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"The Costs of Implementing the Dodd-Frank Act: Budgetary and Economic"

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I wish to thank the Committee for investigating these important questions. My name is James J. Angel and I study financial markets at Georgetown University. I am the former Chair of the Nasdaq Economic Advisory Board, and I formerly served on the Nasdaq OTCBB Advisory Board. I have visited over 50 financial exchanges around the world. I am currently a public member of the board of directors of the Direct Edge Stock Exchanges.[1]

Today's hearings are on the costs of the Dodd-Frank legislation. These costs fall into three categories:

First, there is the opportunity cost of what could have been done with the political momentum for financial reform that was expended on Dodd-Frank. We missed the opportunity to rationalize the fragmentation of our financial regulatory system. For the most part we loaded additional duties onto an unwieldy structure. Without fundamental reform, something will inevitably fall between the numerous cracks until it is once again too late to avoid another financial crisis.

Second, there is the direct cost of implementation to the taxpayers and others. I understand other witnesses will address this issue.

[1] These remarks are my own and do not necessarily represent those of Georgetown University or the Direct Edge stock exchanges.

Finally and most importantly, there are the indirect costs stemming from the impact on the economy. I will focus my remarks on these indirect costs, as they can be the largest costs that matter the most. However, the CBO report to Congress during the deliberations over Dodd-Frank did not even attempt to address the indirect costs or impacts on our economy, but focused solely on the near-term impact on the federal budget.[2]

Our capital markets perform vital functions in our economy and if we mess them up our economy will suffer. Businesses depend on the capital markets to provide the capital needed to grow. Congress has wisely recognized the importance of capital formation and directed the SEC to consider economic efficiency, competition, and capital formation in its rulemakings.[3] At times, the SEC does little more than pay lip service to this Congressional mandate in its rule filings and proclaimed strategic goals.[4]

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[2] http://www.cbo.gov/ftpdocs/115xx/doc11596/hr4173.pdf

[3] . Section 3(f) of the Securities Exchange Act of 1934 states:

> (f) CONSIDERATION OF PROMOTION OF EFFICIENCY, COMPETITION, AND CAPITAL FORMATION.— Whenever pursuant to this title the Commission is engaged in rulemaking, or in the review of a rule of a self-regulatory organization, 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.

[4] For example, the SEC's strategic goal #2 is "Establish an Effective Regulatory Environment". Most of the measurable outcomes relate to measures of regulation, such as the number of foreign regulators trained. There are only three measures devoted to the related sub goal, "Outcome 2.2, The U.S. Capital markets operate in a fair, fair, efficient, transparent, and competitive manner, fostering capital formation and innovation." The three measures for this sub goal are:

The Devil is in the Details of Implementation

Congress has delegated the all important details of Dodd-Frank to several regulatory agencies. I am very concerned that our regulatory structure is not up to the task of implementing Dodd-Frank in an appropriate manner. Why am I concerned?

Previous implementations of Congressional mandates have not all gone well.

Our regulators have an imperfect track record in implementing large complex laws like Dodd-Frank. One classic example is the implementation of Sarbanes Oxley §404. Sarbanes Oxley, like Dodd-Frank, was a piece of complex legislation enacted in response to problems in our financial markets. Title IV, Enhanced Financial Disclosures called for more disclosure of transactions involving management and principal stockholders, disclosure of the existence of an audit committee financial expert, along with §404 disclosure of a management assessment of internal controls.

- Percentage of transaction dollars settled on time each year
- Average institutional transaction costs for exchange listed stocks on a monthly basis.
- Percentage of market outages at SROs and electronic communications networks (ECNs) that are corrected within targeted timeframes

While it is a great step forward that the SEC is beginning to look at these important indicators, there are many more measurable outcomes regarding capital formation. None of these measurable outcomes deal directly with capital formation. Other potential measurable outcomes related to efficiency and capital formation are 1) number of IPOs, 2) number of exchange-listed US public companies, 3) number of firms that voluntarily delist, 4) amount of capital raised in US public markets, 5) amount of venture capital raised, 6) transactions costs in US capital raising v. other countries, 7) compliance costs for US public companies

Sarbanes-Oxley §404 called for an "assessment … of the effectiveness of the internal control structure and procedures of the issuer for financial reporting." [5] Congress did not specify any particular level of controls, just a report on how good they were. This seems like a pretty simple and innocuous requirement. What could be wrong with asking companies how good their controls were? One former senior SEC official from that era said the Commission and staff thought §404 was "no big deal."

An assessment could be as simple as a report card with letter grades: One firm's controls might be graded A, while another's might be graded B+. There could also be a report card that puts different grades on different types of controls. A black-and white-judgment that controls are either effective or ineffective is ludicrous. There is a whole spectrum of quality between a total lack of controls and wasteful overkill. Yes this section was interpreted by accountants and regulators as a *de facto* requirement for wasteful overkill. The SEC itself admitted that the implementation was "overly conservative." [6] Yet the SEC at the time lacked the fundamental understanding of the impact of its rules to see what was happening and to react in a timely manner as this mess was occurring. Even though the SEC had explicit

[5] To be precise, the law reads as follows:

SEC. 404. MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS.
(a) RULES REQUIRED.—The Commission shall prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d))
to contain an internal control report, which shall—
(1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
(2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.
(b) INTERNAL CONTROL EVALUATION AND REPORTING.—With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.

[6] http://www.sec.gov/rules/concept/2006/34-54122.pdf, page 9.

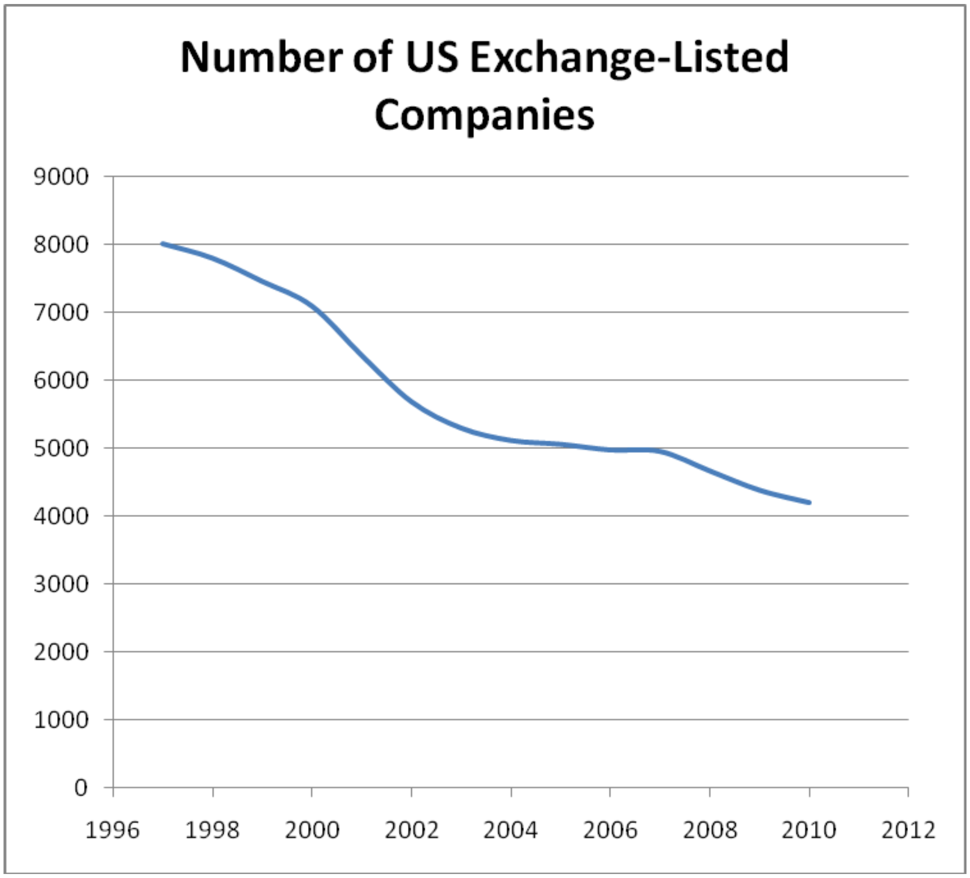
rulemaking authority in §404 itself, and also broad exemptive authority in Section 36 of the Securities Exchange Act of 1934, the SEC did little to prevent the damage and Congress had to step in with §989(g) of Dodd-Frank which exempts firms with a market capitalization of $75 million or less from §404 and calls for the SEC to study the matter further. Given that the SEC already had very broad rulemaking and exemptive authority here, it is not likely that enough will change as a result of §989(g).

The upshot is that compliance costs for public companies, especially smaller ones, jumped significantly. Few people thought that the benefits outweighed the compliance costs. One study by Foley and Lardner found that the average cost of being public for a firm with less than $1 billion in revenue jumped from $1.05 million before Sarbanes-Oxley to $2.88 million by 2005 – a 171% increase.[7] This is a major cost item for these smaller firms.

The result has been a decline in our public equity markets.

Why does this matter? By making it more expensive to be a public company, fewer companies are going public. One of the major trends in the last few years is that our public equity markets have been shrinking. The number of domestic U.S. companies listed on our exchanges is roughly half of what it was 15 years ago, as seen in the following graph:

[7] http://www.foley.com/publications/pub_detail.aspx?pubid=3420



Source: CRSP database

Most of the growth in our economy comes from newer and smaller companies. If we make it harder for these companies to get the capital they need to get started and grow, then we will have fewer jobs and less economic growth.   This is already happening. Our exchange-listed public companies now employ approximately two million fewer workers than they did 15 years ago.

Facebook demonstrates the problems facing our capital markets.

The recent Facebook financing is an example of what is wrong with our capital markets. Facebook was seeking capital to expand its successful and rapidly growing business. Facebook is a well known company and would have little trouble raising substantial sums of money from thousands of investors. This would be one of the easiest IPOs to sell. However, Facebook chose to do a private deal in which Goldman Sachs invested $500 million, and Goldman arranged for foreign investors to invest $1 billion.[8] Although the deal was originally going to be open to US investors, in the end it was only offered to foreign investors to avoid having to become an SEC registrant with all of the disclosure and other obligations that entails.

This illustrates the nature of the problems facing public companies. The US has placed such high burdens on public companies that fewer US companies are going public. The numbers of IPOs we have are not enough to offset the attrition that occurs in our financial markets through bankruptcies and mergers. The increasing burdens on US-listed companies have become so great that many companies are voluntarily delisting, and many foreign firms are exiting the U.S. exchanges. How did the SEC respond? They did not even think about the reasons firms no longer want to be public, but passed a rule making it easier for foreign firms to delist.

One of the basic lessons in entrepreneurial finance is to have an exit strategy. Investors want to know how they will get their money out when they need to. No investor wants a “Roach Motel” investment in which they can get in but they can’t get out. Typical exit strategies are to sell to a “strategic buyer” such as another firm in the same industry or to go public. By reducing the

[8] http://www.prnewswire.com/news-releases/facebook-raises-15-billion-114383494.html

attractiveness of the public markets, entrepreneurs have fewer choices when raising capital and fewer buyers when selling their companies. This will reduce the returns to successful innovation, which will reduce the amount of investment made in the U.S. This means fewer jobs and less economic growth, along with less tax revenue.

Sarbanes Oxley was but one of the many factors affecting public companies. Changes in market structure have an impact as well. In the early 1990s, the market mechanism for trading small companies on NASDAQ was very different from the auction market of the NYSE. The SEC has fostered many well meaning rule changes that had the effect of eliminating differences between the two markets. This has greatly improved the market quality for larger firms, but has also reduced the incentives for the financial services industry to market smaller firms to investors.

To be sure, there are other contributing factors to the decline in the size of our public equity markets. The litigation environment, the collapse of the dot-com bubble, and overall market conditions have also contributed to the decline of public companies. Private equity has stepped in as a partial and more expensive substitute, but even private equity firms need an exit strategy. They cannot keep flipping companies back and forth between each other indefinitely.

Dodd-Frank has many provisions which could backfire like Sarbanes-Oxley.

Dodd-Frank contains many provisions which, if implemented badly, could be much more costly than anticipated and have serious adverse consequences for our economy. Here are a few:

Volker rule

The "Volker rule" places limits on "proprietary" trading by banks, with the implementation of the limits left up to the regulators. If "proprietary" is interpreted too broadly, it will severely limit the range of products that US banks can sell to customers around the world, while foreign competitors are not so restricted. This will hurt the competitiveness of U.S. firms.

Risk retention

Another troublesome area is the risk retention provision requiring securitizers to retain 5% of the risk of securitized deals. While this sounds attractive from a distance, the details are left up to the regulators. If poorly implemented, this could actually increase the systemic risk in the system as large highly leveraged securitizers keep the riskiest slices of their deals and then precipitate a crisis after it suffers major losses. Indeed, this is partly what happened to many large banks in the recent crisis. As they needed to raise cash, they sold the less risky but easier to sell securities. As the crisis reached the panic stage, they were left with the "toxic" securities that declined the most in value and that could not be sold or borrowed against. Another danger of a clumsy implementation is that excessively high risk retention requirements could slow down the needed rebuilding of a non-GSE dominated mortgage industry.

OTC derivative regulation

If not well thought out, the OTC position limits in derivatives could reduce the ability of legitimate hedgers from using these important risk management tools to reduce their risks. If producers cannot offload their risk, they may choose not to produce.

Ability to repay requirements

The "ability to repay" requirements for mortgages are another area where an overly stringent interpretation could preclude good credit risks from obtaining mortgage finance.

The SEC needs the right human resources.

Another reason to be pessimistic about Dodd-Frank implementation is that the SEC does not have enough good people to do all the things Congress wants it to do. It needs more experienced staffers who really understand how financial markets work. The SEC is making efforts to increase the level of staff expertise, but it still has a long way to go. The SEC is just getting around to measuring how many of its staffers have industry designations such as the Certified Fraud Examiner, Chartered Financial Analyst (CFA), or FINRA Series 7. Alas, in their FY2010 annual report they were unable to report the number and reported it as N/A, and listed the goal for FY2011 as "TBD".[9] I searched the CFA Institute's directory and found that only about 60 CFA charter holders are listed as working for the SEC. How can the SEC really review the filings from over 35,000 registrants (public companies, mutual funds, RIAs, broker-dealers, transfer agents, securities exchanges, and rating agencies) with only 60 Chartered Financial Analysts? The SEC seems to be able to hire lots of lawyers, but not enough people with financial expertise.

Suggestions for improvements in rulemaking

[9] http://www.sec.gov/about/secpar/secpar2010.pdf, page 70.

1. *Congress needs to be engaged in regular and active oversight of the regulatory bodies.* Regulation is not a "set it and forget it" activity. Hearings such as this one are useful. My observation is that agencies like the SEC generally pay close attention when they see that Congress is paying attention. Some, but not all, of this oversight can be outsourced by requiring that the GAO and/or outside consulting firms conduct regular studies of the agencies overall performance. These studies would include measures of capital formation, measures of fraud and abuse, and surveys of the experience of market participants with the regulators.
2. *Congress should require reauthorization of all financial regulators every five years, as it does for the CFTC*. Our financial markets are evolving so quickly that even a perfect regulatory structure today will soon grow obsolete. This is especially true for new agencies such as the CFPB, whose performance is yet unknown, but would also be useful for older agencies like the SEC. Agency cultures can become hidebound and dysfunctional over time. Regular reauthorization will force Congress to keep our regulatory structure up to date.
3. *Support reliable, quantitative economic analysis in rulemaking by getting the right people into the agencies.* One of the problems with the SEC is that is has earned a reputation as a lawyer-heavy agency with poor understanding of the markets it regulates. For example, the agency has been operating for some time without a chief economist who reports directly to the Chairman. While the SEC clearly needs more money to perform its mission properly, that money needs to be spent properly.[10] As part of the budget process,

[10] Since its inception in 1934, the cumulative budget of the SEC has been approximately $16 billion in current dollars. This is less than investor losses from one Bernie Madoff. We have been penny wise and pound foolish in underfunding the SEC and allowing the SEC to misallocate its scarce resources.

Congress should specify that the additional funds be spent not on more lawyers, but on people with the appropriate professional credentials such as the Series 7 or CFA designation, along with the technology people needed to understand our technology driven markets and to digest the huge amounts of data coming into the Commission.

4. *Congress should require regulators to pay attention to the rest of the world.* The United States is not the only jurisdiction that wrestles with the many issues that our financial regulators face. There once was a time when the U.S. was so far ahead of the rest of the world that we didn't have to pay attention to what the rest of the world was doing. However, many other countries have caught up and are leapfrogging us. A tremendous amount of fresh thinking has been going on around the world and we should pay attention to it.[11] Alas, most SEC rulemakings pay no attention to the experiences of other jurisdictions. Congress should amend the Administrative Procedures Act to require regulatory agencies to explicitly consider how other jurisdictions both inside and outside the United States have addressed the issue at hand and whether those solutions would be appropriate for the United States.
5. *Support more use of the Intergovernmental Personnel Act (IPA) mobility program.* It may take quite some time for Congress to rationalize our incoherent mishmash of overlapping regulatory agencies. In the meantime, some virtual rationalization can be achieved by strongly encouraging the different regulatory silos to swap personnel among different regulatory agencies. It should be clear that an appropriate career ladder for the professional staffs of the various agencies is that career staffers should expect to move

[11] We should pay attention to the thinking in the debates, although I would be the first to say that the decisions made by foreign jurisdictions may not be the right ones for the U.S.

often between different regulatory agencies. This will give the human resources of these agencies a broader perspective on financial services and reduce myopic decision making.

6. *House the various financial regulatory agencies in one building.* Regulatory fragmentation can be minimized by housing the regulators in a single building. This will make it much easier for the people in these agencies to have both formal and informal interactions, and to make maximum use of the IPA mobility program.
7. *Move the financial regulators closer to the heart of the financial markets.* Even in this electronic age, physical proximity matters. It is no accident that NASDAQ chose to move its headquarters from Washington DC to New York. Pipeline Trading, which was founded by scientists from the Santa Fe Institute in New Mexico, chose to set up shop in New York because that is where the customers are as well as a labor pool that understands financial markets. By being closer to market participants, it is easier for regulators to find out what is going on. The regulatory agencies will also be able to draw from an experienced labor pool of people who have a financial markets background. I have heard that, because of the current budget situation, SEC staffers in DC cannot go to New York to personally see what is going on in the markets. Regulators need to be physically closer to the markets they are regulating, so the financial regulatory apparatus should be in New York City, not Washington DC.

United States House of Representatives
Committee on Financial Services

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Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:	2. Organization or organizations you are representing:
James J. Angel	Self. (I do not represent Georgetown U.)
3. Business Address and telephone number:	
[redacted]	
4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	**5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?**
☐ Yes ☑ No	☐ Yes ☑ No
6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.	
7. Signature:	

Please attach a copy of this form to your written testimony.