⁵⁷ In fact, BSA/AML regulations have been sharply criticized as a costly, ineffective approach to reducing crime.⁵⁸ The rules have also been criticized for being overly intrusive and elaborate, and for distorting the classical constructions

TABLE 18-1

Suspicious-Activity Reports and Cash-Transaction Reports, 2000–2015

Year	Suspicious-Activity Reports	Cash-Transaction Reports
2014	1,726,971	15,375,743
2013	1,640,391	15,413,692
2012	1,587,763	15,205,871
2011	1,517,520	14,826,316
2010	1,326,372	14,065,871
2009	1,281,305	14,909,716
2008	1,290,590	16,082,776
2007	1,250,439	16,219,434
2006	1,078,894	15,946,725
2005	919,230	14,210,333
2004	689,414	13,674,114
2003	507,217	13,341,699
2002	281,373	n/a
2001	204,915	n/a
2000	163,184	n/a

SOURCE: U.S. Department of the Treasury, Financial Crimes Enforcement Network, <https://www.fincen.gov> (accessed August 23, 2016). See appendix for details.

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of criminal law and criminal procedure.⁵⁹ The available evidence even suggests that the BSA/AML framework has forced financial firms to report so much information that it has made law enforcement more difficult because the information overload has reduced the reporting regime’s effectiveness at uncovering crime.

The growth in the reporting volume to law enforcement shows where the information overload has taken place. For instance, the annual number of SARs filed in the U.S. was only 52,000 in 1996, and had jumped to 689,414 by

TABLE 18-2

Bank Secrecy Act/Anti-Money Laundering Compliance Cost Estimates

Requirement	OMB Estimates of Burden Hours	Cost (at \$62/hour, in millions)
FinCEN Suspicious Activity Reports	3,284,320	\$204
FinCEN Currency Transaction Reports	10,193,540	\$632
Customer Due Diligence Requirements for Financial Institutions	7,041,289	\$437
Special Information-Sharing Procedures to Deter Money Laundering and Terrorist Activity	1,087,236	\$67
Futures Commission Merchants, and Introducing Brokers Customer Identification Program	14,608	\$1
Currency and Monetary Instrument Reports	140,000	\$9
AML Program for Dealers in Precious Metals, Precious Stones, or Jewels	20,000	\$1
Banks, Savings Associations, Credit Unions, and Certain Non-Federally Regulated Banks, Customer Identification Program	160,380	\$10
Mutual Funds Customer Identification Program	603,750	\$37
Broker-Dealers Customer Identification Program	520,500	\$32
Anti-Money Laundering Programs for Insurance Companies and Non-Bank Residential Mortgage Lenders and Originators	32,200	\$2
Anti-Money Laundering Programs for Money Services Business, Mutual Funds, Operators of Credit Card Systems, and Providers of Prepaid Access	341,216	\$21
Registration of Money Services Business	44,300	\$3
Subtotal (OMB Burden-Hour Estimates)	23,483,339	\$1,456
AML/Know Your Customer Compliance Training, Systems Implementation, Rule Familiarization		\$3,200–\$6,400
FinCEN Budget		\$157
Internal Revenue Service AML Enforcement Budget		Unknown
Department of Justice AML Enforcement Budget		Unknown
Total		\$4,813–\$8,013

SOURCE: Office of Management and Budget, Office of Information and Regulatory Affairs, <http://www.reginfo.gov/public/> (accessed August 23, 2016). See appendix for details.

2004.⁶⁰ In 2013, U.S. depository institutions (banks) filed almost 1 million SARs, and (separately) MSBs filed nearly 800,000 SARs.⁶¹ In 2014, SAR filings totaled 1.7 million, and 916,709 were filed in the first half of 2015 (a pace of 1.8 million annually).

In 2001, roughly 13 million CTRs were filed with FinCEN.⁶² As shown in Table 18-1, FinCEN reported more than 15 million CTR filings in 2014, a considerably slower growth rate than for SARs. The total volume of BSA/AML filings has reached enormous proportions. For instance, in 2015 the FinCEN director announced that the agency receives “approximately 55,000 electronically filed BSA reports from more than 80,000 financial institutions and 500,000 individual foreign bank account holders each day.”⁶³

Aside from any possible benefits in crime reduction, research suggests that compliance costs are high for financial companies, with a disproportionate burden falling on smaller firms.⁶⁴ For instance, Federal Reserve researchers report that compliance costs are especially burdensome for smaller banks, where hiring even one additional employee can lower the return on assets by more than 20 basis points.⁶⁵ Other research suggests that the increasing compliance burden in the banking industry is at least partly responsible for the trend toward consolidation and the disappearance of smaller banks.⁶⁶

Though it is merely one example, an American Bankers Association (ABA) publication highlights a small bank that reports it has to dedicate more than 15 percent of its employees to compliance-related tasks.⁶⁷ An ABA survey also suggests that the cumulative cost associated with compliance has caused banks to offer fewer services and raise fees, thus harming consumers. For example, almost 20 percent of the banks subject to the CFPB’s new remittance rules plan to simply stop providing remittance services, while 42 percent intend to raise fees to cover the additional compliance costs.⁶⁸ Aside from these direct costs, banks have likely endured the cost of losing law-abiding customers who do not

want to provide personal information, though this cost is difficult to quantify.

There seems to be little attention paid by either FinCEN or Congress to how high these compliance costs have become. Table 18-2 provides an estimate of these costs. The estimates are primarily based on the Office of Management and Budget (OMB) Office of Information and Regulatory Analysis burden-hour estimates for the information-collection requirements. The hours are then monetized using Bureau of Labor Statistics information about compliance personnel salaries. Using these figures, the total BSA/AML costs are estimated to be between \$4.8 billion and \$8 billion annually.

It is important to note that this estimate is probably a significant underestimate of the actual burden. For example, the OMB estimates that FinCEN’s “Future Commission Merchants and Introducing Brokers Customer Identification” requirements can be met in *two minutes* per customer, an assumption which is, at the least, questionable.⁶⁹ The OMB makes a similar estimate regarding the Broker-Dealers Customer Identification Program.

Furthermore, other government agencies, notably the Department of Justice and the IRS, expend resources enforcing these laws although, so far as the authors know, these two agencies do not report the costs they incur from enforcing AML laws.⁷⁰ Thus, only FinCEN’s budget is included in this chapter’s cost estimates. Furthermore, the cost of funds provided by the U.S. government to international organizations, such as the FATF, is not considered in the estimate. To summarize, the Table 18-2 cost estimates are only with respect to BSA/AML compliance costs; they do not include costs relating to information reporting for tax purposes,⁷¹ nor do they include compliance costs due to other banking or securities regulations.

Tables 18-3, 18-4, and 18-5 provide data related to money-laundering investigations, indictments, and sentences from the FBI, IRS, and the U.S. Sentencing Commission. These government sources frequently provide inconsistent information about

TABLE 18-3

FBI: Money Laundering Investigations, Indictments, and Convictions, 2001-2011

Year	Investigations	Indictments	Convictions
2011	303	37	45
2010	323	-	-
2009	350	43	84
2008	402	105	130
2007	548	141	112
2006	473	161	95
2005	507	-	-
2004	509	125	63
2003	496	101	57
2002	571	95	91
2001	497	72	65

SOURCE: Federal Bureau of Investigation, <https://www.fbi.gov> (accessed August 23, 2016). See appendix for details.

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money-laundering crimes, but the overall crime statistics cast serious doubt on the efficiency of the BSA/AML requirements.

The FBI reports a downward trend in money-laundering *investigations*, from 548 in 2007 to 303 in 2011. (See Table 18-3.) There were only 37 indictments and 45 convictions in 2011. Using FBI data, those 45 convictions cost society between \$107 million and \$178 million per conviction, an absurdly low return on the billions in costs incurred by the private sector.⁷²

The IRS initiated between 1,300 and 1,600 money-laundering investigations in fiscal years (FYs) 2013, 2014, and 2015.⁷³ (See Table 18-4.) In FY 2015, the IRS investigations resulted in 691 people being sentenced. Even making the heroic assumption that all 691 money-laundering sentences reported by the IRS were prosecutions that would not have occurred but for the AML statutes, and using the low end of the estimated costs of the AML regime, these prosecutions have a cost of at least \$7 million *each*.⁷⁴

The U.S. Sentencing Commission reports that 667 money-laundering sentences were handed down in 2015, a decrease from 896 in 2006.⁷⁵ (See Table 18-5.) This figure is slightly less than the 691 reported by the IRS. However, for 2014, the Sentencing Commission

shows 885 sentences, compared to the IRS figure of 785. Regardless, these figures are reasonably close to each other and they indicate that the typical number of sentences for AML offenses is fairly low. Another mitigating factor is that many of these AML sentences were in addition to sentences for the underlying, predicate crime.

Separately, in FY 2015, FinCEN issued 12 civil money penalties.⁷⁶ Thus, on the surface, these cases seem like a clear misallocation of law enforcement resources. It is difficult to believe that this regulatory framework is the most effective use of scarce law enforcement and private-sector resources. Yet, FinCEN has not been subject to any meaningful cost-benefit analysis, and federal (and international) bureaucracies keep adding additional costs and burdens.⁷⁷ It is long past the time to change this approach.

After having increasingly forced financial institutions into a quasi-law-enforcement role for more than four decades, federal agencies should be able to easily point to direct net benefits. The available evidence suggests, however, that the BSA/AML regime has been a highly inefficient law enforcement tool. At the very least, a high degree of skepticism about further

TABLE 18-4

IRS: Money Laundering Investigations, Indictments, and Sentences, 2009-2015

Year	Investigations	Indictments	Sentenced
2015	1,436	1,221	691
2014	1,312	934	785
2013	1,596	1,191	829
2012	1,663	1,325	803
2011	1,726	1,228	678
2010	1,597	1,066	751
2009	1,341	936	753

SOURCE: Internal Revenue Service, <https://www.irs.gov> (accessed August 23, 2016). See appendix for details.

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expansion of these and similar requirements is in order. Given the billions of dollars spent annually by the private sector on the existing elaborate and costly AML bureaucracy, a serious data-driven cost-benefit analysis of the existing system is warranted.⁷⁸ Based on the evidence publicly available, the current regime is unlikely to withstand a rigorous analysis.

Lastly, the International Monetary Fund (IMF) has found that the withdrawal of correspondent banking relationships by Western banks with developing-country banks is having a macro-economically significant adverse impact in much of the developing world, and endangers financial stability. This development limits international trade and access to credit. Financial intermediation is important to financial prosperity and economic development.⁷⁹ The IMF staff finds that this development is largely due to the regulatory risk, the risk of enforcement penalties and high compliance costs caused by the AML regulatory regime, and “tax transparency initiatives,” such as FATCA and the FATF’s black list.⁸⁰

BSA/AML RULES THREATEN FINTECH APPLICATIONS

The effect that these rules have on emerging financial services technologies—known as FinTech—should also be considered when assessing the cost and benefit of the BSA/AML

regulatory framework. One major problem is that financial services firms, entrepreneurs, and even regulators, are still learning how these new technologies can be used. It is clear, however, that BSA/AML rules have contributed to existing firms’ hesitancy to use certain technologies, thus slowing down their implementation. For example, traditional banks have been reluctant to develop the blockchain technologies spawned by Bitcoin, and even to work with blockchain-based companies.⁸¹ In particular, the pseudo-anonymous nature of bitcoin transactions has been a challenge for complying with BSA/AML laws.⁸²

Even though bitcoin transactions are completed with an electronic address, they do not include the name or any other direct information about the person sending or receiving bitcoins.⁸³ Naturally, pseudo-anonymous⁸⁴ transactions pose a challenge for complying with know-your-customer laws. Furthermore, the Treasury’s recent request for “Public Input on Expanding Access to Credit Through Online Marketplace Lending” shows that it is clearly contemplating greater regulation of online lenders, a relatively new form of financial intermediary.⁸⁵

Title III of the Jumpstart Our Business Startups (JOBS) Act created an exemption from registration under the Securities Act for equity crowdfunding that allows

TABLE 18-5

U.S. Sentencing Commission: Money Laundering Sentences, 2000–2015

Year	Guideline Offenders in Each Primary Offense Category
2015	669
2014	886
2013	829
2012	822
2011	844
2010	806
2009	812
2008	893
2007	918
2006	912
2005	934
2004	842
2003	831
2002	940
2001	918
2000	991

SOURCE: U.S. Sentencing Commission, <http://www.ussc.gov> (accessed August 23, 2016). See appendix for details.

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entrepreneurs to raise capital using the Internet.⁸⁶ In addition to broker-dealers, Congress created a more lightly regulated category of intermediary called a “funding portal” on which entrepreneurs may list their offerings. FinCEN has proposed a rule titled “Amendments to the Definition of Broker or Dealer in Securities,” treating these funding portals as broker-dealers for AML purposes, even though they are not broker-dealers.⁸⁷ Similar rules were proposed and then rejected by the

Securities and Exchange Commission and the Financial Industry Regulatory Authority.⁸⁸

Rejecting such rules is the right approach because funding portals do not handle customer funds. The JOBS Act prohibits funding portals from doing so.⁸⁹ However, the banks and broker-dealers that do handle customer funds must comply with BSA/AML rules. Thus, the proposed rules quite literally impose duplicative and overlapping requirements. They require both the financial institution holding customer funds and the funding portal—despite the fact that funding portals cannot hold customer funds—to perform the same function (for AML purposes) with respect to the same customer funds.

It is inappropriate to require funding portals to comply with these rules because the ability of the funding portal to engage in, or facilitate, money laundering does not exist to any meaningful degree, and the costs of complying with these rules are likely so high as to make funding portals uneconomical. Implementing such rules will result in a situation where the only intermediaries are broker-dealers, thus frustrating the intention of Congress to establish a more lightly regulated intermediary class. As with all financial services activities, it is critical that personal and financial privacy and compliance costs remain key concerns as policymakers design new regulations for funding portals and all other FinTech applications.

The principle of federalism potentially complicates these matters because each U.S. state has the ability to create its own set of regulations for FinTech firms. Regarding the state–federal relationship, 31 U.S. Code § 5330 (a)(3) explicitly states that it does not supersede “any requirement of State law relating to money transmitting businesses operating in such State.” Congress should consider the possible benefits of pre-empting state registration requirements for money-transmission businesses because the technological changes of the past few decades ensure that any money transmitter, regardless of the state in which it is domiciled, can easily transfer funds around the entire globe.

A BETTER MEANS OF INTERNATIONAL INFORMATION SHARING

The primary goals of international information sharing should be to promote law enforcement, combat terrorism, and prevent and punish fraud in a manner consistent with the principles of a free society. A better means of achieving these goals is to replace the current patchwork of international agreements with a well-considered, integrated international convention that ensures robust information sharing for the purposes of preventing terrorism, crime, and fraud, but also provides enforceable legal protections for the financial and other privacy interests of member states' citizens and the legitimate commercial interests of their businesses.⁹⁰

Membership in this convention should be restricted to governments that (1) are democratic (representative democracies with legitimate elections and protections for political minorities); (2) respect free markets, private property, and the rule of law; (3) can be expected to always use the information in a manner consistent with the security interests of the member states; and (4) have—in law and in practice—adequate safeguards to prevent the information from being obtained by hostile parties or used for inappropriate commercial, political, or other purposes.⁹¹

Such an arrangement would facilitate law enforcement and anti-terrorist aims by allowing more information to be exchanged safely and more expeditiously. It would also provide, for the first time, enforceable legal protections for the rights of citizens of the member states. Regardless, the Senate should not ratify the Protocol Amending the Multilateral Convention on Mutual Administrative Assistance in Tax Matters. Doing so would lead to substantially more transnational identity theft, crime, industrial espionage, financial fraud, and the suppression of political opponents and religious or ethnic minorities by authoritarian and corrupt governments. Ratifying the protocol would put Americans' private financial information at

risk, and the risk would be highest for American businesses involved in international commerce.⁹²

SEVEN POLICY REFORMS

1. Congress should direct the Department of Justice (in consultation with the IRS and FinCEN) to annually report the number of AML referrals, prosecutions, and convictions (including those that were made without a simultaneous prosecution for a predicate crime), and the number of occasions where BSA/AML customer requirements lead to a criminal prosecution or conviction for a non-money-laundering crime. To the extent possible, the data should report retroactively for the previous 10 years.
2. Congress should instruct both the Government Accountability Office and FinCEN to undertake a rigorous data-driven cost-benefit analysis of the current BSA/AML regime that examines the costs incurred by government, financial institutions, and others, and compares them to the benefits of the regime. The cost estimates should be based on a survey of firms that must comply with the current BSA/AML framework.
3. Congress should eliminate currency transaction reports (CTRs) altogether and streamline the reporting process so that suspicious activity reports (SARs) are the only reporting mechanism. Alternatively, if Congress decides to maintain CTRs, the CTR threshold should be adjusted for inflation from \$10,000 to \$60,000. The use of cash should not be criminalized, and it makes little sense to continue collecting millions of reports on lawful transactions. Congress should also adjust the SAR threshold to \$60,000 so that financial institutions do not have to file reports on small transactions.
4. Congress should provide that funding portals are exempt from BSA/AML requirements, since they are prohibited from holding customer funds and the financial institutions that do hold

customer funds must undertake BSA/AML compliance.

5. As a replacement for the current patchwork of existing arrangements, the United States should draft and promote a well-considered, integrated international convention that ensures robust information sharing for the purposes of preventing terrorism, crime, and fraud, but also provides enforceable legal protections for the financial and other privacy interests of member states' citizens and the legitimate commercial interests of their businesses. Membership in this convention should be restricted to governments that fulfill the four requirements listed above: They must (1) be democratic; (2) respect markets, private property, and the rule of law; (3) only use the information in a manner consistent with the security interests of the member states; and (4) have safeguards to prevent the information from being obtained by hostile parties or used inappropriately.
6. Congress should pre-empt state regulation of money-transmission businesses. These businesses are engaging in interstate commerce and there should be one uniform regulatory regime for reducing compliance costs and avoiding duplicative regulations. This is particularly true given the heavy level of federal regulation in this area.
7. The CFPB should be eliminated through repeal of Title X of Dodd–Frank. Title X of the Dodd–Frank Act created the CFPB, an independent federal agency whose regulatory authority is neither well-defined nor fixed. The CFPB is imbued with unparalleled powers over virtually every consumer financial product and service, and it could easily create rules that extend the BSA/AML regime under the pretense of protecting consumers.

CONCLUSION

Financial privacy is a key component of life in a free society, and the U.S. system of

government was designed to ensure individuals a private sphere free of government involvement, surveillance, and control. The current U.S. financial regulatory framework has expanded so much that it now threatens this basic element of freedom. For instance, individuals who engage in cash transactions of more than a small amount trigger a general suspicion of criminal activity, and financial institutions of all kinds—including jewelry stores—have to report such transactions. Regulations have imposed an enormous compliance burden on these firms, and the companies have essentially been forced into a quasi-law-enforcement role.

The cost estimates provided in this chapter suggest that the current regulatory framework is unlikely to withstand a rigorous cost-benefit analysis. For instance, the costs of the current U.S. BSA/AML regime are estimated to be between \$4.8 billion and \$8 billion annually, at least \$7 million for each AML conviction. Nonetheless, the BSA/AML framework has expanded for the past few decades without any meaningful cost-benefit analysis of these rules. Since the current framework appears grossly cost-ineffective, Congress should require regulators to develop better information about the costs and benefits of the current regime.

Internationally, the U.S. has signed a treaty and is engaged in further talks that would allow hostile countries access to American citizens' private financial information. The U.S. should not ratify the Protocol Amending the Multilateral Convention on Mutual Administrative Assistance in Tax Matters. The primary goals of international information sharing should be to promote law enforcement according to the principles of a democratic society, combat terrorism, and prevent and punish crime and fraud. The current patchwork of international agreements fails to accomplish these goals, and the overly complex and burdensome financial regulatory framework has likely impeded efforts to meet these goals. This chapter recommends seven reforms that would better protect individuals'

privacy rights and improve law enforcement's ability to apprehend and prosecute criminals and terrorists.

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APPENDIX

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7. Internal Revenue Code §§1471–1474, and IRS, “FATCA–Regulations and Other Guidance,” <https://www.irs.gov/businesses/corporations/fatca-regulations-and-other-guidance> (accessed August 24, 2016).
8. 26 CFR 1.1441-1; Internal Revenue Service Rev. Proc. 2014-39.
9. Information Sharing Environment, “Annual Report to the Congress,” September 2015, https://www.ise.gov/sites/default/files/FINAL_ISE_Annual_Report_2015_FOR_WEB_0.pdf (accessed August 24, 2016).
10. Federal Bureau of Investigation, “FBI Information Sharing & Safeguarding Report,” 2012, <https://www.fbi.gov/stats-services/publications/national-information-sharing-strategy-1/fbi-information-sharing-and-safeguarding-report-2012> (accessed August 24, 2016), and Information Sharing Environment, “Law Enforcement Information Sharing,” <https://www.ise.gov/law-enforcement-information-sharing> (accessed August 24, 2016).
11. Interpol, “Data Exchange,” <http://www.interpol.int/INTERPOL-expertise/Data-exchange> (accessed August 24, 2016).
12. Virginia Declaration of Rights, June 12, 1776, Section 1 (“That all men are by nature equally free and independent and have certain inherent rights, of which, when they enter into a state of society, they cannot, by any compact, deprive or divest their posterity; namely, the enjoyment of life and liberty, with the means of acquiring and possessing property, and pursuing and obtaining happiness and safety.”); U.S. Declaration of Independence, July 4, 1776 (“We hold these truths to be self-evident, that all men are created equal, that they are endowed by their Creator with certain unalienable Rights, that among these are Life, Liberty and the pursuit of Happiness; That to secure these rights, Governments are instituted among Men.”); U.S. Constitution, 5th Amendment (“No person shall be...deprived of life, liberty, or property, without due process of law.”); 14th Amendment (“[N]or shall any state deprive any person of life, liberty, or property, without due process of law.”) See also, John Locke, *Two Treatises of Government, Second Treatise* (1690) (“Man...hath by nature a power, not only to preserve his property, that is, his life, liberty and estate, against the injuries and attempts of other men.”)
13. Theodore R. Bromund, “Putin’s Long Arm: How Russia Uses Interpol to Harass Opponents,” *The Weekly Standard*, March 2, 2015, <http://www.weeklystandard.com/putin-s-long-arm/article/859638?page=1> (accessed August 26, 2016); Theodore R. Bromund and David B. Kopel, “Necessary Reforms Can Keep Interpol Working in the U.S. Interest,” Heritage Foundation *Backgrounder* No. 2861, December 11, 2013, <http://www.heritage.org/research/reports/2013/12/necessary-reforms-can-keep-interpol-working-in-the-us-interest>; and Herta Däubler-Gmelin, “How Rogue Regimes Have Weaponized Interpol,” *The Wall Street Journal*, June 28, 2016, <http://www.wsj.com/articles/how-rogue-regimes-have-weaponized-interpol-1467151465> (accessed August 24, 2016).
14. Tax evasion is not a crime in many liberal democratic states where, instead, it is treated as a civil violation.
15. Tingting Liu et al., “The Dark Side of Disclosure: Evidence of Government Expropriation from Worldwide Firms,” World Bank Policy Research *Working Paper* No. 7254, May 4, 2015, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2602586 (accessed August 24, 2016) (“[T]he Chinese government is tied to the wide-ranging effort to steal trade secrets.”); Devlin Barrett, “U.S. Plans to Use Spy Law to Battle Corporate Espionage: Sees Big Chinese Hand in Surge in Attempted Trade-Secret Theft,” *The Wall Street Journal*, July 23, 2015, <http://www.wsj.com/articles/u-s-plans-to-use-spy-law-to-battle-corporate-espionage-1437688169> (accessed August 24, 2016); news release, “U.S. Charges Five Chinese Military Hackers for Cyber Espionage Against U.S. Corporations and a Labor Organization for Commercial Advantage,” U.S. Department of Justice, May 19, 2014,

- <http://www.justice.gov/opa/pr/us-charges-five-chinese-military-hackers-cyber-espionage-against-us-corporations-and-labor> (accessed August 24, 2016); and Cory Bennett, "Russia's Cyberattacks Grow More Brazen," *The Hill*, April 12, 2015, <http://thehill.com/policy/cybersecurity/238518-russias-cyberattacks-grow-more-brazen> (accessed August 24, 2016).
16. Currently, the OECD Base Erosion and Profit Shifting Project Action Item 12 raises serious commercial privacy issues. See OECD, "Transfer Pricing Documentation and Country-by-Country Reporting, Action 13–2015 Final Report," October 5, 2015, <https://www.oecd.org/ctp/transfer-pricing-documentation-and-country-by-country-reporting-action-13-2015-final-report-9789264241480-en.htm> (accessed August 24, 2016).
 17. Daniel J. Mitchell, "A Tax Competition Primer: Why Tax Harmonization and Information Exchange Undermine America's Competitive Advantage in the Global Economy," Heritage Foundation *Background* No. 1460, July 20, 2001, <http://www.heritage.org/research/reports/2001/07/a-tax-competition-primer>, and Chris Edwards and Daniel J. Mitchell, *Global Tax Revolution: The Rise of Tax Competition and the Battle to Defend It* (Washington, DC: Cato Institute, 2008).
 18. Internal Revenue Code §6103(k)(4). ("A return or return information may be disclosed to a competent authority of a foreign government which has an income tax or gift and estate tax convention, or other convention or bilateral agreement relating to the exchange of tax information, with the United States but only to the extent provided in, and subject to the terms and conditions of, such convention or bilateral agreement.")
 19. U.S. Department of Treasury, "Resource Center: Treaties and TIEAs," <https://www.treasury.gov/resource-center/tax-policy/treaties/Pages/treaties.aspx> (accessed August 24, 2016).
 20. The U.S. ratified the convention on January 30, 1991. For the original, un-amended text, see OECD, Convention on Mutual Administrative Assistance in Tax Matters, <http://www.oecd.org/ctp/exchange-of-tax-information/conventiononmutualadministrativeassistanceintaxmatters.htm> (accessed August 29, 2016). This is the version of the convention to which the U.S. is a party.
 21. *Ibid.* See also OECD, "Keeping It Safe," July 23, 2012, <http://www.oecd.org/ctp/exchange-of-tax-information/keeping-it-safe-report.pdf> (accessed August 24, 2016).
 22. The U.S. has entered bilateral agreements with many countries. For a complete international list of tax-information-exchange agreements, see OECD, "Tax Information Exchange Agreements (TIEAs)," <http://www.oecd.org/tax/exchange-of-tax-information/taxinformationexchangeagreementstieas.htm> (accessed August 24, 2016).
 23. *Ibid.*
 24. OECD, "Agreement on Exchange of Information on Tax Matters," <http://www.oecd.org/ctp/harmful/2082215.pdf> (accessed August 24, 2016). See, especially, paragraph 39 of the commentary which, referring to paragraph 1 of Article 5 of the model agreement, states: "The paragraph makes clear that the Agreement only covers exchange of information upon request (i.e., when the information requested relates to a particular examination, inquiry or investigation) and does not cover automatic or spontaneous exchange of information. However, Contracting Parties may wish to consider expanding their co-operation in matters of information exchange for tax purposes by covering automatic and spontaneous exchanges and simultaneous tax examinations."
 25. David R. Burton, "Two Little Known Tax Treaties Will Lead to Substantially More Identity Theft, Crime, Industrial Espionage, and Suppression of Political Dissidents," Heritage Foundation *Background* No. 3087, December 21, 2015, <http://www.heritage.org/research/reports/2015/12/two-little-known-tax-treaties-will-lead-to-substantially-more-identity-theft-crime-industrial-espionage-and-suppression-of-political-dissidents>.
 26. OECD, "Standard for Automatic Exchange of Financial Account Information in Tax Matters," July 21, 2014, <http://www.oecd.org/ctp/exchange-of-tax-information/standard-for-automatic-exchange-of-financial-information-in-tax-matters.htm> (accessed August 24, 2016), and OECD, "Standard for Automatic Exchange of Financial Account Information: Common Reporting Standard," <https://www.oecd.org/ctp/exchange-of-tax-information/automatic-exchange-financial-account-information-common-reporting-standard.pdf> (accessed August 26, 2016).
 27. In principle, the shared information can only be used for tax purposes. But the idea that the tax authorities in China, Russia, and other countries will not share the information with their intelligence services and state-owned or politically favored private businesses is extraordinarily naive. It is also naive to think that the U.S. government could detect this intragovernmental transfer of data between foreign government agencies or ensure that it does not take place.
 28. 31 U.S. Code §5311, et seq., and 31 CFR Chapter X. Separately, Title X of the Dodd–Frank Act created the Consumer Financial Protection Bureau (CFPB) and gave the CFPB certain regulatory responsibilities for remittance transfers. The CFPB is an independent federal agency whose regulatory standards are neither defined nor fixed, and thus arbitrary. The CFPB is imbued with unparalleled powers over virtually every consumer financial product and service, and it could easily create rules that extend the AML regime under the pretense of protecting consumers. See Diane Katz, "Title X and the Consumer Financial Protection Bureau: Limiting Americans' Credit Choices," in Norbert J. Michel, ed., *The Case Against Dodd–Frank: How the "Consumer*

Protection” Law Endangers Americans (Washington, DC: The Heritage Foundation, 2016), <http://thf-reports.s3.amazonaws.com/2016/The%20Case%20Against%20Dodd-Frank.pdf>, and Alden F. Abbott, “Time to Eliminate the Consumer Financial Protection Bureau,” Heritage Foundation *Legal Memorandum* No. 172, February 8, 2016, <http://www.heritage.org/research/reports/2016/02/time-to-eliminate-the-consumer-financial-protection-bureau>.

29. The code also defines a financial institution as “any other business designated by the [Treasury] Secretary whose cash transactions have a high degree of usefulness in criminal, tax, or regulatory matters.” See 31 U.S. Code § 5312(a)(2)(z).
30. Financial Industry Regulatory Authority, “Anti-Money Laundering,” <http://www.finra.org/industry/aml> (accessed August 25, 2016).
31. 18 U.S. Code § 1960.
32. 31 U.S. Code § 5330.
33. Internal Revenue Code § 6041, et seq.
34. Cornell University Law School Legal Information Institute, <https://www.law.cornell.edu/> (accessed August 25, 2016).
35. Michael Levi and Peter Reuter, “Money Laundering,” in *Crime and Justice: A Review of Research*, Vol. 34, ed. by M. Tony (Chicago: University of Chicago Press, 2006), pp. 289–375.
36. *Ibid.*, p. 296. The Money Laundering Control Act extended certain provisions of the BSA to banks of all charters by amending the Federal Deposit Insurance Act (FDIA) and the Federal Credit Union Act (FCUA). The Money Laundering Control Act added the following sections to the U.S. Code: 12 U.S. Code 1818(s); 12 U.S. Code 1829(b); and 12 U.S. Code 1786(q).
37. These rules are commonly referred to as “know your customer rules,” but formally referred to by FinCEN as customer due-diligence requirements. These requirements are generally viewed as part of financial institutions’ AML programs. The BSA authorizes FinCEN to impose AML requirements on financial institutions. See FinCEN, “Customer Due Diligence Requirements for Financial Institutions,” Final Rule, *Federal Register*, Vol. 81, No. 91 (May 11, 2016), pp. 29398–29458, <https://www.gpo.gov/fdsys/pkg/FR-2016-05-11/pdf/2016-10567.pdf> (accessed August 30, 2016).
38. Internal Revenue Code § 6050I; 31 U.S. Code § 5313; and 31 CFR Part 1010, Subpart C.
39. See Federal Financial Institutions Examination Council, “Bank Secrecy Act Anti-Money Laundering Examination Manual: Currency Transaction Reporting—Overview,” https://www.ffiec.gov/bsa_aml_infobase/pages_manual/OLM_017.htm (accessed August 24, 2016). Several prominent academics have begun advocating the total abolition of paper currency (cash) in the name of (among other things) reducing criminal activity, so that people can only transact electronically. See Norbert J. Michel, “The Fallacy of Banning Cash,” *Cayman Financial Review*, August 2, 2016, http://www.caymanfinancialreview.com/2016/08/02/the-fallacy-of-banning-cash/?utm_content=buffer29f28&utm_medium=social&utm_source=twitter.com&utm_campaign=buffer (accessed August 26, 2016).
40. FinCEN, “Notice to Customers: A CTR Reference Guide,” <https://www.fincen.gov/whatsnew/pdf/CTR PamphletBW.pdf> (accessed August 25, 2016).
41. News release, “FinCEN Targets Money Laundering Infrastructure with Geographic Targeting Order in Miami,” FinCEN, April 21, 2015, http://www.fincen.gov/news_room/nr/html/20150421.html (accessed August 25, 2016). Also see American Gaming Association, “Best Practices for Anti-Money Laundering Compliance,” December 2014, https://www.americangaming.org/sites/default/files/research_files/aga-best-practices-re-aml-compliance-122014.pdf (accessed August 25, 2016).
42. The SAR thresholds for banks, casinos, and money-service businesses are found at 31 CFR 1020.320, 31 CFR 1021.320, and 31 CFR 1022.320, respectively.
43. Federal law also requires special records, such as multiple currency transaction logs, to be maintained by casinos. See 31 CFR 1021.410.
44. Money-service businesses, including check cashers and providers of prepaid access cards, are defined at 31 CFR 1010.100(ff).
45. The \$3,000 MSB requirement applies to all forms of payment. See FinCEN, “Bank Secrecy Act Requirements: A Quick Reference Guide for Money Services Businesses,” https://www.fincen.gov/financial_institutions/msb/materials/en/bank_reference.html (accessed August 25, 2016).
46. The council is a formal interagency body composed mostly of federal banking regulators. See Federal Financial Institutions Examination Council, “Bank Secrecy Act/Anti-Money Laundering Examination Manual,” 2014, https://www.ffiec.gov/bsa_aml_infobase/documents/BSA_AML_Man_2014_v2.pdf (accessed August 25, 2016).
47. Federal Financial Institutions Examination Council, “Bank Secrecy Act/Anti-Money Laundering Examination Manual,” pp. 47–55 and 56–59, respectively.
48. *Ibid.*, p. 47. Also See 12 CFR 208.63—Procedures for Monitoring Bank Secrecy Act Compliance.
49. Federal Financial Institutions Examination Council, “Bank Secrecy Act/Anti-Money Laundering Examination Manual,” p. 47.

50. *Ibid.*, p. 56.
51. Consumer Financial Protection Bureau, “Electronic Fund Transfers (Regulation E),” Final Rule, 12 CFR Part 1005, 2013, http://files.consumerfinance.gov/f/201304_cfpb_final-rule_remittance-transfers.pdf (accessed August 25, 2016).
52. *Ibid.*, pp. 3–4.
53. See, for example, Masha Gessen, “Banking While Russian,” *The New York Times*, February 11, 2014, <http://mobile.nytimes.com/2014/02/12/opinion/gessen-the-checks-in-the-mail.html> (accessed August 25, 2016). Also see Manuel Orozco, Laura Porras, and Julia Yansura, “Bank Account Closures: Current Trends and Implications for Family Remittances,” *Inter-American Dialogue*, December 2015, http://www.thedialogue.org/wp-content/uploads/2015/12/AccountClosures_final_12.22.15.pdf (accessed August 25, 2016).
54. One comprehensive study points out that the U.S. General Accounting Office (GAO; now the Government Accountability Office) made several unsuccessful attempts to study the effectiveness of SAR filings in terms of prosecutions and convictions. According to the GAO, as of 2002, FinCEN was unable to report whether any of its SAR-based referrals resulted in criminal prosecutions, meaning that researchers may never reach a definitive conclusion on the first three decades of the BSA/AML framework. See Levi and Reuter, “Money Laundering,” p. 342.
55. One difficulty is that drug prosecutions often involve simultaneously charging perpetrators with money-laundering violations, thus making it difficult to tell whether law enforcement discovered a drug crime because of money laundering or vice versa. Furthermore, estimates of the total revenue from illegal drug trafficking in the U.S. vary so widely that “a decline of even 25 percent in a five-year period would be hard to detect with confidence.” Such uncertain estimates complicate estimating any causal relationships. Levi and Reuter, “Money Laundering,” p. 357.
56. The FATF is an inter-governmental body established in 1989 at a G-7 summit in Paris. It originally consisted of the G-7 member states, the European Commission, and eight other countries, but it now has 37 members. See Financial Action Task Force, “History of the FATF,” <http://www.fatf-gafi.org/about/historyofthefatf/> (accessed August 25, 2016). Also see Jason Sharman, “A Look at 20 Years of Anti-Money Laundering: Does the System Work,” *IFC Review*, January 10, 2011, <http://www.ifcreview.com/restricted.aspx?articleId=3573> (accessed August 25, 2016).
57. Terence C. Halliday, Michael Levi, and Peter Reuter, “Global Surveillance of Dirty Money: Assessing Assessments of Regimes to Control Money-Laundering and Combat the Financing of Terrorism,” Center on Law and Globalization, January 30, 2014, p. 7, http://www.lexglobal.org/files/Report_Global%20Surveillance%20of%20Dirty%20Money%201.30.2014.pdf (accessed August 25, 2016).
58. Mariano-Florentino Cuellar, “The Tenuous Relationship Between the Fight Against Money Laundering and the Disruption of Criminal Finance,” *Journal of Criminal Law and Criminology*, Vol. 93, No. 2 (2003), pp. 312–466, <http://scholarlycommons.law.northwestern.edu/cgi/viewcontent.cgi?article=7123&context=jclc> (accessed August 25, 2016). Cuellar argues that the framework displays (among other problems) a “disproportionate imposition of severe penalties on predicate offenders who are easily detected.” In other words, AML charges tend to be simply added to the main offense rather than providing any independent benefit.
59. Tom Naylor, *Wages of Crime* (Ithaca, NY: Cornell University Press, 2002), and Peter Alldridge, *Money Laundering Law: Forfeiture, Confiscation, Civil Recovery, Criminal Laundering and Taxation of the Proceeds of Crime* (Portland, OR: Hart Publishing Co., 2003).
60. Levi and Reuter, “Money Laundering,” p. 340.
61. American Bankers Association, “An Avalanche of Regulation,” 2014, p. 2, <http://www.aba.com/Issues/Index/Documents/2014RegBurdenInfographic.pdf> (accessed August 24, 2016), and Financial Crimes Enforcement Network, “Money Services Businesses,” in *SAR Stats Technical Bulletin*, No. 2, October 2015, https://www.fincen.gov/news_room/rp/files/SAR02/SAR_Stats_2_FINAL.pdf (accessed August 25, 2016).
62. Levi and Reuter, “Money Laundering,” p. 340.
63. Jennifer Shasky Calvery, FinCEN director, speech at the FSSCC–FBIIC Joint Meeting, New York, December 9, 2015, p. 2, https://www.fincen.gov/news_room/testimony/pdf/20151209.pdf (accessed August 25, 2016).
64. In the wake of the 2008 crisis, some policymakers claimed that a benefit of BSA/AML compliance is financial stability in the banking sector, but this link is even weaker than the one between BSA/AML laws and crime reduction. For instance, one recently published scholarly article that blames the 2008 financial crisis partly on a lack of compliance with these rules simultaneously admits that “there is no clear evidence that full compliance from banks and other financial institutions with KYC principles would have averted, relieved, or even reduced the impact of the financial crisis of 2007 to 2009.” Genci Bilali, “Know Your Customer—or Not,” *University of Toledo Law Review*, Vol. 43, No. 2 (Winter 2012), p. 320.
65. According to Federal Reserve research, this figure, which represents 0.20 percent, references banks with \$50 million or less in assets. The research also suggests that an increase in cost of this size could cause more than 10 percent of these banks to switch from profitable to unprofitable. See remarks of Federal Reserve Governor Elizabeth A. Duke, “The Future of Community Banking,”

- delivered at the Southeastern Bank Management and Directors Conference, University of Georgia, Terry College of Business, February 5, 2013, <http://www.federalreserve.gov/newsevents/speech/duke20130205a.htm> (accessed August 25, 2016).
66. Marshall Lux and Robert Greene, "The State and Fate of Community Banking," Harvard Kennedy School *M-RCBG Associate Working Paper* No. 37, 2015, <https://www.hks.harvard.edu/centers/mrcbg/publications/awp/awp37> (accessed August 25, 2016).
 67. American Bankers Association, "An Avalanche of Regulation," p. 3.
 68. *Ibid.*
 69. Office of Management and Budget, Office of Information and Regulatory Affairs, "Supporting Statement, Futures Commission Merchants and Introducing Brokers Customer Identification Program," OMB Control Number 1506-0022, October 30, 2015, <http://www.reginfo.gov/public/do/DownloadDocument?objectID=58650502> (accessed August 25, 2016).
 70. The costs would include the costs of FBI or IRS investigations, the costs of U.S. attorneys or other Justice Department attorneys prosecuting the violation, and the costs of training these investigators and attorneys plus the costs of incarcerating the convicted individuals.
 71. Filing tax information returns (as opposed to ordinary tax returns) cost taxpayers about \$7 billion annually, based on OMB burden-hour estimates. See Scott A. Hodge, "The Compliance Costs of IRS Regulations," Tax Foundation *Fiscal Fact* No. 512, June, 2016 http://taxfoundation.org/sites/taxfoundation.org/files/docs/TaxFoundation_FF512.pdf (accessed August 25, 2016).
 72. Total costs from Table 18-2 of \$4,813–\$8,013 million divided by 45 convictions.
 73. Internal Revenue Service, "Statistical Data–Money Laundering & Bank Secrecy Act (BSA)," October 2015, <https://www.irs.gov/uac/statistical-data-money-laundering-bank-secrecy-act-bsa> (accessed August 25, 2016).
 74. \$4,813 million / 691 convictions = \$7 million per prosecution. \$4.8 billion is the lower bound of our cost estimate and 691 is the largest number of convictions reported.
 75. U.S. Sentencing Commission, "Final Quarterly Data Report," 2015, p. 8, http://www.uscc.gov/sites/default/files/pdf/research-and-publications/federal-sentencing-statistics/quarterly-sentencing-updates/USCC-2015_Quarterly_Report_Final.pdf (accessed August 25, 2016), and U.S. Sentencing Commission, "Final Quarterly Data Report," 2006, p. 8, http://www.uscc.gov/sites/default/files/pdf/research-and-publications/federal-sentencing-statistics/quarterly-sentencing-updates/USCC_2006_Quarter_Report_Final.pdf (accessed August 25, 2016).
 76. Financial Crimes Enforcement Network, "FY 2017 President's Budget," February 9, 2016, p. 4, <https://www.treasury.gov/about/budget-performance/CJ17/14.%20FinCEN%20FY%202017%20CJ.PDF> (accessed August 25, 2016).
 77. Halliday, Levi, and Reuter, "Global Surveillance of Dirty Money."
 78. FinCEN's FY 2016 budget was \$113 million. The Internal Revenue Service, Department of Justice, and other government resources devoted to AML activities are not known to the authors. In addition, the U.S. provides a large share of the funding for various international organizations, such as the FATF. Comprehensive private compliance-cost estimates are measured in the billions.
 79. David R. Burton and Norbert J. Michel, "Financial Institutions: Necessary for Prosperity," Heritage Foundation *Backgrounder* No. 3108, April 14, 2016, <http://www.heritage.org/research/reports/2016/04/financial-institutions-necessary-for-prosperity>.
 80. Michaela Erbenová et al., "The Withdrawal of Correspondent Banking Relationships: A Case for Policy Action," International Monetary Fund, June 2016, <https://www.imf.org/external/pubs/ft/sdn/2016/sdn1606.pdf> (accessed September 1, 2016). U.S. regulators take a different view. See Emily Glazer and Aruna Viswanatha, "U.S. Defends Its Curbs on Money Laundering," *The Wall Street Journal*, August 30, 2016, <http://www.wsj.com/articles/u-s-banking-regulators-seek-to-dispel-certain-myths-on-anti-money-laundering-rules-1472583839> (accessed August 30, 2016).
 81. Lost economic activity from regulation of emerging technologies is especially difficult to estimate.
 82. Bitcoin was the original blockchain-based innovation. See Gerald Dwyer and Norbert J. Michel, "Bits and Pieces: The Digital World of Bitcoin Currency," Heritage Foundation *Backgrounder* No. 3047, September 16, 2015, <http://www.heritage.org/research/reports/2015/09/bits-and-pieces-the-digital-world-of-bitcoin-currency>.
 83. Current policy ensures—for now, at least—that federal regulators will not treat individuals who transfer bitcoins to each other as money transmitters. FinCEN's official guidance states: "A person that creates units of...virtual currency and uses it to purchase real or virtual goods and services is a user of...virtual currency and not subject to regulation as a money transmitter." For the most part, FinCEN guidance and a Treasury/FinCEN Final Rule have updated federal regulations for money-service business (MSBs) to allow digital currency transfers without additional burdens. See FinCEN, "Guidance: Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies," March 18, 2013, http://www.fincen.gov/statutes_regs/guidance/html/FIN-2013-G001.html (accessed August 25, 2016), and "Bank Secrecy Act Regulations; Definitions and Other Regulations Relating to Money Services Businesses," *Federal Register*, Vol. 76, No. 140 (July 21, 2011), p. 43585, <http://www.gpo.gov/fdsys/pkg/FR-2011-07-21/pdf/2011-18309.pdf> (accessed August 25, 2016), amending 31 CFR Parts 1010, 1021, and 1022.

84. Bitcoin transactions are not anonymous, but they are referred to as pseudo-anonymous. That is, the transaction does not provide a user with complete anonymity. The name or any other direct information about a person sending or receiving bitcoins is not included in the transaction, but such information can (typically) be linked to the transaction. See Dwyer and Michel, “Bits and Pieces: The Digital World of Bitcoin Currency.”
85. Department of the Treasury, “Public Input on Expanding Access to Credit Through Online Marketplace Lending,” Billing Code 4810-25-P, July 17, 2015, <https://www.treasury.gov/connect/blog/Documents/RFI%20Online%20Marketplace%20Lending.pdf> (accessed August 25, 2016).
86. Title III, The Jumpstart Our Business Startups Act, Public Law 112-106, April 5, 2012.
87. FinCEN, “Amendments to the Definition of Broker or Dealer in Securities,” *Federal Register*, Vol. 81, No. 64 (April 4, 2016), pp. 19086–19094.
88. Securities and Exchange Commission, Proposed Rule, “Crowdfunding,” *Federal Register*, Vol. 78, No. 214, November 5, 2013, release nos. 33-9470 and 34-70741, file no. S7-09-13, p. 66428, and Financial Industry Regulatory Authority “FINRA Requests Comment on Proposed Funding Portal Rules and Related Forms,” Regulatory Notice 13-34, October 2013.
89. Securities Act §4(b)(2)(B).
90. David R. Burton, “Thinking Anew About Information Exchange and Reporting,” *Cayman Financial Review*, January 15, 2014, <http://www.caymanfinancialreview.com/2014/01/15/thinking-anew-about-information-exchange-and-reporting/> (accessed August 25, 2016). For the text of one such proposed convention, see Task Force on Information Exchange and Financial Privacy, “Report on Financial Privacy, Law Enforcement and Terrorism,” including the “Convention on Privacy and Information Exchange,” May 1, 2002, p. 48, http://iret.org/pub/Final_ReportR15small_forIRET1.doc (accessed August 25, 2016).
91. The United States government should invite governments that meet these criteria to sign the convention, and the convention should provide that participation may be expanded only upon unanimous consent that a prospective candidate meets the criteria. Obvious candidates for inclusion would be EU allies without major corruption problems, Australia, Canada, Japan, New Zealand, South Korea, and Switzerland. For a list of countries with corruption problems, see *2016 Index of Economic Freedom*, “Freedom from Corruption” (third column from the left), (Washington, DC: The Heritage Foundation, 2016), <http://www.heritage.org/index/explore>. Bulgaria, Greece, Romania, and Turkey, for example, are NATO members but have corruption problems. Turkey rates only a 45 *Index* score (of 100) and Bulgaria, Greece, and Romania rate only a 43. The U.S., in contrast, rates a 74, the U.K. rates a 78, and Denmark a 92.
92. Burton, “Two Little Known Tax Treaties Will Lead to Substantially More Identity Theft, Crime, Industrial Espionage, and Suppression of Political Dissidents.”

CHAPTER 19:

How Congress Should Protect Consumers' Finances

Alden F. Abbott and Todd J. Zywicki

Free-market competition is key to the efficient provision of the goods and services that consumers desire. More generally, the free market promotes innovation and overall economic welfare.¹ Imperfect information can, however, limit the ability of competition to be effective in benefiting consumers and the economy. In particular, inaccurate information about the quality and attributes of market offerings may lead consumers to make mistaken purchase decisions—in other words, consumers may not get what they think they bargained for. This will lead to the distrust of market processes, as sellers find it harder to differentiate themselves from their competition. The end result is less-effective competition, less consumer satisfaction, and lower economic welfare.

Fraudulent or deceptive statements regarding product or service attributes, and negative features of products or services that become evident only after sale, are prime examples of inaccurate information that undermines trust in competitive firms. Accordingly, the government has a legitimate role in seeking to curb fraud, deception, and related informational problems.² Historically, the federal government's primary consumer protection agency, the U.S. Federal Trade Commission (FTC), has taken the lead in bringing enforcement actions against businesses that distort markets by engaging in “deceptive” or “unfair” practices when marketing their offerings to consumers.³ In recent decades, the FTC has taken an economics-focused approach in these areas. Specifically, it has limited “deception prosecutions” to cases where consumers

acting reasonably were misled and tangibly harmed, and “unfairness prosecutions” to situations involving consumer injury not outweighed by countervailing benefits (a cost-benefit approach).⁴ In other words, although the FTC may have erred from time to time in specific cases, its general approach has avoided government overreach and has been conducive to enhancing marketplace efficiency and consumer welfare.

However, Congress has not allowed the FTC to exercise economy-wide oversight over consumer protection, in general, and fraud and deception, in particular. For many years, a hodgepodge of different federal financial service regulators were empowered to regulate the practices of a wide variety of financial industry entities, with the FTC only empowered to oversee consumer financial protection with

respect to the narrow category of “non-bank financial institutions.” As part of the 2010 Dodd–Frank financial reform legislation, Congress created a new Consumer Financial Protection Bureau (CFPB), loosely tied to the Federal Reserve Board.⁵ While Dodd–Frank mandated shared CFPB–FTC consumer protection jurisdiction over non-bank financial institutions, it transferred all other authority over the many separate consumer financial protection laws to the CFPB alone. The CFPB is simultaneously one of the most powerful and least-accountable regulatory bodies in United States history. In marked contrast to the FTC’s economics-based approach, the CFPB intervenes in financial market consumer-related practices in a heavy-handed arbitrary fashion that ignores sound economics. The upshot is that far from improving market efficiency, the CFPB *reduces* market efficiency, to the detriment of consumers, producers, and the overall economy. In short, the CFPB’s actions are a prime example of government failure.⁶

THE FAILURE OF CFPB CONSUMER PROTECTION

Although supposedly a subunit of the Federal Reserve Board, the CFPB is not accountable to the Fed, and it is technically classified as an Executive Branch agency. Dodd–Frank provides that the President appoints the director of the CFPB for a five-year term, and the director is removable before that only for cause, such as malfeasance or dereliction of duty.⁷ The CFPB’s budget is provided directly by the Fed, outside the standard appropriations process. Its actions are insulated from judicial review by statutorily mandated *Chevron* deference, which requires courts to defer to the CFPB’s interpretation of any “ambiguous” statutory provisions under its jurisdiction, in preference to any competing interpretations by other agencies.⁸

The substantive powers of the CFPB are vast and ill-defined. The CFPB has power to regulate the terms and marketing of every consumer credit product in the economy. And, because many small businesses use personal credit to

start and grow their businesses (such as personal credit cards, home equity lines of credit, and even products like auto title loans), the CFPB possesses substantial control over much of the allocation of small-business credit as well. The CFPB has the power to take enforcement and regulatory action against “unfair, deceptive, and abusive” consumer credit terms, an authority that the CFPB has exercised with gusto. Moreover, the CFPB has deliberately eschewed regulatory rule-making that would clarify these terms, preferring to engage in case-by-case enforcement actions that undermine predictability and chill vigorous competition and innovation. Yet despite the broad authority granted to the CFPB, its appetite is broader still: The CFPB has taken action to regulate products such as cellphone billing, for-profit career colleges, and even loans made by auto dealers (despite express jurisdictional limits in Dodd–Frank regarding the latter).

The consequences of this unchecked authority have been disastrous for consumers and the economy. Complicated rules with high compliance costs have choked off access to mortgages, credit cards, and other financial products. Overwhelmed by the costs and uncertainty of regulatory compliance, small banks have exited traditional lines of business, such as home mortgages, and feared entering new lines, such as small-dollar loans. Consistent with the general effects of Dodd–Frank, the CFPB has contributed to the consolidation of the American financial sector, making big banks bigger, and forcing consolidation of small banks. By imposing one-size-fits-all bureaucratic underwriting standards on community banks and credit unions, the CFPB has deprived these actors of their traditional model of relationship lending and intimate knowledge of their customers—their lone competitive advantage over megabanks.

Perhaps the most tragic element of the CFPB train wreck is the missed opportunity for reform that it represents. At the time of Dodd–Frank, the system of consumer financial protection was badly in need of modernization: The existing system was cumbersome,

incoherent, and ineffective. Fragmented among multiple federal agencies with authority over different providers of financial services, the federal system lacked the ability to lay down a coherent regulatory regime that would promote competition, consumer choice, and consumer protection consistent with the realities of a 21st-century economy and technology. While there is little evidence that the financial crisis resulted from a breakdown of consumer financial protection (as opposed to safety and soundness issues), reform was timely. But Dodd–Frank squandered a once-in-a-generation opportunity to bring about real reform.

In this chapter, we briefly make the case that some degree of reform of the consumer financial protection system was appropriate, in particular, the consolidation of consumer financial protection in one federal agency. However, we challenge the apparatus constructed by Dodd–Frank that created a new unaccountable super-regulator with a tunnel vision focus on a narrow definition of “consumer protection.” Instead, we argue that existing substantive powers were largely sufficient to the task of consumer protection, and that Congress could have achieved better results by acting within the existing institutional framework by simply consolidating authority in the FTC. By working within the existing framework of long-standing substantive authorities and institutional arrangements, Congress could have provided the needed modernization of the federal consumer financial protection system without the unintended consequences that have resulted from the creation of the CFPB.

BEFORE DODD–FRANK

In the period before Dodd–Frank, the consumer financial protection regime was somewhat of a hodgepodge system that failed to provide a coherent consumer financial protection regime that facilitated competition, consumer protection, and choice for consumers. Authority was scattered among different regulatory bodies with authority over

different providers of financial services, such as the FTC (mortgage brokers and non-bank lenders), the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the National Credit Union Administration, or the Department of Housing and Urban Development (certain mortgage-lending rules). Efforts at joint rule-making resemble United Nations summit meetings as dozens of regulators circled a table seeking consensus on rule-makings. Moreover, each agency had its own constituency to which it gave particular focus, be it the protection of small banks, or jurisdiction over particular products or services.

The problems resulting from this fragmentation of regulatory authority at the federal level were exacerbated by an unclear division of authority between the state and federal governments. While most depository institutions (such as banks and thrifts) were regulated by the federal government, providers of other services and products (such as mortgage brokers, payday lenders, and pawn shops) were primarily regulated at the state and local level. Other providers of finance-related services, such as debt collectors, were subject to a hybrid system.

Yet many products offered by different types of providers compete with each other.⁹ For example, for most payday-loan customers, the closest substitute is bank overdraft protection. Thus, when states eliminate or restrict access to payday loans, the usage of bank overdraft protection and bounced checks typically rises. This suggests that in devising a regulatory policy for access to payday loans, a regulator simultaneously would want to consider policies regarding bank overdraft protection. Similarly, because mortgage brokers compete directly with traditional banks in the provision of mortgages, a coherent consumer protection policy would consider the interrelationships between the two providers so as to construct policies conducive to the promotion of competition and consumer choice.

At the same time, it is important to stress that this case for modernization of the

consumer financial protection system is *independent* of the financial crisis. Indeed, many of the areas in which the CFPB has been most active have *nothing* to do with the factors that contributed to the financial crisis, specifically residential mortgages. Services and products, such as payday loans and credit cards, had nothing to do with the financial crisis. It is equally important to note that even the financial crisis itself had little to do with defects in the consumer protection system—the proliferation of low-down-payment mortgages and the decisions of millions of consumers to walk away from underwater mortgages were a matter of misaligned incentives, not consumer protection.¹⁰ The incentives to default created by factors such as the presence of state anti-deficiency laws on the collection of mortgage defaults, or cumbersome judicial foreclosure processes that substantially slowed the foreclosure process, had little to do with supposed fraud against consumers. Moreover, defaults and foreclosures were much higher in locations with a large percentage of investment and second houses, which suggests that many of the defaults in those areas were driven by investors, not conventional homeowners. Mortgages made with novel terms, such as negative-amortization provisions and so-called teaser rates, did have higher rates of foreclosure, but economists have found little or no support for the hypothesis that the high default rates on those products resulted from fraud against consumers. Yet, the CFPB and the regulatory apparatus created by Dodd–Frank has been premised on the assumption that fraud against consumers was a significant contributor to the foreclosure crisis, thereby mischaracterizing the safety and soundness issues at stake and implementing a set of regulations that would have done little to address the actual problems that brought on the mortgage crisis.¹¹

Finally, adding to this litany of examples of government failure is the CFPB's open-ended authority to sanction “abusive” conduct in the financial services industry. The CFPB has yet to engage in a formal rule-making to define the term “abusive,” choosing instead to define

the term through litigation and settlement, and purposely keeping the reach of the term vague for future cases. This has led to charges of arbitrariness and bias from some actors. The ability of the CFPB to, unexpectedly, attack novel conduct as “abusive,” without regard to its merits, predictably will reduce incentives for financial institutions to develop innovative financial instruments and services offerings that could benefit consumers.

The failure of Dodd–Frank and the CFPB to construct a modern and relevant regulatory regime that meets the needs of today's consumers and economy is one of the great tragedies of the post-crisis period. Instead of a modern regime that harnesses modern understanding of consumer behavior and market structure, the CFPB has instead resuscitated a 1970s-style system of command-and-control regulation—one that focuses on banning certain terms and products, and ignores the benefits to consumers of competition, innovation, and choice.¹²

This adverse result for consumers, however, was completely predictable in light of the CFPB's institutional structure, which provides a narrow, tunnel-vision agency focus on a single mission (“consumer protection” as conventionally defined). Particularly noteworthy in that regard are the CFPB's single-director organization (which makes the agency subject to the specific interests and background of its director); and its insulation from oversight by Congress, the President, or the Federal Reserve, which eliminates an opportunity for balanced input and feedback that could help to rein in the CFPB's excesses and the unintended consequences of its actions.¹³ Moreover, the CFPB's lack of transparency and accountability makes it particularly susceptible to influence from particular interest groups, such as trial lawyers and consumer activist groups, who can collaborate behind the scenes with the agency in the formulation of policies.

A BETTER PATH

A better path to modernizing and systematizing federal consumer financial protection

policy was available at the time of deliberation over Dodd–Frank, and is still available today. Instead of creating an unaccountable super-regulatory agency with a blinkered view of its mission and power concentrated in one person’s hands, consumer financial protection would be better achieved by simply consolidating regulatory authority in an existing agency that already has the capacity to act in a fashion conducive to the promotion of sound consumer financial protection policy. Such an agency already exists in the FTC. Consolidating the powers granted to the CFPB in the FTC, which still retains certain regulatory responsibilities with respect to consumer finance,¹⁴ would have a number of advantages over the course chosen in Dodd–Frank.

First, the FTC is a multimember, bipartisan commission.¹⁵ This is an important improvement over the structure of the CFPB, which is neither an independent commission nor an executive agency. Executive agencies are accountable to the President and the electorate through the democratic process. The power of the President to remove a department head is an important constraint on the ability of the agency to pursue its own parochial goals or potential biases. Multimember independent agencies, such as the FTC, offer an alternative form of accountability, namely internal checks and balances brought about through the bipartisan decision-making process. Whereas a single-director structure raises the potential for the director to indulge in biased, erroneous, or parochial decision making, a multimember, bipartisan decision-making process can provide checks on these deviations from sound decision making. Minority-party commissioners can provide a sort of whistle-blowing function to challenge agency actions that they believe to be biased or unjustified. Moreover, the opportunity to publicly dissent can create a record for review in a subsequent court challenge by calling attention to possible flaws in the majority’s logic and highlighting particular facts. In addition, the mere opportunity for dissenting commissioners to express their views can

increase the legitimacy of potentially controversial agency decisions by providing a partial defense against charges of bias.

Multimember commissions are also useful for providing an array of experiences and backgrounds for members of the commission. For example, over time FTC commissioners have included former state attorneys general’s office staff, former congressional staffers and Members of Congress, economists, lawyers, business people, and others. A single-director structure, by contrast, brings an individual with necessarily limited experience. For example, the first CFPB director, Richard Cordray, was a former state attorney general. Thus, while he had experience as a lawyer and law enforcement official, he had little experience as a regulator, and little subject matter expertise in the economics and regulation of consumer credit. A multimember-commission structure enables such an agency to appoint people of complementary skills to positions of leadership.

Multimember commissions also provide greater stability in policymaking over time, with less dramatic swings from one presidential Administration to another. Thus, given the activist and sweeping nature of the initiatives taken under Director Cordray, it is likely that many of these policies will be dramatically reversed by a Republican Administration.

The FTC is also subject to Congress’s appropriations process, an important check on the agency’s actions. For example, during the 1970s, the FTC engaged in a period of agency overreach and excessiveness very similar to the behavior exhibited by the CFPB since its founding. As a result, however, Congress cracked down on the FTC, reining in its excesses and threatening to close down the agency. Eventually, the FTC corrected course and moved in a more positive direction. In short, although the lack of congressional oversight regarding the CFPB’s budget gives the CFPB broad leeway to act, it also deprives the agency of an important feedback mechanism to rationalize its actions and resource allocation choices.

Finally, the FTC has a large Bureau of Economics,¹⁶ staffed with academically trained economists who would be ideally suited to take into account the regulatory economic policy issues, discussed herein, to which the CFPB has paid no heed. This would make it far more likely that agency regulatory decisions affecting consumer credit markets would be taken in light of the effects of agency actions on consumer welfare and the broader economy. This could be done relatively seamlessly and efficiently. The FTC's economic staff already has substantial experience in employing economic tools to assess potential cases of deception and unfairness, which, as previously indicated, are rooted in economic considerations. Moreover, the FTC already has considerable regulatory experience in assessing practices affecting consumer financial services markets, which antedates the CFPB's entry into the field.¹⁷

CONCLUSION

Long before the 2008 financial crisis, the U.S. consumer financial protection regime was a mess of a system that failed to provide a coherent consumer financial protection regime. Authority was scattered among more than six different regulatory bodies with jurisdiction over different providers of financial services, leading to uncertainty in the marketplace and countless rule-making conflicts among the various regulators. The 2010 Dodd–Frank Act missed an opportunity to correct these problems.

Dodd–Frank did consolidate much of this consumer financial protection authority in one agency, but it gave this power to the CFPB, one of the most powerful and unaccountable regulatory bodies in the history of the U.S. In sum, CFPB regulation of consumer financial services has been an unmitigated disaster. The new framework has harmed consumers and undermined economic efficiency through arbitrary rules. These rules have distorted and, in some cases, destroyed, market opportunities. In particular, poorer Americans, who face limited options for obtaining credit, have been hit especially hard by the CFPB's arbitrary regulatory shotgun approach.

Eliminating the CFPB's authority over consumer protection in financial services, and transferring such authority to the FTC, would greatly improve the current sorry state of affairs. Admittedly, the FTC is a less-than-perfect agency, and even a multimember-commission structure does not prevent institutional mistakes from being made and repeated by the majority. All in all, however, as an accountable institution, the FTC is far superior to the CFPB. Consolidating this authority with the FTC—where it should have been in the first place—will better allow free markets to promote innovation and overall economic welfare. Strengthening this legal framework to provide a single, clearly defined, properly limited set of rules will facilitate competition among financial firms, thus protecting consumers and providing them with better choices.

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ENDNOTES

1. Companies are rivals for sales and profits under the competition that free markets allow. This rivalry leads to innovation in products and services, productivity improvements through technological change, and the drive to differentiate goods and services from those of rivals. See Robert Hessen, “Capitalism,” in David Henderson, ed., *The Fortune Encyclopedia of Economics* (New York: Warner Books, 1993), pp. 110–114.
2. Free markets do, of course, incentivize firms to provide assurances of quality and safety so that consumers will trust their product offerings over those of rival firms. See Daniel Klein, “Consumer Protection,” in David Henderson, ed., *The Concise Encyclopedia of Economics* (Indianapolis, IN: Liberty Fund, 2008), pp. 81–83, <http://www.econlib.org/library/Enc/ConsumerProtection.html> (accessed August 16, 2016).
3. See, generally, Federal Trade Commission, “Bureau of Consumer Protection,” <https://www.ftc.gov/about-ftc/bureaus-offices/bureau-consumer-protection> (accessed November 4, 2016).
4. For a brief discussion of the FTC’s approach to unfairness and deception, see Alden Abbott, “The Federal Trade Commission’s Role in Online Security: Data Protector or Dictator?” Heritage Foundation *Legal Memorandum* No. 137, September 10, 2014, <http://www.heritage.org/research/reports/2014/09/the-federal-trade-commissions-role-in-online-security-data-protector-or-dictator>.
5. Dodd–Frank Wall Street Reform and Consumer Protection Act, Titles X and XIV, Public Law 111–203, 124 Stat. 1376, codified in relevant part at 12 U.S. Code § 5301, §§ 5481–5603, and in laws amended (Title X); and 12 U.S. Code § 5481 note, 15 U.S. Code § 1601 note, § 1602 and § 1631 et seq. (Title XIV). For an overview of the key regulatory provisions of Titles X and XIV, see Federal Trade Commission, “Dodd–Frank Wall Street Reform and Consumer Protection Act, Titles X and XIV,” <https://www.ftc.gov/enforcement/statutes/dodd-frank-wall-street-reform-and-consumer-protection-act-titles-x-and-xiv> (accessed November 4, 2016). In creating the CFPB, Congress transferred consumer financial protections from the Federal Reserve, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Department of Housing and Urban Development. 12 U.S. Code § 5581 (delineating the transfer of consumer financial services functions to the CFPB), and Federal Trade Commission, “Consumer Finance,” <https://www.ftc.gov/news-events/media-resources/consumer-finance> (accessed November 4, 2016) (explaining that the FTC shares authority with the CFPB to enforce the consumer-protection laws with respect to non-bank financial institutions).
6. For a brief assessment of government failure in financial markets (defined as “policy and budget choices by government officials that result in inefficiency”), see Council of Economic Education, “The Role of Government in Financial Markets: Market Failure vs. Government Failure vs. No Failure,” <http://lei.councilforeconed.org/documents/978-1-56183-572-0-activity-lesson-15.pdf> (accessed November 4, 2016).
7. In *PHH Corporation v. Consumer Financial Protection Bureau*, No. 15-1177 (D.C. Cir. Oct. 11, 2016), a three-judge panel of the U.S. Court of Appeals for the District of Columbia held that the CFPB as currently constituted violates the constitutionally mandated separation of powers, and required as a remedy that the “for cause” restriction be stricken from the statute and that the director of the CFPB be made removable at will by the President. One of the three panel judges, however, Karen LeCraft Henderson, dissented from the finding of unconstitutionality, and it is anticipated that the Justice Department will appeal. In short, this holding is tenuous at best. Moreover, even if it is upheld, the holding is of little practical consequence. It “will have no effect in limiting the arbitrary and capricious actions of” the current director. “More generally, as a practical matter, it appears unlikely that any president would closely supervise a highly specialized agency such as the CFPB (let alone seriously consider dismissing its director), given the many high-level responsibilities and political considerations presidents face.” Hans von Spakovsky and Alden Abbott, “A Win for Separation of Powers? Court Rules Against Consumer Protection Financial Bureau,” *Conservative Review*, October 12, 2016, <https://www.conservativereview.com/commentary/2016/10/a-win-for-separation-of-powers#sthash.NXdXRD9T.dpuf>; <https://www.conservativereview.com/commentary/2016/10/a-win-for-separation-of-powers#sthash.NXdXRD9T.dpuf> (accessed November 14, 2016).
8. Todd J. Zywicki, “The Consumer Financial Protection Bureau: Savior or Menace?” *George Washington Law Review*, Vol. 81, No. 3 (April 2013), p. 856, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2130942 (accessed August 16, 2016). Also see Paul Larkin, “The World After Chevron,” Heritage Foundation *Legal Memorandum* No. 186, September 8, 2016, <http://www.heritage.org/research/reports/2016/09/the-world-after-chevron>; Diane Katz, “The CFPB in Action: Consumer Bureau Harms Those It Claims to Protect,” Heritage Foundation *Backgrounder* No. 2760, January 22, 2013, <http://www.heritage.org/research/reports/2013/01/the-cfpb-in-action-consumer-bureau-harms-those-it-claims-to-protect>; and Diane Katz, “Consumer Financial Protection Bureau: Limiting Americans’ Credit Choices,” Heritage Foundation *Backgrounder* No. 3102, April 28, 2016, <http://www.heritage.org/research/reports/2016/04/consumer-financial-protection-bureau-limiting-americans-credit-choices>.
9. Robert Clarke and Todd Zywicki, “Payday Lending, Bank Overdraft Protection, and Fair Competition at the Consumer Financial Protection Bureau,” *Review of Banking and Financial Law*, Vol. 33, No. 1 (2013), p. 235, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2358202 (accessed August 16, 2016).

10. Todd J. Zywicki and Joseph Adamson, "The Law and Economics of Subprime Lending," *University of Colorado Law Review*, Vol. 80, No. 1 (Winter 2009), pp. 1–86, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1106907 (accessed August 16, 2016).
11. Todd J. Zywicki, "Assessing The Effects of Consumer Finance Regulations," testimony before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, April 5, 2016, http://www.banking.senate.gov/public/_cache/files/58bb96f4-8268-4ecc-95dd-5e35f8d26e4a/060C9C587736B1F08DD0A117FC3EE8B6.zywicki-testimony-4-5-16.pdf (accessed August 16, 2016).
12. Todd J. Zywicki, "The Consumer Financial Protection Bureau and the Return of Paternalistic Command-and-Control Regulation," *Engage*, Vol. 16, No. 2 (July 2015), p. 48, <http://mason.gmu.edu/~tzywick2/Zywicki%20CFPB%20Paternalistic%20FINAL.pdf> (accessed August 16, 2016).
13. Zywicki, "The Consumer Financial Protection Bureau: Savior or Menace?"
14. Federal Trade Commission, "Consumer Finance."
15. See generally, Federal Trade Commission, "Commissioners," <https://www.ftc.gov/about-ftc/commissioners> (accessed November 3, 2016).
16. Federal Trade Commission, "Bureau of Economics," <https://www.ftc.gov/about-ftc/bureaus-offices/bureau-economics> (accessed November 4, 2014).
17. Zywicki, "The Consumer Financial Protection Bureau and the Return of Paternalistic Command-and-Control Regulation."

CHAPTER 20:

Reducing Banks' Incentives for Risk-Taking Via Extended Shareholder Liability

Alexander Salter, PhD, Vipin Veetil,
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It has long been understood that deposit guarantees and too-big-to-fail (TbTF) policies create a moral-hazard problem—they incentivize banks to take on too much risk by shielding depositors and shareholders from losses in excess of equity (“left-tail” outcomes)—in American banking.¹ Congress passed the Federal Deposit Insurance Corporation Improvement Act (FDICIA) in 1991 to mitigate the moral-hazard problem by restricting forbearance and implicit subsidies for undercapitalized banks. But the mandates of the act (particularly early intervention to reorganize undercapitalized banks) were ignored when they might have made a difference just before and during the recent financial crisis. Common recommendations for mitigating moral hazard would have the FDIC adopt the techniques that private insurance companies use (deductibles, coinsurance, lower effective limits on coverage), but these have not been adopted, in part because (as seen in the British case of Northern Rock) they can give ordinary depositors reasons to rapidly withdraw money from suspect banks (the dreaded “run on banks”).

This chapter considers a different method for mitigating moral hazard: extended liability for bank shareholders. This reform does not put additional legal restrictions on bank activities, but reduces banks' *incentives* for taking excessive risks by at least partially neutralizing current safety-net subsidies to risk-taking. It shifts the risk of left-tail events from deposit-guarantee agencies to equity-holders as a means for reducing the moral hazard that promotes inefficient risk-taking. Given that the root of the current incentive distortion lies in deposit and TbTF guarantees, a more straightforward approach would be simply to remove the guarantees, shifting risk from guarantee agencies to depositors and giving

them more incentive to monitor and reward safe banking. Portfolio, activity, and capital restrictions might also then be removed, and liability arrangements allowed to be freely chosen by banks.²

While such a move might be first-best, the authors of this chapter take for granted that the guarantees will not be removed. The question to be addressed is whether adding extended liability would be an improvement over today's status quo. Assuming that deposit guarantees remain in place, the potential gain from introducing extended liability is not as a substitute for deposit guarantees, but as a cost-effective way of reducing moral-hazard distortions. In putting this case on the table, the argument

presented in this chapter supports other suggestions made in recent years for the (re-)introduction of extended liability into banking.³

EXTENDED LIABILITY: AN OVERVIEW

Under today's standard arrangement of *single liability*, when a bank (or any corporation) is declared insolvent and closed down with negative net worth, the value of shares goes to zero, but shareholders have no obligation to repay the remaining debts to creditors. Under extended liability—an arrangement common in banking history—shareholders do have an obligation to repay. Shareholders are called upon to cover (in proportion to their shareholdings) some or all of the unpaid debts. Under double liability, the holder of a share with a \$100 face value may be called on to chip in up to \$100 *more*; under triple liability, up to \$200. Under unlimited liability, shareholders are obliged to cover the entire amount of unpaid debt. Their liability can be joint and several, as it was in the U.K. (if some shareholders go bankrupt before paying in full, their unmet burdens fall to the others), or pro rata as in California (each is liable only for his initial share of the unpaid debt). For clarity, note that single, double, and triple liability are all forms of *limited* liability, but double and triple are *extended* by comparison to single liability. Unlimited liability is the limiting case of extended liability.

The same degree of shareholder liability need not apply to all bank debts. Some historical banks' shareholders have retained unlimited liability for banknotes, and single liability for deposits. All bank shares need not carry the same degree of exposure: Non-voting shares might have single liability, while voting shares have extended liability. Finally, where banks are free to choose the division of default risk between shareholders and creditors, all banks need not adopt the same liability arrangements. Goldman Sachs retained unlimited shareholder liability until 1999, long after other investment banks had switched to single liability. Brown Brothers Harriman

today provides private banking and other financial services while retaining unlimited liability for its general partners.⁴

In a banking system without deposit guarantees, bank shareholders might voluntarily adopt extended liability to provide solvency assurance to depositors and other creditors. By standing more fully behind its debts, the bank reduces default risk to depositors and thereby can attract deposits at lower interest rates. A note-issuing bank can likewise attract a larger note-holding clientele. In the presence of deposit guarantees—especially absent deductible, coinsurance, and coverage limits—this motive disappears. If the bank does not repay, the deposit guarantee agency will. Riskier banks no longer have to pay higher rates to attract deposits (below the insured limit). This is the core of the moral-hazard problem already mentioned.

EXTENDED LIABILITY: EXPERIENCES IN THE UNITED STATES

The American colonies under British rule, and after independence the 13 state governments, inherited the English legal system under which a bank (or any other business firm) seeking incorporation had to go to the legislature for a special chartering act. Such charters routinely limited the shareholders' liability for the corporation's debts to the par value of their shares, a system of single liability. In 1837, the chartering rules began to change as a few, and then an increasing number of, states adopted "free-banking" laws under which any applicant who agreed to standardized terms could obtain a bank charter. The charter terms varied from state to state, but some states required bank shareholders to accept extended liability, including double, triple, and even unlimited liability. In a few states, a bank could choose its own shareholders' level of liability, a system known as "voluntary liability."⁵ By 1860, more than half the states in the U.S. had free-banking laws.⁶

The National Banking Acts passed during the Civil War created federal charters with

double liability, and extended liability was common in the U.S. before federal deposit guarantees arrived in 1933. Many states imposed double or greater liability as a feature of their bank charters. All *federal* charters, offered after 1863 under the National Banking system, specified double liability.⁷ Overall, the number of chartering authorities requiring double liability rose from fewer than 10 states in 1851, to the federal government plus 18 states in 1875, to federal plus 34 states in 1930.⁸ As a result, in the early 20th century, the U.S. had two classes of banks: (1) federally chartered National Banks, subject to double liability, and (2) state-chartered banks that operated under various liability rules. Ten states had single liability, Colorado had triple liability, California had unlimited liability, and most other states had double liability.⁹ Between the Civil War and the Great Depression, most depositors and all noteholders were cushioned from losses in bank failures by shareholders who absorbed some risk beyond the value of their shares.¹⁰ Cross-sectional studies indicate that extended liability made banks safer for depositors, inducing banks to hold more liquidity and safer assets.¹¹ Nonetheless, this set of arrangements, having taken nearly a century to evolve, was reversed in less than a decade.

Having apparently proven ineffective at protecting depositors from the huge banking losses of the early Great Depression, extended liability was considered redundant to the creation of federal deposit insurance. In 1933, Congress “amended the National Bank Act and the Federal Reserve Act to remove double liability from national bank shares issued after June 16, 1933.”¹² In 1935, Congress passed an amendment allowing National Banks to terminate double liability after July 1, 1937, on all shares regardless of when they were issued. State governments followed the federal government, and similarly removed requirements for extended liability. By the end of World War II, 31 states had done so.¹³ In 1956, Arizona became the last state to do so. A handful of banks continued to operate

under extended liability, though they were no longer required by law. These arrangements, however, meant little. The FDIC Act includes a provision stating that upon paying for insured deposits of a failed member bank, the FDIC waives any and all claims on shareholders if such claims arise from state laws.

EXTENDED LIABILITY: PERFORMANCE IN THE U.S.

There are a variety of ways to measure the riskiness of a banking system, including the rate of bank failures, asset volatility, the composition of banks’ asset portfolios, equity ratios, and losses to depositors. Empirical studies from the era of extended liability banking are necessarily non-exhaustive for lack of data, but do suggest that extended liability reduced bank risk-taking in contrast to single-liability systems. One recent study of U.S. bank failures from 1892 to 1930 finds that extended liability reduced the risk of bank failures.¹⁴ A separate investigation of the 27 California banks that switched from unlimited liability to double liability between 1909 and 1915 finds

that banks subject to stricter liability rules have lower [on-balance-sheet] equity and asset volatility, hold a lower proportion of risky assets, and are less likely to increase their investment in risky assets when their net worth declines, consistent with the hypothesis that stricter liability discourages commercial bank risktaking.¹⁵

Similarly, an empirical study of U.S. banking in the New Deal era finds that in “states with contingent liability, banks used less leverage and converted each dollar of capital into fewer loans, and thus could survive larger loan losses (as a fraction of their portfolio) than banks in limited liability states.”¹⁶

Two studies examine voluntary versus involuntary liquidations of banks in the U.S. from 1865 to 1933.¹⁷ By closing an unprofitable bank voluntarily, shareholders with extended

liability avoid wealth depletion from future negative profits. They do not face the same incentive to “gamble for resurrection” that shareholders face under single liability, an incentive that grows as net worth approaches zero (and *a fortiori* as it declines below zero, the “zombie bank” problem). Consequently, the ratio of voluntary to involuntary liquidation would be greater in a system with extended liability, a finding reported in both studies.¹⁸ The evidence in these studies is not conclusive, however, because it is difficult to compare the pre-Depression system to the post-Depression system. With federal deposit insurance and other regulatory interventions, fewer banks closed either voluntarily or involuntarily. Nonetheless, the above findings do indicate that voluntary closures were relatively common under extended liability, limiting depositor losses and thereby avoiding possible negative spillovers to the rest of the system.¹⁹

In the United States, from 1865 to 1934, the “average annual loss to depositors of failed national banks was a mere forty-four cents per thousand dollars of deposits.”²⁰ The losses were much greater during the Great Depression, ranging from 50 cents to more than two dollars per *hundred* dollars of deposits (losses borne by depositors of suspended banks average around 20 percent for 1930 to 1933).²¹ Of course, whether the pre-Depression era or the Great Depression itself is a better picture of the extended liability system is a difficult question. On the one hand, the Great Depression was an extraordinary period when many arrangements failed, and does not therefore reflect on the extended liability system. On the other hand, the question remains as to why extended liability did not prevent large-scale banking collapses during the Great Depression.²² While the evidence suggests that extended liability can help to produce more prudent behavior on the part of banks, it also suggests that extended liability cannot prevent shocks that originate outside the banking system, nor can it eliminate the mechanism through which the shocks propagate through the economy. In other words, what

the extended liability can do is reduce the likelihood of shocks that arise from unwise behavior by banks in the management of reserves and the risk-profile of their assets.

EXTENDED-LIABILITY DRAWBACKS: EVIDENCE FROM THE U.K. AND IRELAND

The incentive-aligning features of extended-liability banking, noted above, call into question the desirability of mandatory single liability for banking, and perhaps for financial intermediaries more generally. Extended liability has its own potential drawbacks, however. The same incentive-alignment mechanisms that reduce moral hazard under extended liability might, on other margins, incentivize socially costly behavior. Extended liability might conflict in important ways with preferable contractual arrangements.

For instance, a long-standing concern is that extended liability for bank shares would mean significantly higher transaction costs and therefore *reduced liquidity* for such shares, by comparison with single-liability shares. With joint and several liability, any given shareholder’s expected cost of being called upon to repay depositors and other debt-holders in the event of the bank’s insolvency depends on the wealth of other shareholders: The smaller the amount that other shareholders can chip in before going personally bankrupt, the greater the amount that wealthier shareholders will have to pay. For a shareholder to appraise the expected cost accurately requires costly monitoring of the loss-absorbing capacity of other shareholders.²³

The hypothesis of significantly higher transaction costs implies less trading and lower prices (an illiquidity premium) for bank shares with extended liability, but these implications find little support in regime-change “natural experiments” that have been studied. For instance, one study examined the effects of the Ulster Banking Company’s conversion from unlimited to limited liability in 1883 after new legislation required all banks to convert.²⁴ Contrary to the expectation that conversion to limited liability would

give shares significantly greater liquidity, the study reports that “the move to limited liability does not appear to result in any apparent increase in market activity. If anything, the upward trend in market activity slows somewhat just after the conversion to limited liability.”²⁵ Other research that examined nine separate unlimited-liability banks before and after they were compelled to convert to limited liability finds similar conclusions.²⁶ The study presents evidence that extended liability substantially *reduced* share-transfer costs, and suggests “that the stock of limited banks was no more liquid than that of unlimited banks, and that stock did not become more liquid after banks limited their liability.”²⁷

A second long-standing concern is that wealthy individuals will avoid owning bank shares with unlimited liability in order to avoid the risk of being disproportionately called to repay an insolvent bank’s debts. This concern is sometimes referred to as the Bagehot hypothesis, after Walter Bagehot’s statement that “every person joining a bank shall be liable for every sixpence contained in it, to his last acre and shilling. The consequence is, that persons who join banks have very commonly but few acres and few shillings.”²⁸ Low-wealth shareholders will predominate. If wealthy investors are less eager to own bank shares (at any given rate of return), bank capital will be more costly to raise, and the banking system will be less well capitalized.

The Bagehot hypothesis has been tested using data from the U.K. in the 19th century, when shares of both limited and extended liability banks were traded. Overall, Bagehot’s hypothesis—shareholders without sufficient wealth to repay a bank’s residual debts in the event of insolvency would predominate, so that de jure extended liability would amount de facto to single liability—is not borne out by the balance of historical experience. Put differently, the effects of extended liability were not (in the U.K. experience) commonly undone by trading of shares to impecunious holders.²⁹ In general, the detrimental effects of extended-liability regimes for banking appear to be minor,

a conclusion supported by both time-series studies of the U.K. experience and cross-sectional studies of the U.S. experience.³⁰

CONCLUSION

Single liability combined with federal deposit guarantees (FDIC and TBTF) makes shareholders indifferent to the left-hand tail of the probability distribution over asset losses. Once net worth reaches zero, single-liability shareholders are wiped out, and it does not matter to them how much farther below zero net worth goes. This creates the moral hazard of incentivizing high-risk “gamble for resurrection” strategies by “zombie” (and near-zombie) institutions. Put differently, the shareholders no longer bear the full downside of the risks that the bank takes, and the vast majority of creditors (depositors) are guaranteed by the government. In a TBTF bank even the legally *uninsured* creditors are covered, so the downside risk is externalized to taxpayers. As a result, the shareholders and the managements of banks under single liability, when backed by government insurance, have too little incentive to act prudently (from the point of view of taxpayers), especially as net worth approaches zero. Extended liability mitigates the problem (unlimited liability nearly eliminates it) by giving shareholders something to lose from a gambling strategy even when the bank’s visible net worth is zero.

The incentive-aligning effects of extended liability have the potential to reduce moral hazard and thereby the inefficiency of excessively risky bank portfolios and the frequency of (and damage done by) large bank failures. Short of eradicating moral hazard by removing all guarantees and restrictions from the banking system, the more limited change of imposing extended liability on shareholders in banks with guaranteed deposits could be a move in the right direction.³¹

Extended liability is an *institutional* approach to financial stability rather than government-implemented regulatory policies aimed at preventing financial instability from instigating crises. By changing the underlying

rules governing bank structure, the desired result—preventing crises—is achieved by aligning information and incentives that banks confront, which are a product of underlying institutions, with those that are conducive to social welfare. Financial instability is not something that “just happens,” as is assumed by much of the macroprudential literature. Instead, financial instability is a result

of a particular framework of rules that incentivizes banks to behave irresponsibly. Rather than taking on the significant information and incentive burdens associated with government regulatory solutions to financial instability, extended liability incentivizes banks to discover and undertake voluntarily the sort of practices that promote bank and system stability.

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This chapter is a summary of the three authors’ paper “Extended Shareholder Liability as a Means to Constrain Moral Hazard in Insured Banks,” *Quarterly Review of Economics and Finance* (forthcoming).

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11. Etsy, “The Impact of Contingent Liability on Commercial Bank Risk Taking,” and Grossman, “Double Liability and Bank Risk Taking.”
12. Vincens, “On the Demise of Double Liability of Bank Shareholders,” p. 276.
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16. Kris James Mitchener and Gary Richardson, “Does ‘Skin in the Game’ Reduce Risk Taking? Leverage, Liability and the Long-Run Consequences of New Deal Banking Reforms,” *Explorations in Economic History*, Vol. 50, No. 4 (2013), p. 508.
17. Etsy, “The Impact of Contingent Liability on Commercial Bank Risk Taking,” and Macey and Miller, “Double Liability of Bank Shareholders: A Look at the New Data.”

18. For instance, Esty, “The Impact of Contingent Liability on Commercial Bank Risk Taking,” p. 34, finds that between 1865 and 1933, “voluntary liquidations accounted for 70% of the 8302 national-bank liquidations,” and between 1865 and 1912, they accounted for over 80 percent of the liquidations in the U.S.
19. There is also some evidence to suggest that regulators are aware of this phenomena. After widespread bank failures in Texas in the 1980s, regulators became increasingly concerned with the relationship between banks and bank holding companies (BHC), a corporate structure that allowed BHC shareholders to reap the upside of bank investments while the FDIC carried the downside. The moral hazard threatened the FDIC, and in turn the other banks, through higher FDIC premiums. Regulators responded with provisions in the Financial Institutions Reforms, Recovery and Enforcement Act (FIRREA) of 1989 that require a BHC to use the net worth of its solvent banks to reimburse the FDIC for expenses it incurs resolving an insolvent sibling bank. See William R. Keeton, “Bank Holding Companies, Cross-Bank Guarantees, and Source of Strength,” *Economic Review*, Vol. 75, No. 3 (1990). Knopf and Teall find evidence to support the hypothesis that FIRREA led to a decrease in the risk profile of bank assets: John D. Knopf and John L. Teall, “Risk-Taking Behavior in the US Thrift Industry: Ownership Structure and Regulatory Changes,” *Journal of Banking & Finance*, Vol. 20, No. 8 (1996), pp. 1329–1350.
20. Macey and Miller, “Double Liability of Bank Shareholders: A Look at the New Data,” p. 34. These are losses as a percent of deposits in all commercial banks.
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26. Graeme G. Acheson, Charles R. Hickson, and John D. Turner, “Does Limited Liability Matter? Evidence from 19th-Century British Banking,” *Review of Law and Economics*, Vol. 6, No. 2 (2010), pp. 247–273.
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29. For instance, Hickson and Turner observe that “very few shares were sold to individuals from the lower middle classes or below” (*ibid.*, p. 947), and that “transfers to impecunious individuals were particularly prevented in times of increased bank distress” (*ibid.*, p. 956). Additionally, Acheson and Turner argue that, contrary to the narrative that prevailed at the time, there is no link between the City of Glasgow bank failure in 1878 and the Bagehot Hypothesis. See Graeme G. Acheson and John D. Turner, “The Death Blow to Unlimited Liability in Victorian Britain: The City of Glasgow Failure,” *Explorations in Economic History*, Vol. 45, No. 3 (2008), pp. 235–253. On the “screening” of share transfers, see Timothy L. Alborn, *Conceiving Companies: Joint-Stock Politics in Victorian England* (London: Routledge, 1998). Also see Hickson and Turner on the 1825 Banking Copartnership Regulation Act, a law that worked against the Bagehot hypothesis by making sellers of bank shares retain liability for the bank’s debts if the buyer had insufficient wealth to answer a call. Charles R. Hickson and John D. Turner, “Free Banking and the Stability of Early Joint-Stock Banking,” *Cambridge Journal of Economics*, Vol. 28, No. 6 (2004), pp. 903–919.
30. Esty, “The Impact of Contingent Liability on Commercial Bank Risk Taking,” and Grossman, “Double Liability and Bank Risk Taking.”
31. Retaining deposit insurance while introducing extended liability primarily improves financial outcomes by operating on bank shareholders’ incentives. With this adjustment at the margin, depositors are still protected—thus assuaging the distributional concerns associated with financial instability—while incentivizing banks to behave in a manner more conducive to the health of the financial system as a whole. Of course, there is no need to couple deposit insurance with extended liability in the abstract;

in fact, removing deposit insurance, at the margin, would incentivize depositors to monitor banks more closely. Nonetheless we contend, purely focusing on banks' current asymmetric incentives for risk, that the introduction of extended liability would still be an improvement.

PART VI

Enabling Next Generation Finance

CHAPTER 21: Improving Entrepreneurs' Access to Capital: Vital for Economic Growth

David R. Burton

Capital formation improves economic growth, boosts productivity, and increases real wages.¹ So does entrepreneurship.² It also fosters discovery and innovation.³ Entrepreneurs engage in the creative destruction of existing technologies, economic institutions, and business production or management techniques by replacing them with new and better ones.⁴ Entrepreneurs bear a high degree of uncertainty and are the source of much of the dynamism in the U.S. economy.⁵ New, start-up businesses account for most of the net job creation.⁶ Entrepreneurs innovate, providing consumers with new or better products. By providing other businesses with innovative, lower-cost production methods, entrepreneurship is one of the key factors in productivity improvement and real income growth.⁷ Entrepreneurs are central to the dynamism, creativity, and flexibility that enable market economies to grow, adapt successfully to changing circumstances, and create sustained prosperity.⁸

SECURITIES LAWS: MAJOR IMPEDIMENT TO ENTREPRENEURIAL CAPITAL FORMATION

The evidence indicates that entrepreneurship in the U.S. is in decline.⁹ While there are many causes of that decline,¹⁰ securities laws and regulations are major barriers to entrepreneurial success because they impede entrepreneurs' access to capital. Businesses that cannot raise capital cannot launch or grow.

Current securities laws and regulations:

- **Harm investors** by reducing the return on their investment and by limiting their investment choices;
- **Harm entrepreneurs** by impeding their ability to raise the capital needed to launch and to grow their enterprises;
- **Harm consumers** by reducing competition from new entrants to the marketplace, by preventing entrepreneurs from developing and bringing to market new and better products and services, and by preventing entrepreneurs from developing and bringing to market new and better production processes that will reduce costs;
- **Harm workers** by harming the firms that account for most of the net job creation and much of the dynamism in the economy; and
- **Harm taxpayers**, as the securities laws and regulations have a macro-economically

significant adverse impact on economic growth and reduce the tax base, forcing tax rates to be higher than they would otherwise be.

At least five groups notably benefit from current securities laws and regulations. These groups usually support the current complex, expensive, and economically destructive system or support only minor incremental reforms:

- **Regulators** support complexity because it augments their budgets, salaries, and power and improves their employment opportunities upon leaving government;
- **Incumbent firms** benefit from reduced competition and, unlike entrepreneurial new entrants to the marketplace, they usually have the resources and expertise to comply with needlessly complex laws and regulations;
- **Large broker-dealers and other regulated financial professionals** benefit from reduced competition, from the barrier to entry caused by needlessly complex and expensive laws and regulations, and from legal provisions that de facto or de jure force issuers or investors to use broker-dealers;
- **The securities bar** has a strong interest in complexity because it generates large legal fees; and
- **The accounting profession** benefits from fees generated by securities laws that require internal control reporting and audits, and from needlessly complex financial accounting and laws that require the generation and reporting of information that is, at best, peripherally related to the needs of investors.

Securities regulation reform is needed to remove these obstacles to economic growth and prosperity.

How Entrepreneurs Raise Capital. Sometimes, an entrepreneur has sufficient capital to launch and grow his or her business

from personal savings, including profits from previous entrepreneurial ventures and retained earnings.¹¹ Banks usually will not make unsecured loans to risky, start-up, or young firms. Thus, an entrepreneurial firm will often need capital from outside investors.¹² Other than friends or family, outside investors are typically described as “angel investors” or “venture capitalists.”¹³ Typically, angel investors are individuals who invest at the early “seed stage,” while “venture capitalists” are firms or funds that make investments later in the firms’ life cycle after “proof of concept.” Firms seeking outside investors are often the most dynamic, high-growth companies.¹⁴ The process of raising capital from investors is heavily regulated at both the state and federal level. State laws governing securities are known as blue sky laws.¹⁵

WHICH SECURITIES LAWS MATTER TO ENTREPRENEURS

The Securities Act of 1933¹⁶ makes it generally illegal to sell securities unless the offering is registered with the Securities and Exchange Commission (SEC).¹⁷ Making a registered offering (often called “going public”) is a very expensive proposition and well beyond the means of most small and start-up companies. In addition, the costs of complying with continuing disclosure and other obligations of being a registered, public company are quite high.¹⁸ The act, however, exempts various securities and transactions from this requirement. There are three long-standing exemptions and one new exemption from the requirement to register a securities offering with the SEC that, in principle, are of particular importance to entrepreneurs:

1. **The “Intrastate Exemption.”** This exemption is important if the entrepreneur raises capital in only one state.¹⁹ Some states have used this exemption to establish an intrastate crowdfunding exemption.²⁰ In the modern, mobile, interconnected U.S. economy, this exemption is of declining importance except to the smallest businesses.

2. The “Small-Issues Exemption.” This exemption was meant to provide an exemption for small firms.²¹ This exemption is implemented by Regulation A.²² Although this exemption is important in principle, it has been, in practice, of virtually no value to small firms due to overregulation (primarily by state regulators). Until 2015, it was almost never used.²³ The 2012 Jumpstart Our Business Startups (JOBS) Act may change this. On April 20, 2015, the SEC adopted final rules²⁴ effective June 19, 2015, to implement Title IV of the JOBS Act.²⁵ The SEC’s revisions to Regulation A, while a marked improvement over the previous version of Regulation A, are, nevertheless, cause for serious concern.²⁶ Given the rules that the SEC adopted, Tier 1 offerings will remain unattractive,²⁷ and Tier 2 offerings are unlikely to be as attractive as they should be.

3. The “Exemption for Private Offerings.”²⁸ The primary means of implementing this exemption is Regulation D.²⁹ The SEC adopted Regulation D in 1982 during the Reagan Administration.³⁰ Although private offerings do not necessarily have to be in compliance with Regulation D, Regulation D provides a regulatory safe harbor such that if an issuer meets the requirements of Regulation D, the issuer will be treated as having made a private offering (often called a private placement). As discussed below, Regulation D investments are generally restricted to accredited investors, who are affluent individuals or institutions. The vast majority of Americans are effectively prohibited from investing in Regulation D securities.³¹ Regulation D has become the most important means of raising capital in the United States, particularly for entrepreneurs.³² According to SEC data, in 2014, registered (public) offerings accounted for \$1.35 trillion of new capital raised, compared to \$2.1 trillion raised in private offerings. Regulation D accounted for \$1.3 trillion (62 percent) of private offerings in 2014.³³

The Three Rules of Regulation D. Rule 504³⁴ and Rule 505³⁵ were meant for use by small firms. Rule 504 allows firms to raise up to \$1 million annually.³⁶ Rule 505 allows firms to raise up to \$5 million annually.³⁷ In practice, 99 percent of capital raised using Regulation D is raised using Rule 506.³⁸ This is because Rule 506 offerings, in contrast to Rule 504 or Rule 505 offerings, are exempt from state blue sky registration and qualification requirements.³⁹ Issuers using Rule 506, therefore, do not have to bear the expense and endure the delay of dealing with as many as 52 regulators.⁴⁰ Thus, even though the federal regulatory burden is less under Rules 504 and 505 than under Rule 506, even small issuers use Rule 506 to avoid the burden of state blue sky laws. Overregulation by state regulators destroyed the usefulness of Rules 504 and 505, just as state blue sky laws effectively destroyed the usefulness of Regulation A.⁴¹

Under Rule 506, a company may raise an unlimited amount of money and sell securities to an unlimited number of “accredited investors,” and up to 35 non-accredited but sophisticated investors. Under Regulation D, an “accredited investor” is, generally, either a financial institution or a natural person who has an income of more than \$200,000 (\$300,000 joint) or a residence-exclusive net worth of \$1 million or more.⁴² Unlike under Rule 505, under Rule 506 all non-accredited investors, either alone or with a purchaser representative, must be “sophisticated.” Rule 506 does not actually use the term “sophisticated.”⁴³ “Sophisticated investor” is an almost universal shorthand for an investor who has “sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment”—the language actually used in Rule 506(b)(2)(ii). Given the ambiguity of this sophisticated investor definition and the fact that the price of failing to comply with Regulation D is that the

entire offering may be treated as unlawful, the vast majority of issuers sell only to accredited investors. SEC data show that 90 percent of offerings involve only accredited investors and even those that are not exclusively composed of accredited investors are composed overwhelmingly of accredited investors.⁴⁴

4. The “Crowdfunding Exemption” of the JOBS Act, discussed below, is the fourth exemption of importance to entrepreneurs. Companies that issue securities that are not exempt or exceed various thresholds must register with the SEC. Registered companies (also called reporting or public companies) do not all have the same obligations. Companies with a public float of less than \$75 million are deemed smaller reporting companies and have less onerous disclosure obligations and do not need to comply with the Sarbanes–Oxley Act Section 404(b) internal control reporting requirements.⁴⁵ Title I of the JOBS Act created a new concept of emerging growth companies (EGCs).⁴⁶ EGCs are excused for five years from complying with a number of onerous disclosure requirements and from Sarbanes–Oxley Act Section 404(b) internal control reporting requirements. Moreover, they may submit a confidential draft registration statement to the SEC for review.⁴⁷

Securities Act section 4(a)(1) exempts “transactions by any person other than an issuer, underwriter, or dealer” from registration. Thus, the resale of restricted securities purchased by an investor in a private placement is permitted provided that certain requirements are adhered to so that the seller is not deemed an underwriter.⁴⁸ Rule 144⁴⁹ and Rule 144A⁵⁰ provide regulatory safe harbors. So-called section 4(a)(1-1/2)⁵¹ is a body of case law (and practices and SEC guidance) that generally allows private resales, subject to restrictions, without the seller being deemed an underwriter, and therefore the seller is able to undertake such resales

without registration.⁵² A provision in the 2015 Fixing America’s Surface Transportation (FAST) Act⁵³ provides a safe harbor meant to codify this exemption subject to a number of previously non-existent conditions.⁵⁴

The Securities Exchange Act of 1934⁵⁵ established the SEC and sets forth the general rules governing securities exchanges and broker-dealers. It is often not possible as a practical matter for small public companies to be cost-effectively listed on national securities exchanges,⁵⁶ such as the New York Stock Exchange or NASDAQ.⁵⁷ Instead, they are more often traded on the over-the-counter (OTC) market. However, stocks traded off the national securities exchanges are subject to blue sky laws,⁵⁸ and secondary-market blue sky compliance is expensive and sometimes simply not possible.⁵⁹

THE JUMPSTART OUR BUSINESS STARTUPS ACT

The 2012 JOBS Act⁶⁰ was a bipartisan achievement of consequence.⁶¹ It has improved the regulatory environment for entrepreneurial capital formation. The final SEC rules implementing the JOBS Act are, however, cause for serious concern and will limit its positive impact.⁶²

The changes made by the JOBS Act fall into five categories. Those relating to:

- Smaller public “emerging growth companies” (Title I);
- General solicitation under Regulation D (Title II);
- Crowdfunding (Title III);
- An improved small-issues exemption (often called Regulation A+) (Title IV); and
- Changes to the registration threshold allowing more companies to remain private (Titles V and VI).

1. Title I: Emerging Growth Companies. Title I of the JOBS Act—sometimes called the IPO on-ramp—created a new concept

of EGCs.⁶³ Generally, a company qualifies as an EGC if it has total annual gross revenues of less than \$1 billion during its most recently completed fiscal year and, as of December 8, 2011, had not sold common equity securities under a registration statement. For five years, EGCs are excused from complying with a number of onerous disclosure requirements and from Sarbanes–Oxley Act Section 404(b) internal control reporting requirements. Moreover, they may submit a confidential draft registration statement to the SEC for review⁶⁴ and communication with institutional accredited investors or qualified institutional buyers before or after the filing of the registration statement is permitted.⁶⁵

- 2. Title II: General Solicitation and Title II Crowdfunding.** Title II eliminated the prohibition against general solicitation or general advertising for Regulation D Rule 506 offerings, provided that all purchasers of the securities are accredited investors and that the issuer takes “reasonable steps to verify” that purchasers of the securities are accredited investors, using such methods as determined by the SEC.⁶⁶ Title II also provided an exemption from broker-dealer registration for platforms that facilitate trading of Regulation D securities provided that the platforms meet certain requirements.⁶⁷ This provision is of limited value since the platforms are barred from taking any form of compensation in connection with the purchase or sale of securities via the platform.⁶⁸ Although platforms trading securities issued pursuant to Regulation D have grown rapidly since the passage of the JOBS Act, it is far from clear that this provision in the JOBS Act is the reason. Most are presumably relying on other exemptions (such as 4(a)(1-1/2) and the recently added Securities Act section 4(a)(7)).⁶⁹
- 3. Title III: Crowdfunding.** Title III establishes the framework for a new crowdfunding exemption. Issuers may offer up

to \$1 million in securities annually using this exemption. Investors may not invest in any Title III offering more than (1) the greater of \$2,000 or 5 percent of the annual income or net worth of the investor if either the annual income or the net worth of the investor is less than \$100,000,⁷⁰ or (2) 10 percent of the annual income or net worth of such investor if either the annual income or net worth of the investor is equal to or more than \$100,000.⁷¹ The total amount invested may not exceed \$100,000.⁷² The crowdfunding offering must be conducted through a broker-dealer or funding portal. Both the issuer and intermediary must comply with numerous requirements.

- 4. Title IV: Regulation A Plus.** Title IV creates what has come to be known as Regulation A+. It added a new small-issues exemption under which issuers could raise up to \$50 million in a public offering and sell unrestricted securities subject to such initial and continuing disclosure requirements as the SEC may determine.⁷³ The commission has issued a final rule that was effective June 19, 2015.⁷⁴ In that rule, the commission took the necessary and very positive step of pre-empting state blue sky registration and qualification requirements with respect to “Tier 2” Regulation A+ primary offerings.⁷⁵ It also conditionally exempted Regulation A companies from the requirements that they become a reporting company if they exceed the Securities Exchange Act section 12(g) holder-of-record threshold. Thus, Regulation A+ could become an important means of raising capital for larger small companies. However, the failure to pre-empt blue sky laws with respect to secondary sales of Regulation A+ Tier 2 securities and for all Tier 1 securities will substantially limit the usefulness of the exemption, particularly for smaller firms. Tier 1 is substantially similar to the old Regulation A and can be expected to prove as unpopular as the previous Regulation A.

5. Allowing More Firms to Remain Private or Quasi-Public. Titles V and VI increased the number of holders of record a firm can have before being required to register under section 12(g) of the Securities Exchange Act from 500 persons to 2,000 persons, or 500 non-accredited investors.⁷⁶ Title V also excluded from the count securities held by persons who received the securities pursuant to an employee compensation plan.⁷⁷

REFORM NEEDED TO REDUCE REGULATORY BURDEN ON ENTREPRENEURIAL CAPITAL FORMATION

The list of securities-law provisions that impede small and start-up firms' ability to access the capital they need to launch and grow is long. Hence, the list of proposed reforms is accordingly long. The discussion of each item below is necessarily brief.

Regulation D Reform. In order to improve entrepreneurs' access to capital, Congress should:

- **Repair Regulation D by pre-empting blue sky registration and qualification requirements for Regulation D Rule 505 offerings** (originally meant for smaller firms).⁷⁸ This can be accomplished by defining Rule 505 securities as covered securities, or by defining "qualified purchaser" to include all purchasers of Rule 505 securities, or both.
- **Establish a statutory definition of "accredited investor" that maintains the existing thresholds.**⁷⁹ Regulation D is the most important means of entrepreneurial capital formation today. Congress should prevent the SEC from reducing the number of Americans who have the opportunity to invest in private companies.⁸⁰
- **Stop the promulgation of Regulation D amendments proposed in July 2013.**⁸¹ These proposed rules would substantially increase the regulatory burden on smaller companies seeking to use Regulation D,

and have no appreciable positive impact.⁸² They would require filing three forms instead of one, and would impose a variety of other burdensome requirements.⁸³

- **Change the definition of "accredited investor" for purposes of Regulation D to include persons who have met specific statutory bright-line tests** that determine whether an investor has the "knowledge and experience in financial and business matters" to be "capable of evaluating the merits and risks of the prospective investment." In practice, sophisticated investors without high incomes or net worth are unable to invest in the companies with the most profit potential. People that fall in this category are disproportionately young. It also means that young entrepreneurs seeking to raise capital from their non-wealthy peers find it more difficult to raise capital. For example, Congress could provide that someone is an accredited investor for purposes of Regulation D who has (1) passed a test demonstrating the requisite knowledge, such as the General Securities Representative Examination (Series 7), the Securities Analysis Examination (Series 86), or the Uniform Investment Adviser Law Examination (Series 65),⁸⁴ or a newly created accredited investor exam; (2) met relevant educational requirements, such as an advanced degree in finance, accounting, business, or entrepreneurship; or (3) acquired relevant professional certification, accreditation, or licensure, such as being a certified public accountant, chartered financial analyst, certified financial planner, or registered investment advisor.⁸⁵
- **Specify that the receipt by an issuer of a self-certification of accredited investor status constitutes taking "reasonable steps to verify that purchasers of the securities are accredited investors"** for purposes of the JOBS Act. Most people would probably be surprised to know that until September 23, 2013, it was illegal for an inventor or entrepreneur to place an advertisement in the newspaper

or online seeking rich investors to back their idea. Title II of the JOBS Act changed that by permitting “general solicitation” in Rule 506 offerings, provided that issuers “take reasonable steps to verify that purchasers of securities sold” in the offering are all accredited investors.⁸⁶ This is one of the most important reforms made by the legislation. Small businesses can seek affluent investors using the Internet or otherwise without having a pre-existing relationship or going through broker-dealers. The SEC promulgated rules implementing these provisions, albeit more than a year after the legal deadline.⁸⁷ This provision (called Rule 506(c) after the relevant section in the regulation) is giving rise to new opportunities to raise capital. Some are now using the Internet or traditional media to seek accredited investors.

The rules implementing Title II of the JOBS Act, however, are too onerous.⁸⁸ They impose costs on issuers and investors, and raise privacy concerns that make investors reluctant to invest in Rule 506(c) offerings. The traditional and almost universal current practice in Regulation D offerings not involving general solicitation is to use investor-suitability questionnaires combined with investor self-certification to establish accredited investor status. Congress did not intend to dramatically undermine the laudable policy goals of the JOBS Act by changing this current long-standing practice with respect to verifying accredited investor status.⁸⁹

The final rule creates a safe harbor that inevitably, in practice, will become the rule that “reasonable steps to verify” means obtaining tax returns or comprehensive financial data proving net worth. Many investors will be reluctant to provide such sensitive information to issuers with whom they have no relationship, as the price of making an investment and, given the potential liability, accountants, lawyers, and broker-dealers are unlikely to make certifications except perhaps for very large, lucrative clients.

Self-certification should continue to be allowed for all Rule 506 offerings, and obtaining an investor self-certification should be deemed to constitute taking “reasonable steps to verify that purchasers of the securities are accredited investors,” as required by the JOBS Act. Should policymakers choose not to adopt this approach, it would be possible to remove many of the problems associated with the new SEC rule while still addressing unease that traditional self-certification is inadequate by requiring investors to make their self-certifications under penalty of perjury. This would make investors less willing to lie on their certifications to issuers.

Crowdfunding Reforms. The story of the investment crowdfunding exemption is an object lesson in how a simple, constructive idea can be twisted by the Washington legislative process into a complex morass. Representative Patrick McHenry (R-NC) introduced his Entrepreneur Access to Capital Act on September 14, 2011.⁹⁰ It was a mere three pages; less than one page, if the actual legislative language were pasted into a Word document. It would have allowed issuers to raise up to \$5 million, and limited investors to making investments of the lesser of \$10,000 or 10 percent of their annual income.⁹¹ The exemption would have been self-effectuating, requiring no action by the SEC in order to be legally operative. The bill that was reported out of Committee and ultimately passed by the House was 14 pages long.⁹² By the time the Senate was done with it, it had grown to 26 pages.⁹³ Many of the additions were authorizations for the SEC to promulgate rules or requirements that it do so. The bill was incorporated into the JOBS Act as Title III of the act. The PDF of the October 23, 2013, proposed crowdfunding rule is 585 pages (although double spaced) and sought public comments on well over 300 issues raised by the proposed rule.⁹⁴ The PDF of the final rule was 685 pages long.⁹⁵ This is far from the simple, straight-forward means of raising capital for small businesses laid out in Representative McHenry’s original bill.⁹⁶

University of Florida law professor Stuart Cohn put it this way:

Is there any regulatory burden left unchecked by this supposedly favorable-to-small-business legislation? If so, Congress put icing on the cake by authorizing the SEC to make such other requirements as the Commission prescribes for the protection of investors.... Opportunity knocked, but what began as a relatively straightforward approach to assist small business capital-formation ended with a regulatory scheme laden with limitations, restrictions, obligations, transaction costs and innumerable liability concerns.⁹⁷

The primary advantages of crowdfunding are that it enables small firms to access small investments from the broader public (that is, from non-accredited investors), and that resale of the stock will not be restricted after one year.⁹⁸ In addition, crowdfunding shareholders are excluded from the count for purposes of the section 12(g) limitation relating to when a company must become a reporting company⁹⁹ and crowdfunding securities are treated as covered securities (that is, blue sky registration and qualification laws are pre-empted for crowdfunding offerings).¹⁰⁰ If, however, the regulatory costs associated with crowdfunding are too high, issuers will either use other means to raise capital or be unable to raise capital at all. Moreover, ordinary investors will be denied the opportunity to make these investments. This is no idle possibility. The history of the small-issues exemption (Regulation A), and Regulation D Rule 504 and Rule 505, demonstrates that overregulation can destroy the usefulness of an exemption.¹⁰¹

Given the structure of the underlying statute and the proposed rule, there is strong reason to doubt whether Title III crowdfunding will achieve the promise of the original idea.¹⁰² Following are core solutions to some of the Title III problems that Congress should undertake:

- **Increase the amount that can be raised using Title III to \$5 million.** In order for

crowdfunding to be an attractive option for all but the very smallest start-ups, the amount that can be raised using Title III should be increased.¹⁰³

- **Make it clear that funding portals are not liable for the misstatements of issuers.** The SEC final rule treats funding portals as issuers, turning the funding portals into insurers of issuers against fraud by issuers that use their funding portal. This dramatically increases the risk that funding portals face and makes funding portals a much less viable alternative to a broker-dealer. Funding portals are intermediaries not issuers. Funding portals should only be liable for fraud or misrepresentation if they participated in the fraud or were negligent in discharging their due diligence obligations.¹⁰⁴
- **Repeal the requirement that crowdfunding issuers raising \$500,000 or more provide audited financial statements.**¹⁰⁵ Except for start-up firms with no operating history, audits are expensive. There are many other exemptions, usually used by much larger firms, which do not have this requirement.
- **Repeal restrictions on curation by funding portals.**¹⁰⁶ Funding portals are prohibited from offering “investment advice or recommendations.”¹⁰⁷ Moreover, funding portals are required to “take such measures to reduce the risk of fraud with respect to such transactions, as established by the Commission, by rule.”¹⁰⁸ How, exactly, the portals are to reduce the risk of fraud and limit their own liability without adopting a position on the merit or lack thereof of any potential offerings is a congressionally created mystery that the SEC attempts to solve in its final rule.¹⁰⁹ Assuming that policymakers want to retain the prohibition on personalized “investment advice,” a potential solution to the existing statutory cross purposes would be to allow funding portals to provide “impersonal investment advice” as defined in Advisers Act Rule 203A,¹¹⁰ to wit, “investment

advisory services provided by means of written material or oral statements that do not purport to meet the objectives or needs of specific individuals or accounts.” Applying the distinction between “impersonal” and “personalized” investment advice in the funding portal context would permit responsible curation where a funding portal chose to exclude certain offerings from its platform but did not suggest specific investments. Congress should either repeal the restriction on providing investment advice entirely or explicitly permit “impersonal investment advice.” It should also be clear that a portal may bar an issuer from its platform if the portal deems an offering to be of inadequate quality without fear of liability to issuers or investors, and that this would not constitute providing prohibited investment advice.

- **Substantially reduce the complex initial and ongoing mandatory disclosure requirements on crowdfunding issuers.** The disclosure requirements in the final rule are voluminous. There are 25 specific disclosure requirements—(a) through (y)—most of which have multipart requirements.¹¹¹ The statute is less demanding with 12 specific requirements.¹¹² Companies that raise money via crowdfunding have significant ongoing-disclosure requirements as well. In furtherance of the one-sentence statutory continuing reporting requirement,¹¹³ the final rule requires continuing reporting with respect to 12 multipart matters.¹¹⁴ The bottom line is that these requirements are nearly as burdensome as those found in Regulation A and constitute a large fraction of the burden imposed on smaller reporting companies. Crowdfunding companies are the smallest issuers, and it is inappropriate to impose this level of burden on the smallest companies. A better-scaled disclosure regime is needed.
- **Clarify that funding portals are not subject to the anti-money laundering, “Know Your Customer” and**

associated Bank Secrecy Act requirements.¹¹⁵ Funding portals do not handle customer funds; the JOBS Act prohibits them from doing so.¹¹⁶ The banks and broker-dealers that do handle customer funds must comply with these rules. Requiring funding portals to also do so is duplicative and unnecessary. The Treasury’s Financial Crimes Enforcement Network (FinCEN) has proposed rules that would require funding portals to comply with these rules.¹¹⁷ The Financial Industry Regulatory Authority (FINRA) and the SEC both originally proposed requiring funding portals to comply with the anti-money-laundering rules but did not include the requirement in their final rules.¹¹⁸

Overall, Congress may want to simply start over using Representative McHenry’s original bill as the template.

Reform Regulation A. Congress should take a number of steps to make the small-issue exemption a better means for small firms to raise capital:

- **Pre-empt state blue sky registration and qualification requirements for all primary Regulation A offerings** (as it has done for Rule 506 and crowdfunding offerings).¹¹⁹ State anti-fraud laws should remain fully operative.
- **Codify the exemption from the section 12(g) holder-of-record limitations for Regulation A securities** (as was necessarily done for crowdfunding).
- **Specify a limited scaled disclosure regime for Regulation A offerings.**¹²⁰ In particular, Tier 1 Regulation A offerings must have reasonable requirements for offering statements and periodic disclosure. These provisions should be self-effectuating without having to wait for the promulgation of SEC regulations. The current Tier 2 requirements, which are the “price” of blue sky exemption for primary offerings, are similar to the burden imposed on smaller reporting companies and not

feasible for most companies raising only a few million dollars.

- **Make clear that investor limitations restricting the amount that investors may invest in Regulation A offerings (added by the SEC in its proposed and final rule) to no more than 10 percent of income or net worth are not permitted.** This rule, while not objectively unreasonable for most people, is unreasonable for certain entrepreneurs and, more important, it establishes the precedent of the SEC regulating the content of investor-portfolio composition.
- **Pre-empt blue sky laws with respect to secondary sales of Regulation A securities (along with securities of reporting companies trading on OTC markets).** This will make these securities more liquid and attractive, helping investors to achieve a higher price at a lower cost and helping issuers raise capital, since these securities will be more attractive to investors.¹²¹

Statutory Private Placement Micro Issues Safe Harbor. Section 4(a)(2) of the Securities Act exempts “transactions by an issuer not involving any public offering.” There is no definition of a public offering or, conversely, of what is not a public offering (that is, a private placement) in the Securities Act or, for that matter, in the securities regulations. Thus, in principle, a few guys forming a small little business (such as a local restaurant) who are a little too public in seeking investors (for example, telling a local reporter about their plans when they run into him at the local high school football game, or standing up at the local Rotary Club meeting seeking partners) can run afoul of the securities laws.¹²²

Nevertheless, in this hyper-litigious country, and given the potentially catastrophic impact that unjust enforcement of the law would entail, it is appropriate to create a bright-line safe harbor for very small offerings. If you are raising a small amount of money from a few people most of whom you know already, you should not have to hire a securities lawyer, do

a private placement offering memorandum, and file a Form D or otherwise risk being pursued by federal or state regulators, or more likely, being successfully sued by disgruntled investors if the business fails or does not have the hoped for returns.

Congress should amend the Securities Act to create a safe harbor so that any offering (within a 12-month period),

1. to people with whom the issuer (or its officers, directors, or 10 percent or more shareholders) has a substantial pre-existing relationship;
2. involving 35 or fewer other persons; or
3. of less than \$500,000,

is deemed not to involve a public offering for purposes of section 4(a)(2).¹²³ The anti-fraud provisions of federal and state laws would remain fully applicable.

FINDERS, BUSINESS BROKERS, AND SMALL BROKER-DEALERS

A finder is a person who is paid to assist small businesses to find capital by making introductions to investors, either as an ancillary activity to some other business (such as the practice of law, public accounting, or insurance brokerage), as a Main Street business colleague, or as an acquaintance or friend or family member of the business owner.¹²⁴ Finders are sometimes called private placement brokers.¹²⁵ They are typically paid a small percentage of the amount of capital they helped the business owner to raise. Business brokers (also called M&A brokers)¹²⁶ help entrepreneurs to sell or acquire businesses for a fee. They are typically paid a percentage of the sales price of the businesses. Neither finders nor business brokers should be treated the same for regulatory purposes as a Wall Street investment bank.¹²⁷

Congress should create a statutory exemption needed for small-business finders who are not “engaged in the business” of “effecting transactions in securities for the account of others”¹²⁸ or of “buying and selling securities.”¹²⁹ As an integral component of that

exemption, it is necessary to create a bright-line “small finder” safe harbor such that small finders are deemed not to be engaged in the business of being a securities broker or dealer. Such a bright-line safe harbor would eliminate much of the regulatory uncertainty associated with the use of finders.

Specifically, an exemption should be created for finders from the Section 15 registration requirement providing a safe harbor such that a finder is deemed not to be engaged in the business of effecting transactions in securities for the account of others if the finder meets one or more of the following criteria:

1. The finder does not receive finder’s fees exceeding \$300,000 in any year,
2. The finder does not assist an issuer in raising more than \$10 million in any year,
3. The finder does not assist any combination of issuers in raising more than \$20 million in any year, or
4. The finder does not assist any combination of issuers with respect to more than 15 transactions in any year.

For those “larger” finders (those who do not meet the above criteria), which really are holding themselves out as in the business of being a “private placement broker,” something more akin to the American Bar Association proposal to have finder registration and limited regulation of private placement brokers may make sense.¹³⁰ Some states have pursued this approach, but so long as the SEC holds to its current position, these licensing regimes will be of limited utility (except in the case of intrastate offerings).¹³¹

It would be reasonable to prohibit finders from engaging in certain activities to be eligible for this exemption on the grounds that such activities would constitute crossing the line to effecting transactions in securities or providing investment advice (thus triggered investment advisory registration requirements). Among those activities that would be proscribed would be:

1. Holding investor funds or securities,
2. Recommending the purchase of specific securities,¹³² and
3. Participating materially in negotiations between the issuer and investors.

Small Broker-Dealers. Congress should amend the law to pre-empt state regulation of broker-dealers except with respect to sales practices and fraud. Small broker-dealers are an important part of the small-firm capital-formation process, particularly for those firms seeking to move beyond the friends-and-family stage of raising capital. Requiring small broker-dealers to comply with 51 state securities laws¹³³ governing broker-dealers raises their costs and is a barrier to entry that reduces competition. It places large broker-dealers at a competitive advantage. All broker-dealers are already regulated by the SEC and FINRA.

OTHER REFORMS

S Corporations. In 2012, 4.2 million S corporations with 9.2 million shareholders filed tax returns.¹³⁴ Almost all of these businesses are small businesses. S corporations are subject to three restrictions. They may not have (1) more than one class of stock; (2) non-resident alien shareholders; or (3) more than 100 shareholders.¹³⁵ The third restriction limiting the total number of shareholders to no more than 100 is extremely problematic for S corporations that hope to take advantage of either Regulation A+ or crowdfunding. Both of these exemptions contemplate issuers raising relatively small amounts of capital from a large number of investors. An S corporation will be unable, as a practical matter, to make use of these exemptions to raise capital without endangering its pass-through tax status.¹³⁶

Congress should amend the Internal Revenue Code so that Title III crowdfunding and Regulation A investors are disregarded for purposes of determining whether an S corporation has more than 100 shareholders.¹³⁷

Secondary-Markets Reform. When an equity or debt interest in a company is issued

or sold by that company, it is called a primary securities offering. A secondary securities offering is when an investor who owns a security sells it to another investor, and a secondary securities market is a market where investors trade securities among themselves. Stock exchanges are the leading example of secondary markets. However, a secondary market exists in securities not listed on stock exchanges.

Robust secondary markets are important because their existence facilitates primary securities offerings, because they enhance investor returns, and because they foster a more efficient allocation of scarce capital. The secondary market for large public companies is robust; the secondary market for smaller firms is much less so. The primary reason for this is the U.S. regulatory regime, particularly blue sky laws.

U.S. law should allow the development of venture exchanges¹³⁸ similar to the Canadian TSX Venture Exchange¹³⁹ and the United Kingdom's Alternative Investment Market,¹⁴⁰ so that a robust secondary market for the securities of smaller companies can develop. The most important step that can improve U.S. secondary markets is to reduce the burdens imposed by blue sky laws. In some cases, it is simply impossible to achieve blue sky compliance.¹⁴¹ This means that companies not traded on a national securities exchange,¹⁴² and therefore not having their securities treated as covered securities exempt from blue sky compliance, have serious regulatory difficulties in secondary markets. In order to improve small-firm secondary markets, Congress should:

- **Amend section 18(b) of the Securities Act to treat all securities as covered securities that (1) are traded on established securities markets and (2) have continuing reporting obligations** as (a) a registered company; (b) pursuant to Regulation A; or (c) pursuant to regulation crowdfunding. An established securities market should be defined to include those on electronic markets such as an SEC-designated alternative trading system

(ATS).¹⁴³ This would probably be sufficient to allow venture exchanges to develop in the United States without having to adopt an alternative, separate regulatory framework for venture exchanges.

- **Establish an alternative regulatory regime for venture exchanges** that would treat venture exchanges as national securities exchanges for purposes of blue sky preemption, but more like ATSS for regulatory purposes.¹⁴⁴ The Main Street Growth Act¹⁴⁵ would create venture exchanges along these lines.

Reducing Regulatory Burdens on Small Public Companies. Requiring public companies to disclose information that is material to investment decisions has positive economic effects and protects investors.¹⁴⁶ Excessive disclosure mandates, however, have two adverse effects. First, the costs imposed impede capital formation and have a disproportionate negative impact on small and start-up companies. This, in turn, harms economic growth and job creation. Second, once disclosure documents reach a certain length, they obfuscate rather than inform.¹⁴⁷

The SEC has estimated that “the average cost of achieving initial regulatory compliance for an initial public offering is \$2.5 million, followed by an ongoing compliance cost, once public, of \$1.5 million per year.”¹⁴⁸ This is probably an underestimate. Costs of this magnitude make going public uneconomic for most smaller firms. Public company compliance costs have grown sufficiently high that many smaller firms are “going private.”¹⁴⁹ Sarbanes–Oxley (2002),¹⁵⁰ Dodd–Frank (2010),¹⁵¹ and other legislation and regulatory actions have contributed to these costs. Moreover, U.S. initial public offering (IPO) costs are considerably higher than those abroad.¹⁵² Although the number of IPOs and amounts raised have recovered somewhat recently due to the strong stock market and the IPO On-Ramp provisions of the JOBS Act,¹⁵³ the number of U.S. IPOs remains considerably lower than in the 1980s and 1990s, and the amount raised is

Overview of Bank Lending

IN TRILLIONS OF DOLLARS



IN TRILLIONS OF DOLLARS



NOTE: Total Bank Assets include total assets at all FDIC-insured savings institutions and all FDIC-insured commercial banks. Small Business Loans include all commercial and industrial loans plus Nonfarm Nonresidential loans less than \$1 million; Large Business Loans include all C&I plus Nonfarm Nonresidential loans greater than \$1 million.

SOURCE: Federal Deposit Insurance Corporation, "Bank Data & Statistics," <https://www.fdic.gov/bank/statistical/> (accessed December 20, 2016).

 heritage.org

lower than in the 1990s—despite the fact that the economy is six times larger than 1980 and two and a quarter times larger than 1995.¹⁵⁴

For small and medium-sized firms seeking to raise capital, these costs make access to the public capital markets prohibitively expensive. Obviously, \$2.5 million imposes a hefty 10 percent deadweight cost even on a \$25 million offering. But the continuing costs—\$1.5 million annually on average according to the SEC—are more problematic. A company with shareholders' equity of \$10 million with a healthy return on equity of 20 percent will earn \$2 million. Net of public company regulatory costs, however, that company will earn only \$500,000 and have a return on equity that is an anemic 5 percent. In effect, there is a \$1.5 million annual toll charge for being a public company. This makes going public out

of the question until companies reach a sufficient size that compliance costs can be borne without having a dramatic negative impact on their earnings. Reducing this toll charge would make the public market available for more companies and enable them to grow more rapidly. Another way of looking at this is to capitalize the \$1.5 million annual cost. Using a discount rate of 10 percent, this additional \$1.5 million cost is the equivalent of erasing \$15 million from shareholders' equity.¹⁵⁵ This kind of shareholders' equity erasure cannot be justified by the higher price-earnings ratio that a public company commands until expected risk-adjusted earnings are quite high.

In short, ever-increasing regulatory barriers have cut small and medium-sized companies off from the public capital markets. This needs to change.

Currently, smaller reporting companies (generally those with a public float of less than \$75 million)¹⁵⁶ and emerging growth companies¹⁵⁷ have lower regulatory burdens than larger and older reporting companies. In order to improve capital access for smaller reporting companies, Congress should:

- **Increase the smaller-reporting-company threshold to \$300 million, and conform the accelerated filer definition.**¹⁵⁸ This would, among other things, eliminate the internal control reporting and assessment requirements of Sarbanes–Oxley section 404(b) for companies with market capitalizations of \$300 million or less.¹⁵⁹
- **Make all emerging growth company advantages permanent for smaller reporting companies.**¹⁶⁰
- **Provide a statutory, coherent, and reasonable scaled disclosure regime for smaller reporting companies.** A discussion of how to do this is included in chapter 5, “Securities Disclosure Reform.”

IMPROVING ACCESS TO BORROWING

A Federal Reserve Bank of Cleveland study has found that while large business loans have increased to record levels in the recovery, small business lending has declined.¹⁶¹ A Small Business Administration study had similar findings.¹⁶²

The question is why.¹⁶³ If, as some argue, it is because regulators (especially bank examiners) have without justification deemed small-business loans to be riskier assets and therefore banks struggling to meet capital requirements have become less willing to lend to small firms, it is a phenomenon caused by regulators.¹⁶⁴ Regulators generally deny this.¹⁶⁵ Community bankers often claim this.¹⁶⁶ If the cause of the problem is regulators, a congressional response is appropriate, although it is not yet clear what the response should be.

If, as others argue, the decline in small-business lending is simply a function of small

businesses seeing their balance sheets weaken during the recession compared to larger firms, and become less credit worthy, or, alternatively, that small businesses have been demanding less credit because they have fewer business opportunities, it is a market phenomenon and a specific congressional response is unnecessary.¹⁶⁷ The solution would be for Congress to enact general pro-growth policies to improve overall economic performance.¹⁶⁸ The decline of community banks relative to large money center banks caused by the marked increase in bank regulation is another possible factor.¹⁶⁹ The facts matter. However, the facts of the matter remain very unclear. Of course, it may well be that there are multiple reasons for the decline.

Congress should instruct the Government Accountability Office to investigate the cause of the decline in small-business lending. Congress should repeal the arbitrary limit on credit union small-business lending. Section 107A of the Federal Credit Union Act¹⁷⁰ imposes a limit on credit union business lending (which is almost exclusively small-business lending). The limit is equal to 1.75 times the Section 216 net worth requirement of 7 percent. Thus, no more than 12.25 percent of loans can go to small businesses. As there is no reason to believe that small-business loans involve any more risk than consumer loans, this is an unwarranted restriction from a safety and soundness perspective. It is an artificial impediment to small-business lending by credit unions.¹⁷¹

Peer-to-peer (P2P) lending represents a way of making financial intermediation for consumer and small-business loans much more efficient to the benefit of consumers, small-business owners, and small lenders.¹⁷² There is a very strong need to cut down the regulatory weeds and allow the potential efficiencies of Internet lending and borrowing to take place.

The key substantive, non-legal point here is that a loan is a loan, not a security.¹⁷³ Whether that loan is from a bank, a credit union, a non-bank lender, or an individual via a P2P lending portal should not matter. Under the

current regulatory regime and SEC practice, loans to small businesses by banks, credit unions, finance companies, or individuals not using a P2P lending platform are almost always treated as exempt from registration requirements. Loans via P2P lending platforms are not. This fundamentally irrational disparity in treatment creates a major regulatory impediment to both consumer and small-business lending using P2P lending platforms, harming both small-business and consumer borrowers, as well as investors seeking a better return. It also protects banks from competition from non-bank financial intermediation and protects the two incumbent consumer P2P lending platforms from competition from new entrants.¹⁷⁴

There are three means of eliminating, or reducing, the regulatory impediments to P2P lending generally, and P2P small-business lending, in particular.

1. Congress should exempt P2P lending from the federal and state securities laws.

The House-passed version of the Dodd–Frank legislation adopted a version of this approach.¹⁷⁵ It exempted “[a]ny consumer loan, and any note representing a whole or fractional interest in any such loan, funded or sold through a person-to-person lending platform,” and defined a consumer loan as a “loan made to a natural person, the proceeds of which are intended primarily for personal, family, educational, household, or business use.”¹⁷⁶ Such an exemption should also include loans to small businesses. This approach is the preferred approach. To the extent that Congress wishes to have a regulator overseeing this market, it could assign that task to one of the bank regulators,¹⁷⁷ whose primary role would be anti-fraud enforcement.

2. Congress should amend Title III of the JOBS Act to create a category of crowdfunding security called a “crowdfunding debt security” or “peer to peer debt security”¹⁷⁸ whereby the issuer offering securities pursuant

to Securities Act section 4(a)(6)—the crowdfunding exemption—would be exempt from much of the continuing disclosure requirements. Continuing disclosure requirements may be appropriate with respect to an equity investment, but are entirely inappropriate for debt securities.¹⁷⁹ Valuing equity securities requires making a judgment about expected future returns. Ergo, significant disclosure is appropriate. Moreover, some form of equity security will exist so long as the company exists. In the case of a loan, disclosure related to future earnings prospects is much less appropriate. The question is simply whether the loan is being repaid and, of course, once it is repaid, there is no need for continued disclosure. The exemption should include single-purpose entities whose sole purpose is to allow investors to invest in an entity that holds the debt securities of a single issuer. This approach, which should be adopted in addition to the first approach, might give some vitality to lending via Title III crowdfunding platforms. The statutory peer-to-peer debt security exemption should be self-effectuating and not rely on the SEC to issue rules to become effective.

3. Congress could adopt an alternative regulatory regime for P2P lending.

Such an approach has already been proposed.¹⁸⁰ It would require some regulatory agency (usually the Consumer Financial Protection Bureau is suggested) to promulgate rules, create a division to regulate P2P lending, and, undoubtedly, bureaucratize the entire field. This is the least attractive approach.

CONCLUSION

Capital Formation and entrepreneurship improve economic growth, productivity, and real wages. Existing securities laws impede entrepreneurial capital formation. To promote prosperity, Congress and the SEC need to systematically reduce or eliminate state

and federal regulatory barriers hindering entrepreneurs' access to capital. The regulatory environment needs to be improved for primary and secondary offerings by private and small public companies. This chapter outlines a series of specific steps that should be taken to improve entrepreneurial capital formation.

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ENDNOTES

1. See, for instance, Robert M. Solow, *Growth Theory: An Exposition*, 2nd ed. (Oxford: Oxford University Press, 2000). Legal institutions, human capital, and other factors are also important determinants of economic growth: N. Gregory Mankiw, David Romer, and David N. Weil, "A Contribution to the Empirics of Economic Growth," *The Quarterly Journal of Economics*, Vol. 107, No. 2 (May 1992), pp. 407–437, and Robert J. Barro, *Economic Growth*, 2nd ed. (Cambridge, MA: MIT Press, 2003).
2. In terms of the neo-classical growth model, entrepreneurship is an important factor affecting the rate of technological change and the marginal productivity of capital. Entrepreneurs also play other important roles in the economy. For an introduction to the literature, see Paul Westhead and Mike Wright, *Entrepreneurship: A Very Short Introduction* (Oxford: Oxford University Press, 2013).
3. Israel M. Kirzner, *Competition and Entrepreneurship* (Chicago: University of Chicago Press, 1973); Israel M. Kirzner, "Entrepreneurial Discovery and the Competitive Market Process: An Austrian Approach," *Journal of Economic Literature*, Vol. 35, No. 1 (1997); Randall Holcombe, *Entrepreneurship and Economic Progress* (London and New York: Routledge, 2006); and William J. Baumol, *The Microtheory of Innovative Entrepreneurship* (Princeton, NJ: Princeton University Press, 2010).
4. See, for instance, Joseph A. Schumpeter, *Capitalism, Socialism & Democracy* (London and New York: Routledge, 1942), pp. 81–86, <http://digamo.free.fr/capisoc.pdf> (accessed October 6, 2016); W. Michael Cox and Richard Alm, "Creative Destruction," in *Library of Economics and Liberty: Concise Encyclopedia of Economics*, 2007, <http://www.econlib.org/library/Enc/CreativeDestruction.html> (accessed October 7, 2016); and Henry G. Manne, "The Entrepreneur in the Large Corporation," in *The Collected Works of Henry G. Manne*, Vol. 2 (Indianapolis, IN: Liberty Fund, 1996).
5. Frank H. Knight, *Risk, Uncertainty, and Profit* (Indianapolis, IN: Liberty Fund, 1921), <http://www.econlib.org/library/Knight/knRUP.html> (accessed October 7, 2016). ("The difference between free enterprise and mere production for a market represents the addition of specialization of uncertainty-bearing to the grouping of uncertainties, and takes place under pressure of the same problem, the anticipation of wants and control of production with reference to the future. Under free enterprise the solution of this problem, already removed from the consumer himself, is further taken out of the hands of the great mass of producers as well and placed in charge of a limited class of 'entrepreneurs.'")
6. Magnus Henrekson and Dan Johansson, "Gazelles as Job Creators: A Survey and Interpretation of the Evidence," *Small Business Economics*, Vol. 35 (2010), pp. 227–244, <http://link.springer.com/article/10.1007/s11187-009-9172-z> (accessed October 7, 2016); Ryan Decker et al., "The Role of Entrepreneurship in US Job Creation and Economic Dynamism," *Journal of Economic Perspectives*, Vol. 28, No. 3 (Summer 2014), pp. 3–24, <http://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.28.3.3> (accessed October 7, 2016); and Salim Furth, "Research Review: Who Creates Jobs? Start-up Firms and New Businesses," Heritage Foundation *Issue Brief* No. 3891, April 4, 2013, <http://www.heritage.org/research/reports/2013/04/who-creates-jobs-startup-firms-and-new-businesses>.
7. Ralph Landau, "Technology and Capital Formation," in Dale W. Jorgenson and Ralph Landau, eds., *Technology and Capital Formation* (Cambridge, MA: MIT Press, 1989).
8. Decker et al., "The Role of Entrepreneurship in US Job Creation and Economic Dynamism"; C. Mirjam van Praag and Peter H. Versloot, "What Is the Value of Entrepreneurship? A Review of Recent Research," *Small Business Economics*, Vol. 29, No. 4 (December 2007), pp 351–382, <http://link.springer.com/article/10.1007%2Fs11187-007-9074-x> (accessed October 7, 2016); and G. R. Steele, "Laissez-Faire and the Institutions of the Free Market," *Economic Affairs*, September 1999, <http://www.lancaster.ac.uk/staff/ecagr/Laissez%20faire.pdf> (accessed October 7, 2016).
9. For a detailed discussion of the evidence, see David R. Burton, "Building an Opportunity Economy: The State of Small Business and Entrepreneurship," testimony before the Committee on Small Business, U.S. House of Representatives, March 4, 2015, http://smbiz.house.gov/uploadedfiles/3-4-2015_final_burton_testimony_final.pdf (accessed December 9, 2016); Robert E. Litan and Ian Hathaway, "Declining Business Dynamism in the United States: A Look at States and Metros," Brookings Institution, May 5, 2014, <https://www.brookings.edu/research/declining-business-dynamism-in-the-united-states-a-look-at-states-and-metros/> (accessed October 7, 2016); Decker et al., "The Role of Entrepreneurship in US Job Creation and Economic Dynamism"; John Haltiwanger, Ian Hathaway, and Javier Miranda, "Declining Business Dynamism in the U.S. High-Technology Sector," Kauffman Foundation, February 2014, http://www.kauffman.org/-/media/kauffman_org/research%20reports%20and%20covers/2014/02/declining_business_dynamism_in_us_high_tech_sector.pdf (accessed October 7, 2016); Steve Strongin et al., "The Two-Speed Economy," Goldman Sachs Global Markets Institute, April 2015, Exhibit 6, <http://www.goldmansachs.com/our-thinking/public-policy/regulatory-reform/2-speed-economy-report.pdf> (accessed October 7, 2016); and David R. Burton, "Reducing the Burden on Small Public Companies Would Promote Innovation, Job Creation, and Economic Growth," Heritage Foundation *Backgrounder* No. 2924, June 20, 2014, <http://www.heritage.org/research/reports/2014/06/reducing-the-burden-on-small-public-companies-would-promote-innovation-job-creation-and-economic-growth>.

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11. U.S. Census Bureau, "2007 Survey of Business Owners: Statistics for All U.S. Firms by Sources of Capital Used to Start or Acquire the Business by Industry, Gender, Ethnicity, Race, and Veteran Status for the U.S.," http://factfinder2.census.gov/faces/tableservices/jsf/pages/productview.xhtml?pid=SBO_2007_00CSCB13&prodType=table (accessed October 7, 2016).
12. See, for instance, Tom Alberg et al., "2013 State of Entrepreneurship Address: 'Financing Entrepreneurial Growth,'" Ewing Marion Kauffman Foundation *Research Paper*, February 5, 2013, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2212743 (accessed October 11, 2016), and Douglas Cumming, ed., *The Oxford Handbook of Venture Capital* (Oxford: Oxford University Press, 2012).
13. Angel Capital Association, <http://www.angelcapitalassociation.org/> (accessed October 11, 2016), and National Venture Capital Association, <http://www.nvca.org/> (accessed October 11, 2016). See also Darian M. Ibrahim, "Should Angel-Backed Start-Ups Reject Venture Capital?" *Michigan Journal of Private Equity & Venture Capital Law*, Vol. 2 (Spring 2013), pp. 251–269, <http://scholarship.law.wm.edu/cgi/viewcontent.cgi?article=2734&context=facpubs> (accessed October 11, 2016); Abraham J. B. Cable, "Fending for Themselves: Why Securities Regulations Should Encourage Angel Groups," *University of Pennsylvania Journal of Business Law*, Vol. 13, No. 1 (Fall 2010), pp. 107–172, <https://www.law.upenn.edu/journals/jbl/articles/volume13/issue1/Cable13U.Pa.J.Bus.L.107%282010%29.pdf> (accessed October 14, 2016); Darian M. Ibrahim, "The (Not So) Puzzling Behavior of Angel Investors," *Vanderbilt Law Review*, Vol. 61 (2008), pp. 1405–1452, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=984899 (accessed October 14, 2016); and Brent Goldfarb et al., "Does Angel Participation Matter? An Analysis of Early Venture Financing," Angel Capital Association, April 4, 2008, <http://www.angelcapitalassociation.org/data/ACEF/ACEFDocuments/Does%20Angel%20Participation%20Matter%20-%20Analysis%20of%20Early%20Venture%20Financing.pdf> (accessed October 14, 2016).
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16. The Securities Act of 1933, Public Law 73–22, 48 Stat. 74, 15 U.S. Code §77a et seq. U.S. Securities and Exchange Commission, "Securities Act of 1933: As amended through P.L. No. 112-106, approved April 5, 2012," <https://www.sec.gov/about/laws/sa33.pdf> (accessed October 14, 2016).
17. See §5 of the Securities Act of 1933.
18. The SEC has estimated that "the average cost of achieving initial regulatory compliance for an initial public offering is \$2.5 million, followed by an ongoing compliance cost, once public, of \$1.5 million per year." Proposed Rules, "Crowdfunding," *Federal Register*, Vol. 78, No. 214 (November 5, 2013), p. 66509 (col. 2), <http://www.gpo.gov/fdsys/pkg/FR-2013-11-05/pdf/2013-25355.pdf> (accessed October 14, 2016).
19. §3(a)(11) of the Securities Act provides a statutory exemption for any "security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory." See also SEC Rule 147, 17 C.F.R. 230.147.
20. At least 12 states, plus the District of Columbia. See "Summary of ENACTED Intrastate Crowdfunding Exemptions (as of July, 2014)," http://www.crowdcheck.com/sites/default/files/Summary%20of%20Intrastate%20Crowdfunding%20Exemptions_0.pdf (accessed October 19, 2016), and District of Columbia Department of Insurance, Securities and Banking, "Equity Crowdfunding: DC-Only Securities Offerings Exemption," <http://disb.dc.gov/page/district-columbia-only-securities-offerings-exemption> (accessed October 19, 2016).
21. See §3(b) of the Securities Act of 1933.
22. 17 C.F.R. §230.251 et seq. See also Securities and Exchange Commission, "Revised Regulation A: \$20/\$50 Million Offering Limit in a 12-month Period," <http://www.sec.gov/info/smallbus/qasbsec.htm#rega> (accessed November 7, 2016).
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24. Securities and Exchange Commission, "Amendments for Small and Additional Issues Exemptions Under the Securities Act (Regulation A)," Final Rule, *Federal Register*, Vol. 80, No. 75 (April 20, 2015), pp. 21806–21925, <http://www.gpo.gov/fdsys/pkg/FR-2015-04-20/pdf/2015-07305.pdf> (accessed October 19, 2016).
25. Title IV, The Jumpstart Our Business Startups Act, Public Law 112–106, April 5, 2012.
26. Most importantly, Tier 2 secondary offerings and all Tier 1 offerings are subject to blue sky registration and qualification laws. The federal requirements, however, are much more burdensome than they need be. David Burton, "Regulation A+ Proposed Rule Needs Work," *The Daily Signal*, April 8, 2014, <http://dailysignal.com/2014/04/08/regulation-plus-proposed-rule-needs-work/>; David R. Burton, letter to SEC Secretary Elizabeth M. Murphy, comments on "Proposed Rule Amendments for Small and Additional Issues Exemptions under Section 3(b) of the Securities Act," March 21, 2014, <http://www.sec.gov/comments/s7-11-13/s71113-52.pdf> (accessed October 19, 2016); and Rutheford B. Campbell Jr., "Regulation A and the JOBS Act: A Failure to Resuscitate," *Ohio State Entrepreneurial Business Law Journal*, Vol. 7, No. 2 (2012), pp. 317–333, http://uknowledge.uky.edu/cgi/viewcontent.cgi?article=1369&context=law_facpub (accessed October 19, 2016).
27. During the first 11 months under the new rules, only 37 Tier 1 offerings were made. See chapter 6 in this book, Rutheford B. Campbell Jr., "The Case for Federal Pre-emption of State Blue Sky Laws."
28. Section 4(a)(2) of the Securities Act exempts "transactions by an issuer not involving any public offering," 15 U.S. Code § 77d(a)(2). Prior to the JOBS Act, the exemption was in §4(2). This exemption is typically called the "private placement" or "private offering" exemption. There is no definition in the statute or, for that matter, in the securities regulations, of a "public offering" or, conversely, of what is not a public offering. Investors and their attorneys must rely on various court cases, SEC interpretive releases, SEC concept releases, SEC policy statements, SEC staff interpretations, SEC staff legal bulletins, and SEC "no action" letters to make judgments about what will be deemed a public offering. The leading Supreme Court case interpreting this statutory provision is *SEC v. Ralston Purina Co.* 346 U.S. 119 (1953). In that 1953 case, the court held that "the applicability of §4(1) [now §4(a)(2)] should turn on whether the particular class of persons affected needs the protection of the Act. An offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering.'" This "fend for themselves" formulation is highly suspect in that, whether or not an offering is "public" is analytically unrelated to whether or not the investors in the offering can "fend for themselves." For example, an offering to one utterly unsophisticated person wholly incapable of fending for himself with whom there is a substantial pre-existing relationship is not public in any meaningful sense. (For instance, when the CEO's never-employed son who was a poetry major in college is the sole offeree.) Conversely, an offering limited to those demonstrably able to "fend for themselves" (by whatever measure) conducted on national television and with whom there was no pre-existing relationship is certainly public in the ordinary sense of the term (and the authors of the Securities Act of 1933 undoubtedly intended for it to be treated as such).
29. 17 C.F.R. §230.500 et seq. See also Securities and Exchange Commission, "Regulation D—Rules 504, 505 and 506," <http://www.sec.gov/info/smallbus/qasbsec.htm#regd> (accessed November 7, 2016).
30. "Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers of Sales" (Release No. 33-6389), *Federal Register*, No. 47 (March 16, 1982), p. 11251. Regulation D is found at 17 C.F.R. §230.500 through §230.508. See "Revision of Certain Exemptions from the Registration Provisions of the Securities Act of 1933 for Transactions Involving Limited Offers of Sales" (Release No. 33-6339), *Federal Register*, No. 46 (August 18, 1981), p. 41791, for the original proposed rule.
31. Using Survey of Consumer Finances data, the SEC staff has estimated that only about 7 percent to 9 percent of households qualify as accredited investors: U.S. Securities and Exchange Commission, "Report on the Review of the Definition of 'Accredited Investor,'" December 18, 2015, pp. 100–101, <https://www.sec.gov/corpfin/reportspubs/special-studies/review-definition-of-accredited-investor-12-18-2015.pdf> (accessed October 25, 2016). See also Rachita Gullapalli, "Accredited Investor Pool," SEC Forum on Small Business Capital Formation, November 20, 2014, <https://www.sec.gov/info/smallbus/sbforum112014-gullapalli.pdf> (accessed October 25, 2016), and U.S. Government Accountability Office, "Securities and Exchange Commission: Alternative Criteria for Qualifying as an Accredited Investor Should Be Considered," GAO-13-640, July 2013, <http://www.gao.gov/assets/660/655963.pdf> (accessed October 25, 2016).
32. David R. Burton, "Don't Crush the Ability of Entrepreneurs and Small Businesses to Raise Capital," Heritage Foundation *Backgrounder* No. 2874, February 5, 2014, <http://www.heritage.org/research/reports/2014/02/dont-crush-the-ability-of-entrepreneurs-and-small-businesses-to-raise-capital>.
33. Scott Bauguess, Rachita Gullapalli, and Vladimir Ivanov, "Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009–2014," Securities and Exchange Commission, October 2015, <https://www.sec.gov/dera/staff-papers/white-papers/unregistered-offering10-2015.pdf> (accessed October 25, 2016).
34. 17 C.F.R. §230.504. See also Securities and Exchange Commission, "Rule 504 of Regulation D," <http://www.sec.gov/answers/rule504.htm> (accessed October 25, 2016).
35. 17 C.F.R. §230.505. See also Securities and Exchange Commission, "Rule 505 of Regulation D," <http://www.sec.gov/answers/rule505.htm> (accessed October 25, 2016).

36. Rule 504 offerings are exempt from the additional disclosure requirements for sales to non-accredited investors. See Rule 504(b)(1). General solicitation is permitted only in certain specified circumstances.
37. Rule 505 allows up to 35 non-accredited investors, but investments by non-accredited investors trigger additional disclosure requirements under Rule 502(b).
38. Vladimir Ivanov and Scott Bauguess, “Capital Raising in the U.S.: An Analysis of Unregistered Offerings Using the Regulation D Exemption, 2009–2012,” U.S. Securities and Exchange Commission, Division of Economic and Risk Analysis, July 2013, p. 7; Rutheford B. Campbell Jr., “The Wreck of Regulation D: The Unintended (and Bad) Outcomes for the SEC’s Crown Jewel Exemptions,” *The Business Lawyer*, Vol. 66 (2011), pp. 919–942, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=197200 (accessed October 25, 2016).
39. This has been true since the passage of the National Securities Markets Improvement Act (NSMIA) of 1996, which amended section 18 of the Securities Act (15 U.S. Code 77r) to exempt from state securities regulation any “covered security.” 15 U.S. Code 77r(b)(4)(E) provides that a “security is a covered security with respect to a transaction that is exempt from registration under this subchapter pursuant to...commission rules or regulations issued under section 77d(2) of this title, except that this subparagraph does not prohibit a State from imposing notice filing requirements that are substantially similar to those required by rule or regulation under section 77d(2) of this title that are in effect on September 1, 1996.” Section 77d(2) is a reference to Section 4(2) of the Securities Act (now Section 4(a)(2)), to wit, transactions by an issuer not involving any public offering. Only Rule 506 of Regulation D relied on this provision. See “Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers of Sales,” *Federal Register*, Vol. 47 (March 16, 1982), p. 11251. Rule 505 and Rule 504 rely instead on section 3(b) of the Securities Act. See 17 C.F.R. 230.504(a) and 17 C.F.R. 230.505(a). Accordingly, Rule 504 and Rule 505 offerings are not treated as covered securities by the SEC or the state regulators.
40. Fifty states, the District of Columbia, and the SEC.
41. David R. Burton, “Don’t Crush the Ability of Entrepreneurs and Small Businesses to Raise Capital,” Heritage Foundation *Backgrounder* No. 2874, February 5, 2014, <http://www.heritage.org/research/reports/2014/02/dont-crush-the-ability-of-entrepreneurs-and-small-businesses-to-raise-capital>; Campbell Jr., “The Wreck of Regulation D”; and U.S. Government Accountability Office, “Securities and Exchange Commission: Alternative Criteria for Qualifying as an Accredited Investor Should Be Considered.”
42. The statutory basis for the use of an accredited investor in Regulation D is §2(a)(15) of the Securities Act, 15 U.S. Code §77b(a)(2). 17 C.F.R. §230.501(a) defines “accredited investor” for purposes of Regulation D.
43. However, 17 C.F.R. §230.501(a)(7) (Definitions) does use the term “sophisticated person” in reference to Rule 506(b)(2)(ii).
44. Ivanov and Bauguess, “Capital Raising in the U.S.,” p. 15.
45. 17 C.F.R. 240.12b-2, and 17 C.F.R. 229.10 (Item 10(f)(1)).
46. Section 2(a)(19) of the Securities Act of 1933 (15 USC 77b(a)(19)).
47. Section 6(e) of the Securities Act of 1933 (15 U.S. Code 77f(e)).
48. Robert B. Robbins, “Offers, Sales and Resales of Securities Under Section 4[a](1-1/2) and Rule 144A,” ALI CLE Course of Study, March 14–16, 2013, <http://www.pillsburylaw.com/siteFiles/Publications/RobbinsSalesandResalesunder4112andRule144A2013.pdf> (accessed October 19, 2016), and Rutheford B. Campbell Jr., “Resales of Securities Under the Securities Act of 1933,” *Washington & Lee Law Review*, Vol. 52, No. 4 (1995), pp. 1333–1384, <http://scholarlycommons.law.wlu.edu/wlulr/vol52/iss4/6> (accessed October 19, 2016).
49. Legal Information Institute, “17 CFR 230.144—Persons Deemed Not to Be Engaged in a Distribution and Therefore Not Underwriters,” and U.S. Securities and Exchange Commission, “Rule 144: Selling Restricted and Control Securities,” <http://www.sec.gov/investor/pubs/rule144.htm> (accessed October 19, 2016).
50. 17 C.F.R. 230.144A, “Private Resales of Securities to Institutions,” and Securities and Exchange Commission, “Securities Act Rules: Section 138. Rule 144A—Private Resales of Securities to Institutions,” <http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm> (accessed October 25, 2016).
51. Section 4(1-½) prior to the JOBS Act renumbering of Section 4.
52. See *Ackerberg v. Johnson, Jr.*, 892 F. 2d 1328 (8th Cir. 1989), and Robert B. Robbins, “Offers, Sales and Resales of Securities Under Section 4[a](1-1/2) and Rule 144A,” Pillsbury ALI CLE Course of Study, Regulation D Offerings and Private Placements, March 14–16, 2013, <http://www.pillsburylaw.com/siteFiles/Publications/RobbinsSalesandResalesunder4112andRule144A2013.pdf> (accessed October 26, 2016). For an early discussion, see “The Section ‘4(1 ½)’ Phenomenon: Private Resales of Restricted Securities,” *The Business Lawyer*, Vol. 34, No. 4 (1979), pp. 1961–1978.
53. Fixing America’s Surface Transportation Act, Title LXXVI, section 76001, Public Law No. 114–94, creates a new exemption at Securities Act Section 4(a)(7).

54. These requirements include of long list of information requirements, bad actor disqualifications, and limits on what types of firms are eligible.
55. The Securities Exchange Act of 1934, Public Law 73–291, 48 Stat. 881. 15 U.S. Code §78a et seq. U.S. Securities and Exchange Commission, “Securities Exchange Act of 1934: As amended through P.L. No. 112-158, August 10, 2012,” <https://www.sec.gov/about/laws/sea34.pdf> (accessed October 14, 2016).
56. For a list of exchanges, see Securities and Exchange Commission, see “Fast Answers: Exchanges,” <http://www.sec.gov/divisions/marketreg/mrexchanges.shtml> (accessed October 26, 2016). There are currently 18 exchanges.
57. See Section 6 of the Securities Exchange Act and, for instance, the NASDAQ listing standards, <https://listingcenter.nasdaqomx.com/assets/initialguide.pdf> (accessed November 7, 2016).
58. Section 18(b) of the Securities Act of 1933.
59. Remarks by R. Cromwell Coulson, president and CEO of OTC Markets Group, Inc., at the 33rd Annual Securities and Exchange Commission Government-Business Forum on Small Business Capital Formation, record of proceedings, November 2, 2014, p. 63, <http://www.sec.gov/info/smallbus/sbforum112014-final-transcript.pdf> (accessed October 26, 2016).
60. Jumpstart Our Business Startups Act, Public Law 112–106, April 5, 2012, <http://www.gpo.gov/fdsys/pkg/PLAW-112publ106/pdf/PLAW-112publ106.pdf> (accessed October 26, 2016).
61. H.R. 3606 (112th Cong.) passed the House with overwhelming support, 390 to 23: Final Vote Results for Roll Call 110, H.R. 3606, Recorded Vote, March 8, 2012, <http://clerk.house.gov/evs/2012/roll110.xml> (accessed October 26, 2016), and passed the Senate by a wide margin, 73 to 26: U.S. Senate Roll Call Votes 112th Congress–2nd Session, H.R. 3606, March 22, 2012, http://www.senate.gov/legislative/LIS/roll_call_lists/roll_call_vote_cfm.cfm?congress=112&session=2&vote=00055 (accessed October 26, 2016). For general information, see Securities and Exchange Commission, “Jumpstart Our Business Startups (JOBS) Act,” <https://www.sec.gov/spotlight/jobs-act.shtml> (accessed October 26, 2016).
62. They are (1) the final rule implementing Regulation A+; (2) the final rule implementing Title III crowdfunding; (3) the final rule implementing the Title II general solicitation provisions and the proposed Regulation D amendments; and (4) the final rule implementing Titles V and VI. See also Rutheford B. Campbell Jr., “The New Regulation of Small Business Capital Formation: The Impact–If Any–of the Jobs Act,” April 30, 2014, *Kentucky Law Journal*, Vol. 102, No. 4 (2014), http://uknowledge.uky.edu/cgi/viewcontent.cgi?article=1483&context=law_facpub (accessed December 9, 2016), and David R. Burton, “Proposals to Enhance Capital Formation for Small and Emerging Growth Companies,” testimony before the Capital Markets and Government Sponsored Enterprises Subcommittee, Committee on Financial Services, U.S. House of Representatives, April 11, 2014, <http://www.heritage.org/research/testimony/2014/04/capital-formation-for-small-and-emerging-growth-companies>.
63. Securities Act, Section 2(a)(19) [15 U.S. Code 77b(a)(19)].
64. Securities Act, Section 6(e) [15 U.S. Code 77f(e)].
65. Securities Act, Section 5(d) [15 U.S. Code 77e(d)].
66. Securities Act, Section 4(b) [15 U.S. Code 77d(b)]; JOBS Act section 201(a)(1); and Final Rule, “Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings,” *Federal Register*, Vol. 78, No. 142 (July 24, 2013), p. 44771, <http://www.gpo.gov/fdsys/pkg/FR-2013-07-24/pdf/2013-16883.pdf> (accessed October 26, 2016). See also comment letter of David R. Burton regarding “Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings,” to SEC Secretary Elizabeth M. Murphy, October 5, 2012, <http://www.sec.gov/comments/s7-07-12/s70712-118.pdf> (accessed October 26, 2016).
67. Securities Act, Section 4(b) [15 U.S. Code 77d(b)], and JOBS Act, Section 201(c).
68. Securities and Exchange Commission, “Jumpstart Our Business Startups Act Frequently Asked Questions About the Exemption from Broker-Dealer Registration in Title II of the JOBS Act,” February 5, 2013, <https://www.sec.gov/divisions/marketreg/exemption-broker-dealer-registration-jobs-act-faq.htm> (accessed November 3, 2016).
69. Title LXXVI, Section 76001 of the Fixing America’s Surface Transportation Act, Public Law 114–94, December 4, 2015, creates a new exemption at Securities Act, Section 4(a)(7).
70. Securities Act, Section 4(a)(6)(B)(i).
71. Securities Act, Section 4(a)(6)(B)(ii).
72. *Ibid.*
73. JOBS Act, Section 401.

74. Final Rule, "Amendments for Small and Additional Issues Exemptions Under the Securities Act (Regulation A)," *Federal Register*, Vol. 80, No. 75, April 20, 2015, pp. 21806–21925, <http://www.gpo.gov/fdsys/pkg/FR-2015-04-20/pdf/2015-07305.pdf> (accessed November 3, 2016), and Proposed Rule, "Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act," *Federal Register*, Vol. 79, No. 15, January 23, 2014, p. 3926, <http://www.gpo.gov/fdsys/pkg/FR-2014-01-23/pdf/2013-30508.pdf> (accessed November 3, 2016).
75. Under the final rule, Tier 1 offerings may not exceed \$20,000,000, including not more than \$6,000,000 offered by affiliates of the issuer. Tier 2 offerings may offer up to \$50,000,000 annually but are subject to greater disclosure requirements.
76. JOBS Act, Section 501.
77. JOBS Act, Sections 502 and 503.
78. Pre-empting blue sky laws for Rule 504 offerings would require some modifications to Rule 504, since Rule 504(b)(1) by its terms contemplates state registration in certain cases.
79. For a more detailed discussion, see David R. Burton, "Don't Crush the Ability of Entrepreneurs and Small Businesses to Raise Capital," Heritage Foundation *Backgrounders* No. 2874, February 5, 2014, <http://www.heritage.org/research/reports/2014/02/dont-crush-the-ability-of-entrepreneurs-and-small-businesses-to-raise-capital>.
80. The House-passed Fair Investment Opportunities for Professional Experts Act of 2016 (H.R. 2187, 114th Congress), with a margin of 347 to 8, would statutorily set the accredited investor thresholds at current levels and index them for inflation prospectively.
81. The House-passed Accelerating Access to Capital Act of 2016 (H.R. 2357, 114 Congress) included the Private Placement Improvement Act, which would prevent promulgation of the proposed rules. Securities and Exchange Commission, "Proposed Rule: Amendments to Regulation D, Form D and Rule 156," *Federal Register*, Vol. 78, No. 142 (July 24, 2013), pp. 44806–44855, and Securities and Exchange Commission, "Proposed Rule: Amendments to Regulation D, Form D and Rule 156; Re-Opening of Comment Period," *Federal Register*, Vol. 78, No. 192 (October 3, 2013), p. 61222, <http://www.sec.gov/rules/proposed/2013/33-9416.pdf> (accessed October 19, 2016).
82. Comments from David R. Burton to SEC Secretary Elizabeth M. Murphy, November 4, 2013, <http://www.sec.gov/comments/s7-06-13/s70613-462.pdf> (accessed November 3, 2016).
83. However, filing a simple closing Form D indicating the amount actually raised is justified by the need for improved information about this critical market.
84. FINRA, "Series 7 Exam—General Securities Representative Examination (GS)," <http://www.finra.org/industry/compliance/registration/qualificationsexams/qualifications/p011051> (accessed November 3, 2016).
85. The House passed the Fair Investment Opportunities for Professional Experts Act (H.R. 2187, 114th Cong.), which would treat registered investment advisers and "brokers" (presumably registered representatives) as accredited. It would also allow the SEC to develop rules for who qualifies as a sophisticated investor.
86. 17 C.F.R. § 230.506(c).
87. Pursuant to Section 201 of the JOBS Act, the deadline was 90 days after the April 5, 2012, JOBS Act date of enactment (that is, July 4, 2012). Final Rules, "Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings," *Federal Register*, Vol. 78, No. 142 (July 24, 2013), pp. 44771–44805, <http://www.gpo.gov/fdsys/pkg/FR-2013-07-24/pdf/2013-16883.pdf> (accessed November 3, 2016).
88. David R. Burton, Comments on Proposed Rule "Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings," October 5, 2012, <http://www.sec.gov/comments/s7-07-12/s70712-118.pdf> (accessed November 3, 2016). For a discussion of some of the issues, notably blue sky issues relating to offerings involving general solicitation, see William K. Sjoström Jr., "Direct Private Placements," *Kentucky Law Journal*, Vol. 102, No. 4, pp. 947–969 (2013–2014), <http://law-apache.uky.edu/wordpress/wp-content/uploads/2014/07/12-Sjoström.pdf> (accessed November 3, 2016).
89. For an extended discussion of the legislative history, see David R. Burton, comments on Proposed Rule "Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings," letter to SEC Secretary Elizabeth Murphy, October 5, 2012 <http://www.sec.gov/comments/s7-07-12/s70712-118.pdf> (accessed October 18, 2016).
90. H.R. 2930, 112th Cong., <http://www.gpo.gov/fdsys/pkg/BILLS-112hr2930ih/pdf/BILLS-112hr2930ih.pdf> (accessed October 25, 2016).
91. It also excluded crowdfunding investors from the holders of record count, pre-empted blue sky laws, and entitled issuers to rely on investor self-certification for income level.
92. H.R. 2930, 112th Cong.
93. Senate Amendment to Title III of H.R. 3606, <http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606eas/pdf/BILLS-112hr3606eas.pdf> (accessed November 3, 2016).

94. There were 284 requests for comment, but many of them are multipart requests. Securities and Exchange Commission, “Proposed Rules: Crowdfunding,” October 23, 2013, <http://www.sec.gov/rules/proposed/2013/33-9470.pdf> (accessed November 3, 2016). See also Proposed Rule, “Crowdfunding,” *Federal Register*, Vol. 78, No. 214 (November 5, 2013), p. 66428. Further references to the “Crowdfunding” proposed rules are to the *Federal Register* version.
95. Securities and Exchange Commission, Final Rule, “Crowdfunding,” *Federal Register*, Vol. 80, No. 220 (November 16, 2015), <https://www.sec.gov/rules/final/2015/33-9974.pdf> (accessed December 9, 2016).
96. For a different perspective, see Joan MacLeod Heminway, “How Congress Killed Investment Crowdfunding: A Tale of Political Pressure, Hasty Decisions, and Inexpert Judgments that Begs for a Happy Ending,” *Kentucky Law Journal*, Vol. 102, No. 4 (2013–2014), pp. 865–889, <http://law-apache.uky.edu/wordpress/wp-content/uploads/2014/07/9-Heminway.pdf> (accessed November 3, 2016). (Heminway argues that the crowdfunding statute is deeply flawed and that the SEC would do a better job than Congress.) The statute is, of course, deeply flawed but her analysis assumes that the SEC would ever do anything about crowdfunding in the absence of a congressional mandate. Given its history of inaction with respect to facilitating entrepreneurial capital formation, this is unlikely.
97. Stuart R. Cohn, “The New Crowdfunding Registration Exemption: Good Idea, Bad Execution,” *Florida Law Review*, Vol. 64, No. 5 (October 2012), pp. 1143 and 1145, <http://scholarship.law.ufl.edu/cgi/viewcontent.cgi?article=1032&context=fldr> (accessed October 19, 2016).
98. Securities Act, Section 4A(e).
99. Securities Exchange Act, Section 12(g)(6).
100. Securities Act, Section 18(b)(4)(C).
101. U.S. Government Accountability Office, “Factors that May Affect Trends in Regulation A Offerings,” GAO-12-839, July 2012, and Rutheford B. Campbell Jr., “The Wreck of Regulation D: The Unintended (and Bad) Outcomes for the SEC’s Crown Jewel Exemptions,” *The Business Lawyer*, Vol. 66 (August 2011), pp. 919–942, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1971200 (accessed November 3, 2016).
102. See, for instance, Stuart R. Cohn, “The New Crowdfunding Registration Exemption: Good Idea, Bad Execution,” *Florida Law Review*, Vol. 64, No. 5 (2012), pp. 1433–1446, <http://scholarship.law.ufl.edu/cgi/viewcontent.cgi?article=1032&context=fldr> (accessed November 3, 2016); Samuel Guzik, “SEC’s Proposed Crowdfunding Regulations: Six Deadly Sins,” *Crowdfund Insider*, January 9, 2014, <http://www.crowdfundinsider.com/2014/01/29734-secs-proposed-crowdfunding-regulations-six-deadly-sins/> (accessed November 3, 2016); David R. Burton, comments to SEC Secretary Elizabeth M. Murphy on “Crowdfunding,” February 3, 2014, <http://www.sec.gov/comments/s7-09-13/s70913-192.pdf> (accessed November 3, 2016); Rutheford B. Campbell Jr., comments to SEC Secretary Elizabeth M. Murphy on “Crowdfunding,” February 14, 2014, <http://www.sec.gov/comments/s7-09-13/s70913-278.pdf> (accessed November 3, 2016); and Heminway, “How Congress Killed Investment Crowdfunding.”
103. Section 2 of the original version of the Fix Crowdfunding Act (H.R. 4855, 114th Cong.) would do this.
104. Section 3 of the original version of the Fix Crowdfunding Act (H.R. 4855, 114th Cong.) would do this.
105. Securities Act, Section 4A(b)(1)(D)(iii).
106. Securities Exchange Act, Section 3(a)(80)(A).
107. For a discussion of issues surrounding the provision of investment advice, see Securities and Exchange Commission, “Study on Investment Advisers and Broker-Dealers,” January 2011, <http://www.sec.gov/news/studies/2011/913studyfinal.pdf> (accessed November 3, 2016).
108. Securities Act, Section 4A(a)(5).
109. See 17 C.F.R. §227.402 as adopted in Final Rule, “Crowdfunding,” *Federal Register*, Vol. 80, No. 220 (November 16, 2015), pp. 71387–71680, <https://www.gpo.gov/fdsys/pkg/FR-2015-11-16/pdf/2015-28220.pdf> (accessed November 3, 2016).
110. 17 C.F.R. 275.203A-3 (a)(3)(ii).
111. Securities and Exchange Commission, Final Rule, “Crowdfunding,” *Federal Register*, §227.201.
112. Securities Act, Section 4A(b)(1).
113. Securities Act, Section 4A(b)(4).
114. Securities and Exchange Commission, Final Rule, “Crowdfunding,” *Federal Register*, §227.202.
115. For a more detailed discussion of Bank Secrecy Act and anti-money laundering rules, see David R. Burton and Norbert J. Michel, “Financial Privacy in a Free Society,” Heritage Foundation *Backgrounders* No. 3157, September 23, 2016, <http://www.heritage.org/research/reports/2016/09/financial-privacy-in-a-free-society>.
116. Securities Exchange Act, Section 3(a)(80)(D).

117. Proposed Rule, "Amendments to the Definition of Broker or Dealer in Securities," *Federal Register*, Vol. 81, No. 64 (April 4, 2016), pp. 19086–19094.
118. Regulatory Notice 13-34, "FINRA Requests Comment on Proposed Funding Portal Rules and Related Forms," October 2013, and Proposed Rules, "Crowdfunding," *Federal Register*, Vol. 78, No. 214 (November 5, 2013), p. 66428, Release Nos. 33-9470 and 34-70741, File No. S7-09-13.
119. The SEC has, by rule, pre-empted blue sky registration and qualification requirements for Regulation A Tier 2 primary offerings.
120. David R. Burton, "Securities Disclosure Reform," Heritage Foundation, forthcoming.
121. David R. Burton, "Legislative Proposals to Enhance Capital Formation and Reduce Regulatory Burdens: Venture Exchanges," testimony before the Capital Markets and Government Sponsored Enterprises Subcommittee, Committee on Financial Services, U.S. House of Representatives, May 13, 2015, <http://www.heritage.org/research/testimony/2015/legislative-proposals-to-enhance-capital-formation-and-reduce-regulatory-burdens-venture-exchanges> (accessed December 8, 2016).
122. Assuming they do not have a substantial pre-existing relationship with everyone in the room. Now, if they comply with the investor verification procedures and make a compliant Rule 506(c) offering (by selling only to accredited investors), they could save their situation. The odds are, however, they will not even have heard of Rule 506 and not have the vaguest idea that their actions would be a violation of the securities laws.
123. The original version of the Micro Offering Safe Harbor Act (H.R. 4850, 114th Cong.) would accomplish this objective by creating a separate exemption. The version reported out of committee and passed by the House (as Title II of the Accelerating Access to Capital Act of 2016 (H.R. 2357)) is much narrower and imposes various conditions on the exemption.
124. For a good, recent analysis, see Gregory C. Yadley, "Notable by Their Absence: Finders and Other Financial Intermediaries in Small Business Capital Formation," presentation to the U.S. Securities and Exchange Commission Advisory Committee on Small and Emerging Businesses, June 3, 2015, <http://www.sec.gov/info/smallbus/acsec/finders-and-other-financial-intermediaries-yadley.pdf> (accessed November 3, 2016).
125. Particularly by those familiar with the work and proposals of the American Bar Association Task Force on Private Placement Broker-Dealers. See the American Bar Association, "Report and Recommendations of the Task Force on Private Placement Broker-Dealers," June 20, 2005, <http://www.sec.gov/info/smallbus/2009gbforum/abareport062005.pdf> (accessed November 3, 2016).
126. For "merger and acquisition broker."
127. David R. Burton, "Don't Overregulate Business Brokers," Heritage Foundation *Background* No. 2883, February 19, 2014, <http://www.heritage.org/research/reports/2014/02/dont-overregulate-business-brokers>. See also the Small Business Mergers, Acquisitions, Sales, and Brokerage Simplification Act of 2015 (H.R. 686, 114th Cong.).
128. Securities Exchange Act, Section 3(a)(4) [definition of broker].
129. Securities Exchange Act, Section 3(a)(5) [definition of dealer].
130. American Bar Association, "Report and Recommendations of the Task Force on Private Placement Broker-Dealers."
131. Michigan Department of Licensing and Regulatory Affairs, "Finders & Solicitors," http://www.michigan.gov/lara/0,4601,7-154-35299_61343_32915_59945_60133-269112--,00.html (accessed November 3, 2016), and Texas State Securities Board, "Dealer & Adviser Registration," http://www.ssb.state.tx.us/Dealer_And_Investment_Adviser_Registration/Frequently_Asked_Questions.php#oneC (accessed November 3, 2016).
132. Analogous to personalized investment advice provisions in Advisers Act Rule 203A, 17 C.F.R. 275.203A-3 (a)(3)(ii).
133. 50 states and the District of Columbia.
134. IRS Statistics of Income, "Table 1--S Corporations: Total Receipts and Deductions, Portfolio Income, Rental Income, and Total Net Income, by Major Industry, Tax Year 2012," http://www.irs.gov/file_source/pub/irs-soi/12co01s.xls (accessed November 3, 2016).
135. 26 U.S. Code §1361 et seq.
136. Alternatively, they could convert to an LLC by merging the S corporation with an LLC, with the LLC as the surviving entity. This involves costs and other issues.
137. H.R. 4831, 114th Cong. would achieve this objective.
138. These are often called SME exchanges, or alternative investment markets in the European or academic literature. SME stands for small and medium-sized enterprises. See Securities and Exchange Commission, "Remarks at FIA Futures and Options Expo," speech by Commissioner Daniel M. Gallagher, November 6, 2013, <https://www.sec.gov/News/Speech/Detail/Speech/1370540289361#.VlsXvXt4zYg> (accessed November 3, 2016) ("Through well-designed venture exchanges governed by scaled, sensible regulation, small companies would be provided with a proper runway for them to grow while at the same time providing investors with the material disclosures they need to make informed decisions."); Securities and Exchange Commission,

- “Whatever Happened to Promoting Small Business Capital Formation?” speech by Commissioner Daniel M. Gallagher, September 17, 2014, <https://www.sec.gov/News/Speech/Detail/Speech/1370542976550#.VlnvAht4zYg> (accessed November 3, 2016) (“I’ve called for the creation of ‘Venture Exchanges’: national exchanges, with trading and listing rules tailored for smaller companies, including those engaging in issuances under Regulation A. Shares traded on these exchanges would be exempt from state blue sky registration. The exchanges themselves would be exempted from the Commission’s national market structure and unlisted trading privileges rules, so as to concentrate liquidity in these venues. This should in turn bring market makers and analysts to these exchanges and their issuers, thereby recreating some of the ecosystem supportive of small companies that has been lost over the years.”); and Securities and Exchange Commission Advisory Committee on Small and Emerging Companies, “Recommendation Regarding Separate U.S. Equity Market for Securities of Small and Emerging Companies,” February 1, 2013, <https://www.sec.gov/info/smallbus/acsec/acsec-recommendation-032113-emerg-co-ltr.pdf> (accessed November 3, 2016) (“The Commission should facilitate and encourage the creation of a separate U.S. equity market or markets that would facilitate trading by accredited investors in the securities of small and emerging companies, and such small and emerging companies would be subject to a regulatory regime strict enough to protect such investors but flexible enough to accommodate innovation and growth by such companies.”)
139. News release, “TSX Venture Exchange Celebrates its 15th Anniversary,” TMX, November 28, 2014, <http://www.tmx.com/newsroom/press-releases?id=228&year=2014&month=11> (accessed November 3, 2016).
 140. London Stock Exchange, “AIM,” <http://www.londonstockexchange.com/companies-and-advisors/aim/aim/aim.htm> (accessed November 3, 2016). AIM is a multilateral trading facility (MTF) as defined under the Markets in Financial Instruments Directive (MiFID) 2004, EUR-Lex access to European Union Law, Title I, Article 4, “Definitions,” Section 15, <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:32004L0039> (accessed November 3, 2016). An MTF is the EU analog to the U.S. alternative trading system (ATS).
 141. Remarks of R. Cromwell Coulson, President and CEO, OTC Markets Group, at 33rd Annual Securities and Exchange Commission Government-Business Forum on Small Business Capital Formation, November 2, 2014, p. 63, <http://www.sec.gov/info/smallbus/sbforum112014-final-transcript.pdf> (accessed November 3, 2016) (“The other 10 percent, it’s impossible. You cannot become blue sky, whether you are Roche’s ADR [American Depositary Receipt], you are an SEC-reporting company, you’re a billion-and-a-half-dollar community bank holding company. You cannot become blue sky in the United States in every jurisdiction.”)
 142. See Securities Exchange Act, Section 6.
 143. Regulation ATS, 17 CR § 242.300 et seq., and Securities and Exchange Commission, “Alternative Trading Systems with Form ATS on File with the SEC as of June 1, 2015” [approximately 90], <http://www.sec.gov/foia/ats/atlist0615.pdf> (accessed November 3, 2016).
 144. David R. Burton, “Legislative Proposals to Enhance Capital Formation and Reduce Regulatory Burdens: Venture Exchanges,” testimony before the Capital Markets and Government Sponsored Enterprises Subcommittee, Committee on Financial Services, U.S. House of Representatives, May 13, 2015, <http://www.heritage.org/research/testimony/2015/legislative-proposals-to-enhance-capital-formation-and-reduce-regulatory-burdens-venture-exchanges>.
 145. H.R. 4638, 114th Cong.
 146. Burton, “Securities Disclosure Reform.”
 147. David R. Burton, “Reducing the Burden on Small Public Companies Would Promote Innovation, Job Creation, and Economic Growth,” Heritage Foundation *Backgrounder* No. 2924, June 20, 2014, <http://www.heritage.org/research/reports/2014/06/reducing-the-burden-on-small-public-companies-would-promote-innovation-job-creation-and-economic-growth>.
 148. Proposed Rules, “Crowdfunding,” *Federal Register*, Vol. 78, No. 214 (November 5, 2013), p. 66509 (col. 2).
 149. See, for instance, Committee on Capital Markets Regulation, “Interim Report,” November 30, 2006, <http://www.capmktsreg.org/2006/11/30/interim-report/> (accessed November 3, 2016); Ehud Kamar, Pinar Karaca-Mandic, and Eric Talley, “Going-Private Decisions and the Sarbanes–Oxley Act of 2002: A Cross-Country Analysis,” Kauffman–RAND Institute for Entrepreneurship Public Policy, February 2008, http://www.rand.org/content/dam/rand/pubs/working_papers/2008/RAND_WR300-2.pdf (accessed November 3, 2016); and Robert P. Bartlett III, “Going Private But Staying Public: Reexamining the Effect of Sarbanes–Oxley on Firms’ Going-Private Decisions,” *University of Chicago Law Review*, Vol. 76, No. 7 (2009), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1088830 (accessed November 3, 2016).
 150. The Sarbanes–Oxley Act of 2002, Public Law 107–204 (July 30, 2002).
 151. The Dodd–Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203 (July 21, 2010).
 152. See, for instance, Michele Meoli et al., “The Cost of Going Public: A European Perspective,” *International Journal of Economics and Management Engineering*, Vol. 2, No. 2 (May 2012).
 153. The IPO On-Ramp as enacted is Title I of the JOBS Act, Public Law 112–106 (April 5, 2012), which generally delays application of some of the most onerous provisions governing public companies for five years for companies that meet the definition of an

- “emerging growth company.” For IPO data, see Jay R. Ritter, “IPO Data,” Warrington College of Business, <http://bear.warrington.ufl.edu/ritter/ipodata.htm> (accessed November 3, 2016). See also Burton, “Reducing the Burden on Small Public Companies Would Promote Innovation, Job Creation, and Economic Growth.”
154. Gross domestic product was \$2.9 trillion in 1980, \$7.7 trillion in 1995, and \$17.4 trillion in 2014. Bureau of Economic Analysis, “National Data,” <http://www.bea.gov/iTable/iTable.cfm?ReqID=9&step=1#reqid=9&step=3&isuri=1&904=2014&903=5&906=a&905=1980&910=x&911=0> (accessed November 3, 2016).
 155. The present discounted value of \$1.5 million annually with a 10 percent discount rate is \$15 million.
 156. 17 CFR 240.12b-2.
 157. See discussion previously in this chapter under “The Jumpstart Our Business Startups Act: Title I: Emerging Growth Companies.”
 158. In general, an accelerated filer is an issuer with an aggregate worldwide common equity market value of \$75 million or more, but less than \$700 million that is not a smaller reporting company. An accelerated filer must file its 10-Qs within 40 days of the close of the quarter and its 10-Ks within 75 days of the close of the year. See 17 C.F.R. 240.12b-2(1).
 159. Jiamin Wang, “Sarbanes–Oxley Section 404 Places Disproportionate Burden on Smaller Public Companies,” The Heritage Foundation Center for Data Analysis, August 2008, http://www.heritage.org/-/media/CDA/CDA_features/SOXCDAdited3.ashx, and Charles River Associates, and Charles River Associates, “Sarbanes-Oxley Section 404 Costs and Remediation of Deficiencies: Estimates from a Sample of Fortune 1000 Companies,” April 2005, <https://www.sec.gov/spotlight/soxcomp/soxcomp-all-attach.pdf> (accessed November 3, 2016).
 160. Among those would be: Exemption from the requirement in Securities Exchange Act section 14A(a) to conduct shareholder advisory votes on executive compensation (for exemption, see Securities Exchange Act section 14A(e)(2)); Exemption from the requirement in Securities Exchange Act section 14A(b) to provide disclosure about and conduct shareholder advisory votes on golden parachute compensation (for exemption, see Securities Exchange Act section 14A(e)(2)); Exemption from the requirement in section 953(b) of the Dodd–Frank Wall Street Reform and Consumer Protection Act, as implemented by the Commission in Item 402 of Regulation S-K (17 C.F.R. §229.402), to provide disclosure of the ratio of the median annual total compensation of all employees (except the CEO) of the registrant to the annual total compensation of the chief executive officer (for exemption, see JOBS Act section 102(a)(3)); Exemption from the requirement in Securities Exchange Act section 14(i) to provide disclosure of the relationship between executive compensation and issuer financial performance (for exemption, see Securities Exchange Act section 14A(i)); Exemption from compliance with new or revised financial accounting standards until those standards apply to private companies (for exemption, see Securities Exchange Act section 13(a)); and Exemption from the Sarbanes–Oxley section 404(b) internal control reporting requirements (for exemption, see JOBS Act section 103).
 161. Ann Marie Wiersch, “Good News and Bad News on Small Business Lending in 2014,” Federal Reserve Bank of Cleveland, January 5, 2015, <https://www.clevelandfed.org/en/newsroom-and-events/publications/community-development-briefs/db-20150105-good-news-bad-news-small-bus-lending.aspx> (accessed October 25, 2016).
 162. Victoria Williams, “Small Business Lending in the United States, 2012,” U.S. Small Business Administration, Office of Advocacy, July 2013, https://www.sba.gov/sites/default/files/files/sbl_12study.pdf (accessed October 25, 2016).
 163. For an analysis, see Ann Marie Wiersch and Scott Shane, “Why Small Business Lending Isn’t What It Used to Be,” Federal Reserve Bank of Cleveland, August 14, 2013, <https://www.clevelandfed.org/newsroom-and-events/publications/economic-commentary/2013-economic-commentaries/ec-201310-why-small-business-lending-isnt-what-it-used-to-be.aspx> (accessed November 3, 2016). See also Karen Gordon Mills and Brayden McCarthy, “The State of Small Business Lending: Credit Access During the Recovery and How Technology May Change the Game,” Harvard Business School *Working Paper* No. 15-004, July 22, 2014, http://www.hbs.edu/faculty/Publication%20Files/15-004_09b1bf8b-eb2a-4e63-9c4e-0374f770856f.pdf (accessed November 3, 2016).
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170. 12 U.S. Code 1757a.
171. Concerns that Internal Revenue Code section 501(c)(14) affords an unfair advantage to credit unions is reasonable. Unfair competition by tax-exempt organizations against businesses is commonplace. But that Internal Revenue Code provision has a long history and whatever advantage is accorded to credit unions is equally applicable to *any* loan made by credit unions, so it does not logically justify a provision affirmatively discriminating against small businesses. Banks compete against credit unions in the consumer-lending or home-loan markets, which is where most of their lending currently takes place. For more on this issue, see John A. Tatom, "Competitive Advantage: A Study of the Federal Tax Exemption for Credit Unions," Tax Foundation, February 28, 2005, <http://www.taxfoundation.org/sites/taxfoundation.org/files/docs/8ccda96dc9aa7b1b47ca29f2632c796.pdf> (accessed November 3, 2016); U.S. Department of the Treasury, "Comparing Credit Unions with Other Depository Institutions," January 2001; and Donald J. Melvin, *The Federal Income Tax Exemption of Credit Unions: A Historical, Competitive, and Legal Analysis* (Washington, DC: Defense Credit Union Council, 1981).
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174. The P2P lending firms Lending Club and Prosper have now learned how to deal with the current SEC requirements and have reached sufficient size that the regulatory costs can be managed.
175. The provision provided "primary" jurisdiction to the CFPB. It did not explicitly pre-empt blue sky laws. Any pre-emption of state blue sky laws should not pre-empt state antifraud provisions.
176. Section 4315 of H.R. 4173, 111th Cong. (House-passed version), <http://www.gpo.gov/fdsys/pkg/BILLS-111hr4173eh/pdf/BILLS-111hr4173eh.pdf> (accessed October 25, 2016).
177. This is probably unnecessary, since such fraud would be a violation of countless existing laws, including state blue sky laws, state consumer-protection laws, state banking laws, and the common law of fraud.
178. A debt security would be defined "as any contract that (1) provides for the repayment of the principal amount over a definite period together with interest and (2) provides no payments to the holder other than principal payments, interest payments and penalties for late payments."
179. "Peer-to-peer debt security" issuers should be exempt from Securities Act: Section 4A(b)(1)(D)(ii)-(iii); Section 4A(b)(1)(G); Section 4A(b)(1)(H); Section 4A(b)(4); and Section 4A(b)(5).
180. See, for example, Eric C. Chaffee and Geoffrey C. Rapp, "Regulating Online Peer-to-Peer Lending in the Aftermath of Dodd-Frank: In Search of an Evolving Regulatory Regime for an Evolving Industry," *Washington and Lee Law Review*, Vol. 69, No. 2 (2012), pp. 485-533, <http://scholarlycommons.law.wlu.edu/wlulr/vol69/iss2/4/> (accessed October 25, 2016), and Verstein, "The Misregulation of Person-to-Person Lending."

CHAPTER 22:

Federalism and FinTech

Brian Knight

Americans are currently seeing a period of potentially significant change as financial technology (FinTech) companies seek to harness advances in communications, data processing, and cryptography to compete with traditional providers across a host of services. FinTech is changing how financial services are provided in a host of ways that make it possible for new competitors to compete with incumbents.¹ Some of the most powerful are removing geographic limitations on where a company can offer its services, and lowering barriers to entry. This newly competitive landscape is exposing weaknesses, inefficiencies, and inequities in the United States' financial regulatory structure.

Many of these problems stem from the awkward way in which the federal and state governments share regulatory power over FinTech. The uneven application of state and federal law places some competitors at a disadvantage. In some situations, the application of state law subjects the citizens of some states to regulation by other states. The changing economic and business realities wrought by technology frequently (though not universally) argue in favor of the federal government replacing state-by-state regulation with consistent national regulation. Considerations of efficiency, competitive parity, and political equity should drive decisions about whether federal or state regulation is appropriate.

FinTech is a very broad area; this chapter uses a few select examples to explore the interaction between federalism and financial technology. This chapter focuses on

“marketplace lending,”² virtual currencies, and Internet securities sales. While these three examples occur in different markets and are governed by different laws, they share certain common attributes. Each innovation has been governed by a regulatory framework focused on retail customers, has drawn both state and federal regulatory attention, and has been characterized by significant, technologically driven change.

This chapter briefly describes each innovation and how technology is changing the relevant market. For each innovation, the chapter outlines the allocation of state and federal regulation, how competition is regulated, and the problems created by the divide of responsibility between the federal and state governments. Finally, the chapter briefly discusses options to make regulation of each innovation fairer and more efficient.

THE INNOVATIONS

Marketplace Lending. Marketplace lending is a broad term that encompasses new non-bank lenders with certain traits. First, marketplace lenders use the Internet to advertise and interact with borrowers, and in some cases capital sources, nationwide. This allows lenders to match borrowers to capital suppliers from across the country.³ Second, marketplace lenders fund loans through a combination of their own balance sheet, securitizations of loans into asset-backed securities, or the sale of loans (either whole or fractionalized) to individual and institutional investors. This differentiates them from banks, which frequently fund loans with capital from insured deposits. Third, marketplace lenders frequently use non-traditional data sources and proprietary algorithms to underwrite borrowers in addition to, or to the exclusion of, traditional methods, such as scores from credit bureaus.

Marketplace lenders often are able to make lending decisions more quickly than traditional banks.⁴ There is also some evidence that they can provide some borrowers with better prices than traditional lenders⁵ or make loans to borrowers who are unlikely to obtain credit from traditional sources.⁶ This may be the result of the lenders enjoying a lower cost-structure than banks because of the lack of branches.⁷

Marketplace lenders make money through several different channels. The most obvious is collecting the interest payments for loans they hold on their books. Lenders also collect servicing fees from investors who purchase the loans (or securities backed by the loans) for maintaining the loan and providing the conduit for the borrower to repay. Marketplace lenders also earn origination fees charged to the borrower at the inception of the loan.

Many marketplace lenders make their loans through one of two methods: directly or through a bank partnership.⁸ The direct model requires the lender to be licensed in every state into which it extends credit.⁹ The

bank-partnership model, by contrast, allows the lender to leverage banks that have a federally granted right to lend nationwide, subject primarily to the law of its home state.¹⁰ The bank-partnership model has recently come under judicial and regulatory scrutiny that may call its continued viability into question.

The bank-partnership method reflects an important difference in how marketplace lenders and banks are regulated. Banks enjoy the ability to, among other things, extend credit to borrowers subject to the higher of the limit allowed under the state law of the bank's home state or the borrower's home state. The 1864 National Bank Act¹¹ originally granted this power to banks to end discrimination by states seeking to protect their own state-chartered banks. The National Bank Act created a national charter that was arguably designed to replace state banks that had previously dominated the United States banking sector.¹² The newly created national banks were "National favorites," in the words of the Supreme Court in *Tiffany v. National Bank of Missouri*,¹³ which merited protection from "ruinous competition with State banks."¹⁴

The interest-rate-export provision took on a new importance in the 1970s as credit cards changed how financial services were provided. Credit cards allowed banks to compete for customers across state lines without having to open branches, which was legally difficult at the time.¹⁵ This development again raised the question of whether the law of the bank's home state or the borrower's home state should control the rate of interest the issuing bank was allowed to charge.

The Supreme Court took up this question in *Marquette National Bank v. First of Omaha Corp.*¹⁶ The court held that under section 85 of the National Bank Act, a nationally chartered bank was able to charge the interest rate allowed by its home state, even if that rate exceeded what was allowed by the laws of the borrower's state. The court also found that the bank's home state was the state listed on its organizational certificate, even if the bank extended credit in another state.

In the wake of *Marquette*, state banks found themselves at a competitive disadvantage because they could not export interest rates. Congress provided state-chartered banks with parity through section 521 of the 1980 Depository Institutions Deregulation Act (DIDA),¹⁷ which effectively copied the language of the National Bank Act to “prevent discrimination against State-chartered depository institutions.”¹⁸ This provision was, as its proponents pointed out, intended to “allow □ competitive equity among financial institutions, and reaffirm□ the principle that institutions offering similar products should be subject to similar rules.”¹⁹

The definition of “interest” for the purposes of banks exporting interest rates is broader than just the numerical rate. The Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) have interpreted interest to include “any payment compensating a creditor or prospective creditor for an extension of credit, making available of a line of credit, or any default or breach by a borrower of a condition upon which credit was extended,”²⁰ an interpretation that was embraced by the Supreme Court in *Smiley v. Citibank (South Dakota)*.²¹ This means that not only can banks export the numerical interest rate from their home state, they can also export the structure of interest charges.

The ability to export interest rates allows banks to offer consistent prices on loans nationwide without regard for the variance in state interest-rate limits, thereby providing greater efficiency. Conversely, non-banks that are regulated on a state-by-state basis are subject to different limits on what they can charge borrowers and what type of fees they can collect.²²

This limitation is part of the reason why many (though not all) marketplace lenders partner with banks. By partnering with a bank that originates and then sells the loan, either directly to the marketplace lender or to an investor, the marketplace lender is able to leverage the bank’s ability to charge consistent

prices and have a consistent fee structure nationwide. This allows marketplace lenders to enjoy economies of scale and compete on a more similar regulatory footing to that of their bank competition. It does not provide perfect parity, because the marketplace lender must bear the cost of compensating its bank partner.

Recent legal and regulatory developments have called the long-term viability of the bank-partnership model into doubt. The United States Court of Appeals for the Second Circuit’s recent decision in *Madden v. Midland Funding, LLC*²³ has cast a pall on the ability of non-banks to buy loans from banks and continue to charge the same rate of interest, if that rate of interest exceeds the limits of the borrower’s state. While not directly involving marketplace lenders, the case does implicate the bank-partnership model.

In *Madden*, a nationally chartered bank located in Delaware offered a credit card to a borrower in New York at an interest rate of 27 percent. This rate was consistent with Delaware law, but exceeded New York’s 25 percent limit. However, the National Bank Act allowed the bank to export its home state rate. After the borrower defaulted on her account, it was sold to Midland Funding LLC, a non-bank debt-collection agency. Midland Funding attempted to collect on the loan, including not only the money owed while the loan was held by a bank, but also the interest due on an ongoing basis at the original 27 percent annual rate.

The borrower sued, arguing that the loan was usurious under New York law and that Midland Funding was not entitled to National Bank Act pre-emption. While the trial court held that Delaware law might apply, the borrower appealed this decision to the Court of Appeals for the Second Circuit. The Second Circuit decided in favor of the borrower, finding that Midland Funding was not entitled to state law pre-emption. It reached this conclusion after finding that extending the pre-emption was not necessary to protect the powers of the national bank. Limiting the ability to

sell debt to non-banks on the same terms the bank enjoyed did not “significantly interfere” with the powers of the national bank.

While the Office of the Solicitor General and the OCC criticized the Second Circuit’s decision to the Supreme Court,²⁴ the Solicitor General also argued that the Supreme Court should not take up the case for procedural and judicial economy reasons. The Supreme Court agreed with the Solicitor General and opted not to grant certiorari. It is unclear whether other circuits will follow the Second Circuit’s lead. They may instead defer to the OCC’s rejection of the Second Circuit’s interpretation of the National Bank Act. However, the decision remains good law in the Second Circuit.

While the *Madden* decision does not directly involve marketplace lenders, it appears to be negatively affecting access to marketplace loans for borrowers with lower credit, as funding for loans with interest rates in excess of the state limit has declined significantly in the Second Circuit.²⁵ It has also contributed to at least one court case arguing that a marketplace lender is using its bank relationship as a sham to avoid state usury law. However, in that case, unlike in *Madden*, the question raised is whether the bank is the lender at all.

The plaintiff in *Bethune v. Lending Club Corp. et al.*²⁶ is a borrower who took out a loan with Lending Club at a 29.97 percent annual percentage rate (APR) and later alleged that the loan violated New York’s usury law.²⁷ The borrower argued that the loan violated New York’s usury law because Lending Club was the “true lender” and used a Utah bank simply as a “sham pass through” to take advantage of Utah’s lack of an interest rate cap. The borrower argues that because Lending Club is the true lender and not a bank New York law should apply. This would render the loan invalid as usurious.

The question of who is the true lender is an important one for marketplace lenders that partner with banks. If the bank partner was never the actual lender, the interest rate

exportation would not attach, and the loan would be subject to the borrower’s state regulations that apply to non-bank lenders. The scope of the true lender doctrine is unclear. Some courts follow the contracts to determine the lender,²⁸ while others claim to look beyond the contract to the economic reality of the transaction.²⁹ It remains unclear how courts will treat marketplace lenders.

Marketplace lenders’ true-lender troubles may not be limited to private civil litigation. The Bureau of Consumer Financial Protection (CFPB) has successfully invoked the true-lender doctrine to argue that the use of a tribal partnership (which operates somewhat similarly to a bank partnership) does not shield a lender from state usury laws.³⁰ The CFPB argued that attempting to collect on loans that were invalid because they were usurious under the state law of the borrower was a violation of the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010.³¹ Additionally, regulators in several states, including New York and California, are beginning to look at marketplace lending business models with a possible eye to true-lender issues.³² These inquiries may mean that the states are looking to assert substantive jurisdiction over marketplace loans because the true lender is a non-bank and therefore subject to significant state control, as opposed to banks who enjoy broad federal pre-emption.

Federal banking regulators have sent mixed messages regarding marketplace lending and bank partnerships. The OCC has expressed openness to the idea of allowing marketplace lenders (and other types of Fin-Tech firms) to become special-purpose banks, which would provide them with the same relevant powers as traditional banks.³³ Both the OCC and FDIC have also cautioned banks about the risks inherent in partnering with non-bank lenders. It is unclear whether there will be any meaningful movement toward a new charter, or if the regulators’ cautioning of banks will be interpreted by banks as a warning shot against partnerships.

MONEY TRANSMISSION

Like lending, money transmission operates in a system where both federal and state actors regulate. It is currently undergoing a potentially significant shift thanks to technology, including the use of distributed ledgers and virtual currencies. Regulatory fractures between the states and federal government and among the states themselves may unduly hamper these new technologies, and citizens find themselves subject to regulations over which they have no control.

Money transmission regulation occurs at both the federal and state levels. The nature of the regulation depends on whether the entity in question is a bank or a stand-alone money transmitter. Generally, federal regulation is primarily concerned with preventing money laundering and other criminal activities. The Bank Secrecy Act³⁴ requires, *inter alia*, that money-services businesses (which it defines broadly) register with the Treasury Department's Financial Crimes Enforcement Network (FinCEN) and provide it with reports of suspicious activities. Federal law also criminalizes the unlicensed provision of money transmission services if a state's law would make it a crime to provide a service without a license.³⁵

Congress has not passed a uniform money transmission law, but it has called on the states to create more uniform laws³⁶ to help prevent money laundering. Through the Dodd-Frank Act, Congress has added a layer of regulation and created a new federal regulator—the CFPB. The CFPB has asserted jurisdiction in actions against two players in the payments system on the grounds they are covered persons under Dodd-Frank.³⁷ It is unclear whether this represents the beginning of a concerted “consumer protection” effort at the federal level, or if the federal government will remain primarily focused on preventing criminal activity.

Conversely, money-transmitter regulation at the state level is heavily focused on consumer protection.³⁸ State laws frequently restrict who may own a money-transmitter business

based on character, fitness, and criminal history.³⁹ They also frequently have provisions, such as minimum-worth requirements, and demand a surety bond to help protect consumers from transmitter insolvency.⁴⁰ Requirements can vary significantly from state to state⁴¹ and while banks are frequently exempted, the scope of state money-transmission law is otherwise frequently quite broad.⁴²

In response to Congress' request, the Uniform Law Commission drafted a uniform money-transmitter statute⁴³ that has been adopted by seven states. Additionally, the Money Transmitter Regulators Association and the Conference of State Bank Supervisors have created agreements to facilitate multi-state reviews and examinations of money transmitters. Despite this, the state regulatory environment for money transmission still has significant inconsistencies.

Virtual currencies, the largest and most famous of which is bitcoin, have become entangled with money-transmission regulation. However, given the potential non-monetary uses for virtual currencies, including recording ownership of non-monetary assets, the impact of money-transmitter regulation may extend beyond money.

Briefly, Bitcoin, is a protocol that runs on computers, creating a common network.⁴⁴ This protocol involves a token (bitcoin) that can represent value. These tokens can be transferred between users of the protocol, with the transfer being recorded on a generally accessible distributed ledger (the bitcoin ledger is called “the blockchain”). Different protocols use different methods to ensure that the record created is accurate. In bitcoin, for example, computers perform cryptographic work to maintain the accuracy of the records. These “miners” are rewarded with bitcoins, which creates an incentive for users to police the system. While some proposed virtual currency systems are designed to be “permissioned” in that access to the protocol is gated by an entity that decides who can use it, the Bitcoin blockchain is a permission-less and open-source system that can be used by anyone.

Users can transfer tokens to other users, which can be used for payment if the tokens have a value. Some virtual currencies, especially Bitcoin, compete with traditional government-sponsored currencies as a store of value and means of payment.

As part of the transfer of value, additional information can be recorded on the distributed ledger. This capability is what has led industries, including real estate, banking, and corporate securities, to investigate distributed currencies, and Bitcoin specifically, as a better way to record and disseminate records of ownership and transfer of property. These recording and transfer functions necessitate the transfer of a small amount of virtual currency. In permissioned systems the transfer of a token may have no monetary value because there is no “market” for the tokens, but in open systems like Bitcoin the tokens have value, which makes it more likely that transfers may be considered money transmission.

Virtual currencies are subject to overlapping and diverse regulation at the federal level. FinCEN has provided guidance stating that parties that maintain virtual currencies exchanges (where people exchange virtual currencies for other stores of value including government-backed money) and “administrators” (parties who create virtual currencies, place them in circulation, and can remove them from circulation) are money-services businesses and subject to Bank Secrecy Act requirements. Conversely, users (people who use the virtual currency to buy things) and miners are not.⁴⁵

Other federal agencies have begun to regulate transactions involving virtual currencies. The IRS has provided guidance holding that virtual currencies are property for tax purposes.⁴⁶ The Commodity Futures Trading Commission has brought at least one enforcement action related to virtual currency futures.⁴⁷ The Securities and Exchange Commission (SEC) has brought enforcement actions around virtual-currency-based securities trading⁴⁸ and a Ponzi scheme involving virtual currencies.⁴⁹ The Federal Trade

Commission has brought an enforcement action against a company that sold computers used to mine bitcoins.⁵⁰ The CFPB and bank regulators have provided guidance regarding the potential risks of virtual currencies to consumers and banks.⁵¹

States have taken different tacks on regulating virtual currencies. Virtual currencies are fully covered under some states’ existing money-transmission laws. Other states, such as Kansas and Texas, consider exchanges to be covered if they offer to exchange virtual currency for real currency.⁵² A Florida trial court found that Florida’s money-transmitter law does not cover virtual currencies, throwing out a case brought against an individual who sold bitcoins to an undercover agent without a money-transmitter license.⁵³ Other states have amended, or are attempting to amend, their money-transmission laws to cover virtual currency.

So far, New York is the only state to create a specific virtual-currency regulatory regime with its “BitLicense.”⁵⁴ The scope of the license is quite broad, covering a wide swath of activities, and applies to any transaction that involves New York residents or the state itself. It exempts non-money-transmissions that involve the transfer of a de minimis amount of virtual currency as well as end use and software development.

The BitLicense regime imposes requirements that largely mirror those placed on traditional money transmitters. However, it also creates a New York-specific anti-money-laundering-reporting requirement that overlaps with FinCEN’s requirements, but applies even if the licensee is not subject to FinCEN reporting. It also requires that licensees employ a Chief Information Security Officer and maintain a cybersecurity program. BitLicense has been met with mixed reviews. Some firms argue that it is too onerous and claim they will boycott New York.⁵⁵ Given the importance of New York for financial services it is unclear how effective or feasible such a boycott would be. So far only two firms, Circle and Ripple, have obtained the licenses.

SECURITIES

Regulation A. The sale of corporate securities is another area where technology has outstripped regulatory assumptions, including assumptions about whether federal or state law should apply. The first major federal securities laws, the Securities Act of 1933 and the Securities and Exchange Act of 1934, did not generally pre-empt concurrent state regulation.⁵⁶ However, as the securities market became more national, in part because of changes in technology, Congress began to feel that state regulation of certain offerings and securities was “redundant, costly, and ineffective.”⁵⁷ This belief resulted in the National Securities Markets Improvement Act (NSMIA) of 1996,⁵⁸ which pre-empted state regulations over many securities transactions.

The NSMIA displaces state registration requirements and most substantive regulations for “covered securities,” which include securities issued pursuant to an exemption from registration, sold to “qualified purchasers” or traded on certain exchanges. The NSMIA also allowed the SEC to change the definition of qualified purchaser by rulemaking. While the NSMIA limited the powers of the states considerably, it did not completely remove them. The states retained the ability to enforce state anti-fraud laws and require notice filings by companies that were offering securities in the state. The states also maintained their authority over securities not covered by the NSMIA.

Among the securities not covered were those offered under Regulation A,⁵⁹ an exemption from full SEC registration that allowed companies to offer and sell up to \$5 million of securities to the general public per year. Even though offerings under Regulation A were exempt from the full registration process, they were considered public offerings and therefore not covered by the NSMIA. As such, companies that made Regulation A offerings were required to comply with both the federal and state requirements.

Regulation A saw peak use in the late 1990s, with 116 initial offerings in 1997, and 57 “qualified” offerings (offerings that had

successfully made it through SEC review) in 1998.⁶⁰ However, over time, the use of Regulation A declined in favor of offerings made under Rule 506 of Regulation D.⁶¹ Although these offerings were limited mostly to accredited investors (generally wealthy individuals or institutions), Rule 506 offerings had several advantages over Regulation A offerings. Unlike Regulation A—which did not have state law pre-emption, required qualification by the SEC, and imposed a limit on how much a company could raise—Rule 506 offerings were covered by the NSMIA, required only notice filings with the SEC, and had no offering limit. Thus, Rule 506 came to be considered the more efficient means of accessing capital. In 2011, there were only 19 initial Regulation A offerings, only one of which was qualified.⁶²

In response to the economic crisis of 2007–2009, Congress passed the Jumpstart Our Business Startups (JOBS) Act.⁶³ The JOBS Act made several changes to the securities laws in order to ease companies’ ability to obtain capital, including amending Regulation A to allow companies to offer up to \$50 million of securities per year. While the act did not explicitly pre-empt state regulation, it allowed the SEC to include purchasers of Regulation A securities as qualified purchasers under the NSMIA. It also directed the Government Accountability Office (GAO) to perform a study on the causes of the decline in Regulation A offerings.

The GAO study found evidence that both the low offering limit and the costs and difficulty of complying with state-by-state regulation limited the appeal of Regulation A.⁶⁴ While state regulators acknowledged that technology may have outstripped regulation and that state regulation may have added to the burden of using Regulation A, they argued that state regulation protects consumers from fraud.⁶⁵ The states also pointed out that they were adapting, including by creating a new coordinated review process to help reduce regulatory friction. Finally, they maintained that it was premature for the federal government to consider pre-emption because the market

and regulators had not yet adapted to the increased offering size.⁶⁶

State protestations notwithstanding, the SEC's proposal for an amended Regulation A included two tiers of offerings. The first defined purchasers as qualified purchasers, thereby pre-empting the states, but required companies to provide ongoing reporting on a regular basis after the offering closed. The second tier retained state regulation and did not require ongoing reporting by the company.

These proposed changes were controversial. State regulators, some Members of Congress, some consumer advocacy organizations, and others opposed the pre-emption. Supporters, including business groups and other Members of Congress, countered that pre-emption was necessary for Regulation A's viability. Pre-emption made it into the final rule and was promptly met with law suits from Massachusetts and Montana.⁶⁷ These states argued that the SEC's expansion of the definition of "qualified purchaser" exceeded the SEC's authority and was arbitrary and capricious. The court did not agree, finding that the SEC had the authority to change the definition and that the change was not arbitrary and capricious.

Regulation A in its amended form became effective on June 19, 2015. Uptake does seem to have improved, at least relative to the low-water mark, with 108 offerings filed with, and 48 qualified by, the SEC as of July 19, 2016. There is a roughly even mix between the two tiers.

Rule 147. Rule 147⁶⁸ is a safe harbor for intrastate offerings that are exempt from the requirements of the Securities Act. If an offering meets the rule's criteria, a company can feel comfortable being exempt from registration. Many states condition their laws regarding small-scale offerings on compliance with Rule 147. Over time, companies expressed concern that Rule 147 compliance was becoming more difficult, in part because of technology. The SEC Advisory Committee on Small and Emerging Companies, for example, noted that a company advertising its offering of securities via the Internet could violate the

rules by "offering" securities to out-of-state investors, even if the offer was legally open only to residents of the same state.⁶⁹

In response, the SEC proposed several changes to Rule 147.⁷⁰ Most fundamentally, the proposal would change Rule 147 from a safe harbor to an exemption under the SEC's general exemptive authority. The proposal contains several modernizing changes, including allowing general solicitation (and therefore the use of the Internet). The proposal also would impose substantive requirements for offerings to qualify under Rule 147, including a \$5 million annual offering limit, a requirement that the relevant state place a limit of its choosing on the amount investors can purchase.

States, practitioners, policy professionals, and other commenters argue that the proposal would unnecessarily impose federal requirements on transactions that are, for all practical purposes, located within a single state and therefore better suited to state control. These commenters argue that, unlike interstate offerings, Rule 147 offerings are limited to one state and that all the potentially affected participants have a means of influencing policy and seeking redress in that state. They also argue that state regulation of Rule 147 offerings lacks the potential to "leak" into other states. Rule 147 offerings are a perfect candidate for experimentation in what Justice Brandies termed "laboratories of democracy"; the states can experiment with how to best protect investors without constraining their fellow states. At the time of this writing the SEC's proposed rule is still pending.

WHAT DOES IT MEAN?

Lending, money transmission, and the securities markets are all seeing significant changes due to technology. In particular, the ability of technology to facilitate communications nationwide (and worldwide) and the increased competition due to lower barriers to entry have significantly affected how people's needs can be met. These changes in technology and markets are pressuring the existing

division of regulatory responsibility between states and the federal government.

The existing structure, which is showing signs of obsolescence, may be causing harm to consumers and citizens. Specifically, the current structure may be harming the efficiency of the markets, the interests of competitive equity, and the political equality of the citizens of different states. While much of this is driven by the state-by-state nature of regulation for certain market participants, Rule 147 provides an illustration of where unnecessary federalization has the potential to cause harm.

Efficiency. Redundant regulations can harm the very groups that regulation seeks to help. To use Regulation A as an example: Businesses were harmed because it was harder to access capital via the methods they believe will work best for them. Investors, particularly retail investors, were also harmed by being deprived of investment opportunities that instead went almost exclusively to the wealthy. (Regulation D strongly encourages selling only to accredited investors.) Further, there were likely additional cascading harms to employees and communities. When businesses are unable to effectively access capital, economic growth, consumer options, and job opportunities suffer, too.

Likewise, the state-by-state regulation of non-bank money transmitters and lenders increases the regulatory burden faced by those firms (but not their bank competition), making it more difficult and expensive for firms to comply with regulations or offer uniform products nationwide. Multiple overlapping regulations and regulators increase the burden on firms to investigate and determine the requirements, comply with them, and thereafter constantly monitor all of the rule makers for changes.⁷¹ Redundant but inconsistent regulation may also prevent firms from harnessing economies of scale, making services more expensive and possibly making them economically non-viable.

While concerns about consumer protection are often cited to justify inefficient state-by-state regulation, redundant regulation can

harm consumers. If the burden of the overlapping regulations is so great that it impedes legitimate transactions, there is a real possibility that the redundancy does more harm than good. Inefficient overlapping regulations can create a barrier to entry, making markets less competitive and depriving consumers of choice.

Further, the burden of complying with multiple, redundant regulations falls especially hard on start-ups and smaller firms that lack the resources to employ large legal teams. Where technology allows new competitors, overlapping regulatory requirements may stand in the way. As such, inefficient redundancy can harm the dynamism of the market, as incumbents, who perhaps could not outcompete new firms, can “out-comply” them. This would deprive consumers of beneficial innovations and contribute to market ossification.⁷²

Competitive Parity. Regulation should contribute to consumer protection, but it should not needlessly distort the competitive landscape. Unfortunately, the division of state and federal responsibility can provide some firms with an advantage over others offering similar services based not on the service provided or risks created, but on charter status.

The example of marketplace lenders and interest-rate exportation is illuminating. Marketplace lenders compete directly with banks and are subject to the same federal consumer protection laws, but are not able to export their home state interest rate nationally the way banks can. This places them at a very clear disadvantage to banks because they cannot price their products consistently nationwide. To address this disadvantage, many marketplace lenders partner with banks—which, by necessity, adds cost and inefficiency compared to allowing marketplace lenders to compete on an even playing field.

This inefficiency and the lack of a fully competitive market harms not only firms that seek to compete with regulation-advantaged incumbents, it also hurts consumers by depriving them of the benefits of competition. Consumers may face higher than necessary

costs and reduced access because the incumbents are not as disciplined by competition as they would be if they were regulated equally. This is not to say that equal regulation always means identical regulation. Different business models may pose different risks, and regulation should acknowledge such differences. However, in the cases presented above there does not appear to be a difference that would justify allowing banks to enjoy federal pre-emption while non-banks do not.

Political Equity. State regulatory decisions can spill over into other states, and the citizens of those states may lack a means of political redress. State legislators and regulators may create policies that benefit them or their home state at the expense of others,⁷³ such as imposing significant restrictions on services that are politically popular within the state but limit the range of services available to others. This distorting, de facto regulation of the national market by some states at the expense of others can serve as another justification for pre-emption.

The problem of regulatory spillover is particularly acute if large and economically important states seek to regulate in a way that imposes significant limitations, obligations, and costs, such as the New York's BitLicense. The requirements imposed by New York are sufficiently onerous that multiple firms have stated they will simply avoid New York. Given New York's importance to the financial system, the broad scope of its law, and the difficulty in being able to confidently exclude customers based on geography, it is unclear whether firms will be able to remove themselves from New York's jurisdiction.

The cost of such extraterritorial regulation is borne not only by firms, but also the residents of other states who may not even agree with New York's policy. If firms feel they need to comply with New York law, that will affect how they structure their products and services and what they choose to offer (or not). At a minimum, the costs of complying with New York law will likely be priced into services nationwide. Non-New Yorkers lack democratic

representation in Albany and cannot influence New York state policy.

As more states regulate, this problem may compound, especially if other large states regulate inconsistently, imposing multiple overlapping regulatory regimes on the national market. Further, some residents in smaller states may find that companies are less likely to offer services if the additional burden of complying with the small state's rules is not considered cost-effective by firms already complying with multiple large-state rules.

Efforts to restrict state-by-state regulation and provide consistency are not hostile to consumer protection. First, a national policy is likely to be a compromise between the extremes found in the states, providing some significant measure of protection.⁷⁴ For example, while the SEC pre-empted the states in some Regulation A offerings, it also mandated significant and ongoing disclosure that was not required for offerings that included state regulation. Second, protecting consumers also involves protecting their right to have a say in the rules that bind them, a right that is eviscerated by state regulations that de facto regulate national markets. By contrast, the federal government provides broad democratic representation and accountability. Even in cases like the National Bank Act's interest rate exportation provision, which references state laws, the regulatory system is still a federal law that was voted on by representatives of all of the states and could be repealed by those same representatives if their constituents demanded it.

As such, federal pre-emption can be appropriate if state regulation is distorting the market. It would not only provide redress to the population that is being regulated but would also better balance the costs and benefits of regulation by internalizing both, instead of allowing states to create rules that capture benefits while passing the costs to others.

Rule 147: An Example of Why Not Everything Should Be a Federal Issue. Much of this chapter deals with cases in which technology has moved the economic reality

of markets from the local level to the national level, but regulation has struggled to keep up. The SEC's current Rule 147 proposals, by contrast, present a case where, technically, federal transactions are at their core inherently local. In such a case, the federal government should not regulate substantively, even if it legally could, because the states are better able to create rules that meet their citizens' needs without creating problems in the national market.

Unlike Regulation A offerings, marketplace loans, or money transmissions, Rule 147 offerings are by their very nature limited to a single state. This means that state regulation does not create inefficiency because only one state is involved. It also means that there are no competitive equity concerns because every company pursuing a Rule 147 offering in a given state is subject to the same laws. Finally, there are no political equity concerns; in state-specific markets, the affected investors and issuers have a means of democratic redress within the state.

The federal government can allow the states to experiment without imposing substantive restrictions. The states are in the best

position to adopt rules that suit local needs and preferences and are more likely to be responsive to their constituents without unduly distorting the market in other states. Intra-state offerings can work as a true "laboratory of democracy" without the risk of lab spills.

CONCLUSION

Financial technology's ability to allow small firms to operate instantly on a nationwide basis is calling into question the current allocation of regulatory responsibility between the states and the federal government. While universal federalization is not appropriate, wise, or constitutional, in matters of interstate commerce, the federal government can take action. While the mere ability to act does not serve as a justification, in cases where state-by-state regulations hamper efficiency, competitive parity, and political equity, the federal government should consider pre-emption to provide consistent national rules. Conversely, in cases where the states are able to regulate without imperiling those values because the economic reality of the transaction is *intrastate*, the federal government should defer.

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CHAPTER 23:

A New Federal Charter for Financial Institutions

Gerald P. Dwyer, PhD, and Norbert J. Michel, PhD

Banks and non-bank financial firms are extensively regulated in the United States. While banks are even more heavily regulated than other financial firms, virtually all financial companies are subject to extensive restrictions on their activities, capital, and asset composition. There have been many changes to federal rules and regulations during the past few decades, and some of those changes have allowed financial firms to engage in activities from which they were previously prohibited. However, there has never been a substantial reduction in the scale or scope of financial regulations in the U.S.

Regulation of banks, in particular, has increased episodically. Simultaneously, in the name of ensuring stability, U.S. taxpayers have absorbed more of the financial losses due to risks undertaken by private market participants. This combination of policies has produced a massive substitution of government regulation for market competition, which culminated in the 2008 financial crisis. Fixing this framework requires rolling back both government regulation and taxpayer backing of financial losses, making it possible for private citizens to build a stronger financial system that efficiently directs capital to its most valued uses.

Government rules that profess to guarantee financial market safety create a false sense of security, lower private incentives to monitor risk, increase institutions' financial risk, and protect incumbent firms from new competitors. It is important to reverse these

trends because competition in markets drives innovation, lowers prices, prevents excessive risk taking, and allows people to invest their savings in the best investment opportunities. There are many policy solutions to begin restoring the competitive process and strengthening financial markets, such as providing regulatory off-ramps for firms with higher equity funding. This chapter focuses on one option: creating a new federal charter for financial institutions, whose owners and customers absorb all of their financial risks.

BASIC REGULATORY OFF-RAMP

In September 2016, the House Financial Services Committee passed H.R. 5983, a regulatory reform bill called the Financial CHOICE Act.¹ This legislation would replace large parts of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act, and also provide banks a regulatory off-ramp

in the form of a *capital election*. This off-ramp relieves banks of certain regulations if they improve their ability to absorb losses by funding their operations with higher equity capital. Put differently, the provision exempts banks from regulations if they meet a higher capital ratio, thus credibly reducing their probability of failure and any consequent taxpayer bailouts.

The CHOICE Act's capital election requires banks to have an average leverage ratio of at least 10 percent. The off-ramp mainly provides relief from Dodd–Frank regulations related to capital and liquidity standards, capital distributions to shareholders, and mergers and acquisitions.² It effectively relieves qualified banks of compliance with the Basel III capital rules.³ Though there are many ways to implement a regulatory off-ramp, this approach—requiring a firm to meet a higher capital ratio—can easily be expanded to provide additional regulatory relief.

The most obvious method would be to raise the equity-capital threshold above a 10 percent ratio, and increase the list of exemptions as higher capital ratios are met, though implementing an off-ramp in such a tiered fashion would be needlessly complex. An alternative approach is to create a new federal charter under which financial institutions are regulated more like banks were regulated before the modern era of bank bailouts and government guarantees. Broadly, the idea is to replace government regulation and supervision with a sensible disclosure regime contingent on high-equity capital.

A NEW FEDERAL CHARTER FOR FINANCIAL COMPANIES

Currently, creating a new national bank requires the approval of a charter application by the Office of the Comptroller of the Currency (OCC) or the state banking regulator in which the headquarters will be located. The Federal Deposit Insurance Corporation (FDIC) must also approve a deposit-insurance application.⁴ The charter proposed in this chapter would explicitly prohibit FDIC insurance for

the proposed new banks or any subsidiaries. Only the OCC would approve these proposed charters because these charters provide exemptions from federal regulations. The OCC currently applies several *evaluative factors* to new charter applications, and assesses these factors on three main elements: (1) the business plan; (2) the character and competence of the bank's management and directors; and (3) financial resources.⁵

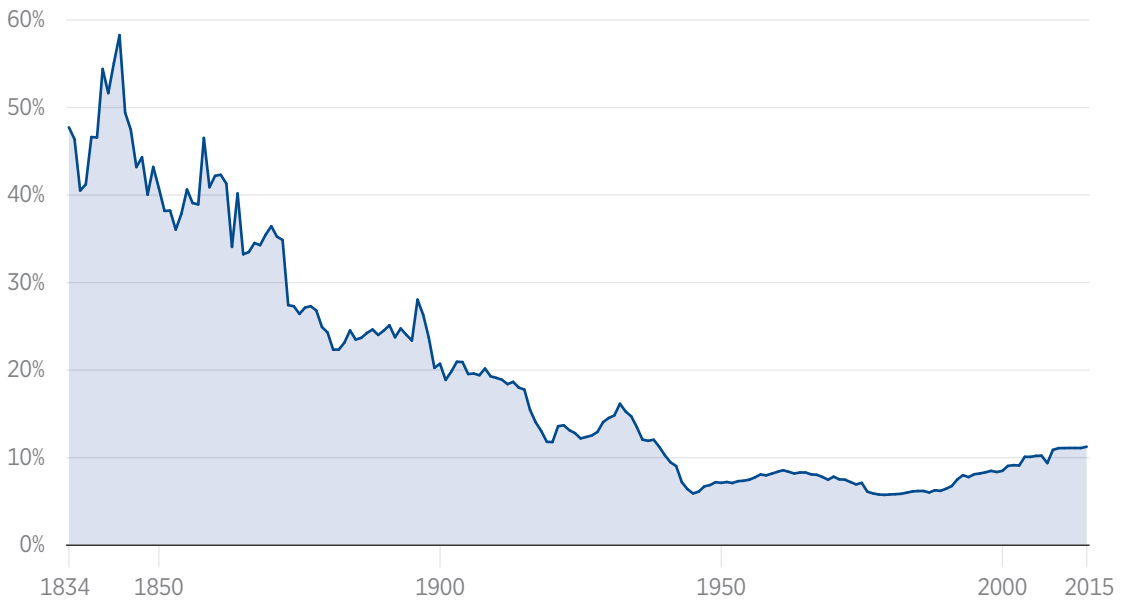
The charter proposed in this chapter would essentially restrict the OCC to ensuring the character of management and directors through standard background checks and verifying that the firm meets a relatively high equity ratio. The OCC would no longer, for example, approve an application based on the agency's assessment of the company's risk profile, the owners' ability to attract and maintain community support, or whether the agency believes the company can remain profitable.⁶ The purpose of eliminating such criteria is to eliminate regulators' subjective view of the bank's prospects from the approval process.

Instead, the OCC would verify whether the company satisfies various objective requirements. One of the requirements would be that the bank can absorb substantial losses before it is forced into resolution. The bank would be allowed to operate with relatively few regulatory requirements. The core economic rationales for current subjective evaluations of new banks' charters center on federal deposit insurance and bailouts, both of which put taxpayers at risk. Eliminating those factors removes the core justification for extensive government regulation. FDIC deposit insurance in particular would not be available to the bank's depositors.⁷

EXTENDED LIABILITY, NON-CORPORATE ENTITIES, HIGHER EQUITY

Policies that help to ensure that financial firms' owners and creditors bear any financial losses impose market discipline on the firms. When financial firms' capital suppliers have

Bank Capital as a Share of Total Bank Assets



SOURCES: Historical Statistics of the United States, <https://hsus.cambridge.org/HSUSWeb/HSUSEntryServlet> (accessed November 14, 2016), and Federal Deposit Insurance Corporation, “Liabilities and Equity Capital, FDIC-Insured Commercial Banks, US and Other Areas Balances at Year End, 1934–2012,” Table CB14, January 29, 2014, http://www.business.unr.edu/faculty/liuc/files/fin415/commercialbanks_Laib.pdf (accessed November 14, 2016).

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more of their own funds at risk, they invest more carefully and monitor firms’ operations more closely. Prior to the expansion of federal policies that shift those losses to others, financial firms signaled their financial strength by having very high capital ratios (by today’s standards) and by other means, such as extended liability for shareholders.

Figure 1 shows capital-to-asset ratios for banks since 1834. The much lower ratios today, due in no small part to federal deposit insurance since 1933, are obvious. Capital ratios were much higher in the 19th century, falling from about 35 percent after the Civil War to 20 percent by 1900.⁸ While today’s bankers often will argue that 6 percent capital is high enough, it is clear that commercial banking without deposit insurance and bailouts involved significantly higher capital than today’s extraordinarily low levels. Besides capital,

owners of banks often were obligated to provide additional funds to banks’ depositors.

Extended liability—by way of double, triple, or, in California, unlimited liability—was common for commercial banks before Congress enacted federal deposit guarantees in 1933 through the FDIC.⁹ Investment banks were typically partnerships (rather than corporations) until late in the 20th century, with Goldman Sachs being the last of the big firms to go public in 1999.¹⁰ Given that there are some financial firms currently organized as general partnerships, it is at least plausible that some investors would be willing to organize financial firms under an extended liability regime if they were allowed to do so as part of a regulatory off-ramp. Such firms would have a disadvantage in raising capital from widespread investors because stockholders would have to be qualified to assume the

possible liability, but such a disability relative to publicly traded corporations should not prevent policymakers from giving investors the *option* of organizing such banks to obtain regulatory relief.¹¹ In some ways, extended liability would be an advantage because the ownership of such banks would be concentrated in owners able and willing to bear the risk in exchange for the rewards.¹²

The organization of most large financial firms as publicly traded companies without extended liability certainly suggests that a better option, at least at this time, would be to tie a regulatory off-ramp to a higher equity requirement. A natural starting point for thinking about a reasonable equity ratio is something on the order of the ratios prior to the advent of federal deposit guarantees and bailouts. One problem, of course, is that state-chartered banks were the rule in the U.S. banking industry until after the Civil War, and state regulations differed widely. Nonetheless, research indicates that New York banks had an average capital-to-asset ratio of 39 percent in 1850, and that the ratio had fallen to 14 percent by 1900.¹³ Other estimates indicate that national banks had capital-to-asset ratios between 30 percent and 40 percent from 1866 until just prior to 1900.¹⁴

Based on these historical figures, and the fact that such a high capital requirement would only be imposed on a firm that actively chooses to organize under the new charter, one plausible minimum ratio of capital to assets would be 40 percent. Naturally, the new charter would also have to define capital and assets, a process that is more involved now than it was in the early 1900s. Capital should be defined to include only common-equity Tier 1 capital,¹⁵ and assets should be a comprehensive measure that includes total off-balance-sheet and net-derivatives exposures.¹⁶ The ratio of these two quantities is most nearly comparable to these historic ratios.

While this ratio is extraordinarily high compared to present capital ratios, banks' current capital ratios (as low as 6 percent) are extremely low by historical standards, and

lowest for large banks. The ratios are too low and offload substantial risk and losses onto taxpayers. Policymakers and financial experts have suggested various alternative ratios. For instance, Alan Greenspan, Anat Admati, and Martin Hellwig have suggested that 20 percent capital for all banks is far more consistent with a sound banking system than the current single-digit levels of capital relative to assets.¹⁷

An equity ratio at such a relatively high level might well impose higher funding costs on firms adopting the new charter relative to today's commercial banks and the typical non-banking financial company. However, meeting this relatively high equity ratio would drastically reduce a firm's probability of failure and lower the probability of taxpayer bailouts under any circumstances. As a result, there is no economic justification for regulating such firms' operations. The reduction in regulation would provide a benefit to any such highly capitalized bank, a benefit that can be compared to the cost of additional capital. There is a very long list of regulations from which firms organizing under the new charter could be exempt to make this structure attractive and economically feasible.

REGULATORY FRAMEWORK AND EXEMPTIONS

Banks are highly regulated by both state and federal regulators, perhaps more so than any other business. These regulations can be broadly grouped into: (1) chartering and entry restrictions; (2) regulation and supervision; and (3) examination.¹⁸ A goal of this charter proposal, in addition to lowering federal government guarantees and reducing bank bailouts, is to lower federal regulatory restrictions. In practice, both state and federally chartered banks are also subject to state laws and regulations governing the basic transactions with customers.

For instance, state laws, most notably the Uniform Commercial Code, govern practices such as transactions in commercial paper and

promissory notes, bank deposits, funds transfers, secured transactions, and contracts.¹⁹ While federal law governs federally chartered banks' rights and obligations as chartered entities, state laws typically govern some banks' charters, safety, and soundness as well as securities transactions, insurance, real property, and mortgages. This charter proposal does not seek to usurp state laws concerning contracts or which prohibit fraud and material misstatements. The charter should, however, pre-empt state authority over the registration of securities.²⁰

Because the proposal aims to replace government regulation and supervision with a sensible disclosure regime contingent on high-equity capital, the main task of government regulators would be to examine banks to ensure compliance with the capital requirement. Laws that mandate disclosure and enhance enforcement through civil liability rules have a more positive impact than other forms of securities regulations, and evidence suggests that this type of disclosure and private monitoring would work well even in the banking sector.²¹ Using the proposed charter, therefore, banks would be faced mostly with regulations that focus on punishing and deterring fraud, and fostering the disclosure of information that is material to investment decisions.

Following is an outline of what the regulatory framework would look like for a firm organized under the new charter:

- **The OCC would evaluate the new charter**, ensuring the character of management and directors through standard background checks.
- **The OCC would serve as the primary regulator for the bank**, and the agency's main task would be to ensure that the firm adheres to the capital requirement. The OCC would examine the bank's assets and capital every six months.
- **The firm would have to demonstrate that it meets a 40 percent capital-to-asset ratio** with capital defined as common-equity Tier 1 capital, and total assets defined to include off-balance-sheet and net-derivatives exposures.
- **After beginning operation, failure to meet the capital requirement would result in the bank losing its charter and being closed.**²² A bank that fails to meet the capital ratio would be given a grace period to return capital to 40 percent, say two or three months, and then suspension of operations would be required. Starting from such a high capital level, the losses to depositors and other creditors are likely to be small or zero.
- **The firm would be subject to the affiliate restrictions in Section 23A and Section 23B of the Federal Reserve Act.** Section 23A limits the aggregate amount of transactions the bank (and its subsidiaries) can conduct with *any* affiliate to no more than 10 percent of the bank's capital stock and surplus, and also limits the aggregate amount of transactions the bank (and its subsidiaries) can conduct with *all* affiliates to no more than 20 percent of the bank's capital stock and surplus.²³ Section 23B essentially restricts financial transactions between affiliates so that the relationship is not used simply to gain preferential terms or treatment relative to what would be available by interacting with, instead, nonaffiliated companies.²⁴
- **Bank holding companies would be limited** to owning either a traditional bank or one of the newly chartered banks.
- **In the act of providing credit, the firm could not lawfully discriminate** based on race, color, religion, national origin, sex, marital status, or age, where discrimination is defined as disparate treatment rather than disparate impact.²⁵

The new charter should also include an explicit prohibition against receiving government funds from any source. In particular, the charter should prohibit the firm and any subsidiaries from receiving:

- FDIC deposit insurance,
- FDIC emergency assistance and loan guarantees,
- Federal Reserve discount window borrowing,
- Federal Reserve emergency credit assistance under any Section 13(3) facility,
- Federal Home Loan Bank Advances,
- Loans from any community development financial institution,
- Loans from any government-sponsored enterprise, federal agency, or newly created government assistance program, and
- Federal or state grants from any government agency.

The charter will also exempt the bank from several specific federal regulations. The following is a list of federal regulations from which the newly chartered firm should be exempt:

- **Sections 16 and 21 of the Glass–Steagall Act.** Many policymakers mistakenly believe that the 1999 Gramm–Leach–Bliley Act (GLBA) repealed the Glass–Steagall Act (the Banking Act of 1933). In fact, the GLBA only repealed sections 20 and 32 of Glass–Steagall, those that generally prohibited commercial banks from affiliating with investment banks. To this day, two major Glass–Steagall restrictions on banks’ securities dealings remain: (1) Section 16, which generally prohibits commercial banks from underwriting or dealing in securities; and (2) Section 21, which generally prohibits investment banks from accepting demand deposits.²⁶ These restrictions should be eliminated because the simpler the bank’s structure, the easier it would be for depositors and shareholders to monitor the bank’s activities.²⁷
- **Capital stress tests and financial-stability mandates.** The charter should exempt the bank from any and all regulations promulgated under Title I of Dodd–Frank. Title I created the Financial Stability Oversight Council (FSOC) and tasked the FSOC

with, among other things, recommending heightened regulations for risk management at financial firms.²⁸

- **Federal capital and liquidity rules.** The charter will exempt the bank from any federal law, rule, or regulation addressing capital or liquidity requirements or standards.²⁹ In the late 1980s, federal banking regulators introduced the complex Basel capital rules, a purported improvement over the previous capital requirements. While these rules were intended to improve the safety and soundness of the banking system, the Basel system, in particular its reliance on risk weights, contributed to the 2008 financial crisis.³⁰
- **Capital-distribution restrictions.** The charter will exempt the bank from any federal law, rule, or regulation that permits a federal regulatory agency to object to a capital distribution. If the bank is temporarily below the required capital level, no dividends or share repurchases would be allowed, but otherwise there is no restriction on such distributions to shareholders.
- **Merger and acquisition restrictions.** Any federal law, rule, or regulation that provides limitations on mergers, acquisitions, or consolidations, should not apply to the bank, provided such proposed merger, acquisition, or consolidation maintains the required capital ratio and is consistent with the anti-trust laws.
- **Truth in Lending Act.** The Truth in Lending Act (TILA) was enacted in 1968 to provide uniform consumer protection standards in credit markets, and focused mainly on disclosure requirements for items such as finance charges and the annual percentage rate (APR).³¹ TILA has been amended numerous times, and it now requires extensive disclosures on calculation methods and explanation of cost-related information.³² In the absence of a federal requirement, financial firms will have incentives to provide adequate disclosures to potential customers and,

indeed, it is difficult to see how they could operate successfully without doing so.

- **The Home Ownership and Equity Protection Act.** Congress passed the Home Ownership and Equity Protection Act (HOEPA) as Title I, Subtitle B of the Riegle Community Development and Regulatory Improvement Act of 1994.³³ HOEPA amended TILA to subject certain loans—the rates or fees for which exceed specified limits—to heightened disclosure requirements.³⁴ As enacted, these rules applied to closed-end home equity loans and closed-end loans made to refinance existing mortgages that charged either (1) an APR of more than 10 percentage points above the yield on Treasury securities of comparable maturities, or (2) points and fees that exceed the greater of 8 percent of the loan amount or \$400 (adjusted annually for inflation).³⁵ HOEPA requires the disclosure of loan information that financial firms will already have incentives to adequately provide. Furthermore, most of the practices that HOEPA prohibits—such as fraud, deception, and document falsification—are already illegal under state laws.³⁶
- **Real Estate Settlement Procedures Act.** The Real Estate Settlement Procedures Act (RESPA) was passed in 1974, largely to see that borrowers “are provided with greater and more timely information on the nature and costs of the settlement process and are protected from unnecessarily high settlement charges.”³⁷ The high charges with which the act was concerned stemmed from complaints over lenders advertising loans at a low rate of interest provided the borrower used a specified title insurance company; the title company would then charge an inflated price and kick back a portion of the fee to the lender. It is unclear how the borrower benefits from prohibiting such a practice if lenders can simply raise the interest rate they charge, and evidence suggests that RESPA did not achieve its stated purpose of lowering lending rates. Furthermore, the

amount of information that lenders are now required to disclose obfuscates rather than informs the typical borrower, and it is unclear that federal regulation of title and closing costs is even desirable.³⁸

- **Home Mortgage Disclosure Act.** A primary goal of the 1975 Home Mortgage Disclosure Act (HMDA) was to require banks and savings and loan associations to make data about their overall geographic lending patterns publicly available.³⁹ Over time, the focus of HMDA has changed, first to whether banks were lending in the neighborhoods from which their deposit customers lived, then to whether lenders and even non-bank lenders were discriminating, and ultimately to whether certain groups were being targeted with unfavorable loan terms.⁴⁰ While HMDA has increased the reporting and liability burden on financial institutions, HMDA itself was not designed as part of an experimental study, and the data generally should not be used to prove discrimination.
- **Equal Credit Opportunity Act.** The 1974 Equal Credit Opportunity Act (ECOA) was intended to promote adequate disclosure of information to and about credit consumers, and also to shield protected classes of consumers from discrimination when applying for credit.⁴¹ Over time, the law has been used more broadly, and now is part of the framework used to prove disparate impact using, among other things, a judicial doctrine known as an effects test, whereby regulators can “prohibit a creditor practice that is discriminatory in effect because it has a disproportionately negative impact on a prohibited basis, even though the creditor has no intent to discriminate and the practice appears neutral on its face.”⁴² As explained above, the charter would include a provision against discrimination—where discrimination is defined as disparate treatment rather than disparate impact—based on race, color, religion, national origin, sex, marital status, or age.

- **Fair Housing Act.** The Fair Housing Act (FHA) was passed in 1968 to prevent discrimination in housing.⁴³ As one Federal Reserve report notes, the “examination of every institution, whether or not the agency suspects discrimination, is strikingly different from the practices of the federal agencies responsible for other areas of anti-discrimination law enforcement.”⁴⁴ As explained above, the charter would include a provision against discrimination—where discrimination is defined as disparate treatment rather than disparate impact—based on race, color, religion, national origin, sex, marital status, or age.
- **Community Reinvestment Act.** The 1977 Community Reinvestment Act (CRA) was supposed to address banks’ provisioning of credit in the communities in which they operate, with a particular focus on how banks provide credit to low-income and moderate-income neighborhoods.⁴⁵ The CRA was amended in 1989 to require public disclosure of banks’ CRA ratings, and again in 2005 to account for differences in bank sizes and business models.⁴⁶ The 1999 GLBA required bank holding companies to register with the Federal Reserve, and made approval contingent upon Fed certification that both the holding company and all of its subsidiary depository institutions were (among other requirements) in compliance with the CRA.⁴⁷ Regulators currently take CRA ratings into account when considering (among other things) applications to open new branches, move existing branches, and merge with other banking organizations.⁴⁸ Simply put, sound underwriting—not social policies—would guide lending decisions by these newly chartered institutions.
- **Money Laundering/Know-Your-Customer rules.** The current anti-money-laundering (AML) regulatory framework is clearly not cost-effective. The AML regime costs an estimated \$4.8 billion to \$8 billion per year, yet results in fewer than 700 convictions annually, a proportion of

which are simply additional counts against persons charged with other predicate crimes.⁴⁹ The current framework is overly complex and burdensome, and its ad hoc nature has likely impeded efforts to combat terrorism and enforce laws. The newly chartered bank should be exempt from the existing reporting requirements, particularly the low-threshold currency-transaction reports (CTRs) and suspicious-activity reports (SARs). In the absence of an AML regulatory framework, these firms would remain legally liable for facilitating criminal behavior.⁵⁰

- **The Volcker Rule.** Section 619 of the Dodd–Frank Act imposed a banking regulation known as the Volcker Rule. This rule is intended to protect taxpayers by prohibiting banks from making risky investments (trades) solely for their own profit, a practice known as proprietary trading. Although it sounds logical to stop banks from making “risky bets” with federally insured deposits, this idea ignores the basic fact that banks make risky investments with federally insured deposits every time they make a loan. Furthermore, the practical difficulties associated with implementing the rule caused regulators to spend years working on what ended up being an enormously complex rule.⁵¹ Regardless, it makes no sense to subject banks that organize under the charter proposed in this chapter to the Volcker Rule, because such banks would not be eligible for federal deposit insurance.

CONCLUSION

There is little, if any, justification for heavily regulating financial firms that absorb their own financial losses. Furthermore, centralized government regulation and micromanagement of financial risk has repeatedly failed to maintain the safety and soundness of the financial system. Replacing government regulation of financial firms with true market discipline would lower the risk of future financial crises and improve individuals’ ability

to build wealth. It is of course possible that no one would want to start such a bank. The value of current subsidies may well offset the value of being less regulated.

On the other hand, small banks are currently allowed to fail with losses imposed on non-insured depositors and other creditors, and such a charter might have substantial value

to some investors and some depositors. There is no reason to prevent people from organizing such banks and depositing funds in these institutions should they wish, and providing the option to organize such banks would give Americans a clear path to prosperity thanks to reduced government regulations.

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ENDNOTES

1. The acronym CHOICE stands for Creating Hope and Opportunity for Investors, Consumers and Entrepreneurs. The Committee passed the CHOICE Act on September 13, 2016, by a vote of 30 to 26; the text is available at [Congress.gov](https://www.congress.gov/bill/114th-congress/house-bill/5983/actions), “H.R. 5983–Financial CHOICE Act of 2016,” <https://www.congress.gov/bill/114th-congress/house-bill/5983/actions> (accessed September 14, 2016).
2. Norbert J. Michel, “Money and Banking Provisions in the Financial CHOICE Act: A Major Step in the Right Direction,” Heritage Foundation *Background* No. 3152, August 31, 2016, <http://www.heritage.org/research/reports/2016/08/money-and-banking-provisions-in-the-financial-choice-act-a-major-step-in-the-right-direction>.
3. The Basel III requirements are not directly mandated by Dodd–Frank. The Dodd–Frank Act did not explicitly require adoption of the Basel III rules, but it did include language—mostly in sections 165 and 171— that effectively directed federal banking agencies to implement the Basel III proposals as part of its heightened regulations for specially designated firms. Although the Basel rules themselves are aimed at large international banks, U.S. federal banking regulators have imposed the Basel standards on virtually all U.S. commercial banks beginning in the 1980s. The 1983 International Lending Supervision Act gave federal regulators the explicit authority to regulate banks’ capital adequacy, and to define what constitutes adequate capital levels. See 12 U.S. Code § 3907.
4. Office of the Comptroller of the Currency, “Becoming a National Bank,” February 2011, <http://www.occ.treas.gov/publications/publications-by-type/licensing-manuals/becoming-a-national-bank.pdf> (accessed September 15, 2016). Chartering a bank holding company (BHC) also requires Federal Reserve approval. As explained above, this chapter suggests having only the OCC approve the new financial institution charter. The OCC has the authority to charter national banks (even uninsured banks) under the National Bank Act of 1864, as amended, 12 U.S. Code Chapter 1 et seq., and federal savings associations under section 5 of the Home Owners’ Loan Act, 12 U.S. Code § 1464.
5. For a general discussion, see Office of the Comptroller of the Currency, “Becoming a National Bank,” pp. 5–10. These OCC regulations are found at 12 C.F.R. 5.20.
6. Most of the current requirements regarding these types of factors are in 12 C.F.R. 5.20(e) through 12 C.F.R. 5.20(h).
7. The bank would of course be required to post this fact—that the bank is not eligible for federally backed deposit insurance— prominently in advertising, on any website, and in any offices frequented at which business with customers is conducted.
8. Howard Bodenhorn, “Double Liability at Early American Banks,” NBER *Working Paper* No. 21494, August 2015, <http://www.nber.org/papers/w21494.pdf> (accessed September 15, 2016), and Richard Grossman, “Other People’s Money: The Evolution of Bank Capital in the Industrialized World,” Wesleyan Economics *Working Paper* No. 2006-020, April 2006, http://repec.wesleyan.edu/pdf/rgrossman/2006020_grossman.pdf (accessed September 15, 2016).
9. Congress amended the National Bank Act and the Federal Reserve Act to remove double liability from national bank shares issued after 1933. In 1935, Congress allowed national banks to terminate double liability after July 1937 on all shares. By the end of World War II, more than half of the states had removed extended liability requirements, with Arizona being the last state to do so in 1956. See Alexander Salter, Vipin Veetil, and Lawrence H. White, “Extended Shareholder Liability as a Means to Constrain Moral Hazard in Insured Banks,” *Quarterly Review of Economics and Finance*, forthcoming.
10. Though relatively small in size and number, some investment banking firms are still organized as general partnerships. See “Wall Street Partnerships, Brown-Blooded Holdouts,” *The Economist*, June 16, 2011, <http://www.economist.com/node/18836248> (accessed September 15, 2016). Commercial banks are generally not organized as partnerships, though in the past some private banks may have been. The history on private banks in the U.S. is somewhat murky. See Richard Sylla, “Forgotten Men of Money: Private Bankers in Early U.S. History,” *The Journal of Economic History*, Vol. 36, No. 1 (March 1976), pp. 173–188, http://www.jstor.org/stable/2119809?seq=1#page_scan_tab_contents (accessed October 18, 2016).
11. Several options could be explored in the partnership context, and all of the firms’ debts would not have to be exposed to the same degree of extended liability. General partners could, for instance, take on limited partners with clearly defined limits for only certain types of non-deposit liabilities.
12. Such a framework would also necessitate rules to ensure that owners have sufficient resources. One option would be to adopt rules similar to the SEC’s Regulation D, which define an *accredited investor* as either a financial institution or a natural person who has an income of more than \$200,000 or a residence exclusive net worth of \$1 million or more. Incidentally, the new charter proposed herein could also include this type of requirement for shareholders.
13. Bodenhorn, “Double Liability at Early American Banks,” p. 25. The National Bank Acts of 1864 and 1865 did not specify a capital ratio but, instead, established how much capital was required to start a bank based on the population of the town.
14. Grossman, “Other People’s Money,” p. 32.
15. Regulatory capital components are specified at 12 C.F.R. 3.20.
16. There are also several different ways to define a firm’s derivatives exposure; the goal should be to define such exposure as simply as possible without using risk weights. For instance, a flat percentage of notional derivatives could be combined with a firm’s

net current credit exposure, and this total could be included in the measure of total assets. See Michel, “Money and Banking Provisions in the Financial CHOICE Act: A Major Step in the Right Direction.”

17. Alan Greenspan, “More Capital Is a Less Painful Way to Fix the Banks,” *Financial Times*, August 17, 2015, <https://www.ft.com/content/4d55622a-44c8-11e5-af2f-4d6e0e5eda22> (accessed October 3, 2016), and Anat Admati and Martin Hellwig, *The Bankers’ New Clothes: What’s Wrong with Banking and What to Do About It* (Princeton, NJ: Princeton University Press, 2013).
18. For an overview of these bank regulatory functions, see Michael P. Malloy, *Principles of Bank Regulation*, 3rd ed. (New York: Thomson Reuters, 2011). Also see David Burton and Norbert J. Michel, “Financial Institutions: Necessary for Prosperity,” Heritage Foundation *Backgrounder* No. 3108, April 14, 2016, http://www.heritage.org/research/reports/2016/04/financial-institutions-necessary-for-prosperity?ac=1#_ftn21.
19. Uniform Commercial Code, <https://www.law.cornell.edu/ucc> (accessed March 21, 2016). The UCC is not actually “uniform” throughout the country. Different states have enacted somewhat different versions.
20. This is desirable in any case. See Rutheford B. Campbell Jr., “An Open Attack on the Nonsense of Blue Sky Regulation,” *The Journal of Corporation Law*, Vol. 10, No. 3 (Spring 1985), pp. 556–557, and Rutheford B. Campbell Jr., “Blue Sky Laws and the Recent Congressional Preemption Failure,” *The Journal of Corporation Law*, Vol. 22, No. 2 (Winter 1997), p. 188.
21. Rafael La Porta, Florencio Lopez-De-Silanes, and Andrei Shleifer, “What Works in Securities Laws?” *The Journal of Finance*, Vol. LXI, No. 1 (February 2006), <http://onlinelibrary.wiley.com/doi/10.1111/j.1540-6261.2006.00828.x/pdf> (accessed March 15, 2016), and James R. Barth et al., “Do Bank Regulation, Supervision and Monitoring Enhance or Impede Bank Efficiency?” *Journal of Banking & Finance*, Vol. 37 (2013), pp. 2879–2892.
22. The OCC currently retains receivership authority for national banks, even those that are uninsured, at 12 U.S. Code § 191–200. In fact, the OCC recently proposed a new rule to address how the agency would conduct the receivership of an uninsured national bank. See Office of the Comptroller of the Currency, “Receiverships for Uninsured National Banks,” Notice of proposed rulemaking, *Federal Register*, Vol. 81, No. 177 (September 13, 2016), <https://www.gpo.gov/fdsys/pkg/FR-2016-09-13/pdf/2016-21846.pdf> (accessed November 1, 2016). Also see Michael H. Krimminger, “Moving Towards a FinTech National Banking Charter?” Harvard Law School Forum on Corporate Governance and Financial Regulation, October 22, 2016, <https://corpgov.law.harvard.edu/2016/10/22/moving-towards-a-fintech-national-banking-charter/> (accessed November 1, 2016).
23. These sections specify several *covered* transactions, including loans, the purchase of investments and securities, and the purchase of assets. See 12 U.S. Code § 371c. The restrictions may have to be written into the charter since the bank would not, in general, be subject to the Federal Reserve Act.
24. These sections specify several *covered* transactions, including the sale of securities or other assets (including repurchase agreements), and the payment of money or the furnishing of services under a contract or lease. See 12 U.S. Code § 371c–1. The restrictions may have to be written into the charter since the bank would not, in general, be subject to the Federal Reserve Act.
25. Roger Clegg, “Symposium: The Fair Housing Act Doesn’t Recognize Disparate-Impact Causes of Action,” Supreme Court of the United States Blog, January 7, 2015, <http://www.scotusblog.com/2015/01/symposium-the-fair-housing-act-doesnt-recognize-disparate-impact-causes-of-action/> (accessed October 5, 2016).
26. Norbert J. Michel, “The Glass–Steagall Act: Unraveling the Myth,” Heritage Foundation *Backgrounder* No. 3104, April 28, 2016, <http://www.heritage.org/research/reports/2016/04/the-glasssteagall-act-unraveling-the-myth?ac=1>.
27. Some of the actions by the FSOC are consistent with a belief that banks have complicated corporate structures, which obfuscate the effects of their activities and make them difficult to resolve.
28. 12 U.S. Code § 5322. For a discussion of Title I of Dodd–Frank, see Peter Wallison, “Title I and the Financial Stability Oversight Council,” in Norbert J. Michel, ed., *The Case Against Dodd–Frank: How the “Consumer Protection” Law Endangers Americans* (Washington, DC: The Heritage Foundation, 2016), <http://thf-reports.s3.amazonaws.com/2016/The%20Case%20Against%20Dodd-Frank.pdf>, and Norbert J. Michel, “The Financial Stability Oversight Council: Helping to Enshrine ‘Too Big to Fail,’” Heritage Foundation *Backgrounder* No. 2900, April 1, 2014, <http://www.heritage.org/research/reports/2014/04/the-financial-stability-oversight-council-helping-to-enshrine-too-big-to-fail>.
29. The 1983 International Lending and Supervision Act (Public Law 98–181; 97 Stat. 1284) authorized the federal banking agencies to establish minimum levels of capital, and in 1988 the agencies adopted the Basel capital rules. All such requirements are implemented via rulemaking rather than by statute, and the standards are implemented through multiple rules. See, for instance, Board of Governors of the Federal Reserve System, “Risk-Based Capital Guidelines; Market Risk,” Final Rule, *Federal Register*, Vol. 78, No. 243 (December 18, 2013), 12 C.F.R. Parts 208 and 225, <https://www.gpo.gov/fdsys/pkg/FR-2013-12-18/pdf/2013-29785.pdf> (accessed October 5, 2016), and Office of the Comptroller of the Currency, “Liquidity Coverage Ratio: Liquidity Risk Measurement Standards,” Final Rule, *Federal Register*, Vol. 79, No. 197 (October 10, 2014), <https://www.gpo.gov/fdsys/pkg/FR-2014-10-10/pdf/2014-22520.pdf> (accessed October 5, 2016).

30. Kevin Dowd, Martin Hutchinson, Jimi Hinchliffe, and Simon Ashby, "Capital Inadequacies: The Dismal Failure of the Basel System of Capital Adequacy Regulation," Cato Institute *Policy Analysis* No. 681, July 29, 2011, <http://www.cato.org/publications/policy-analysis/capital-inadequacies-dismal-failure-basel-regime-bank-capital-regulation> (accessed October 3, 2016), and Norbert J. Michel and John Ligon, "Basel III Capital Standards Do Not Reduce the Too-Big-to-Fail Problem," Heritage Foundation *Backgrounders* No. 2905, April 23, 2014, http://www.heritage.org/research/reports/2014/04/basel-iii-capital-standards-do-not-reduce-the-too-big-to-fail-problem?ac=1#_ftn4.
31. 15 U.S. Code 1601 et seq. TILA is implemented by Regulation Z (12 C.F.R. 1026). TILA was title I of the Consumer Credit Protection Act (Public Law 90–321).
32. Thomas A. Durkin, Gregory Elliehausen, Michael E. Staten, and Todd J. Zywicki, *Consumer Credit and the American Economy* (New York: Oxford University Press, 2014), pp. 453–481.
33. Riegle Community Development and Regulatory Improvement Act of 1994, Public Law 103–325.
34. *Ibid.*, § 152.
35. Riegle Community Development and Regulatory Improvement Act of 1994 § 152. HOEPA excludes from its coverage residential mortgage transactions (purchase-money mortgages also known as seller or owner financing), open-end credit, and reverse mortgages.
36. Durkin, Elliehausen, Staten, and Zywicki, *Consumer Credit and the American Economy*, p. 410.
37. 12 U.S. Code 2601 et seq. The Department of Housing and Urban Development (HUD) originally implemented RESPA by Regulation X. Under Dodd–Frank, the Consumer Financial Protection Bureau (CFPB) restated HUD's implementing regulation at 12 C.F.R. Part 1024 (*Federal Register*, Vol. 76, No 244 (December 20, 2011), p. 78978). See Consumer Financial Protection Bureau, "Integrated Mortgage Disclosure Rule Under the Real Estate Settlement Procedures Act (Regulation X) and the Truth in Lending Act (Regulation Z)," *Federal Register*, Final Rule, Vol. 78, No. 251 (December 31, 2013), <https://www.gpo.gov/fdsys/pkg/FR-2013-12-31/pdf/2013-28210.pdf> (accessed July 20, 2016).
38. Kevin Villani and John Simonson, "Real Estate Settlement Pricing: A Theoretical Framework," *Real Estate Economics*, Vol. 10, No. 3 (September 1982), pp. 249–275, and Mark Shroder, "The Value of the Sunshine Cure: The Efficacy of the Real Estate Settlement Procedures Act Disclosure Strategy," *Cityscape*, Vol. 9, No. 1 (2007), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1089448 (accessed September 30, 2016).
39. The HMDA is implemented by Regulation C, and Dodd–Frank transferred HMDA rulemaking authority from the Federal Reserve Board to the CFPB.
40. Joseph Kolar and Jonathan Jerison, "The Home Mortgage Disclosure Act: Its History, Evolution, and Limitations," *Consumer Finance Law Quarterly Report*, Vol. 59, No. 3 (2005), <http://buckleysandler.com/uploads/36/doc/HistoryofHMDApr06.pdf> (accessed September 30, 2016), and Patricia McCoy, "The Home Mortgage Disclosure Act: A Synopsis and Recent Legislative History," *Journal of Real Estate Research*, Vol. 29, No. 4 (2007), pp. 381–397.
41. The ECOA is implemented by the CFPB's Regulation B. (See 12 C.F.R., part 1002.) For an overview of policy concerns, see John Matheson, "The Equal Credit Opportunity Act: A Functional Failure," *Harvard Journal on Legislation*, Vol. 21 (1982), p. 371, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1874297 (accessed September 30, 2016).
42. See 12 C.F.R. Part 1002 (Regulation B), Supplement I to §1002.1(a), Section 1002.6—Rules Concerning Evaluation of Applications, December 30, 2011, <http://www.consumerfinance.gov/eregulations/1002-Subpart-Interp/2011-31714#1002-1-a-Interp-1> (accessed September 30, 2016). Also see Hans A. von Spakovsky, "'Disparate Impact' Isn't Enough," Heritage Foundation *Commentary*, March 22, 2014, <http://www.heritage.org/research/commentary/2014/3/disparate-impact-isnt-enough>.
43. The FHA is Title VIII of the Civil Rights Act of 1968, as amended (42 U.S. Code 3601, et seq.).
44. John Walter, "The Fair Lending Laws and Their Enforcement," Federal Reserve Bank of Richmond *Economic Quarterly*, Vol. 81 (1995), p. 62, <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.202.7566&rep=rep1&type=pdf> (accessed July 20, 2016). Also see Roger Clegg, "Silver Linings Playbook: 'Disparate Impact' and the Fair Housing Act," *Cato Supreme Court Review* (2014–2015), <http://object.cato.org/sites/cato.org/files/serials/files/supreme-court-review/2015/9/2015-supreme-court-review-chapter-6.pdf> (accessed October 5, 2016).
45. See 12 U.S. Code 2901; the CRA is implemented by Regulations 12 C.F.R. parts 25, 195, 228, and 345.
46. Darryl E. Getter, "The Effectiveness of the Community Reinvestment Act," Congressional Research Service, 7-5700, January 7, 2015, <https://www.fas.org/sgp/crs/misc/R43661.pdf> (accessed October 5, 2016).
47. Code of Federal Regulations, Title 12, Ch. II § 225.82, <http://www.gpo.gov/fdsys/pkg/CFR-2013-title12-vol3/pdf/CFR-2013-title12-vol3-part225.pdf> (accessed October 5, 2016).
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49. David Burton and Norbert Michel, "Financial Privacy in a Free Society," Heritage Foundation *Backgrounder* No. 3157, September 23, 2016, <http://www.heritage.org/research/reports/2016/09/financial-privacy-in-a-free-society>.
50. Aside from overt criminal and civil violations, banks would not be permitted, under current law, to rely on willful ignorance as an excuse. In the 2011 *Global-Tech Appliances, Inc. v. SEB S.A.*, the U.S. Supreme Court affirmed the validity of the willful blindness doctrine in both civil and criminal settings. See National Association of Criminal Defense Lawyers, "Criminal Defense Issues: Willful Blindness," <https://www.nacdl.org/criminaldefense.aspx?id=21211> (accessed November 10, 2016).
51. Norbert J. Michel, "The Volcker Rule: Three Years and Nearly 1,000 Pages Later," The Daily Signal, December 12, 2013, <http://dailysignal.com/2013/12/12/volcker-rule-three-years-nearly-1000-pages-later/>. For the final (jointly issued) rule, see Department of the Treasury, "Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds," *Federal Register*, Vol. 79, No. 21 (January 31, 2014), <https://www.gpo.gov/fdsys/pkg/FR-2014-01-31/pdf/2013-31511.pdf> (accessed November 10, 2016).



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