Financial Services & E-Commerce

Can the Dodd-Frank Act Be Reformed To Strengthen the Financial System and the Overall Economy? We Think So

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Note from the Editor:

This article is about potential reforms to the Dodd-Frank Wall Street Reform and Consumer Protection Act. The authors received extensive input from other members of the Federalist Society's Financial Services & E-Commerce Practice Group Executive Committee. Any expressions of opinion are those of the authors and/or the members of the executive committee who shared their ideas and recommendations. This is not an expression of the views of the Federalist Society, nor intended to influence the adoption of any particular legislation. Neither should it be considered an expression of the views of the firms or organizations with which the authors may be associated. The Federalist Society seeks to further discussion about the Dodd-Frank Act. To this end, we offer links below to other perspectives on the issue, and we invite responses from our audience. To join this debate, please email us at info@fed-soc.org.

Related Links:

- Center for American Progress, Dodd-Frank Financial Reform After 2 Years (July 2012): https://cdn.americanprogress.org/wp-content/uploads/issues/2012/07/pdf/dodd_frank.pdf
- Mike Konczal, *Ignore the Naysayers: Dodd-Frank Reforms Are Finally Paying Off*, The New Republic, Jul. 22, 2014: http://www.newrepublic.com/article/118814/dodd-frank-reforms-are-finally-paying
- Martin Neil Baily & Douglas J. Elliott, *Financial Reform Progress: Cause for Considerable Celebration and Some Concern*, Brookings Institution, Dec. 22, 2014: http://www.brookings.edu/research/opinions/2014/12/22-financial-reform-progress-celebration-concern-baily-elliott
- Hester Peirce & James Broughel, Dodd-Frank: What It Does and Why It's Flawed, Mercatus Center (2012): http://mercatus.org/publication/dodd-frank-what-it-does-and-why-its-flawed

I. Introduction & General Themes

A. Reform Amendments Already Approved by the House

During the 113th Congress, the House Financial Services Committee reported more than two dozen bills that amend provisions of the Dodd-Frank Act (DFA), in many cases with strong bipartisan majorities. Several of these have also been overwhelmingly passed by the House.

These bills address a variety of concerns that have been raised about DFA:

- Improving the operation of regulatory agencies created or impacted by Dodd-Frank. For example, one bill would subject the Bureau of Consumer Financial Protection (BCFP) to more accountability by replacing its sole director with a board and placing it under the regular Congressional authorization and appropriations processes. Another measure would require additional cost-benefit and economic impact analysis by the SEC of its regulations.

- Several bills would amend provisions regulating swaps or other derivatives.

- At least two would provide small business relief from DFA regulations or related securities laws.

These legislative proposals provide an excellent starting point for the 114th Congress to improve the supervision and regulation of the U.S. financial system.

B. Cost-Benefit Analysis Requirements for Rulemakings

For decades bi-partisan legislation and executive orders have required certain Federal financial regulators, including the Securities and Exchange Commission, the Commodity Futures Trading Commission, and the Office of the Comptroller of the Currency, to engage in cost-benefit analysis when preparing major and certain other rulemakings to ensure that rules are founded on facts and avoid imposing unnecessary burdens. However, these requirements are usually either ignored, do not apply to particular regulators (including the Federal Reserve), or are addressed in a cursory manner. Although the cost-benefit analyses of executive agencies have been subject to review by the Office of Management and Budget (OMB), the quality of that review has waxed and waned from administration to administration. With regard to *independent* agencies, there has been no administrative oversight of the quality of cost-benefit analyses. Rules that are not subjected to a good faith cost-benefit analysis not only fail to achieve their stated policy objectives, but they also hinder job creation and weaken the economy.

Financial regulators should be required to perform rigorous cost-benefit analysis as part of every rulemaking to get a

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full understanding of the potential impact of proposed rules, avoid flaws that could have been identified and addressed, and tailor rules to reduce regulatory burdens and more effectively achieve policy objectives. Additionally, financial regulators should be required to conduct further cost-benefit analysis at an appropriate time after rules have been implemented to determine the actual costs and burdens and make adjustments based on the new evidence.

C. Accountability for Financial Regulators' Activities in International Fora

Since Basel got into the business of developing global capital rules, U.S. regulators have gotten into the practice of taking financial regulatory issues to international bodies, working out "non-binding" global agreements, and then bringing them back to the U.S. to translate into very binding regulations. With the global imprimatur, U.S. regulators have been reluctant to deviate from the global deal in developing final rules. Key decisions are made away from the general view of the American public, embodying compromises to obtain global agreement, even when the compromises are out at odds with the realities of the U.S. markets and financial system.

U.S. regulators, before going abroad for negotiations on a regulatory project, should put the project out for advance public comment in the U.S. This can be done using the Advance Notice of Proposed Rulemaking (ANPR) procedures, inviting comment on the problem, its scope and consequences, and the possible avenues of resolution.

D. Extraterritoriality

U.S. financial regulators pursue some regulatory approaches not embraced internationally, and either to stimulate international cooperation or to ignore its absence the U.S. imposes final rules that follow U.S. firms, persons, or customers beyond U.S. shores. The result can place U.S. firms in a conflict of laws situation, drive foreign customers away from entanglements with U.S. firms or U.S. persons, and/or invite retaliation in kind by foreign regulators.

U.S. financial regulators need to refrain from extraterritorial application of their rules, seeking instead reciprocal or parallel arrangements with other governments wherever needed.

II. Specific Provisions

A. Reforming FSOC

DFA created a Financial Stability Oversight Council (FSOC), composed of the heads of the various financial regulators (and others), with powers that include designating individual financial institutions as systemically important (SIFIs) and then applying a heightened regulatory program as FSOC considers appropriate (administered by the Federal Reserve). Yet, the FSOC operates in an opaque fashion with closed hearings, little meaningful opportunity for public comment, and a lack of clear, objective standards for designating companies as systemic. By any measure, the FSOC's decision-making process violates the most basic notions of due process of law. Whether a company presents a systemic risk depends on whether the FSOC says it does, rather than whether a company satisfies transparent and specified metrics. The FSOC is a clear and far-reaching example of a transfer of important decision making authority from elected representatives to unelected officials of potentially a single political party (the current heads of the government agencies). In addition, the broad authority given to the FSOC raises questions about the institutional competence of the body to monitor systemic risk, since its member institutions failed to spot, and take action in response to, prior market bubbles and systemic risks such as government-sponsored enterprises involved in housing finance.

The following reforms would address some of these concerns:

- Congress should prohibit FSOC from making further designations of SIFIs until Congress has had the opportunity to review the authorities of FSOC and has, at a minimum, circumscribed its discretion and responsibilities in a manner that eliminates problems caused by its current broad authority and that is consistent with its institutional competence.

- Congress should designate government sponsored enterprises such as Fannie Mae and Freddie Mac as SIFIs, their systemic risks amply demonstrated in practice by the recent financial crisis.

- The FSOC should be reformed, at a minimum, to improve its transparency and establish specific metrics as to which activities would constitute systemic risks.

- The FSOC should have a clear process by which designated firms can take actions that would allow them to have their designations revoked.

- All private parties should have full, normal judicial recourse against the FSOC.

- The FSOC structure should be reformed to require that voting be conducted on an agency basis, rather than by the heads of an agency, to allow for the other Senate-confirmed principals of agencies to participate in the process.

- The Office of Financial Research (OFR) should either be repealed, with a requirement that financial regulators share data with the FSOC, or be removed from Treasury and placed in the Department of Commerce as a nonpartisan producer of information and analysis.

B. Artificial Asset Thresholds

Under the Dodd-Frank Act, all bank holding companies with assets of $50 billion or more are automatically subject to systemic risk regulation by the Federal Reserve, regardless of whether FSOC has identified any of these holding companies as being systemically significant. The Federal Reserve has exercised this authority by applying detailed, intrusive, and complex systemic risk regulation to all bank holding companies that satisfy the $50 billion threshold, regardless of the risks they present, even though the Dodd-Frank Act explicitly provides that systemic risk regulation should be applied in a graduated fashion based on, among other factors, risk and accommodating different business models.

Congress should require the Federal Reserve to revise its systemic risk regulations to apply only where there are clear systemic risks and to focus such regulations on addressing these specific risks. This focus could help minimize systemic risk by signaling to the market which activities will face higher regulatory burdens, while also avoiding the imposition of unnecessary costs that are ultimately paid by bank customers and impact the economy generally by reducing the efficient allocation and management of capital.

C. Resolution Plans

DFA Section 165(d) requires certain financial institutions to submit to the FDIC and the Federal Reserve plans for the resolution of the institutions in case of failure. A fundamental problem is that the statute gives the FDIC and the Federal Reserve too much discretion to define the assumptions that companies are required to make in order for their resolution plans to avoid a determination that a company's plan is "not credible," a finding that can trigger a process of very intrusive regulatory mandates on healthy institutions, including potential reorganization, restructuring, and perhaps even divestitures. This discretion can result in assumptions that impose an immediate and substantial adverse impact on the U.S. economy, including on the supply and cost of money and credit, job creation, and economic output, in order to provide excessive protection against a remote event.

In order to restore balance and transparency to this process, Section 165(d) should be amended to:

- Require the FDIC and the Federal Reserve to make public, through a formal rulemaking, the assumptions that they would mandate that companies make under Section 165(d);

- Assign the Government Accountability Office (GAO) to conduct a study of the quantitative impact on the U.S. economy, including on the supply and cost of money and credit, job creation, and economic output of the United States, of any and all of these assumptions;

- Require the FDIC and the Federal Reserve to conduct a meaningful cost-benefit analysis of any assumptions required in resolution plans under Section 165(d) in order to avoid a "not credible" determination, subject to review by the OMB.

D. Stress Testing

The federal banking regulators primarily apply two stress test regimens, the Comprehensive Capital Analysis and Review (CCAR), and Dodd-Frank Act Stress Tests (DFAST). On the basis of the results of these stress tests, regulators impose a variety of conditions on banks, including limitations on dividends. While the stress-tests have many benefits, the process is too opaque and discretionary, which is inconsistent with the rule of law and good government, and is subject to the limitations of all modeling of future conditions (for example, none of the recent models included the impact of rapid decline in oil prices). In addition, CCAR and DFAST have become incredibly costly and time-consuming endeavors that interfere with the daily operations of institutions, making them less efficient and increasingly focused on satisfying regulatory requirements rather than on serving their customers.

In order to address these deficiencies, Title I should be amended to require the Federal Reserve to disclose to the public for comment the assumptions and parameters of the models it uses to conduct supervisory stress testing. It should also be amended to require regulators to conduct CCAR and DFAST in the least intrusive and least costly manner possible.

E. Orderly Liquidation Authority (Title II)

Title II of DFA creates an elaborate structure and set of rules for the orderly liquidation of failing financial institutions, where, it is assumed, normal bankruptcy procedures would be inadequate. A fundamental problem with the orderly liquidation authority in Title II is that it gives the FDIC too much discretion, which is inconsistent with the rule of law and undermines legal certainty and predictability, affecting the market treatment of healthy institutions. Some have criticized Title II as creating the market impression that investors in institutions (to which Title II would be applied) may receive financially better treatment than they might under bankruptcy procedures.

- <u>New Chapter 14.</u> To reduce the need for Title II, the Bankruptcy Code should be amended to facilitate a single-point-of-entry recapitalization strategy through a new Chapter 14.

- <u>Duty to Maximize Value</u>. To make Title II more consistent with the rule of law if invoked, Title II should be amended to impose a duty on the FDIC to maximize the value of a covered company for the benefit of the claimants in its receivership and eliminate the FDIC's discretion to discriminate among similarly situated creditors, unless and only if such differential treatment would maximize the value of the receivership for the benefit of all creditors (the bankruptcy standard for differential treatment).

- <u>Regulators' Resolution Plans</u>. Require the FDIC and the Federal Reserve to develop jointly a resolution plan under Title II for each company that is required to submit a resolution plan under Title I.

    - Require the FDIC and the Federal Reserve to announce publicly their preferred strategy for resolving each such company under Title II in sufficient detail to provide legal certainty and predictability to the public.

    - Impose a duty on the FDIC to use that preferred strategy to resolve the company if it is put into a Title II receivership, unless the FDIC, the Federal Reserve, and the Secretary of the Treasury jointly determine that the strategy would result in serious adverse effects on financial stability in the United States at the time of the receivership.

- Remedy for Abuse of Discretion. To address the potential for abuse of discretion, provide after-the-fact judicial review of any exercise of discretion by the FDIC in carrying out its responsibilities under Title II with respect to any covered company.

F. Office of Minority and Women Inclusion (Waters Amendment)

DFA Section 342 requires financial agencies not only to evaluate their own "diversity" practices, but also to "assess" the "diversity policies and practices" of "entities regulated" by each financial agency. While it explicitly prohibits any new mandates or requirements on these entities, regulators have published elaborately detailed "guidance" on what they expect and will look for in their assessments. This kind of provision lays the groundwork for quotas and other restrictions, entirely unnecessary, since all of the "entities" covered are also subject to a variety of statutes prohibiting unlawful discrimination.

This provision should be deleted as superfluous at best and potentially leading to quotas and other intrusive and counterproductive government mandates.

G. Volcker Rule

DFA Section 619 prohibits federally insured banks from engaging in proprietary trading or investing in hedge funds (definitions and details left to five financial regulators to work out, individually or jointly). A fundamental problem with the Volcker Rule is that its principal definitions are vague, overbroad, and indeterminate, resulting in excessive legal uncertainty and unintended consequences. Another fundamental problem is that the statute's implementation, interpretation and enforcement are shared among five competing agencies, a bureaucratic structure that has proven to be unworkable.

The following amendments would address these flaws:

- Cost-Benefit Analysis. Impose a requirement on each agency to conduct a meaningful cost-benefit analysis of any proposed or final regulations implementing the Volcker Rule, subject to review by the OMB or an independent cost-benefit review agency.

- Single Agency. Simplify the administrative process by giving the power to implement, interpret, and enforce the statute to a single regulatory/executive agency.

- Exemptive Authority. Change the standard for the exercise of exemptive authority from the very restrictive standard of promoting and protecting the safety and soundness of banking entities and financial stability to the more traditional standard of "consistent with the purposes of the statute and the public interest."

- Proprietary Trading. Revise the definition of "proprietary trading" to mean the taking of short-term positions in financial instruments by individual traders or units for the specific purpose of making a profit for the banking entity's own account without any meaningful connection to client activity or hedging the banking entity's risk.

  - In particular, the concept of a "trading account" should be removed from the definition, because it has proven to be unworkable.

  - Add specific exemptions for the following activities:

    - asset-liability management;

    - trading in the sovereign debt of a country where a banking entity or its top-tier parent is organized or where a branch is located and licensed to do business, including debt of any multinational central bank (e.g., the European central bank) of which such country is a member;

    - trading in futures or other derivatives for U.S. government securities or permitted foreign sovereign debt.

  - Remove the backstop provisions, which are vague and unworkable.

- Hedge Funds and Private Equity Funds**.** The current rules and definitions have led to lawsuits, confusion, and repeated needs to address unintended consequences.

  - Limit the coverage of the terms "hedge funds" and "private equity funds," which should be clearly and specifically defined. Options include limiting the covered funds to collective investment vehicles engaged in proprietary trading or investing in portfolio companies that are not required to be registered under the Investment Company Act of 1940, rather than the current structure that relies upon any issuer that would be an investment company but for sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 or any similar company, which structure has proven to be overbroad and unworkable; or defining covered funds along the lines of the SEC's Form PF.

  - Revise the definition of "banking entity" as used in the Volcker Rule to apply to nothing more than insured depository institutions and broker dealers. Such a definition would, for example, exclude hedge funds, private equity funds, portfolio companies, registered investment companies, and foreign public funds, among other entities not intended to be treated as banking entities by the Volcker Rule.

  - Revise the definition of "covered transaction" to include the exemptions from that term contained in section 23A of the Federal Reserve Act and Regulation W.

  - Fix the conformance rules to be more practical, including by clarifying that any fund primarily invested in non-publicly traded portfolio companies is an illiquid fund entitled to a full 5-year conformance period, without any further conditions to qualify.

H. Federalizing of Corporate Law

Several provisions in Dodd-Frank represent a significant expansion of Federal authority over areas of corporate governance traditionally subject to state law. This includes, among other provisions:

- A requirement for public companies to conduct "say-on-pay" votes on a regular basis;

- A requirement for the SEC to promulgate rules requiring clawbacks of executive compensation in the event of an accounting restatement, even in circumstances where the executive had no involvement in the matter leading to the restatement; and

- A grant of authority to the SEC to adopt so-called "proxy access" rules, in which certain shareholders would be entitled to include their nominees for director in the company's proxy materials.

In addition, Dodd-Frank mandates a number of corporate disclosure requirements intended to impact substantive behavior at companies, including, among other things, requirements for the SEC to adopt rules regarding conflict mineral disclosure and disclosure of pay ratios comparing CEO and median employee compensation.

Congress should eliminate Dodd-Frank mandated disclosure requirements not supported by empirical evidence and for which the costs of compliance vastly outweigh the benefits to shareholders—in other words, requirements that effectively hurt rather than help shareholders. This would include the conflict mineral and pay ratio disclosure requirements mentioned above. Congress should also review and revise DFA corporate governance provisions that interfere with the ability of boards of directors, under state law, to choose governance solutions. For example, this would include at a minimum (1) revising the clawback rules to provide more discretion to boards in deciding when to seek to clawback compensation from an executive that is not at fault and (2) eliminating the ability of the SEC to impose universal proxy access rules or any other similar governance reform not supported by empirical evidence or a proper cost-benefit analysis.

I. Consumer Bureau Reform

The Consumer Bureau (Bureau of Consumer Financial Protection) is arguably an even more flagrant violation of democratic checks and balances than is the FSOC. It is funded directly from the Federal Reserve (without any discretion by the Federal Reserve Board); is headed by a single Director, who has all authority for the Bureau and who can be removed from office only for cause; lacks any effective check to prevent its Director's actions from threatening the safety and soundness of banks; and receives proceeds from enforcement actions (to be placed in a fund for victims or, where these cannot be adequately identified, to be disbursed by the Bureau for financial education efforts). Given the Bureau's broad enforcement authority and concentration of power in the office of the Director, the structure of the Bureau violates the requirements of due process and basic notions of fairness by making the Director the prosecutor, judge, and jury in actions the Director brings against companies and individuals under the Bureau's jurisdiction, which may include firms or individuals that the Bureau in its own view determines to be engaged in consumer financial services.

The following amendments would help to address these problems:

- Convert the Bureau into an ordinary independent agency (for example along the lines of the FTC) with a bipartisan commission structure.

- The Bureau's automatic funding from the Federal Reserve—which is equivalent to funding from general revenues—should be revoked. The Bureau should be made subject to normal congressional authorization and appropriations processes, similar to the FTC.

- The Director of the Bureau should no longer be a member of the FSOC, since the Bureau has little to do with issues of national financial stability.

- The Bureau should be able to enforce no rules except those which have been duly adopted in accordance with the APA (no *ex post facto* enforcement).

- Any financial settlements/penalties from CFPB enforcement actions should be paid into the general Treasury.

- Require formal public rule-making to define the meaning and limits of the DFA-created "abusiveness" standard.

- Require formal public rule-making with respect to data-mining projects and efforts of the Bureau.

- Even if it remains part of the Federal Reserve, the Bureau's regulatory actions should be subject to OMB (OIRA) oversight and rigorous cost-benefit analysis standards.

J. HMDA Expansion

HMDA requires banks to gather and report data collected with regard to home mortgages and mortgage customers. The Dodd-Frank Act adds approximately 14 additional items of data to be collected and reported. In its draft regulations to implement the DFA changes, the Consumer Bureau has proposed to double the Dodd-Frank expanded number of HMDA data items to be collected. Collecting and submitting the data is not costless. Moreover, expanding the data points increases regulatory risk (either due to clerical error or regulatory disagreements about definitions, format, deadlines, and other pitfalls of regulatory risk), while also expanding the potential exposure to predatory class action lawsuits.

The Bureau should be prohibited from expanding the HMDA data collection beyond the items specified in the statute. In addition, statutorily mandated data on rates of loan approvals and disapprovals should be matched against the credit performance of borrowers grouped by the same categories. Unless such loan performance data are added to HMDA, there should be no other expansion of this burdensome and misleading reporting.

K. Special Interest Provisions (e.g. Conflict Minerals)

Several provisions were included in Dodd-Frank to address social foreign policy goals, such as conflict mineral disclosures and resource extraction payments, to be administered by the SEC. These provisions were never fully debated by Congress but were added during the conference committee, were not related to the financial crisis, fall outside of the skill set of the SEC, and cost the business community billions of dollars. Implementing rules have already either been thrown out or restricted in scope by the courts.

These provisions should be repealed, as the SEC's disclosure regime is designed to provide investors with the information they need to make investment decisions. That function should not be coopted to advance other policy goals, which would be more appropriately handled by the State Department.