THE GROWTH OF FINANCIAL REGULATION AND ITS IMPACT ON INTERNATIONAL COMPETITIVENESS

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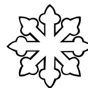

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THE GROWTH OF FINANCIAL REGULATION AND ITS IMPACT ON INTERNATIONAL COMPETITIVENESS

Wednesday, March 5, 2014

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON OVERSIGHT
AND INVESTIGATIONS,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:02 p.m., in room 2128, Rayburn House Office Building, Hon. Patrick McHenry [chairman of the subcommittee] presiding.

Members present: Representatives McHenry, Fitzpatrick, Barr, Rothfus; Green, Cleaver, Sinema, Beatty, and Heck.

Chairman MCHENRY. This hearing of the Subcommittee on Oversight and Investigations will come to order. Without objection, the Chair is authorized to declare a recess of the subcommittee at any time.

I want to welcome our witnesses and members. This hearing is entitled, "The Growth of Financial Regulation and its Impact on International Competitiveness." The purpose is to examine the impact of increasing regulations on U.S. financial institutions and markets, as well as to evaluate whether differences between domestic and foreign regulations create competitive disadvantages and decrease the attractiveness of U.S. financial markets.

I will now recognize myself for 5 minutes for an opening statement. For a century, American dominance in the financial services industry has proven vital to the strength of our national economy. Through the Great Depression, the Great Recession, and many ups and down in between, American supremacy in this sector has provided access to capital and economic freedoms that other nations can only aspire to create. And yet, it should not be taken for granted. We live in an extremely competitive and dynamic global marketplace, and the United States faces a period of rising regulation.

In the course of implementing the Dodd-Frank Act and Basel III rules, U.S. regulators have imposed and continue to impose regulations that will undoubtedly constrain banking and financial services. This hearing will examine both the cumulative impact of these regulations and the extent to which differences between domestic and foreign regulatory regimes have made it more difficult for U.S. financial institutions to compete. In remarks before the International Monetary Conference in June 2011, then-Treasury Secretary Timothy Geithner explained why Congress and financial

regulators needed to consider the competitiveness of U.S. financial markets.

He said, "We live in a global financial marketplace with other financial centers competing to attract a greater share of future financial activity and profits." The divergence of regulation across borders, however, creates the risk of regulatory arbitrage, in which financial institutions and markets direct resources and locate their activities to minimize the cost of regulation. As U.S. regulators continue to implement the Dodd-Frank Act, including the Volcker Rule, and set capital and liquidity requirements that exceed the Basel III recommendations, other countries have been slow to adopt similar rules or have refused to adopt them at all.

Given advances in communications technology, financial institutions are looking outside the United States to avoid the burdens of U.S. regulation. As policymakers, we need to be aware of that. Because U.S. financial institutions are in the process of building the compliance structures necessary to comply with hundreds of new rules, the aggregate cost of all these rules cannot be quantified. Because regulators have refused to undertake cost-benefit analyses for these new rules, estimating their cost is difficult. Nonetheless, these regulatory burdens will impose costs in the form of anemic economic growth and weak job creation.

In a world in which capital knows no boundaries and competition is global, the extent to which new financial regulations impose greater burdens on U.S. firms and financial markets relative to Europe, Asia, and other advanced economies will further harm the U.S. economy as foreign banks and capital markets grow at our expense. Now, we have to talk about the regulation within our regime and what we can control. That is what this hearing is about. Overregulation extends to all areas of finance, even those intended to help small entrepreneurs seeking to raise capital through crowdfunding.

Rather than helping these entrepreneurs access a new source of capital, the regulations issued by the Securities and Exchange Commission require these small businesses to comply with a proposed rule that was so complicated that it required 568 pages for the SEC to explain it. This is unacceptable. As the United States awaits a final rule from the SEC, European securities-based crowdfunding has been permitted to operate under a much more reasonable regulatory framework that is continually expanding. Other opportunities in Asia are already existent. We are slow to catch up when it comes to crowdfunding.

As it stands today, the United States is a net importer of capital and a net exporter of financial services. And yet, the United States' financial services faces a period of rising regulation that could threaten this advantage. Financial regulators implementing Dodd-Frank in international courts have imposed, and continue to impose, regulations to prevent our constrained banking and financial services in virtually all of its capacities. As we continue down this path it is imperative that we view the regulatory costs and burdens in a larger global context. That is how the capital markets view it, and as policymakers, that is how we must view it.

I look forward to hearing from our witnesses today, and the questions our Members have, and I know that we can benefit from the broad expertise of this panel.

With that, I will now recognize the ranking member of the subcommittee, Mr. Green, for 5 minutes.

Mr. GREEN. Thank you, Mr. Chairman. I also thank the witnesses for appearing this afternoon.

Mr. Chairman, America has long been a leader within our global community. Many look to us and see a land of opportunity, where hard work and persistence can mean a better life. Many more view our great Nation as an economic superpower whose leadership is central to the success of the entire global economy. The question of whether America should lead or be led is one that we in Congress confront daily. And I am confident that no Member of Congress believes that America should follow when our leadership is needed.

This is why, when the question of American competitiveness in the global economy is raised in the context of regulatory reform, I do not oppose a thorough discussion that considers many points of view. Such a discussion should include, at minimum, some laconic indication as to why a global economic meltdown was imminent, how it was avoided, and what was done to avoid a recurrence.

Why was the global meltdown imminent in 2009? Among many reasons advanced were a lack of regulatory structure, such that risky products gained global acceptance, significant capital quality was poor, risk-based capital ratios of too many huge corporations were too low, countercyclical capital was too low, leverage ratios of many significantly significant financial institutions were too high, liquidity standards were generally inadequate among some major financial institutions, and capital standards for many systemically significant financial institutions were insignificant or insufficient.

The conditions led to a circumstance wherein capital was frozen to the extent that banks would not lend to each other, and FDIC coverage had to be increased from $100,000 to $250,000 to maintain depositor confidence.

How was the global meltdown avoided? When the markets nearly collapsed, costing an estimated $13 trillion in economic output, countries were devastated as the housing bubble burst. The U.S. Government took unprecedented steps to avoid a global economic depression by supporting American financial institutions critical to the global markets, extending over $1 trillion in support, including an estimated $580 billion in liquidity swap blinds for foreign countries, all of which is to be repaid.

Now, what was done to avoid a recurrence? The codification and passage of Dodd-Frank—this legislation deals with too-big-to-fail taxpayer bailouts—indicates America's leadership, and this is a great piece of legislation that was passed. Many other countries have followed suit and have begun considering their own similar regulatory efforts.

Mr. Chairman, I believe—I have always contended and believed that we should amend Dodd-Frank, not end it. Legislation of this magnitude is rarely perfect, and I believe that we must do all that we can to avoid unintended consequences. However, I also believe that Dodd-Frank was, and is, necessary. Important evidence of the

necessity for Dodd-Frank is the fact that Congress passed Dodd-Frank in this time of a divided Congress. As I mentioned earlier, any analysis of American economic competitiveness merits a thorough discussion. It is important for the record to reflect that much of Dodd-Frank's rulemaking has not been finalized. Further, it is also important to note that many times, our Federal regulators have amended the rules when the public and Congress has raised concerns.

The Basel III framework was originally agreed upon in 2010. However, the provisions of the agreement are still being implemented, and some are scheduled to come online as late as 2019. In addition, other important regulatory rulemakings have not been finalized at this time, and we should consider their impacts as I am concerned it may be premature, at this time, to draw final conclusions on rules that are far from final without evidence of an adverse impact.

The SEC is woefully underfunded, to the extent that mission-critical capacity may be compromised. This is why, in part, I support the President's requested amount, and believe that in so doing, in funding the SEC, we might engender greater progress and stronger enforcement, which means better investor protection. When we comport with the belief that regulatory reform places America at a competitive global disadvantage, we expose ourselves to the risk of a great irony: there will always be the fear of failing, or falling behind the innovation curve. That is what has led to the new regulations and has caused us to turn a blind eye to securities markets that caused a great downturn and that we still do not fully understand.

America must lead. We did this with Dodd-Frank, and we must expect the same from our global counterparts as they work to strengthen their regulatory frameworks.

I look forward to hearing from our witnesses, and I thank you, Mr. Chairman. I yield back the balance of my time.

Chairman MCHENRY. We will now recognize our distinguished witnesses. I will introduce the panel, and then we will begin and go in order here.

First, Louise Bennetts is the associate director of financial regulation studies at the Cato Institute. She focuses on the impact of financial regulatory reform since 2008, including attempts to address too-big-to-fail and the impact of cross-border regulatory initiatives on financial stability and global capital flows.

Second, we have Alon Hillel-Tuch, the co-founder and CFO of RocketHub, which is a rapidly expanding online crowdfunding portal. He was previously a special situations manager at BCMS Corporate.

Third, Peter J. Wallison is co-director of the American Enterprise Institute's program on financial policy studies. Previously, as General Counsel to the U.S. Treasury Department, he had a significant role in the development of the Reagan Administration's regulatory reforms in the financial services marketplace.

And finally, Michael Barr is a law professor at the University of Michigan Law School. He was previously on leave in 2009 and 2010, serving as the Treasury Department's Assistant Secretary for

Financial Institutions. He was very involved in the development of the Dodd-Frank Act during that time, as well.

Now, for those of you who are well-acquainted with this, you understand the lighting situation we have here in Congress. As Members of Congress, we need very simple rules of the road. And so green means go, yellow means hurry up, and red means stop.

Without objection, the witnesses' written statements will be made a part of the record. And the idea here is for you to summarize your written statement in 5 minutes.

We will begin with Ms. Bennetts.

STATEMENT OF LOUISE C. BENNETTS, ASSOCIATE DIRECTOR OF FINANCIAL REGULATION STUDIES, THE CATO INSTITUTE

Ms. BENNETTS. Chairman McHenry, Ranking Member Green, and distinguished members of the subcommittee, I thank you for the opportunity to testify in today's important hearing. As Chairman McHenry noted, I am Louise Bennetts, the associate director of financial regulatory studies at the Cato Institute, which is a non-profit, nonpartisan public policy institute here in Washington, D.C.

Before I begin, I would like to highlight that all comments I make and opinions I express are my own and do not represent any official positions of the Cato Institute or any other organization.

In the United States, since 2010, we have seen the rollout of one of the most comprehensive reform agendas targeting the financial services industry. The centerpiece of the reform agenda, the Dodd-Frank Wall Street Reform and Consumer Protection Act, has 394 associated rulemaking requirements, and has already spurred thousands of pages of related rules.

But this is just the tip of the iceberg. As of February 2014, only 52 percent of the rules required by the Act have been finalized. Around 20 percent have yet to be proposed. And Dodd-Frank is but one component of a much, much larger financial regulatory reform agenda which includes a complete overhaul of capital and liquidity rules imposed on the U.S. banking sector; a radical revision of the regulation of non-bank financial companies, such as insurance firms and asset managers; changes in the regulation of U.S. operations of foreign banks; changes in the regulation of consumer credit; and the imposition of new monitoring and enforcement obligations on behalf of the Federal Government.

And all of these obligations are multiplied for banks that operate cross-border. In addition, barely a month passes without a new financial initiative being proposed either in Congress or through the regulatory agencies. While many of these proposals will never see the light of day, they nonetheless impose a significant cost on the private sector in terms of the uncertainty they generate. The question before the committee today is, how is this regulatory overhaul impacting the global competitiveness of the American financial services sector and, indeed, American consumers of financial services?

To date, no assessment has been made of the cumulative impact or cost of all of this regulation. To answer it, in my view, we need to address two related issues. The first is, what are the individual and cumulative costs? And second, and more importantly, are we likely to achieve the desired outcome, that is, creating a financial

system that is safer and more transparent, without damaging credit provisions.

First, I would like to make a few observations about the United States' position in the global economy. As Chairman McHenry noted, the United States is a net importer of capital and a net exporter of financial services. And despite its fragmented regulatory system and its crisis-prone banking history, the United States has nonetheless developed the world's most vibrant capital markets and currently has the only well-developed debt market and short-term or overnight dollar funding market. Most foreign companies and banks raise a significant portion of their non-depository funding here in the United States. Because of this, the United States today has the world's reserve currency and is able to finance its significant deficits, where other countries have struggled to do so.

However, while the United States may have had a head start, one cannot assume a permanent state of dominance. Steps are being taken to develop high-yield and other short-term funding markets, particularly in Southeast Asia, as well as in Europe, although I note that the European funding markets remain weak. In addition to the large European banks, several emerging markets, most notably China, are taking noteworthy steps towards the creation of worldwide banking conglomerates. Both defendants and opponents of the current regulatory reform agenda frequently present this issue as a binary choice between profitability and competitiveness one hand, and safety and stability on the other.

For the reasons we will discuss today, and as set out in my written testimony, I view this as a false dichotomy. The time has come to acknowledge that we are at a crossroads globally and domestically. One path leads to a system where American banks and financial services firms, buckling under the weight of excessive regulation, become less diversified, less competitive globally, more inward-looking and, in my view, potentially more unstable. This path leads to a suboptimal outcome, where firms are focused on pleasing regulators rather than on market risk and meeting the needs of their consumers.

Another path begins with the recognition that we really may have gone a step too far. The time has come to ask ourselves what was the purpose of all of this? If the purpose is to make the United States banking sector less crisis-prone, safer, and more competitive, we need a comprehensive and realistic assessment of whether all these regulations, given their costs, are achieving this outcome.

I thank you for the opportunity to testify today.

[The prepared statement of Ms. Bennetts can be found on page 32 of the appendix.]

Chairman MCHENRY. Thank you, Ms. Bennetts.

Mr. Hillel-Tuch?

STATEMENT OF ALON HILLEL-TUCH, CO-FOUNDER AND CHIEF FINANCIAL OFFICER, ROCKETHUB

Mr. HILLEL-TUCH. Mr. Chairman and members of the subcommittee, thank you for this opportunity to provide testimony. My name is Alon Hillel-Tuch. I am a co-founder and chief financial officer of RocketHub. RocketHub is an established crowdfunding platform that has initiated over 40,000 campaigns and has provided ac-

cess to millions of dollars worth of capital for entrepreneurs and small businesses in over 180 different countries.

My testimony today is based on my field experience working closely with new and small business. Domestic job growth comes from the new and small business sector. Approximately 90 percent of U.S. firms employ 19 or fewer workers, and these companies create jobs at nearly twice the rate of larger companies. According to January's ADP national employment report, between December and January small businesses with fewer than 50 employees added 75,000 positions. That is more than double the number of jobs large businesses created in the same period.

Job creation is the most prevalent in new companies. And if our job goal is to drive job growth within the United States, our focus should be on new business formation. The spirit of entrepreneurship in the United States is unparalleled and, as a result, more Fortune 500 companies exist in the United States than anywhere else in the world. Those large companies are serviced well by big banks and the public markets. But new and small businesses often find it difficult to access capital.

In the United States, investment capital is mainly limited to regions such as New York City, Boston, and Silicon Valley. However, most new and small businesses do not have access to these capital zones, let alone the innovation hubs recently created by the White House. Crowdfunding platforms such as RocketHub provide capital access to new and small businesses that are either neglected by large banks or face unmanageable interest rates due to different risk mechanisms.

Until recently, the crowdfunding market was allowed to evolve and innovate without government oversight. Platforms sprouted, and the public quickly adopted this social form of capital formation. Equity crowdfunding was the next evolutionary step in the market, and the first time Congress became involved. The House of Representatives passed several bills focused on economic revitalization and democratizing access to capital. This became the Jobs Act that the President signed into law on April 5, 2012.

But since then, implementation delays have been significant. It took the FCC 566 days to release proposed rules for Title III. In the meantime, basic forms of equity crowdfunding have been operational for almost 3 years in the United Kingdom and the Netherlands, and for nearly 5 years in Australia. The United States is a market that is a magnet for domestic and foreign entrepreneurs. But they must have the necessary tools available within the United States to innovate and grow.

And other countries are actively pursuing these entrepreneurs. For example, Chile has a special visa program for foreign entrepreneurs that includes a $40,000 grant. And they proactively approached RocketHub. They sat down with me to discuss leveraging crowdfunding, including equity-based crowdfunding, within the Chilean market. I have had similar discussions with foreign direct investment agencies in France, as well as the Ontario securities commission in Canada. The World Economic Forum's global competitive report identifies the United States as an innovation powerhouse, yet we rank only 5th in competitiveness.

Certain countries that ranked lower in competitiveness, such as the Netherlands (8th) and the United Kingdom (10th) are catching up. And they are doing this by being forward-thinking market innovators, encouraging new capital formation policies such as equity-based crowdfunding, well in advance of the United States. This is not a brand-new market. It is a market that has been in existence for awhile. And it has its wings clipped in the United States by overregulation. This is an important economic tool that helps small and young businesses grow, which will drive job creation.

And if it is not allowed to continue to develop in the United States, the market will ultimately continue to develop outside this country. The Jobs Act, and Title III in particular, was intended to mandate low-cost regulation that relied on individuals within the marketplace and their socially-informed investment appetite. However, it has evolved into a high-cost solution relying heavily on frameworks developed over 80 years ago.

At this point, legislative support is needed to assist the Securities and Exchange Commission in creating functional rules for Title III. Checks and balances within emerging markets are critical not only for consumer protection purposes, but also to generate trustworthiness in the market. I believe appropriate regulation, leveraging a soft yet informed approach, is crucial. With congressional support, we can increase the economic benefit provided by crowdfunding and remain competitive in the international market.

The current market dynamics abroad, demonstrated by countries such as Canada, the United Kingdom, the Netherlands, Australia, Italy, and now New Zealand make it clear that only a proactive approach in ensuring functional regulation will enable the United States to maintain a dominant international position for new and small businesses. I hope to have the opportunity to elaborate further on key provisions.

And I thank you for your time.

[The prepared statement of Mr. Hillel-Tuch can be found on page 46 of the appendix.]

Chairman MCHENRY. Thank you.

Mr. Wallison?

STATEMENT OF PETER J. WALLISON, ARTHUR F. BURNS FELLOW IN FINANCIAL POLICY STUDIES, THE AMERICAN ENTERPRISE INSTITUTE

Mr. WALLISON. Chairman McHenry, Ranking Member Green, and members of the subcommittee, my testimony today will focus on a different aspect of financial regulation and competition: the competition between banks and non-bank financial firms, what bank regulators call "shadow banking." This needs much more attention from Congress. Under the Dodd-Frank Act, the Financial Stability Oversight Council (FSOC) has the authority to designate any financial firm as a systemically important financial institution (SIFI) if the institutions's financial distress will cause instability in the U.S. financial system.

Non-bank financial firms designated as SIFIs are then turned over to the Federal Reserve for what appears to be prudential bank-like regulation. The troubling extent of the FSOC's authority

was revealed recently, when it designated the large insurer, Prudential Financial, as a SIFI. Every member of the FSOC that was an expert in insurance and was not an employee of the Treasury Department dissented from the decision, arguing that the FSOC had not shown that Prudential's financial distress would cause instability in the financial system.

Virtually all other members, knowing nothing about insurance or insurance regulation, dutifully voted in favor of Prudential's designation. Indeed, there was little data in the document that the FSOC issued in support of its decision. The best way to describe the decision is perfunctory. There is a reason for this. In effect, the decision on Prudential had already been made before the FSOC voted. The previous July, the Financial Stability Board (FSB), an international body of regulators, empowered by the G20 leaders to reform the international financial system, had already declared that Prudential was a SIFI.

The FSOC's action was simply the implementation in the United States of a decision already made by the FSB. Since the Treasury and the Fed are members of the FSB, they had already approved its July action. This raises a question of whether the FSOC will be doing a thorough analysis of whether financials firms are SIFIs, or simply implementing decisions of the FSB. This is important because the FSB looks to be a very aggressive source of new regulation for non-bank financial firms.

In early September, it said that it was looking to apply the "SIFI framework," as it called it, to securities firms, finance companies, asset managers, and investment funds, including hedge funds. These firms are the so-called "shadow banks" that regulators want so badly to regulate. But it will be very difficult to show that these non-bank firms pose any threat to the financial system. For example, designating large investment funds as SIFIs would be a major and unwarranted extension of bank-like regulation. Collective investment funds are completely different from the banks that suffered losses in the financial crisis.

When a bank suffers a decline in the value of its assets, as occurred when the mortgage-backed securities were losing value in 2007 and 2008, it still has to repay the full amount of the debt it incurred to acquire those assets. Its inability to do so can lead to bankruptcy. But if an investment fund suffers the same losses, these pass through immediately to the fund's investors. The fund does not fail, and thus cannot adversely affect other firms. Asset management, therefore, cannot create systemic risk.

Nevertheless, right after its Prudential decision, and following the FSB's lead, the FSOC now seems to be building a case that asset managers of all kinds should also be designated as SIFIs and regulated by the Fed. It recently requested a report from the Office of Financial Research, another Treasury body created by Dodd-Frank, on whether asset management might raise systemic risk. Not surprisingly, OFR reported that it did. Unless the power of the FSOC is curbed by Congress, and soon, we may see many of the largest non-bank firms in the U.S. financial system brought under the control of the FSOC, and ultimately the Fed, and regulated like banks.

As shown in my prepared testimony, these capital markets firms, and not the banks, are now the main funding sources for U.S. business. Bringing them under bank-like regulation will have a disastrous effect on economic growth and jobs. And this outcome could be the result of decisions by the FSB, carried out by the FSOC. This is an issue Congress should not ignore.

I look forward to your questions. Thank you.

[The prepared statement of Mr. Wallison can be found on page 60 of the appendix.]

Chairman MCHENRY. Thank you, Mr. Wallison.

And last, we will hear from Professor Barr.

STATEMENT OF MICHAEL S. BARR, PROFESSOR OF LAW, UNIVERSITY OF MICHIGAN LAW SCHOOL

Mr. BARR. Chairman McHenry, Ranking Member Green, and members of the subcommittee, I am pleased to appear before you today to discuss financial regulation and U.S. competitiveness. In 2008, the United States plunged into a severe financial crisis, one that shuttered American businesses and cost millions of households their jobs, their homes, and their livelihoods. The crisis was rooted in unconstrained excesses and prolonged complacency in major financial capitals around the globe.

In the United States, 2 years later, the Dodd-Frank Act created the authority: to regulate these major firms that pose a threat to financial stability without regard to their corporate form, and to bring shadow banking into the daylight; to wind down major firms in the event of a crisis without feeding a panic or putting taxpayers on the hook; to attack regulatory arbitrage, restrict risky activities, regulate short-term funding, and beef up banking supervision; to require central clearing and exchange trading of standardized derivatives, and capital, margin and transparency throughout the market; to improve investor protections; and to establish a new Consumer Financial Protection Bureau (CFPB) to look out for American households.

Since enactment, the CFPB has been built and is helping to make the marketplace level and fair. New rules governing derivatives transactions have largely been proposed. Resolution authority and improvements to supervision are being put in place. The Financial Stability Oversight Council has begun to regulate the shadow banking system by designating non-bank firms for heightened supervision. And regulators have recently finalized the Volcker Rule.

To continue to make progress on reform, the Federal Reserve needs to finalize its limits on counterparty credit exposures and propose a cap on the relative size of liabilities held by the largest firms. It must also continue the reform of REPO and other short-term funding at the heart of the financial panic. Five years after the money market mutual fund industry faced a devastating run, stopped only with a $3 trillion taxpayer bailout, we still do not have fundamental reform of that sector, with the necessary buffers to prevent a financial collapse.

And we need legislation to determine the ultimate fate of the government-sponsored enterprises in a way that protects taxpayers, while assuring that the mortgage system works for Amer-

ican families. Strong and effective regulation in the United States is crucial to a safer and fairer financial system, but it is not enough. We also need global reforms. Strong capital rules are one key to a safer system. There is already double the amount of capital in the major U.S. firms than there was in the lead-up to the financial crisis.

At the same time, globally, regulators are developing more stringent risk-based standards and leverage caps for all financial institutions, and tougher rules for the biggest players. More needs to be done to make resolution of an international firm a practical reality. In the United States and Europe, further work is needed on implementing structural reforms that could reduce risks, improve oversight, and make the largest firms more readily resolvable in the event of a crisis.

On derivatives, while much progress has been made, the United States remains concerned about whether Europe's rules will end up strong enough. And many in Europe worry about whether the United States will extend the reach of its rules too far. Yet, the global system is moving to a more coordinated approach for derivatives that is making a meaningful difference. The United States has taken a strong lead in all of these efforts, galvanizing the G20 and pursuing global reforms. Now is not the time to weaken this global effort.

In sum, strong U.S. financial rules are good for the U.S. economy, good for American households, and good for American businesses. We cannot afford to roll back the clock on financial reform in the name of U.S. competitiveness. Engaging in a race to the bottom is a bad idea for both the United States and for the global financial system. We should address the current potential for international regulatory arbitrage by pushing for more global reforms, not by weakening our own standards or exposing our own country to the risks of another financial crisis.

The fact that the United States acted forcefully in implementing reforms is good for the United States, ensuring that our financial system is more stable and able to weather our future financial crises. In contrast, Europe still faces serious sources of risk in their financial systems. In Europe, its piecemeal approach to reform has led to considerable uncertainty that has hurt investment and delayed economic recovery. Rather than focusing on how we can lower our own standards, we need to focus on continuing to push for global reforms so that the risks that could develop overseas do not come back to our own shores in a future financial crisis.

Thank you very much.

[The prepared statement of Professor Barr can be found on page 26 of the appendix.]

Chairman MCHENRY. I will now recognize myself for 5 minutes for my questions. The success of our capital markets in the United States has to do a lot with property rights and contract law and certainty of our regime, as well as wise regulation, not the absence of regulation, which is a misunderstanding and a wrong conclusion of the last financial crisis. There was regulation prior to 2008. It did exist. Perhaps it was bad regulation that led to some bad outcomes.

But just to put that as a marker down to this first question I have, which is if you look at the world and the flow of capital around the world, Ms. Bennetts, is there a rapid increase in financial regulation? And is that rapid increase of regulation having an effect on the flow of capital in the world? Is that a proper understanding, that regulation and capital have some linkage?

Ms. BENNETTS. Yes, and certainly—I think that the most recent sort of noteworthy study on that was undertaken by the McKinsey Global Institute. They brought it out, I think, in about March of last year. And what they have said is that since the crisis, since about 2007, I think, global capital flows have declined about 60 percent. Some of that has to do with the crisis in Europe, which I think is an issue of government data and placing the banking sector in an extraordinarily difficult position. And that is a separate issue.

But a lot of it also has to do with the fact that following a crisis, the natural tendency of regulatory authorities, wherever they may be, is to look inward and to put barriers, and it is sort of a process, which I think is frequently referred to as "balkanization." And that makes the local sector far more insular and far more inward-looking. That is a problem because it has a real cost for the flow of capital.

And one other thing I would say about that is, you often hear or you read in pieces that people say it almost sounds like these flows are a bad thing, that it is a bad idea to have capital flowing across borders. But in fact, the crisis would have been far, far worse in 2008 if we didn't have the free flow of movement across borders. So that was actually, for the United States, a very big and important—

Chairman MCHENRY. But there is a—everyone is talking about Europe here when they testify—financial regulators in the United States are testifying about European movements and perhaps following in a similar direction, as we have in our regime. But isn't it, in fact, the case that with three of the world's largest banks being Chinese, there is a movement in Asia to go a different direction in terms of regulation?

Ms. BENNETTS. First of all, Europe is an interesting case. Because, for example, if you take a recent initiative—and I will use one that is in both countries—the Volcker Rule, right? The Volcker Rule came out in the United States and it is, as we know, a mammoth undertaking. It is a very complex rule that spans hundreds of pages. There is a lot of micromanaging within the rule, a lot of ongoing enforcement and monitoring.

And when you look at the way that the Europeans have approached it, they have released a similar rule recently. But theirs is more sort of a principal-based approach. They come out and say, "We would prefer that you didn't do this proprietary trading that has no client benefit, but we are not really going to institute ongoing and expensive monitoring and enforcement type requirements." So I would argue that is a lot less burdensome for the institutions which are following it.

That has been a consistent approach that they have adopted. They certainly have a very different approach in Asia, certainly in Hong Kong and Singapore, which is where the main markets are,

you don't see the same level of regulation. They want high capital, but they don't have the same level of micromanagement.

Chairman MCHENRY. Mr. Hillel-Tuch, about crowdfunding, I authored that section of the Jobs Act that has a regime so that we can have low-dollar equity raising online. You have done a study on what those 568 pages have—the cost structure on a crowdfunding raise. Do the regulations have a bearing on the costs of raising money through crowdfunding?

Mr. HILLEL-TUCH. Yes. It took a long time to read through all those pages. It was quite cumbersome to do, and unfortunately I have had to do it a few times due to inconsistencies. But we did an analysis which I included as a chart in my written testimony that you are free to take a look at. But there are friction points created within the regulation that basically allow for up to 50 percent of the money raised going towards overhead and compliance costs. So what happens is, you have an act that, instead of becoming a reform act or an innovation act becomes a regulatory act with regulatory friction points.

Some of them have to be changed, and that is only something that could be done with congressional support. Some of them can be changed at the discretion of the SEC, with proper support given by not just Congress but other people, as well. It is quite significant when you are a small business owner and you are facing upfront costs that can easily go over $30,000 without any kind of a guarantee that you are going to receive the capital you raised. And that is a significant debt people should not bear.

Chairman MCHENRY. My time has expired.

We will now recognize Mr. Cleaver for 5 minutes.

Mr. CLEAVER. Thank you, Mr. Chairman. When I played football, we lived for the moment of getting a running back or a wide receiver out in the middle of the field, putting your helmet into him, and hearing the crowd go, "Ooh." That was delicious. It has been outlawed; you can't do it anymore. You can't even trip anyone anymore. Tripping used to be one of the best things going, but you can't trip, they won't let you trip anymore.

And you can't even—you have to pamper the quarterback. You have to go in and say, "Sir, is it okay if I hit you?" There are all of these new regulations imposed on these football teams. And every winter, there is a committee of owners who meet to consider new regulations. I traveled with the Kansas City Chiefs playing in Tokyo, actually twice. They played in Mexico, and then London. Sellouts. And there is a great market for all of the memorabilia that you buy for the Chiefs and the Giants and the Cowboys all over the world.

In Canadian football, which is similar to American football, they constantly look at what we are doing in the United States to make decisions on what they are going to do in Canada. We don't alter the American rules to accommodate what the Europeans or the Africans or Asians are doing in what they call football, which we call soccer. Football is still the number one sport in the world economically, just like the United States is. And there is simply no reason for the NFL to abandon rulemaking and regulations, because they are making the game safer.

And I am wondering what is wrong with trying to make the game safer, as we are talking about the economics of the United States. I was here with Mr. McHenry and Mr. Green—I guess we may now be the only three who were here on the day that we had the economic collapse. I don't ever want that to happen again. And to the degree that we can make rules and regulations that will prevent it, how many of you don't—who believes that is wrong? Anybody else?

Mr. BARR. I think you are right, Mr. Cleaver. I think that we need to have strong rules of the game that make the system safer and fairer for American families and businesses, and that make us have a strong and vibrant financial system. And I think we are on the right path to do that.

Mr. CLEAVER. Mr. Wallison?

Mr. WALLISON. I would like to point out that there are, as the chairman suggested, bad regulations. And one of them is the Basel regulations, I, II, and III.

Mr. CLEAVER. Basel II?

Mr. WALLISON. Beginning with the different risk weights that were put on assets, and as a result, the capital cost was much cheaper for banks to buy mortgage-backed securities. They did this in vast numbers because they were only required to hold 1.6 percent capital for mortgage-backed securities but 8 percent capital for perfectly good corporate securities. The result of this, of course, was when mortgage-backed securities collapsed in 2007 and 2008, banks were hurt very badly.

In fact, that was the immediate cause of the financial crisis. So I think we have to be very careful about the kinds of regulations that we put in place. Some of them can be extraordinarily harmful, and that is one.

Mr. CLEAVER. Yes, I would agree. But what you do is that you revisit any of the rules that became an impediment to the game, which is not what we are doing. You want to make the rules better. The problem is that instead of making the rules better, we attack the rules.

My time has run out, and I didn't even get to basketball.

Chairman MCHENRY. I didn't follow you at all. I don't follow football or soccer much, but I do follow NASCAR. So if you had done that, I would have maybe tracked a little bit—no. I appreciate my colleague.

I now recognize the vice chairman of the subcommittee, Mr. Fitzpatrick, for 5 minutes.

Mr. FITZPATRICK. I appreciated Mr. Wallison's comment that the rules, or in this case the regulations, have to be thoughtful. They have to be fair, they have to be evenly applied, and not just simply cumulative or reactionary. I am mainly concerned about the risk of retaliation against the United States by foreign regulators, number one. Number two, is there a possibility that foreign banks will seek to do business with United States firms from abroad?

And finally, the impact of all of this on jobs here in the United States, which as we consider rules and regulations and new laws and cumulative laws, we also have to consider and weigh carefully the impact of all of this on how it affects people here in this country, people at home in our districts, those jobs. And I was won-

dering, Ms. Bennetts, would you be able to comment on the question of whether or not—the first question, is there a risk of retaliation against the United States by foreign regulators?

Ms. BENNETTS. Yes, I think—and Representative Green sort of mentioned, I think, in his opening statements about being a leader. The United States is a leader in the global financial services sector. So what the United States does is important in the global economy. And one of the problems, for example, a piece of research I have recently done is on the Federal Reserve's Foreign Bank Proposal, and the potential impacts of that down the road.

When you undermine your ability to work with foreign regulators, and you say, "We are going to take an approach where we are essentially going to ring-fence your operations in our country," that really opens up the door for those foreign regulators to say, "If you are doing that in your country, we don't believe firms can be resolved on a global level. So we are going to do the same to your firms in our country." And that creates a lot of problems, particularly for U.S. institutions that operate cross-border. And also for institutions or companies, American companies, that use these financial services and need the ability to move money and services across borders.

And then further down the road, I think, as I said, the United States is in a lucky position today. Because they are able to—sort of in a unique position because they have these debt markets that aren't developed elsewhere in the world. But that is now. And we have seen them move towards developing them elsewhere. And so all that will happen is foreign banks that do all that business here will move it elsewhere. And that is a few years down the road, but it is definitely coming.

Mr. FITZPATRICK. How about the potential for retaliation by foreign regulators?

Ms. BENNETTS. Michel Barnier said, when the first proposal of the Fed's rule—this is just the most recent example that came out—one of the letters that came into the Federal Reserve comment ledgers was from foreign regulators. And they said, "We are under pressure. If you do this, we are under pressure to do the same thing in our own markets." And so, that is a big problem. And we will see what happens. It is early days, but I think they are likely to retaliate.

Mr. FITZPATRICK. Mr. Hillel-Tuch, you do business with a lot of foreign firms, I assume, from the United States. So what is the risk that foreign banks are going to say, we will do business with the United States, but from over here?

Mr. HILLEL-TUCH. Yes. What is starting to get interesting specifically about some of the points that the other witnesses made is, you are looking at banks that are sort of becoming incentivized to trade with other foreign banks instead of entering the United States at all. And you are going to start getting collaboration between different banks who may not even want to work with companies such as mine because we are mainly affiliated with the U.S. banking system.

We are seeing that more and more often. Operating in over 180 different countries, we are on the foreign exchange all the time for different currencies, having to move that around globally in real

time. That is becoming increasingly harder to do as people are uncertain about what is happening next. What that means for me is, I am starting to have to become more selective on what countries I am operating in as a U.S.-born firm, and I have to start considering registering in other countries as an entity purely because I am being kind of hindered in my ability to operate out of the United States.

Mr. FITZPATRICK. Mr. Wallison, can you address the impact on jobs here in the United States of what was just discussed?

Mr. WALLISON. Certainly. I happen to believe that one of the reasons that we have had such a slow recovery from the financial crisis and from the recession that followed is that the regulations that we have placed on the financial system have really brought it to its knees, to use the expression that is used in other contexts. People in the financial world are now quite afraid of interference by the government, charges of various kinds by the government, and are unable to understand the very complex regulations that they have to face.

In particular, I think the Basel regulations have become enormously complex. It is almost impossible to understand them. So, we need a much simpler set of regulations, such as a simple leverage ratio for banks instead of this very complex set of regulations. They have just gotten worse since Basel I was adopted in the 1980s.

Mr. FITZPATRICK. I appreciate the comments.

Thank you.

Chairman MCHENRY. We will now recognize Mrs. Beatty for 5 minutes.

Mrs. BEATTY. Thank you, Mr. Chairman, and Mr. Ranking Member. And thank you to the witnesses for being here today. I am trying to wrap my head around this whole crowdfunding issue. So let me kind of go back, and maybe Mr. Barr or anyone who wants to address it. You will certainly recall that in April 2012, President Obama signed into law the Jumpstart Our Business Startups Act, or the Jobs Act, which was designed to spur hiring through relaxed regulations regarding public and private companies' ability to raise capital.

And the Jobs Act was widely supported and received almost 400 votes from both Democrats and Republicans, who felt that it was the right way to improve the economic climate in the United States. However, since its passage, the SEC has come under scrutiny for having something moving too slowly and creating new rules, or for creating rules that were still too restrictive. In particular, some have expressed concerns that the proposed Title III crowdfunding rules will unduly restrict access to private capital, especially when compared with the regulations in place in the U.K.

So with that said, two questions: First, can you speak generally about what types of considerations must be addressed when creating rules for the new crowdfunding platforms and mandatory disclosures?

Mr. BARR. I would be happy to say a few words about it. I think the question is how to get the balance right. And my understanding is, the SEC received lots of comments about their initial proposal from lots of different kinds of parties: small businesses; sites and brokers that were interested in participating; and from investors

and investor protection advocates. And no one was especially happy. So the SEC is going to have to, I think, go back and look at the rule and see if they can come up with a simpler approach that protects investors and also permits efficient raising of funds.

My understanding is that the U.K. and the E.U. are in the midst of reevaluating their current framework, as well, and they may make adjustments in either direction on where they are. So I think that it is an evolving area; it is a relatively new area. And I think getting the balance right is going to be really critical.

Mrs. BEATTY. Let me just follow up, because you also used the word "protection." Some of the commentators are suggesting that the businesses that are most likely to seek to raise capital through crowdfunding are the ones with the greatest risk of failure. Or they don't have a sufficient track record to satisfy the concerns of venture capitalists. How would you categorize the level of risk faced by the investors who use crowdfunding?

Mr. BARR. There are significant risks involved in investing in new companies. That doesn't mean it shouldn't be done, but new companies can be quite risky to invest in, and I think that is why it is important, while you are expanding access to these sources of funds, to make sure that the information and disclosure and protections are there so that investors understand the risks that they are taking on and engaging in the funding.

Mrs. BEATTY. Have you or any of the panelists had any instances of failure by businesses that raised capital through crowdfunding?

Mr. HILLEL-TUCH. We have had well over 40,000 campaigns at this point. We have had no successful instances of fraud. We have had no significant failures. More revampings. A small business might have had to change the direction it was looking to take, which is expected at an early stage of a company. We have seen everything from idea stage all the way to product concepts. What is really interesting is that right now, there are no upfront costs they have to face in trying out what is currently available, which is perk-based crowdfunding.

What is happening with the Jobs Act, though, because of the equity component we have to put in new regulation, which is critical. But there are a lot of requirements, in order to ensure information is correct. It puts the cost burden directly on the small business. So if you are a small business—let's say a coffee shop in Kentucky—you really cannot afford, out of pocket, $30,000 up front in order to then say, "I am able to raise over $500,000 because I was able to afford an audit," while maybe you don't even have historical financial information to truly audit.

There are a lot of nonsensical components. The intent was great, but the execution of it does not actually make sense at the small business level.

Mrs. BEATTY. Thank you.

Thank you, Mr. Chairman.

Chairman MCHENRY. We will now recognize Mr. Barr of Kentucky for 5 minutes.

Mr. BARR OF KENTUCKY. Thank you, Mr. Chairman. I want to kind of focus on the issue of contradictory regulatory mandates. Has this phenomenon proliferated as a result of Dodd-Frank? And can you all provide a couple of examples of where this kind of ava-

lanche of regulations has contributed to regulatory confusion and contradictory regulatory requirements imposed on financial institutions?

Ms. BENNETTS. Yes, I definitely think that—so, for example, where you have an issue like the Volcker Rule and you have several regulatory agencies. This is a big problem in the Dodd-Frank Act. And we see the United States has a very fragmented regulatory system, as well, which allows for a lot of the regulatory arbitrage that we talk about. But Dodd-Frank made that problem a lot worse because you have many, many agencies that had mandates over the same rules.

And just for example, it is not exactly an overlapping mandate, but the SEC has a mandate over security-based swaps. The FTC has a mandate over ordinary swaps. For an entity that is trying to put those rules into place, that is an extremely high cost. So Dodd-Frank is listed with those kinds of examples.

Mr. WALLISON. I think there are other examples in the Volcker Rule itself. The Volcker Rule is internally contradictory, from my perspective. And that is one of the reasons why it took so long for it to be put in final form. The Volcker Rule says you cannot engage in prop trading, which means that you cannot buy and sell securities—they are talking here about debt securities—for your own account. But it also says that you can continue your market-making activities and your hedging activities. Both of those are extremely important for the markets.

Market-making is vital for the markets because if you want to sell a fixed-income security of some kind, there is always a very thin market. You may not be able to find a buyer in the world at large. You have to go to someone who will actually buy your security, or sell you one. This is because of the thinness of the market. That is a market-maker. When a market-maker buys or sells, it is very difficult to tell the difference between what is a market-making activity and what is a prop trading activity. And as long as that is true, banks are going to be very fearful of engaging in market-making when there is some danger that they might be accused of violating the prop trading rules.

Mr. BARR OF KENTUCKY. Mr. Wallison, I think you have included in your prepared testimony also, that in addition to its role, its mission of identification of a risk to financial stability, FSOC is also supposed to coordinate regulation among the multiplicity of regulatory agencies. I take it from your testimony that FSOC has failed to properly coordinate and limit this—the contradiction that we see in a lot of these regulations.

Mr. WALLISON. Yes. I don't see any evidence that the FSOC has attempted to coordinate. It has attempted to press its own views—these are the views of the Treasury Department—on other agencies, such as the SEC. But it hasn't attempted to bring the agencies together to coordinate policies. At least from the outside, it is very difficult to see that is happening.

Mr. BARR OF KENTUCKY. In my remaining time, let me just shift over to something else. A lot of the focus of the hearing so far has been on the proliferation of regulations and compliance costs. But let me ask the panel just for your views on the tendency of financial regulators to circumvent the Administrative Procedures Act re-

quirements related to notice and comment rulemaking—so-called "informal rulemaking"—where there is a requirement of notice and comment. And we see this in particular with the CFPB, how they have been governing on an ad hoc basis. Not through rulemaking, which kind of sets predictable standards before, but instead, after the fact, there is kind of ad hoc enforcement actions or guidance where notice and comment and the opportunity for regulated parties of the consumers to participate in rulemaking is not available.

Can you all comment on whether or not you are seeing a lot of that guidance, informal interpretive memorandum, general statements of policy as a means of circumventing rulemaking? And what effect does that have on financial markets?

Ms. BENNETTS. That was a phenomenon that we saw after the business roundtable decision a couple of years ago, where an ACC rule—a proxy rule was overturned by the court. And since then, we have been seeing regulatory agencies, especially where they are not 100 percent sure that they can do a cost-benefit analysis or a full analysis as required by the rules, they release guidance. And we saw, actually, to Peter's point about the FSOC designation rule, if you looked at the rule it was actually a very limited rule, where everything, all of the meat, was in the guidance.

But the guidance was just guidelines, and so you couldn't, in fact—and I suppose you could comment on them, but it wouldn't really be taken into account because it wasn't part of the rule.

Chairman MCHENRY. The gentleman's time has expired. And I would announce to the committee, with their indulgence, with 15 minutes to vote on the House Floor just announced, a series of votes, with the Members' cooperation we will be able to get everyone in before we adjourn for the votes. That would be the best thing for the witnesses and for members, as well.

So we will now recognize Mr. Heck for 5 minutes, followed by Mr. Rothfus for 5 minutes, and then finally the ranking member, Mr. Green, for his traditional last series here.

Mr. Heck?

Mr. HECK. Thank you, Mr. Chairman. And as someone who is to the right of the Chair, sitting to the right of the Chair, I am an individual who comes to this task believing that, in fact, it is possible to overdo it on the regulatory side and to stifle competitiveness. You can get them wrong, you can have too many, you can make them too complex and the like. But at the end of the day, I am fascinated by the pursuit of the right balance between competitiveness and stability. I see them as values, both worthwhile and often in competition with one another.

And in that spirit, Mr. Wallison, if I can pick on you briefly, you said something earlier that fascinated me within this paradigm. And I am paraphrasing, but I think accurately and in keeping with the spirit of your remark, that regulations had brought financial institutions to their knees. What is the evidence of that?

Mr. WALLISON. This is a really interesting question. And I wish there was more attention paid to it. When economists look at the reasons that we are having such a slow recovery from the financial crisis, they blame the Fed. And, to some extent, people blame the Affordable Care Act. But no one is spending time looking at the costs that are imposed on financial institutions by regulations.

There is a very small paragraph in my prepared statement that I would offer to you. And that is an article recently in the newspapers about JPMorgan Chase.

JPMorgan Chase hired 3,000 compliance officers this year. They hired 7,000 compliance officers last year. But they are cutting their total employment by 5,000 people this year. What that means to me is that JPMorgan Chase is now focusing a lot—not exclusively, but a lot—on the regulations they face. And they are calling back into headquarters, or eliminating, the people who actually go out and offer financing to business.

The result of that, of course, is that there is less interest in financing, there is less credit going to businesses, there are fewer jobs, and much less economic growth. However, we don't hear economists who are studying the economy focusing on that issue. So I think you have raised an important one. We should be looking at the question of the regulatory costs not only in dollars, but in terms of what it does to people's will and people's interest in hiring others to go out and do—

Mr. HECK. Fair enough, Mr. Wallison. Let the record also reflect that we have added jobs in the private sector every month for something like 50 months. And more importantly, and I think frankly, sir, in absolute stark contrast with your assertion, the 6 largest banks in America reported $76 billion in profits in 2013—$76 billion. That is $6 billion short of their high in 2006, when the housing market was white hot, which hardly seems to me to translate—excuse me, sir, my time—to being brought to their knees.

Professor Barr, on the other end of that teeter-totter—and I am concerned about both sides—is the stability side. I realize you are not an economist, but I would appreciate and respect your insight or opinion nonetheless. If we had been at full employment last year, economists estimate that we would have grown by an additional trillion dollars. And that is not full employment in terms of zero; that is full employment as is generally accepted. And yet, we are significantly below that and have been since the crash.

Is it not also true that in terms of the issue of wealth creation and job creation that if we err too much on the side of the teeter-totter for competitiveness without enough regard to stability, that we do not just material harm to the economy, but structural and—if not permanent long-term, as we certainly have experienced in the last 5 years and as we absolutely experienced in the many years after the Great Depression onset?

Mr. BARR. I agree with you. I think that having good, strong regulations is good for financial stability and that is good for growth.

Chairman MCHENRY. The gentleman's time has expired.

We will now recognize Mr. Rothfus for 5 minutes.

Mr. ROTHFUS. Thank you, Mr. Chairman. I would like to talk a little bit about the new Basel III requirements and their complexities. Specifically, I will go to Ms. Bennetts and Mr. Wallison. So if you could—as I give you the background here. The new Basel III capital requirements introduce enormous complexity to the capital structure of banks. Multiple protective buffers are included which contain incentives to maintain or increase different types of capital.

The regulators have substantial discretion to dictate how much and what type of capital shall be held at what times. Furthermore,

by maintaining the authority to do change risk weights when measuring the risk-weighted assets of a bank, banks can be forced in and out of different financial products at different times. Given the complexity of the measures of assets and capital, the market's ability to determine the true capital position of a bank will be thoroughly clouded. The uncertainty arising out of the regulators' discretion to modify measures of capital and assets will cause a permanent concern that will constrain banking business and increase that industry's dependence on government.

It is likely that, given the discretion that regulators have provided themselves, regulators will feel greater responsibility over a bank's success or failure. Hence, the manipulation of these capital and asset variables may occur. Ms. Bennetts, given the complexity of the Basel III cap—Basel III-based capital requirements, is it more difficult to discern the true level of regulatory capital held by a financial institution?

Ms. BENNETTS. It is certainly difficult in the sense—I think that the banks would release, obviously, their tier one capital, and that would be public knowledge and you would be able to measure it. But one thing I want to add to that is that the problem with a risk-weighting system and, more importantly, a risk-weighting system where everybody uses the same model—this isn't a bank's internal risk model that it has kind of come up with of its own markets evaluations, everybody is using the same model—is that you have increasing asset concentration in certain pools of assets.

Which, as you correctly noted, are the assets that the regulators have determined are safe assets at a given point in time. That does not necessarily mean that the bank is better capitalized. Because if there is a run on that particular type of asset—and we saw pre-2008, as Mr. Wallison mentioned earlier—everybody thought that triple-A rated mortgage-backed securities were a safe asset. So that is a real problem and a real flaw in the risk-weighting system.

And because of the complexity, and also, you don't just have the Basel III capital standards, you also have the liquidity coverage ratio and all these other measures of stability. Now, I do think banks need to be well-capitalized. That is not the argument. The question is, how do you capitalize them in a way that doesn't create systemic risk?

Mr. ROTHFUS. Mr. Wallison, would you think that this level of complexity imposes significant costs and uncertainty on financial institutions and on those that invest in them?

Mr. WALLISON. Of course. The more complex regulations are, the more attention has to be paid to them by the regulated industry. They have to hire more people, they have to hire more accountants to do all this work for them. And then there becomes, as Louise Bennetts' just suggested, a lot of difficulty in people outside trying to understand how the bank has put together its capital position. I would suggest that we would be much better off if we had a simple leverage ratio for all banks, rather than these complex rules that began with Basel I and have now gone through Basel II, and Basel III.

Mr. ROTHFUS. Would these complex rules be prone to manipulation by regulators and subject to substantial political pressure?

Mr. WALLISON. That is harder to say. I don't know whether regulators would manipulate these things for political purposes. But I would say that there is only one way, really, to prevent risk in this world. And that is diversification. The trouble with regulation is that it tends to make everyone do exactly the same thing. And to the extent they are doing the same thing, as occurred with the Basel capital rules, they all fail at the same time when something happens in the world that no one expected. So we have to start looking at the Basel rules and other regulations from this perspective, and say—

Mr. ROTHFUS. Can you comment on how these capital requirements might impact on economic growth?

Is it the complexity of these regulations?

Mr. WALLISON. It does have an impact on economic growth because the banks, then, are pushed into certain areas that they have to focus on because they have to comply with the regulations. And that starves other areas of the economy from receiving adequate amounts of credit. So the economy is shaped, in a way, by where the banks are directed to go. I want to mention one other thing, and that is we are talking about banks all the time. This hearing was about banks.

The most important funder of the U.S. economy are the securities markets and the capital markets. In my prepared testimony, there is a chart which shows that the banks are tiny in terms of their financing of growth and business in the United States. The securities markets are where all the action is, and—

Chairman MCHENRY. We are going to have to leave it there, Mr. Wallison. The gentleman's time has expired.

The ranking member is now recognized for 5 minutes. And with 2 minutes left to vote on the Floor, I will leave it to the gentleman to determine when we should leave.

Mr. GREEN. I assure you, Mr. Chairman, I will consider the time. I would like to ask unanimous consent to place in the record the testimony of Mr. Chris Brummer, who was originally scheduled to be a witness but could not make it today because of the rescheduling.

Chairman MCHENRY. Without objection, it is so ordered.

Mr. GREEN. Thank you. I will be very terse with this. Mr. Wallison, you indicate that bad laws seem to be more of a problem than a lack of regulation. Permit me to ask you quickly, what bad law could we have repealed such that AIG would not have been a liability to the world economy? What bad law could we have repealed?

Mr. WALLISON. I don't think AIG did what it did because of a bad law, although I don't think—

Mr. GREEN. I assume, then, that you do agree that there are times when we have to have additional laws?

Mr. WALLISON. Sure.

Mr. GREEN. That it is just not a question of repealing bad laws.

Mr. WALLISON. Absolutely. Regulation is necessary in some respects. It can be overdone, as I suggested.

Mr. GREEN. It can be overdone. And do you agree that it can be, in the sense of not having enough, underdone? That you can have a circumstance where you don't have enough regulation?

Mr. WALLISON. Sure. In principle, you can; you might not have enough regulation.

Mr. GREEN. All right. And do you agree that we do need some way to wind down these systemically—these very huge corporations, that we call SIFIs, in the event they become a liability to the world economy?

Mr. WALLISON. No, I don't agree with that.

Mr. GREEN. Do you think—

Mr. WALLISON. First of all, I don't think we understand what SIFIs are—

Mr. GREEN. Excuse me, if I may ask quickly because time is of the essence. Would you just allow them to go into bankruptcy?

Mr. WALLISON. Yes, of course. I would allow large firms and small firms to go into bankruptcy. That is the way the market works.

Mr. GREEN. And do you agree that Dodd-Frank provides bankruptcy as a remedy?

Mr. WALLISON. No, it doesn't.

Mr. GREEN. You do not agree that Dodd-Frank has bankruptcy as a remedy?

Mr. WALLISON. No, it does not.

Mr. GREEN. Oh, well, you and I differ. My time has expired, and I apologize to you for being abrupt. I will yield back to you, Mr. Chairman.

Chairman MCHENRY. I thank the ranking member, and I want to apologize to the witnesses for when they called votes today. But I certainly appreciate your willingness to testify and to take Members' questions. I ask unanimous consent to submit for the record letters from the National Association of Federal Credit Unions and the Chamber of Commerce of the United States of America. Without objection, they will be entered into the record.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

I want to thank our witnesses for your testimony, for your time, and for your input. And without objection, this hearing is adjourned.

[Whereupon, at 3:18 p.m., the hearing was adjourned.]

APPENDIX

March 5, 2014

Testimony of Michael S. Barr
Professor of Law
University of Michigan Law School
Before the House Financial Services Committee
Subcommittee on Oversight and Investigations
Hearing on Financial Regulation and U.S. Competitiveness
March 5, 2014

Chairman McHenry, Ranking Member Green, I am pleased to appear before you today to discuss financial regulation and U.S. competitiveness.

In 2008, the United States plunged into a severe financial crisis that shuttered American businesses, and cost millions of households their jobs, their homes and their livelihoods. The crisis was rooted in unconstrained excesses and prolonged complacency in major financial capitals around the globe. And the crisis demanded a strong regulatory response as well as fundamental changes in financial institution management and oversight.

Two years later, the Dodd-Frank Act created the authority to regulate Wall Street firms that pose a threat to financial stability, without regard to their corporate form, and bring shadow banking into the daylight; to wind down major firms in the event of a crisis, without feeding a panic or putting taxpayers on the hook; to attack regulatory arbitrage, restrict risky activities, regulate short-term funding markets, and beef up banking supervision; to require central clearing and exchange trading of standardized derivatives, and capital, margin and transparency throughout the market; to improve investor protections; and to establish a new Consumer Financial Protection Bureau (CFPB) to look out for the interests of American households.

The Path of U.S. Reforms

Since enactment, the new CFPB has been built and is helping to make the marketplace level and fair. New rules governing derivatives transactions have largely been proposed. Resolution authority and improvements to supervision are being put in place. The Financial Stability Oversight Council has begun to take on the shadow banking system by designating non-bank firms for heightened supervision and at the end of the year regulators finalized the Volcker Rule.

To continue to make progress on reform, the Federal Reserve needs to use its authority under Dodd-Frank to finalize its rules for tough new oversight, including requiring limits on counterparty credit exposures, and imposing a cap on the relative size of liabilities held by the largest firms. The Fed must speed up reforms to repo and other short-term funding markets that were at the heart of the financial panic five years ago. It must also use its authority under Dodd-Frank to bolster resiliency in clearance and settlement of foreign currency markets.

Five years after the money market fund industry faced a devastating run, stopped only with a $3 trillion taxpayer bailout, we still do not have fundamental reform of that sector, with the necessary buffers to prevent a financial collapse.

And we need legislation to determine the ultimate fate of the government-sponsored enterprises in a way that protects taxpayers while assuring that the mortgage system works for American families.

Strong and effective regulation in the United States is crucial to a safer and fairer financial system, but it is not enough. We also need global reforms.

Global Capital Rules

Strong capital rules are one key to a safer system. There's already double the amount of capital in the major US firms than there was in the lead up to the financial crisis. Globally, regulators are developing more stringent risk-based standards and leverage caps for all financial institutions, and tougher rules for the biggest players.

In the U.S., regulators have proposed an even stronger leverage requirement for the largest U.S. firms, and other countries are putting in place stricter approaches when warranted by their local circumstances. In my judgment, the local variation based on a strong minimum standard is healthy for the system, taking into account the different relative size of financial sectors and differing local economic circumstances. There's been progress on the quality of capital—focusing on common equity—and on better and more comparable measures of the riskiness of assets, but more could be done to improve transparency of capital requirements across different countries and to make them stronger buffers against both asset implosions and liquidity runs. And in Europe, there is still a long way to go in implementing tough and transparent stress tests and in forcing the largest firms to hold sufficient capital to withstand these tests.

Improved capital regulation alone, however, is not enough.

Structural Reform and Resolution

Globally, much more work needs to be done to make resolution of an international firm a practical reality. In the U.S. and Europe, further work is needed on implementing structural reforms, such as the U.S. Volcker rule, the U.K.'s Vickers Report, and Europe's Liikanen Group, that could reduce risks, improve oversight, and make the largest firms more readily resolvable in the event of a crisis.[1]

First, having a clear sense of who is in charge of what is vital when it comes to management and supervision, especially in times of stress. Structural reform and

[1] This section draws heavily from Barr & Vickers, Banks Need Far More Structural Reform to be Safe, Financial Times, July 21, 2013.

"living wills" can be used to help clarify lines of authority, align business risk with organizational form, and simplify structures of complex financial institutions.

Second, structural reform can help to bolster "horizontal buffers", which can help stop crises spreading when they start. Limits on the activities of retail deposit banks, restrictions on transactions between retail banks and their affiliates, independent capital, and caps on counterparty credit exposures can help minimize contagion.

Third, paying attention to structure will help to resolve companies when they get into distress. The FDIC is developing a "single point of entry" model for resolution that would allow it to wind down a complex financial conglomerate through its holding company with "resolution-ready" debt and equity, while permitting solvent subsidiaries to continue to operate. Similar approaches are being discussed in Europe. Structural reform will make it much more likely that complex financial companies can be credibly resolved in a crisis.

While different countries are taking different approaches to structural reform, there is also convergence on the importance of the approaches.

The US has long used the bank holding company structure to try to separate banking from other financial activities within a complex group. The Dodd-Frank Act strengthened the wall between banks and other parts of a financial group, moved some derivatives activities to affiliates, and pushed proprietary trading and significant hedge fund investing outside the holding company entirely. The UK is moving forward with reforms based on the recommendations of the Independent Commission on Banking, which will move Britain more towards the US approach of using bank holding companies with separate subsidiaries. The retail banking subsidiary would have more restricted activities and would be ring-fenced from other units. Europe is considering similar reforms proposed by the Liikanen report.

Recently, the Federal Reserve proposed rules for foreign banking organizations operating in the U.S. Under the rules, large foreign banking organizations will need to put non-branch assets under a U.S. intermediate holding company. Under many circumstances, foreign firms will need to meet U.S. capital and liquidity rules and prudential standards with respect to their U.S. operations. In my judgment, these rules are consistent with national treatment and prudent as measures to reduce systemic risk and improve the safety and soundness of the U.S. financial system. Nonetheless, they have been met with significant controversy.

None of these approaches is perfect, or perfectly aligned, and all are evolving. Structural reform involves difficult trade-offs: introducing rigidity may decrease efficiency and increase the risks faced by individual banks, while reducing the potential harm done to the system as a whole. In response to these trade-offs, the US, UK and Liikanen approaches all accept that forms of universal banking can be efficient but see the need for it to have structural safeguards and limitations. Further global progress on these measures would be well warranted.

Ring fencing by itself, of course, will not bring financial stability. We had forms of ring fencing before the crisis, where it blinded regulators to the dangers of shadow banking. Non-bank financial institutions engaged in increasingly risky activities with too little oversight and far too much leverage. So structural reforms need to be part of a broader change in supervision and capital requirements, including resolution procedures for large financial companies regardless of their corporate form, and much needed reforms to derivatives markets. Ring fencing is no excuse to avoid regulating non-bank firms and markets that can pose a risk the financial system.

Derivatives and Other Markets

One such important reform is regarding the derivatives markets. During the financial crisis, over the counter derivatives transactions contributed to the panic. And in the lead up to the crisis, OTC derivatives grew significantly in size without enough margin and capital in the system as buffers against losses. OTC derivatives were traded without transparency, and regulators, market participants and the public at large were left in the dark about the true extent and nature of risks.

The US led reforms of derivatives markets, and pushed for strong G-20 commitments for global reform. The Dodd-Frank Act moves derivatives markets towards central clearing, exchange trading, strong capital and margin rules, market-wide transparency, and sound business conduct standards. Europe agreed to implement similar reforms and is engaged in two important policy initiatives—the European Market Infrastructure Regulation and the Markets in Financial Instruments Directive—to further these reforms. While many in the US remain concerned about whether Europe's rules will end up strong enough, and many in Europe worry about whether the US will extend the reach of its rules too far, the global system is moving towards a more coordinated approach for derivatives.

Other market reforms still need much more work. Global rules on liquidity, including governance of repo markets and other short-term funding mechanisms, are still in flux. Hot money is still a big risk to stability. Furthermore, global coordination to strengthen the resiliency of foreign currency markets is in order. In addition, apparently widespread manipulation of global rates, including LIBOR and foreign currency trading, has not yet been met with the fundamental changes required to restore trust and confidence—and veracity, to global rates.

Global Financial Regulatory Coordination

The United States has taken a strong lead in pursuing global reforms, galvanizing the G-20, pushing for the creation of the global Financial Stability Board, and pursuing strong global reforms on capital, derivatives, and other matters.

Yet some want to sidetrack reforms through a new trade-focused process. Recently, the United States and the European Union have embarked on a new round of trade

talks that may bring real benefits on both sides of the Atlantic. But the talks should not be used to weaken US financial reforms that are just taking root.

The financial industry is pushing the talks as a way to overturn the rules being implemented in the US under Dodd-Frank. Some commentators and academics, moreover, view the talks as another forum for cooperation, hoping that trade negotiations will improve coordination among financial regulators.

The US has wisely rejected that view. Now is not the time to place America's hard-fought financial reforms at risk. Shadow banking is coming into the light; new derivatives regulation is entering into force; capital requirements are going to be higher; structural reforms and resolution authority are reducing subsidies; and investors and consumers are better protected.

To be sure, there have been sharp disagreements between the US and Europe over elements of reform. Until recently, the US Commodity Futures Trading Commission had been at odds with Europe over the territorial scope of US derivatives rules. Likewise, the Federal Reserve's capital, liquidity and holding-company requirements for foreign firms operating in the US – while better than national treatment and, in my judgment, prudent – angered the European Commission. And the US has been concerned about providing for national treatment in European rules governing derivatives, as well as rules regarding hedge fund managers.

Yet there are plenty of other fora in which to resolve disagreements between US and European regulators, including the bilateral process that ultimately resulted in the agreement between the US and Europe on a framework for derivatives regulation.

The G-20 has been driving financial reforms at a global level; the Financial Stability Board pursues agreement among regulators; and technical teams at the Basel Committee on Banking Supervision, the International Organization of Securities Commission, and the International Association of Insurance Supervisors hash out industry-relevant reforms. These mechanisms should be strengthened and improved, not bypassed.

While the process of reaching global agreement has at times been quite messy, divisive, and incomplete, the last thing we need is another process, particularly one not focused on how to prevent another financial meltdown like the one from which the US and Europe are still trying to recover. Trade talks would merely serve as a one-way ratchet to pull back from reforms, not advance them.

Conclusion

Globally, there is much work still to be done. On bank resolution, the US has a solid framework in place, but is still working through how to make winding down a major financial firm plausible; in Europe, there is agreement on the need for resolution authority, but a lot more to do to make this authority work within the context of EU

member states' legal and political frameworks. On derivatives, there is now general agreement on how to approach trading, clearing, and transparency, but much more work to do on capital requirements, margin requirements, clearinghouse supervision, determination of equivalency across national borders, and other issues. Capital rules are taking shape, but a final agreement on liquidity and leverage must still be worked out, and transparent and tough stress testing in Europe and consistent implementation globally will be critical going forward.

Strong US financial rules are good for the US economy, American households and businesses, but we also need a stronger, harder push to reach global agreement on core reforms. In fact, such an approach is essential in order to reduce the chances of another devastating global financial crisis.

TESTIMONY

Regulatory Fragmentation, the Balkanization of Financial Markets and the Competitiveness of the American Financial Services Sector

By: Louise C. Bennetts[1]

Subcommittee on Oversight and Investigations
Committee on Financial Services
United States House of Representatives

Introduction

Chairman McHenry, Ranking Member Green, and distinguished members of the Committee, I thank you for the opportunity to testify in today's important hearing.

I am Louise Bennetts, Associate Director of Financial Regulation Studies at the Cato Institute, a non-profit, non-partisan public policy research institute located here in Washington, D.C.

Before I begin, I would like to highlight that all comments I make and opinions expressed herein are my own and do not represent any official positions of the Cato Institute or any other organization. In addition, outside of my interest as a U.S. resident, consumer and taxpayer, I have no financial interest in the subject matter before the Committee today, nor do I currently represent any entities that do.

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[1] Associate Director of Financial Regulation Studies, The Cato Institute, Washington DC.

Background

Since 2008, commentators, industry professionals, regulators, and elected officials have made numerous, often contradictory, suggestions about how to deal with, or avoid, banking crises. These suggestions range from "bailing in" creditors, to making banks smaller (whether through size caps or limitations on acquisitions), to limiting the activities that banks undertake (the "Volcker Rule" and similar initiatives), to imposing ever more stringent regulations, in particular, on larger organizations. In addition, increasingly regulators are looking inward, trying to insulate their domestic banking sectors from external shocks.[i]

In the United States since 2010 we have seen the rollout of one of the most comprehensive "reform" agendas targeting the financial services industry both in the United States and abroad. The centerpiece of the reform agenda – the Dodd-Frank Wall Street Reform and Consumer Protection Act – has **394** associated rulemaking requirements and already has spurred thousands of pages of related rules.

But this is just the tip of the iceberg. As of February 2014, only 52% of the rules required by the Act have been finalized.[ii] Around 20% have yet to be proposed. And Dodd-Frank is but one component of a far greater regulatory reform agenda that includes a complete overhaul of the capital and liquidity rules imposed on the U.S. banking sector (the "Basel III" regime); a radical revision of the regulation of nonbank financial companies such as insurance firms and asset managers; changes in the regulation of the U.S. operations of foreign banks; changes in the regulation of consumer credit; imposing new monitoring and enforcement obligations on banks on behalf of the Federal government. All of these new obligations are only magnified for banks and financial service companies that operate cross-border. In addition, barely a month passes without a new initiative aimed at the financial services sector being proposed either in Congress or through the regulatory agencies.[iii] While most of these proposals will never see the light of day, they nonetheless impose a

significant cost on the private sector in terms of the uncertainty they generate and the time and resources private firms must spend on evaluating the potential impact of such proposals.

The question before the Committee today is: how is this regulatory overhaul impacting the global competitiveness of the American financial services sector and, indeed, American consumers of financial services? To date, no assessment has been made and no studies have been undertaken to assess the cumulative impact or cost of all this regulation. To answer this question, in my view, we need to address two related issues:

- What are the costs associated with the individual impact and, more importantly, cumulative effect of all these regulations?
- And secondly, given the sheer volume, complexity and the unintended consequences of this massive undertaking, are we likely to achieve the desired outcome – that is: creating a financial system that is safer and more transparent without damaging credit provision and profitability?

Before I discuss these two key points with an analysis of some specific cases, I would like to make a few observations about the United States' position in the global economy. **The United States is a net importer of capital and a net exporter of financial services and products.** Despite, or possibly even because of, its inauspicious and crisis-prone banking history, the United States has the world's most vibrant capital markets and, currently, has the only well-developed debt market and short-term or overnight dollar funding market. Many foreign companies and banks raise a significant portion of their non-depositary short-term funding in the United States.

However, while the United States may have had a head start, one cannot assume a permanent state of dominance. Steps are being taken to develop high yield and other short-term funding markets in South East Asia, particularly in Hong Kong and

Singapore as well as in Europe (although the European funding markets remain weak).[iv] In addition to the large European banks, several emerging markets, most notably China, are taking noteworthy steps towards the creation of worldwide banking conglomerates, by acquiring significant stakes in banks and financial companies in the developing, and to a lesser extent, the developed world.

The Costs of Regulatory Fragmentation within the United States

The United States' financial services sector has long been subject to a fragmented regulatory regime, in part due to the structural spilt that historically characterized the market (between activities such as loan-making and underwriting) and the deep-seated American aversion to the "universal" banking model.[v] In most countries, banks and financial services companies report to a single regulatory authority. In the United States, even monoline financial firms such as commercial or investment banks must report to more than one regulatory agency and these agencies frequently have overlapping jurisdiction. This creates a competitive disadvantage for U.S. financial institutions as it increases the costs associated with regulatory compliance, decreases the efficiency of both the regulators and the regulated, opens the door for regulatory arbitrage and creates a lack of transparency as to who bears ultimate responsibility for regulatory oversight.

It could also result in the release of rules and regulations that are contradictory in nature, making it impossible for a regulated entity to be compliant with all rules at all times. The Dodd-Frank Act made this problem worse not better. Instead of streamlining the regulatory agencies responsible for the oversight of the financial system, the Dodd-Frank Act adds several new regulatory bodies – the Consumer Financial Protection Bureau, the Office of Financial Research and the Financial Stability Oversight Counsel. It also gives overlapping jurisdiction to multiple regulators and carves up the regulatory "turf" in arbitrary ways.[vi] This has led to the situation where, for example, multiple versions of rules on the same topic have been

released by more than one agency (such as was the case with the first release of the Volcker Rule proposal).

The Dangers of Financial Sector "Balkanization"

Several commentators and industry experts have drawn a parallel between the current climate in global financial regulation and the relations that characterized trade politics among the world's largest economies in the early 1930s following the passage of the "Smoot-Hawley" Tariff Act, a situation known as "balkanization."[vii] In this regard, particular attention has been paid to current measures that have protectionist implications or serve to encourage the further balkanization of financial services or the isolation of American banks, companies and individuals, (such as the Federal Reserve's recent Foreign Banking Organization proposal or the FATCA legislation). I believe the comparison is well made.[viii]

In the two years following the passage of Smoot-Hawley, the volume of U.S. imports fell 40 percent. This was due, in part, to a decline in domestic demand, but scholars estimate that at least a quarter of this decline can be directly attributable to the act itself.[ix] In addition, retaliatory actions against the United States resulted in a decline of 60 percent in U.S. exports in the 1930s, and this discrimination against U.S. products persisted for decades. In addition, Smoot-Hawley encouraged other countries—most notably Germany—to institute retaliatory measures, leading to a worldwide trade freeze that exacerbated hardships for local consumers and almost certainly contributed to the increasingly Balkanized international environment in the period leading up to World War II.

Following a crisis, the natural inclination for any regional authority is to attempt to erect walls around local industries and operations to make it easier—at least, theoretically—to address problems at a local level. Usually this also serves to meet the demands of local interest groups harmed by the crisis. But for U.S. regulators, the lesson from the Smoot-Hawley experience should be clear: this approach may

yield positive results in the immediate term only, if at all, and any positive outcomes are far outweighed by the negative effects of retaliation. As the world's leading financial services economy, the actions of U.S. policymakers have a disproportionate effect on the global financial sector and are likely to spur retaliatory actions elsewhere in the world. When it comes to the regulatory "marketplace," the United States is a "price-setter" and ought to lead by example.

Indeed, my great fear is that the response to the 2007–08 Financial Crisis in the United States may be a classic example of policymakers throwing the baby out with the bathwater. In this case it is global capital flows—as with global trade flows in the 1930s—that could potentially suffer a steep decline in the wake of the measures adopted to address the perceived problems in the financial services industry.

Although the increased size, depth, liquidity, and complexity of financial markets has received widespread criticism, including being labeled as a "cause" of the crisis, in my view this criticism is misplaced. It overlooks the significant global benefits that fluid and highly developed capital markets have accrued—benefits that have not come close to being wiped out even in the wake of the financial crisis.[x]

In the only detailed study released to date on the effect of post-crisis reforms on global capital flows, the McKinsey Global Institute (the research arm of the consulting firm McKinsey and Co.) found that since 2008, cross-border capital flows have fallen dramatically as banks and borrowers deleverage.[xi] **The firm estimates that cross-border capital flows have declined 60 percent since 2007.**[xii] Financial assets had been increasing by close to 8 percent per annum since the early 1990s, but they are now growing at under 2 percent.[xiii] At the same time, **government debt securities have increased by more than $15.4 trillion worldwide.** The authors note that "for three decades, capital markets and banking systems rapidly expanded and diversified, but now that process—called financial deepening— has largely ground to a halt. . . . Today, global financial markets are at an inflection point. One path leads to a more balkanized structure that relies

primarily on domestic capital formation and concentrates risks within local banking systems."[xiv]

The study also notes: "facing new regulations on capital and liquidity as well as pressures from shareholders and regulators to reduce risk, **many banks in advanced economies are winnowing down the geographies and business lines in which they operate. Since early 2007, commercial banks have sold off more than $722 billion in assets and operations, with foreign operations accounting for almost half of this total.** Regulators in many countries are moving to exert more control over the foreign banks that remain active in their jurisdictions, in some cases requesting that banks operate as subsidiaries rather than branches."[xv]

Although the "Foreign Banking Organization" rule release last month by the Federal Reserve (discussed below) may stop short of requiring the full subsidiarization of foreign banks' U.S. operations, the likely chilling effect on global capital is the same. The McKinsey Global Institute study concludes with the warning that regional differences in the availability of capital could emerge and that regions with high savings rates could find themselves with surplus capital and a shortage of good investment opportunities, while other countries could find themselves short of capital and facing lower growth.[xvi]

Undoubtedly, there are many factors contributing to the collapse of global capital flows post-2008, not least the European public debt crisis, the weaknesses in the Chinese financial sector, and a general lack of investor confidence worldwide. Nonetheless, any measures on the part of U.S. regulators that have the effect—whether intentional or incidental—of hastening the decline of such flows should be approached with extreme caution. This is especially true when it is unclear whether the measures will deliver their promised benefits.[xvii]

U.S. Regulatory Overreach and Potential Retaliatory Actions against American Banks and Financial Services Firms: The Case of the Federal Reserve's "Foreign Banking Organization" Proposal[xviii]

The Federal Reserve's FBO proposal represents a seismic shift in the regulation of U.S.-based subsidiaries and operations of foreign banks. Since the passage of the International Banking Act of 1978, foreign banks seeking to operate in the United States have been afforded considerable flexibility in the structuring of their U.S. operations.[xix] The Federal Reserve would now change this approach for important market players. This would require foreign banks to transfer their U.S.-based operations to an existing holding company or to a newly created one.[xx] Once this transfer is complete, the subsidiary would be required to comply with U.S. capital and liquidity standards as well as U.S.-specific requirements such as single counterparty credit limits, enhanced risk management practices, and early remediation requirements *in addition* to meeting all home country requirements.[xxi]

At the macro level, the proposal interferes with the ability of global banks to allocate capital and liquidity in the manner they determine to be most efficient. The proposal would trap a material amount of capital and liquidity inside the U.S. subsidiary, rendering it unusable for the rest of the institution. Ironically, the Federal Reserve itself noted the benefits of its traditional approach to foreign bank supervision in the preamble to the FBO proposal: "[T]he structural diversity and consolidated management of capital and liquidity permitted under th[is] approach has facilitated cross-border banking and increased global flows of capital and liquidity."[xxii] But the corollary is also true. If such flows stimulate economic growth, any reduction in those flows is likely to inhibit growth and prolong recessionary or sluggish tendencies. This seems a major drawback to a proposal introduced at a time when the Federal Reserve is engaged in unprecedented expansionary monetary policies to stimulate growth.

The Federal Reserve's FBO proposal also contains a potential serious drawback for American banks and financial services firms, particularly those with significant cross-border operations. If foreign regulators use the same reasoning as the Federal Reserve, the FBO proposal would likely further encourage additional protectionist measures to be taken by foreign regulators. These measures could include retaliatory actions against U.S. banking organizations with significant international operations.

Many foreign supervisors have raised concerns about the Federal Reserve's proposal during the public comment process, and they may well take more drastic actions if the FBO proposal is retained.[xxiii] Indeed, if the United States' principal "systemic" regulator takes the position that ex ante ring-fencing of the U.S. operations of foreign banks is necessary to safeguard the U.S. financial system, why would other home country regulators not follow suit? And if they do, we will see a domino effect where host countries impose inefficient individual capital and liquidity requirements or move to requiring full subsidiarization.[xxiv] Moreover, the Federal Reserve's FBO proposal *explicitly* questions the principle of international cooperation that has been at the heart of cross-border bank supervision and regulation for decades

"Optimal" Levels of Capital and American Competitiveness

It is an article of faith that "well-capitalized" banks are safer banks. There can be no doubt that despite meeting existing regulatory capital requirements, many banks were under-capitalized and over-leveraged going into the Financial Crisis in 07/08. This increased the need for these institutions to rely on volatile short-term funding. While it is easy to suggest banks need to be "well-capitalized," no-one seems able to agree on exactly what this term means, hence the difficulties associated with structuring global capital standards and the resulting complexity of the Basel III regime and related initiatives. In addition, there is a clear trade-off here: imposing very stringent capital requirements unavoidably reduces the funds available to

banks to lend out or otherwise put to use in the broader economy. But there is also a more fundamental question: are high levels of capital and low leverage really a cure-all for financial crises?

Many commentators have noted - correctly - that smaller commercial banks, particularly those with assets of less than a billion dollars - operate with much higher equity capital reserves and far lower leverage than their larger and more diversified peers. Yet, in the United States, these smaller banks have a significantly higher rate of failure than larger banks. If capital were the only measure of stability, why should this be so? As we learn during every financial crisis, banks fail for one reason – undiversified risk.

We cannot eliminate risk from the banking system. Banking is nothing more than the pooling and management of risk. But if we view undiversified risk as the key cause of bank failure, then initiatives such as the Basel III risk-weighting system can potentially heighten the riskiness of banks even though the intention is to make banks better capitalized. This is because the regime uses advanced modeling techniques to determine which classes of assets are "safer" than others. It then incentivizes banks to hold assets in those "safer "classes, resulting in the assets held by banks becoming more concentrated not less – at both the firm and the industry-level.

I support the use of risk weighting models at the individual firm level. But, the industry-wide reliance on the same financial models is a recipe for a future crisis because all financial models, regardless of the complexity or sophistication, will contain some errors and when adopted by all industry participants, these errors can lead to a system-wide problem. The same concerns can be raised about the C-CAR/stress-testing process run by the Federal Reserve in which all major U.S. banks participate. While the models the Federal Reserve uses to determine whether banks are adequately capitalized are extremely sophisticated, they are nonetheless just that – models. And early indications are that

U.S. banks have become increasingly focused on aligning their models with that of the Federal Reserve instead of focusing on their own concerns about market risk.

Some policymakers have proposed including a simple leverage ratio be used as a "backstop". I should note that the proposed leverage ratio is an **additional** measure, *not* a replacement. It is also an idea that has far greater traction in the United States – while regulators in Europe and Asia will adopt some leverage measure, it is unlikely to be especially stringent. Therefore, a proposal such as the one contemplated by some senior officials at the FDIC is an added burden on U.S. financial institutions and creates a competitive disadvantage because it is one that their foreign peers will not be subject to. Although a leverage ratio has the benefit of simplicity as a standalone measure and can be easily monitored and understood, it nonetheless does not cure the fundamental flaw in the risk weighting system - the tendency for concentration in certain asset pools. Therefore as an addition to the Basel III regime it is not especially helpful, in my view. It is clear that many of the proponents of the initiative view it not as a means to create safer institutions, but rather as a means to downsize large institutions (by forcing them to include derivative and other off-balance sheet activities in their liability calculations). The effect of this is to drive those activities into the unregulated sector or into single-activity shops, which may not be the most desirable outcome and may further segment the market.

But this begs the question: if we are so concerned about leverage, why do we continue to incentivize banks and individuals to become over-leveraged in the first place? We have a system that heavily penalizes equity holders, while rewarding holders of debt with tax breaks and the like. Instead of imposing blunt tools that require expensive monitoring and enforcement on these institutions, we could begin by reforming the incentive structure that they operate under.

Differing Approaches to Regulation: Europe v. the United States

It may be worth highlighting that the United States and the European parliament have taken very different approaches to imposing the financial reform agenda and that this may further place U.S. institutions at a disadvantage. The recent passage of the final "Volcker Rule" in the United States (in particular the ban on proprietary trading) and its equivalent proposal before the European parliament is a useful case in point. While I should note that I disagree with the imposition of a ban on proprietary trading in any form as I consider it to be unnecessary, it nonetheless illustrates the differences in approaches taken by the United States and Europe. I should also note that the proposal before the EEC is in its very early stages and may never be enacted in its current form or at all).

The Europeans favor a "principle-based" approach, by outlining a simple prohibition. They do not impose extensive or costly compliance and monitoring obligations. They do not attempt to guess the intention of the trader or list and carve out every scenario that may conceivably lead to or indicate the presence of proprietary trading. If a bank can demonstrate that its trading activities are nominally in the client interest, it should fall comfortably within the rule. In contrast, the final Volcker Rule in the United States is an extremely poorly-drafted and highly-technical document that spans hundreds of pages and imposes an extremely complex and costly regime on banks and industry participants.

Conclusion

The time has come to acknowledge that we are at a crossroads – globally and domestically. One path leads to a system where American banks and financial services firms, buckling under the weight of excessive and contradictory regulations, become less diversified, less competitive globally, more inward looking and, in my view, potentially more unstable. This path leads to a sub-optimal outcome – one in which financial firms are less focused on market drivers and

meeting the needs of consumers and more on pleasing local regulatory authorities. Another path begins with the recognition that we already may have gone a step too far. The time has come to ask ourselves, "what was the purpose of this all?" If the purpose is to make the United States banking sector less crisis-prone, safer and more competitive, we need a comprehensive and realistic assessment of whether all these regulations – given their significant costs – are achieving that outcome. I thank-you for the opportunity to testify today.

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[i] For a recent discussion of this phenomenon in Europe, see Sonia Sirletti and Yalman Onaran, "Banking Balkanization Prevails in Europe on Eve of Review," *Bloomberg*, October 23, 2013, http://mobile.bloomberg.com/news/2013-10-22/banking-balkanization-prevails-in-europe-on-eve-of-review.html.
[ii] Available at: http://www.davispolk.com/Dodd-Frank-Rulemaking-Progress-Report/
[iii] These include proposals such as the Brown-Vitter bill, tabled in April 2013, the Federal Deposit Insurance Corporation's soon-to-be proposed leverage ratio, and most recently, the proposed tax levied on banking institutions with over $500 billion dollars in assets.
[iv] See e.g.: http://www.mckinsey.com/app_media/reports/financial_services/between_deluge_and_drought.pdf
[v] See e.g. Charles W. Calomiris & Stephen H. Haber, *Fragile by Design The Political Origins of Banking Crises and Scarce Credit* (Princeton; Princeton University Press, 2014).
[vi] The swap market is a good example of this. The CFTC has jurisdiction over ordinary swaps; the SEC has jurisdiction over security-based swaps. These agencies have taken different approaches to regulating the swap market, particularly in the agencies' respective approaches to the cross-border application of the rules, creating much confusion for the market participants who are tasked with implementing the rules.
[vii] See, e.g., Davis Polk & Wardwell, "Governor Tarullo Foreshadows Proposal to Ring-Fence Large U.S. Operations of Foreign Banks;" Client Memorandum (New York, December 2, 2012); H. Rodgin Cohen of Sullivan & Cromwell LLP and Hal Scott of Harvard Law School have also made this point. See also Alex Barker and Tom Braithwaite, "EU Warns US on Financial Protectionism," *Financial Times*, April 22, 2013, http://www.ft.com/cms/s/0/6d599a10-ab59-11e2-ac7100144feabdc0.html.
[viii] In June 1930, Congress passed the Tariff Act, colloquially known as "Smoot-Hawley" after its two Republican sponsors. Smoot-Hawley raised tariffs on approximately 20,000 imported products to unprecedentedly high levels. Ostensibly, the act's purpose was to protect U.S. industries, workers, and prices in the wake of the stock market crash of 1929, but its medium- and long-term effects were dire. Although imports accounted for only 4 percent of U.S. gross domestic product at the time, Smoot-Hawley had significant, if concentrated, regional effects and in particular served to further weaken the United States' already-struggling banking system. (The Tariff Act of 1930 (19 U.S.C. ch. 4). See also: Thomas Rustici, *Lessons from the Great Depression* (Washington: Capitalism Works Publishing, January 2012).
[ix] Douglas Irwin, "The Smoot-Hawley Tariff: A Quantitative Assessment," National Bureau of Economic Research Working Paper 5509, March 1996, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=4916.
[x] The significant gains in wealth across the globe, including the vast numbers of people lifted out of poverty in the three preceding decades, have been well documented and are attributable in no small part to the fluidity of global capital. See, e.g., Shaohua Chen and Martin Ravallion, "An Update to the World Bank's Estimates of Consumption Poverty in the Developing World," *Briefing Note*, Development Research Group, World Bank, January, 3, 2012, http://siteresources.worldbank.org/INTPOVCALNET/Resources/Global_Poverty_Update_2012_02-29-12.pdf.)
[xi] McKinsey Global Institute, *Financial Globalization: Reset or Retreat*? March 2013, www.mckinsey.com/mgi.
[xii] Ibid.

[xiii] Ibid.
[xiv] Ibid.
[xv] Ibid.
[xvi] Ibid.
[xvii] Former U.S. treasury secretary Henry Paulson has made this point as well, warning that such post-crisis reforms could lead to "walling off markets, constricting cross-border access to capital, and conflicting requirements for global firms." See Tom Braithwaite, "Hank Paulson Warns of Regulatory Conflict," *Financial Times*, September 19, 2013.
[xviii] For a more detailed discussion of this important topic, please see my Cato discussion paper, co-authored with Arthur Long and available at: http://www.cato.org/publications/policy-analysis/new-autarky-how-us-uk-domestic-foreign-banking-proposals-threaten
[xix] 12 U.S.C. § 3102(a), 3105(d).
[xx] 12 C.F.R. Part 252 (proposed).
[xxi] Ibid.
[xxii] *Federal Register* 77, no. 249, p. 76629.
[xxiii] Letter from Michel Barnier, Commissioner for Internal Market and Services, European Commission, to Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, April 18, 2013.
[xxiv] It is worth noting this trend is already underway in some European countries (e.g., Spain). See Jonathan Fiechter et al., "Subsidiaries or Branches: Does One Size Fit All?" IMF Staff Discussion Note, Washington, March 2011, http://www.imf.org/external/pubs/ft/sdn/2011/sdn1104.pdf

Mr. Chairman and Members of the Committee:

Thank you for this opportunity to provide testimony.

My name is Alon Hillel-Tuch. I am a co-founder and Chief Financial Officer of RocketHub. RocketHub is an established crowdfunding platform that has initiated over 40,000 campaigns, and has provided access to millions of dollars' worth of capital, for entrepreneurs and small businesses in over 180 different countries. My testimony today is based on my field experience working closely with new and small-businesses.

Domestic job growth comes from the new and small-business sector. Approximately 90% of U.S. firms employ 19 or fewer workers, and these companies create jobs at nearly twice the rate of larger companies.[1] According to January's ADP National Employment Report,[2] between December and January, small businesses with fewer than 50 employees added 75,000 positions. That is more than double the number of jobs large business created in the same period. Job creation is most prevalent in new companies, and if our goal is to drive job growth within the United States, our focus should be on new business formation.

The spirit of entrepreneurship in the United States is unparalleled, and as a result more Fortune 500 companies exist in the U.S. than anywhere else in the world. Those large companies are serviced well by big banks and the public markets, but new and small-businesses often find it difficult to access capital. In the U.S., investment capital is mainly limited to regions such as New York City, Boston, and Silicon Valley, and most new and small-businesses do not have access to these capital zones, let alone the innovation hubs recently created by the White House. Crowdfunding platforms, such as RocketHub, provide capital access to new and small-businesses that are either neglected by large banks or face unmanageable interest rates due to the different risk mechanism involved.

Until recently, the crowdfunding market was allowed to evolve and innovate without government oversight. Platforms sprouted and the public quickly adopted this social form of capital formation. Equity crowdfunding was the next evolutionary step in the market, and the first time Congress became involved. The House of Representatives passed several bills focused on economic revitalization, and democratizing access to capital, which eventually become the JOBS Act that the President signed it into law April 5th, 2012. But since then, implementation delays have been significant. It took the SEC 566 days to release proposed rules for Title III of the JOBS Act. In the meantime, basic forms of equity crowdfunding have been operational for almost three years in the United Kingdom and The Netherlands, and for nearly five years in Australia.[3]

The U.S. market is a magnet for domestic and foreign entrepreneurs, but they must have the necessary tools available within the United States to innovate and grow. Other countries are

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[1] http://blogs.wsj.com/economics/2014/02/24/say-it-together-new-businesses-not-small-ones-drive-job-growth/
[2] http://www.adpemploymentreport.com/2014/January/NER/NER-January-2014.aspx
[3] The Australian Small Scale Offerings Board has been operational since 2007 operating with a maximum investment cap of $5M having generated over $135MM of investment capital for entrepreneurs.

actively pursuing these entrepreneurs. For example, Chile has a special visa program for foreign entrepreneurs that includes a $40,000 grant, and they also proactively approached RocketHub and discussed leveraging crowdfunding, including equity based crowdfunding, within the Chilean market. I have personally had similar discussions with the foreign direct investment agency of France, as well as the Ontario Securities Commission in Canada.

The World Economic Forum's Global Competitive Report (2013-2014) identifies the U.S. as an innovation powerhouse, yet the U.S. ranks only 5th in competitiveness.[4] Certain countries that ranked lower in competitiveness, such as The Netherlands (8th) and the United Kingdom (10th), are catching up. They are doing this by being forward thinking market innovators and encouraging new capital formation policies, such as equity-based crowdfunding, well in advance of the United States.

Crowdfunding is not a brand new market, it is an existing market that has had its wings clipped in the United States by over-regulation. Crowdfunding is an important economic tool to help new and small-businesses grow and drive job creation, and if it is not allowed to continue to develop in the U.S., ultimately the market will continue to develop outside of this country. The JOBS Act, and Title III in particular, was intended to mandate low-cost regulation that relied on individuals within the market place and their socially informed investment appetite. However, it has evolved into a high-cost solution relying heavily on frameworks developed over 80 years ago.

At this point legislative support is needed to assist the SEC in creating functional rules for Title III of the JOBS Act. Checks and balances within emerging markets are critical, not only for consumer protection purposes, but also to generate trustworthiness in the market place. I believe appropriate regulation, leveraging a soft yet informed approach, is crucial in the United States. With Congressional support, we can increase the economic benefit provided by crowdfunding and remain competitive in the international market. The current market dynamics abroad, demonstrated by countries such as Canada, the United Kingdom, The Netherlands, Australia, and Italy, make it clear that only a pro-active approach in ensuring functional regulation will enable the United States to maintain a dominant international position for new and small-business formation.

I hope to have the opportunity to elaborate further on key-provisions that need to be addressed, and I thank you for your time.

[4] http://www3.weforum.org/docs/WEF_GlobalCompetitivenessReport_2013-14.pdf

Securities and Exchange Commission Proposed Rules Summary

RocketHub acknowledges the Commission's diligence and effort in producing the proposed regulations. We believe, however, that the proposed rules fail to address the realities of operating a crowdfunding Portal,[5] and fail to respond to the needs of an issuer considering a Section 4(a)(6) offering. The proposed rules need to be more cost-sensitive, less burdensome and more realistic to permit the development of a vibrant, sustainable, and scalable securities crowdfunding market, as envisioned by the JOBS Act.

In RocketHub response paper available at http://www.sec.gov/comments/s7-09-13/s70913-206.pdf, RocketHub argues that the proposed regulations are cumbersome and expensive. We believe the Commission has not taken full advantage of the opportunity provided by the JOBS Act to craft rules for a low-cost, web-based offering exemption and has instead imported expensive concepts from traditional regulatory frameworks. This is amply demonstrated by Rockethub's cost-analysis of the filing and audit requirements,[6,7] which establish an upfront cost that is too high for small businesses to accept. These proposed regulations also require businesses to engage an excessive amount of outside expert advice, which is not appropriate for the size of the market. Furthermore, Portals are saddled with misplaced liability, hindering their ability to operate in the market alongside other intermediaries.

RocketHub is concerned that the Commission too frequently relies on traditional concepts, instead of addressing and exploring the modern social media marketplace that underpins this new market. The complexity of the proposed regulations (585 pages) will increase costs associated with compliance, and discourage issuances. One reason that crowdfunding has become so popular is its low barrier to entry. Project leaders can leverage RocketHub's system to test the market, see if there is support for their ideas, and use that information to inform their decisions on how to move forward. Under the proposed rules, issuers will be faced with significant upfront costs, and the real possibility of a failed offering leaving them in a worse position than before the attempt.

In the response paper RocketHub has endeavored to bring operational insight, and an experienced crowdfunding & technology industry perspective to the discussion of the proposed rules. RocketHub believes that this perspective will benefit the Commission, allowing them to create regulation that will provide adequate protection of the consumer, and opportunity to the issuer. While we will continue to push for legislation that will reduce costs to the market, we urge the Commission to reexamine its approach in implementing the crowdfunding provisions of the JOBS Act. As part of this witness testimony RocketHub has included a summary of critical points.

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[5] Funding Portal as defined in section 3(a)(80) of the Securities Exchange Act of 1934, as amended.

[6] See Appendix I, II and III

[7] See page 8

Overview of Responses to the Commission's Request for Comments

Ongoing Reporting Requirements

This is in response to the following requests for comment: 17, 18, 24, 25, 26, 29, 30, 31, 32, 33, 34, 36, 37, 38, 41, 42, 72, 73, 74, 75, 79, 84, 92, 93, 94, 96.

As currently proposed, the initial and ongoing reporting requirements for issuers impose unnecessary costs and complexity, which fail to take advantage of the web-based nature of crowdfunding, and are not supported by the JOBS Act.

- The requirement for issuers to file a Form C with the SEC prior to making an offering on a Portal imposes an up-front cost on issuers with no benefit to investors. The up-front cost is that issuers need to incur the time and expense of completing the Form C. This is especially troublesome for issuers who are ultimately not successful in completing their capital raise. The Form C, however, is neither reviewed, nor declared effective by the SEC. As a result, there is no countervailing benefit to investors in terms of rule compliance or anti-fraud. Instead, <u>all</u> potential investors in the offering will be viewing the materials that are posted and available on the Portal's site. A better solution would be to only require a Form C be filed upon the completion of the offer. This "final" Form C would include the final versions of materials disclosed to investors during the offering process. The "final" Form C should be filed exclusively electronically, and should allow for reference to materials on the Portal's website (if the Portal has agreed to keep such information available).

- The requirements for issuers to file "Form C-U" progress updates are similarly flawed. If an offering is unsuccessful, the requirement that issuers make a filing upon reaching the 50% commitment threshold is irrelevant. If an offering is successful, the requirement that issuers make a filing upon reaching the 50% commitment threshold is useless because the issuer will have disclosed reaching 100% of funding. These progress updates also fail to account for (i) the various lengths of offering periods, (ii) the nature of the timing of funding commitments (which may all come in at the end of the funding period, making interim filings irrelevant), and (iii) the visibility of funding status to all potential investors on the Portal's website. As a result, these progress reports (which are not required for other types of offerings) add a layer of useless regulation and cost on small business issuers.

The proposed rules seek to implement a pre-offering filing requirement with subsequent amendments (analogous to a registered offering) which is inappropriate for an exempt offering that utilizes social media and web-based communications. All potential crowdfunding investors have access to all information posted on the funding Portal's website, either by the issuer or by other potential investors contemplating an investment. The issuer has the opportunity to engage in public discussion with the investors, and the investors have the opportunity to raise concerns and request additional information. We do not expect that many (or any) investors will look to

the EDGAR system over having the same information provided (and discussed) on the funding Portal's website. The rules as proposed fail to integrate this reality in their approach and as a result, impose unnecessary filing requirements.

While such filings may serve certain statistical compilation purposes, they do not provide a direct benefit to investors, and impose real costs on issuers. As such, we urge the SEC to revisit their approach in providing information to investors and reduce the filing requirements.

Instead, the Commission should set minimum reporting requirements with the understanding that such requirements can be enhanced or adjusted through collective decisions by issuers and investors. If too many disclosures, filings, reports, and forms are required, issuers will face unnecessary hurdles and costs. Issuers would also be better positioned to serve their investors' interests if not distracted from successfully building and running their enterprises.

The Commission should generally rely on investors to ensure adequate disclosure through the initial offering materials. As discussed throughout, if the investors do not feel that sufficient information has been disclosed, they are free to simply not invest or request further information. The crowd will be able to compel the issuer to make the requested disclosure in order to attract or retain investors. The Commission should also specify the material changes that would trigger an issuer's responsibility to disclose such information. The Commission should provide a list similar to that accompanying Form 8-K; however, the list should be modified to appropriately acknowledge the difference between public and private companies, and the different types of material events that early growth companies experience. Issuers would then be able to easily identify and comply with their reporting obligations. While investors would then have access to this information, they would also retain the ability to request disclosure of additional material changes from the issuer. Rather than create a rigid, one-size-fits-all solution, this would enable investors to determine what changes they deem material to their particular investment.

Material changes should be disclosed by the issuer on the Portal, where they can be used by investors and potential investors to make informed decisions. This method of disclosure will also permit issuers to use various media to communicate with investors (e.g., written statements, video presentations, etc.).

Ability of Intermediaries to Define and Police their Platforms

This is in response to the following requests for comment: 15, 103, 104, 113, 114, 115, 116, 133, 134, 135, 166, 167, 168, 169, 170, 219, 220, 221, 222, 223.

Intermediaries require the ability to define their market position and "police" their platform for inappropriate use. To do so, intermediaries must be allowed to determine the content that will

appear on their platforms and be allowed to select certain issuers (and exclude others) based on predefined criteria. Such criteria could include, but would not be limited to:

- Issuer's industry (i.e., permitting industry specific intermediaries);
- Type of securities being offered (i.e., permitting offering term specific platforms);
- Size of offering;
- Geographic location of issuer's business;
- Stage and operating history of company;
- Valuation methodology; and
- Securities and background check results (i.e., permitting intermediaries to impose higher standards than the Commission).

Regulation should likewise not interfere with a Portal's ability to use its discretion to accept or reject certain campaigns. Similar to specialty stores, Portals may specialize by industry, size of the offering, geography, and investor type or issuer history. This may improve disclosure and investor protection, as (i) investors may more easily compare investment opportunities in similar businesses (and educate themselves) on a Portal that specializes in that industry, (ii) competition may drive market norms (Portals or investors may decide that "idea only" companies are too risky and not worth their attention, or that such companies provide the only attractive returns), and (iii) Portals may develop special knowledge regarding the industry or class of issuer which may help reduce fraud and improve disclosure to investors. Such decisions should not be interpreted as an endorsement of individual campaigns or provision of investment advice, and should not be subject to intrusive regulation.

Portals must also maintain the ability to "police" their own platforms for inappropriate content. For example, nearly every web-based business, which allows users to post comments or content, moderates the forums where content is posted. Intermediaries must be allowed to remove content that is unlawful, harmful, threatening, abusive, harassing, defamatory, vulgar, obscene, invasive of another's privacy, hateful, or racially, ethnically or otherwise objectionable. Intermediaries must also be allowed to suspend or ban users who repeatedly abuse the system.

Issuer's Ability to Restrict the Offer

This is in response to the following request for comment: 15.

An issuer should be allowed to determine the nature of its own offering by restricting the investors it chooses to accept. For example, an issuer my wish to leverage Section 4(a)(6) specifically to formalize a "friends and family" investment round. To facilitate such an offering, the issuer should be allowed to make the offering "invite only" by delivering invitations to a specified list of perspective investors while restricting all others from viewing the offering.

Issuers should be permitted to choose investors based on specific criteria, such as the size of the required investment, the investor's geographic location, or any other legal, non-discriminatory metric. Issuers should also be permitted to approve or reject individual investors before the offering is formally closed. Receipt of an indication that a perspective investor would like to invest in the issuer should not obligate the issuer to accept that investor. As long as the issuer's justification for rejecting an investor is not discriminatory in nature, issuers should not be obligated to explain such decisions to investors, intermediaries, the SRO, or the Commission.

This approach is consistent with basic legal principles and other private placements in which the issuer has the right to determine to whom to make offers to participate.

Promotion by the Portal

This is in response to the following requests for comment: 99, 100, 101, 187, 216, 217, 218, 220, 223.

Portals should be permitted to advertise to: (i) draw interest to their sites generally, and (ii) encourage issuers to fund through them. Portals should be barred from language that implicates the level of risk involved in the investment or the overall quality of the investment opportunity. Nevertheless, if a Portal chooses to feature or highlight certain offerings based on its discretion or the use of specific metrics (e.g. topic, press, or momentum), such decisions should not be viewed by the Commission as investment advice, a recommendation, or a solicitation. Portals need the ability to feature campaigns to compete with other Portals.

Portals should be barred from soliciting investments for any specific campaign by providing offering details outside of the Portal itself. However, Portals should be allowed to advertise more generally, as well as highlight ongoing offerings through various communication channels. Additionally, like other businesses, Portals may have staff dedicated to handling business development and marketing initiatives. Such standard business practices should not be limited.

Promotion by the Issuer

This is in response to the following requests for comment: 97, 100, 101, 103, 105, 106, 108.

There is a clear distinction between an issuer hiring an individual or entity for promotion and more standard web-based advertising, such as Google ads, Facebook ads, or sponsored tweats. When an issuer hires an individual or entity for promotion, investors may not be aware of the commercial relationship between the parties. The Commission should not enact rules that may

interfere with promotional compensation, but should rather require simple disclosure of a commercial relationship where it would not otherwise be apparent to investors.

Notice to investors can be achieved by highlighting comments or postings by promoters or affiliates of the issuer. To avoid confusion, the Commission must also provide clear definitions regarding what constitutes compensation and payment for promotion. A simple disclosure by the issuer on its offering page that compensation was provided to select promoters should suffice. The Commission should also supply examples of the application of these definitions in major social media outlets (e.g., the use of hashtags on Twitter), where traditional recognition of a commercial relationship may not be possible.

We anticipate that most promotions will be limited to notices that direct investors to the intermediary's platform, which are not prohibited by the proposed rules. We also anticipate that when investors or potential investors have questions or comments for an issuer, they may publicly tweet an issuer or post a question on the issuer's Facebook account. If the question pertains to the offering, the issuer should be able to respond to the investor with a link directing the investor to the public communication channel on the intermediary's platform. While the link the issuer provides could technically be considered a communication, we believe any communication directing an investor to the compliant communication offered through the Portal should be permitted.

Liability of Funding Portals

This is in response to the following requests for comment: 129, 130, 131, 134.

We disagree with the SEC's commentary in the proposing release that, "it appears likely that intermediaries, including funding Portals, would be considered issuers for purposes of [liability under Section 4A(c)]". In this context it would be akin to holding a securities exchange liable for fraud committed by an issuer listed on such exchange.

To resolve any dispute, however, we encourage the SEC to adopt a clear position and safe-harbor that acknowledges that a Portal providing the services permitted under applicable rules is not an "issuer" for purposes of the Securities Act. This position is consistent with the historical treatment of securities marketplaces and the common (and statutory) understanding of the term "issuer". Failure to address this provision exposes Portals to misplaced liability and threatens the fundamental economics of the crowdfunding marketplace.

While funding Portals can perform basic background checks on the issuer and certain disclosed equity holders, they have neither the resources, nor the expertise to examine statements to determine truth (or detect omissions). Issuers will make statements regarding business plans,

affiliate transactions and contracts which Portals will have no ability to verify. Exposing the Portals to liability as an issuer requires that the Portal conduct diligence as if it were the issuer. As the Portal does not receive the economic benefit of the issuer, this burdens the Portal with risks that are not commensurate with the reward.

Investors should be informed of the explicit and limited steps to police fraud that the Portal has undertaken, and acknowledge that their recourse for misstatements lies solely against the issuer of the securities. Investors will instead be protected through disclosure regarding the risks of investing and the receipt of adequate disclosure from the issuer. Investors will have the opportunity to perform diligence and pose questions to the issuer. Each investor will then have the ability to review the issuer's responses, as well as feedback on those responses from other potential investors. The nature of crowdfunding encourages disclosure of relevant information through the negotiation and agreement that will occur between the issuer and investors.

Viewing Portals as issuers (or underwriters) misstates their role in the marketplace and threatens to create economic disincentives so extreme as to eliminate any possibility of non-Broker.[8] / Dealer.[9] Portals operating under the proposed rules.

Financial Statements

This section is in response to the following requests for comment: 12, 18, 19, 20, 29, 31-33, 47-48, 50-58, 60-62, 64-66, 69, 71, 80, 85, 86, 88, 122-127.

After assessing the proposed rules, the dynamics involved in a crowdfunded offering, and the types of issuers most likely to seek to leverage Section 4(a)(6), there appear to be significant costs which are structured in a manner that will jeopardize the viability of the potential market for a crowdfunded offerings. Since there is no guarantee of an offering's success, excessive up-front costs will penalize issuers and create an issuer oriented risk-exposure to debt (due to regulatory compliance costs) that may cripple the very small businesses the JOBS Act was designed to support.

[8] Broker as defined in Section Section 3(4) of the Securities Exchange Act of 1934, as amended.
[9] Dealer as defined in Section Section 3(a)(5) of the Securities Exchange Act of 1934, as amended.

Figure 1.1.[10, 11]

	Offerings of $100,000 or less	Offerings of more than $100,000, but not more than $500,000	Offerings of more than $500,000
Compensation to the intermediary. **A**	$2,500 - $7,500	$15,000 - $45,000	$37,500 - $112,500
Costs per issuer for obtaining EDGAR access codes on Form ID. **B**	$60	$60	$60
Costs per issuer for preparation and filing of Form C for each offering. **C**	$6,000	$6,000	$6,000
Costs per issuer for preparation and filing of the progress updates on Form C-U. **D**	$400	$400	$400
Costs per issuer for preparation and filing of annual report on Form C-AR. **E**	$4,000	$4,000	$4,000
Costs for annual review or audit of financial statements per issuer. **F**	Not Required	$14,350	$28,700
Costs per issuer for preparation and filing of Form C-TR to terminate reporting. **G**	$600	$600	$600

Figure 1.1 can be used to model issuers' potential cost structures. An issuer conducting an offering to raise $501,000 would have to allocate 21.15%.[12] of the total amount raised in costs, with $34,760 in potential up-front costs..[13] On a $101,000 raise, if one year of accountant-reviewed financials is required, the predicted costs amount to **40.01%**.[14] of the total raise, with at least $20,410 in anticipated up-front costs..[15] This percentage increases to **54.22%** if two years' worth of accountant reviewed financial statements are required..[16] Given these proposed rules, more funds would be spent on compliance costs than retained by the issuer.

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[10] Securities and Exchange Commission, Release Nos. 33-9470; 34-70741; File No. S7-09-13, Pg. 358, http://www.sec.gov/rules/proposed/2013/33-9470.pdf, October 23, 2013

[11] See Appendix I

[12] See Appendix III.A

[13] See Appendix III.F

[14] See Appendix III.C

[15] See Appendix III.G

[16] See Appendix III.C

These calculations do not include additional costs that will be imposed on issuers and Portals to ensure compliance. Therefore, these figures understate the true cost of the proposed rules.

Figure 1.2

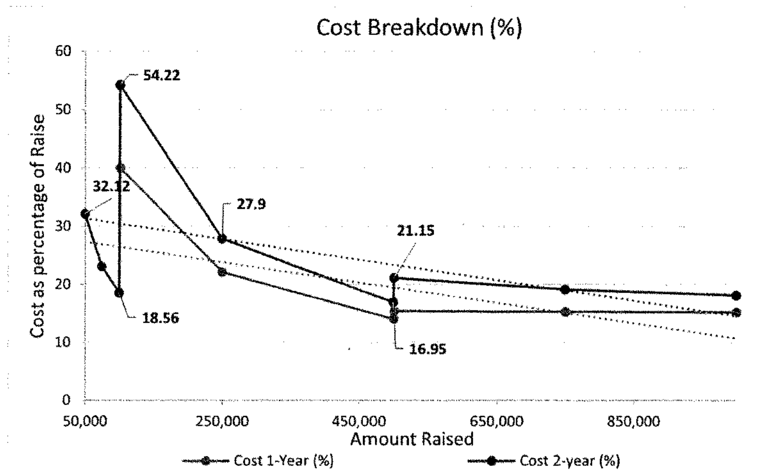


Figure 1.2 demonstrates that the proposed rules create resistance points in the amount being raised..[17] This structure creates a disincentive to raise amounts in excess of the resistance point, unless an issuer can raise considerably more and mitigate the cost. This could force increased dilution or a larger capitalization table than desired. Although some aspects of the resistance points can only be reduced through legislative change, a considerable up-front cost component imposed by the Commission can be avoided. The bulk of these upfront costs are associated with preparing filings for the Commission, obtaining an EDGAR access code, and using the proposed Form C..[18]

RocketHub believes that the Financial Condition of Issuer requirements are excessive in cost and misguided in intent. While subsection Sec.302(b)/Sec4A.(b)(1)(D)(i)(II) requires issuers to provide certified financial statements, an early stage company may not have historical financial

[17] These points are $100,000 & $500,000, respectively.

[18] This becomes very apparent for an issuance of less than $100,000. Using the function $ax + by + c = 0, y = 0.05x + 13{,}560$. When the slope of the linear line is marginal (0.05), but the y-intercept point (when amount raised [x] is equal to zero) is a large portion of total range of $(0 \leq x \geq 100{,}000)$ this means that the up-front cost component is the largest influencer. At the high-end of the range, when x = 100,000, up-front cost is equal to 13.56% of the total amount raised, which is the best case scenario.

statements to provide. "Financial statements" should therefore be interpreted to mean "historical financial statements" only for periods that the issuer has been in existence. Moreover, not all issuers will have historical financial information that can be audited, and the prohibitively expensive nature of audits contradicts the spirit of the Act. Regardless of historical financials, the requirements when applied to offerings of less than $1,000,000 highlight that the funds appropriation ratios are excessive.

Sec.302(b)/Sec4A.(b)(1)(D)(iii) explicitly permits the Commission to adjust the target offering amount where audited financials are required. As audited financials are generally not required for angel investments or venture capital investments of this size (largely due to the cost incentives described above), the target offering amount should be raised to an amount in excess of $1,000,000. This will permit elimination of the audit component of the proposed requirements for offerings of less than $1,000,000.

Request for Comment 58 specifically addresses the ability to require issuers to provide financial statements that are certified by the principal executive officer to be true and complete in all material respects for issuers looking to raise more than $100,000 but less than $500,000. RocketHub fully supports certification by the principal executive officer in lieu of the costly accounting requirements, though we recognize that legislative support may be necessary to accomplish this. The ability to self-certify would help reduce up-front costs. Furthermore, a serious reduction in the unnecessary rate of reporting through Form-C would further reduce the up-front costs, making Section 4(a)(6) viable for the market the JOBS Act is intended to support.

Rescission Period

This is in response to the following requests for comment: 34, 171-172, 182-186.

We support the Commission's position on not prescribing how oversubscribed offerings would be allocated, as well as the simple disclosure of the target offering amount and oversubscription cap. However, the Commission has included proposed rules on the process to cancel commitments without requesting comment. RocketHub has serious concerns with the process as proposed. The Commission's proposal leaves investors open to considerable risk of "pump & rescind" schemes.[19] It also leaves issuers at risk of "short fall" situations.[20] Investors must have

[19] Pump & Rescind: An unscrupulous issuer could have fake investors "pump up" the campaign by committing large dollar amounts up-front, in order to create the appearance of momentum, thereby attracting other investors. According to the proposed rules, at the end of the offering, those initial investors could slowly "rescind" their investments, leaving only the new investors committed. This amounts to fraudulent promotion through faux-investing, and should not be permitted.

[20] Short Fall: Investors who are allowed to rescind their commitments to invest, after the campaign has reached the target amount, may cause the campaign to fall short of the target amount. This short fall may jeopardize the entire offering if the issuer does not have enough time to replace the lost investors before the campaign expires.

the ability to cancel their commitments within a reasonable time limit. However, as provided in the proposed rules, the right to rescind exposes both the investor and issuer to specific types of fraud and risk, and the proposed rules methodology unnecessarily exceeds the JOBS Act's requirements.

RocketHub suggests that once an investor expresses an intent to invest, the investor's investment should be placed in a "pending" state for 24-hours. After that 24-hour rescission period expires, the investor's funds should transition from "pending" to "committed," and should be held in escrow until transferred to the issuer. Notices of commitment can be submitted to investors after their rescission period has ended, and a secondary notice can be submitted to investors at the completion of the issuance. If the offering does not reach its funding target before the campaign deadline, the investor's funds should be released from escrow and returned to the investor.

As described in the proposed regulations, the Commission allows for a rescission period that is as long as the offering itself. This does not reflect the dynamics of crowdfunding. As Sec.302(b)/Sec4A.(a)(6) requires a minimum offering period of 21 days, the investor should have enough time to review the investment opportunity before investing, rendering a longer rescission period unnecessary. A short rescission period will protect investors from "pump & rescind" schemes and minimize an issuer's exposure to the risk of "short fall."

Intermediary's Ability to Provide Ancillary Services

This is in response to the following requests for comment: 76, 77, 78, 79, 80, 81, 82, 94, 96, 102, 105, 106, 107, 108, 114, 116, 128, 140, 146, 187, 226.

An intermediary may initially seem to serve solely as the platform on which an issuer's offering appears. In actuality, the intermediary creates the user experience and the user interface for both issuers and investors. The intermediary also creates the system through which issuers and investors interact with one another and third-party service providers. For example, whether or not a Portal uses a third-party payment service or its own technology, the issuer will perceive them as one and the same.

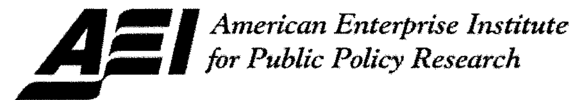
It would be impractical to have issuers and investors switching between various parties' software (i.e., EDGAR) in order to complete tasks. Intermediaries, and in particular Portals, are centrally located and will be able to unify the experience for issuers and investors, thereby increasing compliance and oversight.

Examples of services Portals seek to offer include, but are not limited to:

- Form-C filing;
- Form-C update filing;

- Amendment filing;
- Additional investor and issuer education;
- Direct registration of securities;
- Allocation and disbursement of funds as appropriate;
- Assist issuer with corporate structure;
- Connect issuer and investors with qualified service providers (including lawyers, accountants, etc.);
- Assist with and/or directly perform background checks and income verification;
- Post-issuance investor relations;
- Financial statement construction; and
- Copywriting, and video production.

Fundamentally, the crowdfunding market is designed to enable fundraising by issuers that represent idea-only, early stage, and small businesses. These issuers seek to actively engage with investors who have a genuine interest in the success of their businesses, often for reasons that are not limited to a return on investment. This includes family and friends that are connected with the issuers via online and offline social networks. These businesses may not be venture capital ready, or may not be traditionally venture-backable, and their Section 4(a)(6) offerings may be their first exposure to securities regulation. Therefore, allowing Portals to provide the necessary ancillary services will not only facilitate a smooth offering, but also ensure investors and issuers are fully protected, compliant, and informed.



Statement before the House Financial Services Subcommittee on Oversight and Investigations

Hearing on "The Growth of Financial Regulation and its Impact on International Competitiveness"

The Financial Stability Oversight Council and the Financial Stability Board: Issues in International Regulation

Peter J. Wallison

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American Enterprise Institute

March 5, 2014

The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.

March 5, 2014

The Financial Stability Oversight Council and the Financial Stability Board: Issues in International Regulation

Peter J. Wallison
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Chairman McHenry, Ranking Member Green, and members of the subcommittee:

Thank you for the opportunity to testify this afternoon on a number of issues in international financial regulation that I believe deserve serious attention by Congress. Financial services is one of the most important and successful industries in the United States. It includes banks, of course, as well as insurers, asset managers, securities firms, finance companies, private equity firms, and hedge funds. The services of these companies enable Americans to save for the future, buy and sell assets, and retire comfortably. As important, financial services firms provide the financing for business, which in turn creates jobs and—through growth in productivity—improves the standard of living for all of us.

Although some observers of the financial markets favor more regulation than others, it is not in dispute that financial regulation can have a major effect on the performance of financial institutions, and thus on economic growth. For this reason, Congress should have a major role in formulating the policies that underlie the decisions that affect the US financial industry. In the case of banking regulation, Congress has generally not intervened in the development of the bank capital regulations—Basel I, II and III—as these were developed, agreed internationally among bank regulators, and applied to the US banking industry. However, as discussed later in this testimony, there are reasons to believe that this abstention was not a good idea.

The Dodd-Frank Act, the FSOC, and the growth in the scope of regulation

In 2010, in the wake of the financial crisis, Congress adopted the Dodd-Frank Act, which created a special body known as the Financial Stability Oversight Council (FSOC). The FSOC is composed of the heads of all the federal financial regulators—the Federal Reserve, FDIC, SEC, CFPB, etc.—and a person who is appointed by the President and confirmed by the Senate as an expert in insurance, which is not regulated by the federal government. The secretary of the Treasury is the chairman of the FSOC and runs the meetings. The secretary also has an effective veto over the FSOC's most important decisions, since his affirmative vote is necessary for approval. Because the act specifies that the members are the heads of the regulatory agencies—not the agencies themselves—virtually all the members are appointees of the administration in power. They are not required to represent their agencies and they don't; they seem generally to follow the directions of the Treasury secretary.

Dodd-Frank enjoins the FSOC to "identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large interconnected bank holding companies or nonbank financial companies." (Sec 112). To implement this idea, Section 113 authorizes the FSOC to designate a nonbank financial firm as a systemically important financial institution (SIFI) if "the Council determines that material financial distress at the US nonbank financial company...could pose a threat to the financial

stability of the United States." Firms so designated are then turned over to the Fed for regulation which the act requires to be more "stringent" than the regulation to which they are ordinarily subject. Other elements of the act suggest that this regulation be prudential and bank-like—that is, it should involve their capital and their risk-taking activities.

This is a sharp change in substantive US regulatory policies from those that prevailed in the past. The 2008 financial crisis was a disaster for the American people, but it was a huge gift for financial regulators in the US and abroad. After all major financial downturns, those who support government involvement in the economy claim that it wouldn't have occurred if financial regulators had more power. Congress usually gives in to this argument, despite the evidence. The collapse of the S&Ls in the late 1980s brought forth the Financial Institutions Reform, Recovery and Enforcement Act of 1989 and the FDIC improvement Act of 1991. The Enron scandal produced the Sarbanes-Oxley Act. All these new laws promised to prevent the recurrence of the prior events. As we can see from the 2008 financial crisis, none of them succeeded.

The 2008 financial crisis was no different from earlier crises, except in two respects: it was much larger than any previous crisis and it involved the whole financial system and not just depository institutions. The narrative that grew out of the crisis was, once again, that it could have been prevented if the regulators had more power.[1] But there was a difference; before the crisis, the only theory for federal prudential regulation of financial institutions supported the regulation of banks; since banks were backed by the government, regulation was necessary to prevent moral hazard and to protect the taxpayers. But after the crisis, which involved many large financial institutions in addition to banks, the conventional Washington narrative became something far more expansive. In that narrative, the failure of any large financial institution could be a danger to the entire financial system. This spawned a wholly new and expansive theory for regulation—that the risk-taking and capital position of *any* financial institution should be subject to prudential bank-like regulation if there is even a minimal case that its failure could cause a financial crisis. That's why the Dodd-Frank Act adopted the idea that any firm should be subject to this regime if its "financial distress" could cause "instability in the US financial system." However, since it is impossible to know whether a particular institution's "distress" would cause instability in the US financial system (whatever *that* is), the FSOC's authority is in effect a blank check to consign to Fed control any large financial firm that the government wants to regulate.

The practical effect of this huge shift in regulatory policy was a large increase in the potential reach of bank-like prudential regulation and thus a large increase in regulatory power. Now, *all* large financial institutions in the US—not just banks—can be made subject to bank-like prudential regulation unlike anything they have faced before. It seems reasonable that Congress should have a say, at the very least, about how this unprecedented change in the scope and range of regulation is being implemented, especially because the degree of regulation can have a substantial effect on economic growth and the well-being of all Americans.

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[1] See, e.g., the majority Report of the Financial Crisis Inquiry Commission, from which I dissented. http://www.aei.org/files/2011/01/26/Wallisondissent.pdf

Much of the rest of my testimony will discuss why congressional intervention is necessary as a matter of broad policy, but I'd like to mention one fact at this point that I think will be particularly salient with Congress. Recently, the FSOC has taken steps that indicate it is likely to designate large asset managers as SIFIs. When this became known, Barney Frank, the chief House sponsor of the Dodd-Frank Act and the authority of the FSOC, said that he had never intended that asset managers should be considered SIFIs.[2] Nevertheless, the breadth of the language in the congressional authority given to the FSOC would allow them to go this far. If Congress didn't intend this, it should step in to make its intentions clearer to the FSOC.

The scope of the FSOC's authority

The first thing to be said about the language of Section 113 is that it is an extraordinary grant of authority, and essentially permits the FSOC to determine the scope of its own jurisdiction. Although the courts often frown on this when it is called to their attention, it is unlikely that this particular grant of authority will ever be tested; regulated firms, fearing retaliation, are very reluctant to challenge the legal authority of their regulators. Indeed, after Prudential Financial was designated as a SIFI it initially suggested that it would challenge the FSOC's decision, but after going through a pro forma administrative appeal process decided not to engage.

Thus, because the key terms the FSOC must apply in order to take jurisdiction over any particular firm—"financial distress" and "market instability"—have no clear meaning, and because both involve predictions about the future, they amount to an enormous grant of discretionary power. Where judicial intervention is unlikely, wide discretionary power can result in arbitrary, capricious and politically-based administrative decisions. This can be rectified if an agency develops and applies standards that limit its own discretion, provides a roadmap for compliance by affected companies, and allows the basis of its decisions to later be judged by Congress and the public. However, the FSOC has not developed any standard. Quite the opposite. In its recent decision to designate the insurance firm Prudential Financial as a SIFI, the FSOC studiously avoided any standards that might restrict its discretion in the future. As a result, other insurers can have no idea what they should do or not do to avoid a SIFI designation, and no way for Congress or anyone else to determine whether the FSOC is acting objectively and carefully with its extraordinary statutory mandate. For example, in summarizing its Prudential decision, the FSOC stated:

> Prudential is a *significant* participant in financial markets and the U.S. economy and is *significantly* interconnected to insurance companies and other financial firms through its products and capital markets activities. Because of Prudential's interconnectedness, size, certain characteristics of its liabilities and products,...material financial distress at Prudential could lead to an impairment of financial intermediation or of market

[2] Joe Morris, "Fidelity not a 'systemic risk' in Barney Frank's book," *Financial Times*, December 8, 2013.

functioning that would be sufficiently severe to inflict *significant* damage on the broader economy.[3] [emphasis supplied]

Although this was a summary paragraph, it was never followed by any numerical or otherwise intelligible analysis of Prudential's effect on the market if it should encounter financial distress. In its 12 page statement, The FSOC used the term "significant" 47 times. The most useful numerical data in the whole statement were the page numbers. Thus, the first concern that Congress should have about the FSOC is that it is failing to circumscribe its discretionary authority in any way that will give financial institutions a way to change their activities in order to avoid a SIFI designation, or a way for Congress to determine whether the FSOC is carrying out its extraordinary mandate as Congress had intended. If the agency is unable to do this, its authority should be restricted.

But there is another point that makes the FSOC's power particularly troubling. As noted earlier, the pattern established in bank regulation—and implicitly accepted by Congress—is that agreements among international regulators can become the rule in the US without the express approval of Congress. This pattern was established with the capital accords of the Basel Committee on Bank Supervision in the 1980s. We are all familiar with the substance of these capital rules, in which bank regulators from the developed countries got together and decreed that while 8 percent risk-based capital was the suitable capital charge for a corporate loan, only 4% was necessary for a mortgage and 1.6% for high quality mortgage-backed securities. These internationally-agreed rules were made applicable to all US banks by the US bank regulators. Congress never voted on any of this; although Congress clearly acquiesced in these rules, there was never any debate on whether these rules were good policy.

It turned out that the rules were terrible policy. They encouraged banks worldwide to buy mortgage-backed securities that were rated triple-A, because the capital charge was so small. And when the mortgage-backed securities market collapsed in 2007 and 2008, the resulting losses led directly to a financial crisis because most banks had followed the incentives created by the Basel capital rules. In other words, international regulatory accords, which can be very popular with *regulators* because they eliminate regulatory competition (usually called "regulatory arbitrage" by the regulators) can be very bad policy, and can become law in the US without any kind of serious debate in Congress. This experience should give Congress pause before it acquiesces in a similar process again.

This is especially true in SIFI designations, where the FSOC has wide discretionary authority from Congress to identify specific institutions for special and harsher treatment. It would be unprecedented and not within the likely contemplation of Congress if this judgment were to be made through an international agreement among regulators, without the thorough case-by-case decision-making that Congress seems to have expected the FSOC to provide when it makes SIFI designations. Yet that might be exactly what is happening now through the work of an international body of financial regulators and government officials known as the Financial Stability Board (FSB).

[3] Financial Stability Oversight Council, "Basis for the Financial Stability Oversight Council's Final Determination Regarding Prudential Financial, Inc.," September 19, 2013, p2

The authority of the Financial Stability Board

In November 2008, shortly after the financial crisis, the leaders of the G20 countries met in Washington, DC. There, they authorized an international organization now known as the Financial Stability Board to effect "a fundamental reform of the financial system, to correct the fault lines that led to the global financial crisis and to rebuild the financial system as a safer, more resilient source of finance that better serves the real economy."[4] Both the Treasury and the Fed are members of the FSB, along with representatives of all the major developed countries and many other international government organizations, such as the International Monetary Fund, the Basel Committee on Bank Supervision, the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS).

Thus far, the FSB has designated 39 banks and 9 insurance firms (including the US firms AIG, Prudential and MetLife) as global SIFIs. In making these designations, the FSB did not indicate either the standards that it used or the way the standards were applied to the banks or insurance firms that were designated as SIFIs. In the case of the insurance firms, the IAIS had developed a methodology that purported to assign weights to various activities. For example, mere size was accorded a 5% weight, while interconnectedness was accorded 40% and non-insurance or bank-like activities were accorded 45%. Whether one agrees with these weightings or not, it sounds like a legitimate process of designation would be followed. But it was not to be. The FSB made its designations without saying how it applied the IAIS methodology to any particular insurer. This is a pattern that, as outlined above, has been repeated at the FSOC. It is typically adopted by regulators when they do not want to limit their discretion in the future.

If the FSB follows the pattern of the Basel Committee on Banking Supervision, an agreement among all the central banks and financial regulators that are participating in the decision will declare certain additional financial institutions to be SIFIs, as they have already done with 39 banks and 9 insurance firms. The designations will be published for comment by the affected parties, altered as the FSB deems appropriate after the comment period, and eventually adopted; they then become binding on all the affected firms because their regulators have reached an accord with regulators elsewhere. In this process, Congress will hold hearings, but—if the Basel process is followed—there will be no legislation, no debate and no vote.

Since it has been supercharged by the G20, the FSB does not lack ambition. In addition to its designation of certain banks and insurance firms, it has suggested that large asset managers should be designated as SIFIs, recommended that MMFs hold capital if they do not adopt a floating NAV, and announced that it is planning to go much further to press bank-like regulation of nonbank financial firms. In a report on September 2, 2013, for example, it stated: "The FSB is reviewing how to extend the SIFI Framework to global systemically important non-bank non-insurance (NBNI) financial institutions. This category of firms includes securities broker-dealers, finance companies, asset managers and investment funds, including hedge funds."[5]

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[4] Financial Stability Board, "Overview of Progress in Implementation of ther G20 Recommendations for Strengthening Financial Stability" *Report of the Financial Stability Board to G20 Leaders*, September 5, 2013, p3.
[5] FSB, "Progress and Next Steps Towards Ending 'Too-Big-to-Fail,'" Report of the Financial Stability Board to the G-20, September 2, 2013, p17.

To demonstrate how radical this idea is, consider the treatment of asset managers as SIFIs. This would be a major extension of government power. Collective investment funds are completely different from the banks or investment banks that suffered losses in the financial crisis. When a bank or investment bank suffers a decline in the value of its assets—as occurred when mortgages and mortgage-backed securities were losing value in 2007 and 2008—it still has to repay the full amount of the debt obligations it incurred to acquire those assets. Its inability to do so can lead to bankruptcy. But if a collective investment fund suffers the same losses, these pass through immediately to the fund's investors. The fund does not fail and thus cannot adversely affect other funds. In other words, asset management cannot create systemic risks,[6] yet the FSB seems bent on including the largest firms in this industry among the SIFIs it will designate. And, as outlined below, the FSOC seems to be following this lead.

I have covered the FSB in detail for a reason. Since the Treasury and the Fed are both members of the FSB, there is a substantial likelihood that they will sign on to its decisions, and if the FSB's recommendations follow the pattern that has been pursued thus far by the Basel Committee on Bank Supervision and US bank regulators, the FSB's SIFI designations will be adopted in the US by the FSOC without any specific authorizing legislation by Congress. To be sure, the FSOC has this authority already, but it is one thing for the FSOC to make its decisions based on an independent and objective analysis contemplated under the Dodd-Frank Act, but quite another for the FSOC to designate particular US firms as SIFIs by agreement or compliance with a decision by an international organization.

It does not appear that the FSOC has been authorized by the Dodd-Frank Act to do this. Section 175 of the act authorizes the president to "coordinate through all available international policy channels, *similar policies as those found in United States law* relating to limiting the scope, nature, size, scale, concentration, and interconnectedness of financial companies, in order to protect financial stability and the global economy." [emphasis supplied] The language focuses on *policies*, not on the designation of specific institutions as SIFIs. The FSOC is authorized in the same section to consult with international organizations, and the Fed is authorized to *consult* with these organizations to "encourage comprehensive and robust prudential supervision and regulation for all highly leveraged and interconnected financial companies." This language does not amount to an authorization for the FSOC or the Fed to *agree or comply* with an international body like the FSB on which specific financial institutions should be designated as SIFIs; it is phrased as a direction to the Fed to press international bodies to do what the Fed is doing on supervision and regulation.

Thus, the Dodd-Frank Act authorizes the FSOC to designate, and the Fed to regulate, banks and nonbank financial institutions that are deemed to be a threat to the stability of the US financial system, but the act does not authorize the FSOC, the Fed or the Treasury Department to enter into international agreements that designate specific US firms as SIFIs. Yet the evidence thus far suggests that the FSOC is in fact coordinating its activities with the FSB. For example, as noted above, the FSB has recommended that if money market mutual funds do not adopt a floating net asset value (NAV), they should be subject to capital requirements like banks.[7] FSOC

[6] See, Peter J. Wallison, "Unrisky Business: Asset Management Cannot Create Systemic Risk," *Financial Services Outlook*, January, 2014.
[7] Financial Stability Board, "Overview of Progress in the implementation of the G20 Recommendations for Strengthening Financial Stability" September 5, 2013, p24

then pressured the SEC to adopt similar rules for MMFs. The FSB has indicated that all asset managers with assets of more than $100 billion may be subject to prudential regulation,[8] and the Office of Financial Research (OFR), another agency created by Dodd-Frank, has produced two reports at the request of the FSOC to the effect that large asset managers should be designated as SIFIs. The FSB has designated three US insurance firms as SIFIs—AIG, Prudential and MetLife—and the FSOC has already designated AIG and Prudential as SIFIs and is currently investigating MetLife for a possible SIFI designation.

The likelihood that the FSB, the FSOC and the Fed will coordinate their activities is high. In a sense, it could not be otherwise; the Treasury and the Fed are members of the FSB; if they participate in its discussions they have to agree with its decisions. Given the importance of the US market and US financial institutions, it is difficult to imagine that the FSB would make any SIFI designations without the concurrence of the Treasury and the Fed. Moreover, it is difficult to imagine that the FSB could designate a US financial firm as a SIFI while the FSOC does not. This would put the US firm in a position of operating abroad under rules that are different from those imposed by the FSB, and may mean that it would not be able to operate abroad at all. Similarly, if the FSOC were to designate a US firm as a SIFI while the FSB does not, the US firm would be at a competitive disadvantage in competing outside the US. Accordingly, it is reasonable to assume that the FSOC and the FSB are eventually going to come to identical conclusions for which firms are SIFIs and which are not.

This raises questions about the objectivity of the investigative and analytical work that the FSOC is supposed to do before declaring US firms to be SIFIs under the Dodd-Frank Act—a concern that is fully validated by the kind of analysis the FSOC did in the Prudential case. There, the FSOC produced what can only be called a perfunctory decision. All the bank regulators, who know nothing about insurance regulation, voted for designating Prudential as a SIFI, but Roy Woodall, the sole voting member of the FSOC who has insurance expertise and the independent person appointed to FSOC because of his insurance knowledge, had this to say in his dissent:

> In making its Final Determination, the Council has adopted the analysis contained in the Basis [the FSOC's statement of its reasoning and analysis]. Key aspects of said analysis are not supported by the record or actual experience; and, therefore, are not persuasive. The underlying analysis utilizes scenarios that are antithetical to a fundamental and seasoned understanding of the business of insurance, the insurance regulatory environment, and the state insurance company resolution and guaranty fund systems. As presented, therefore, the analysis makes it impossible for me to concur because the grounds for the Final Determination are simply not reasonable or defensible, and provide no basis for me to concur. [9]

Roy Woodall played it straight, but the decision on Prudential seems to have been baked in the cake before it was made by the FSOC. The fact that the FSB, in in the preceding July, had

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[8] FSB, "Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Importyant Financial Institutions: Proposed High Level Framework and Specific Methodologies," *Consultative Document*, January 8, 2014.

[9] Roy Woodall, "Views of the Council's Independent Member having Insurance Expertise," p1, http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/September%2019%202013%20Notational%20Vote.pdf

already determined that Prudential was a SIFI—with the concurrence of the Treasury and the Fed—made it inevitable that the FSOC would come to the same conclusion. It seems highly likely that the FSOC will make the same decision about MetLife, which has also been designated as a SIFI by the FSB. Clearly, if the Basel Committee's procedures are followed in the FSB and acquiesced in by Congress, many large nonbank financial institutions in the US may become subject to prudential bank-like regulation for reasons other than the objective analysis that Dodd-Frank expected the FSOC to apply.

Are the interests of US firms being protected?

The next legitimate question, then, is whether the interests of US financial institutions are being protected by the Treasury's and the Fed's involvement in the FSB's deliberations. Ideally, one would hope this is true, but the fact is we'll never know. The deliberations of the FSB are secret. Neither the public nor the media are permitted to observe. After the meetings, there is occasionally a brief report on the deliberations, but not in enough detail to reveal who said what.

At this point it is important to point out that what's at stake in these meetings is not necessarily the interests of the private sector in each country, particularly the US. As noted earlier, the narrative that came out of the financial crisis—that private sector risk-taking and lack of adequate regulation caused the crisis—has given rise to the idea that every large financial firm, not just large banks, could be potentially dangerous. If so, regulators believe they need the power to control all risk-taking by large financial firms, which means placing all large financial institutions—not just banks—under prudential, bank-like regulation.

Although we cannot know what goes on in the FSB and FSOC meetings, we can understand the incentives. What is important to the regulators is to come to some agreement that will allow them to extend their authority over more of the financial system—essentially what they call "shadow banking." In effect, they are trading with other people's money. The US regulators are not likely to hold out for better treatment for US financial firms if that prevents an international agreement that will help them extend their regulatory control over shadow banking in the US.

One way to prevent this secret negotiation for power, of course, is for Congress to insist that it, or at least the media, have an opportunity to observe the proceedings of the FSB and the FSOC. The US has laws like the Government in the Sunshine Act and the Federal Advisory Committee Act to prevent government agencies from engaging in private deal-making at the expense of the public's interests. These laws can be easily circumvented, and are, and in some cases are more harmful than beneficial, but the FSB and the FSOC have such enormous discretionary power, and can cover so much of the world's economy, that they are exactly the kinds of government institutions that should be open to objective scrutiny. The FSOC, in particular, is so secretive that non-chair members of regulatory bodies are not permitted to attend. This insures that no views other than the current administration's, are likely to be seriously considered at meetings. (For some reason, an exception is made for the Fed; at least one governor, in addition to the chair, is permitted to attend.)

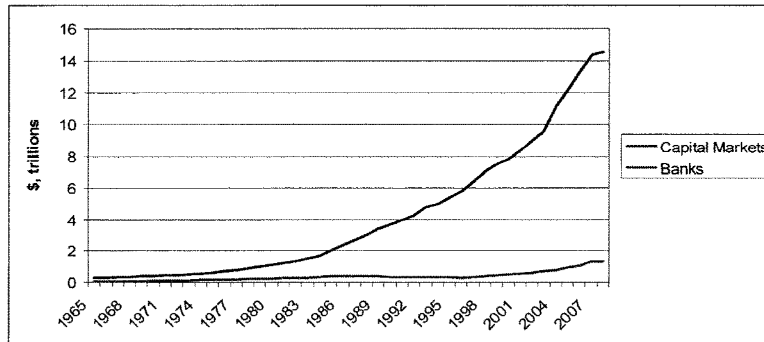
There is also another point that should be mentioned here—that the success and growth of nonbank financial institutions (again, what the regulators call shadow banking) over the last

30 years has reduced the importance of banks, and thus the importance and regulatory latitude of bank regulators. In the chart below, we can see that since the 1980s the securities industry—more generally the capital markets—have outcompeted the banks for financing corporations and states and municipalities.

This is because commission-based intermediation is inherently more efficient than principal intermediation. The communications revolution that occurred in the mid-1980s allowed corporations to disseminate directly to investors the financial information they were filing with the SEC. With that information, investors and analysts could make their own judgments about credit issues, buying bonds, notes and commercial paper from, and paying commissions to, securities intermediaries. The traditional intermediary advantage of banks—that they had information about companies that no one else had or could easily get—disappeared. Once the information was available elsewhere, the principal intermediation of banks was simply too expensive. This made it more difficult for regulators to restrict bank activities, since that only weakened banks further in the face of capital markets competition. If the main competition for banks can be brought under effective regulatory control, bank regulation can become even tighter.

Chart 1 compares the cumulative level of financing for business corporations and state and local governments from 1965 until 2007. As can be seen, securities intermediation through the capital markets—generally, what the regulators call the shadow banking system—has substantially out-competed the banks. It is easy to imagine what would happen to business and state and local credit if the shadow banking system were brought under the control of bank regulators.

Chart 1. Bank loans and fixed income securities intermediation to business and state and local governments, in trillions of dollars



Source: Federal Reserve Flow of Funds Level data

Examples of international and US rules that will have major effects on the US growth

The Dodd-Frank Act itself, by imposing enormous regulatory costs on all parts of the financial system, is in my view one of the major causes of the slow US recovery from the recession that followed the financial crisis. Much attention has been focused on the Affordable Care Act, of course, but there is at least as strong a case that—in addition to compliance costs—Dodd-Frank has created so much uncertainty and so much fear of regulatory intervention among financial services firms that the normal level of risk-taking in the US financial industry has been blunted. In some cases, as discussed below, certain kinds of activity, formerly profitable and vital to the economy, have been impeded by specific provisions in Dodd-Frank and new regulations on banks.

Notable examples are the Liquidity Coverage Ratio adopted by the Basel Committee, and the Volcker Rule adopted in Dodd-Frank.

Liquidity Coverage Ratio

In January 2013, the Basel Committee on Banking Supervision unanimously endorsed a concept known as the Liquidity Coverage Ratio (LCR). At the time, Mervyn King, chairman of the Basel committee that developed the LCR, said "The Liquidity Coverage Ratio is a key component of the Basel II framework. The agreement reached today is a very significant achievement. For the first time in regulatory history, we have a truly global minimum standard for bank liquidity."[10] He is assuming, based on past precedent, that whatever the bank regulators agree will be the rule everywhere. Legislatures, like the US Congress, won't interfere.

The LCR requires a banking organization (that is, a bank holding company (BHC) and its subsidiaries) to maintain a minimum amount of liquid assets to withstand a 30 day liquidity stress event. The rule outlines the kinds of liquid assets that must be held in order to put the BHC in a position to withstand a 30 day liquidity crunch. The US rule appears to be somewhat stricter than the European rule, but all BHCs world-wide must comply. Because liquid assets like Treasury bills and reserves at the Fed have very low yields, this rule will be very costly to banks and BHCs. We get the idea; if banking organizations hold more liquid assets they won't be caught short if we have another event like the financial crisis. Leaving aside the question of whether such an event is likely in the near future—the last one appears to have been in 1907, one hundred years ago—what affect will it have on banks and other financial institutions, those designated as SIFIs, that will be regulated like banks?

From what we know about regulatory requirements that are globally applicable, we should be wary of the LCR. Recall that the exception to the bank capital requirements for mortgages and mortgage-backed securities turned out to be a disaster for the world's banking system, bringing on the financial crisis and the Dodd-Frank Act. The LCR is another of these universally applicable rules, like the capital requirements in Basel I, II and III. As Mervyn King noted proudly, the LCR requires all banking organizations to do the same thing, and although it is difficult to predict how this could backfire in the future, we have to recognize that it could. For one thing, maintaining this liquidity buffer eliminates some of the market discipline that comes from depositors refusing to make deposits, or withdrawing funds, if they don't like the bank's

[10] Bank for International Settlements, "Group of Governors and Heads of Supervision endorses revised liquidity standard for banks," January 6, 2013. http://www.bis.org/press/p130106.htm

risk-taking posture. Since banks will now have large liquidity pools, depositors will be less worried about their ability to pull out their deposits if the bank gets in trouble. Thus, while the LCR will certainly mean reduced bank profitability (LCR assets do not produce much yield), it might also enable them—by reducing market discipline—to take more risks in order to recover that profitability. That's the way uniform rules come back to bite the framers. As with all universally applicable rules, we will not be able to compare how banks that are not subject to the rule behave. We also have to consider that if all SIFIs are going to be regulated like banks, they will be subject to the same LCR requirements, and will also be less profitable, setting in motion not only competitive effects in every industry but the likelihood that they too will take more risks in order to recover their profitability—and will be allowed to do so because their LCR will reassure their short-term creditors.

Volcker Rule

On the subject of rules that may backfire, one can't ignore the Volcker Rule. The rule prohibits proprietary trading of securities by banking organizations (a BHC and its bank and nonbank subsidiaries). Proprietary trading involves buying and selling securities for one's own account and not for the account of customers. There has never been any indication that prop trading by banking organizations (or anyone else) had any role in the financial crisis. The rule was advertised as preventing banks from using insured deposits for risky trading activities, but that claim was false in two ways. First, the Volcker rule applies to the holding company and all nonbank subsidiaries, as well as subsidiary banks. BHCs and their nonbank subsidiaries have no access to insured deposits, so preventing them from prop trading was not the result of any effort to protect insured deposits. Second, prop trading, which was a profitable activity that allowed banking organizations to make use of their financial knowledge, helped them understand what was happening in the market on a daily basis, and allowed them to participate in a growing business, is less risky than lending, which is something banks are encouraged to do. When a bank makes a loan, it is putting funds in another entity's hands and rarely has effective control over whether those funds are used effectively. In prop trading, the bank holds a portfolio of debt securities which it can liquidate at any time if it thinks the securities will lose value in the future.

In addition, while the Volcker Rule prohibits prop trading, it permits banking organizations to engage in market making and hedging. Market-making is a vital market function. The debt markets are not nearly as liquid as the equity markets. There is frequently no exchange where an investor can buy or sell a debt security. If investors are not able to sell a security easily, they are taking a risk in buying it. The market maker reduces this risk by standing ready to buy a security when approached by an investor who wants to sell. Hedging, which reduces risks on investments, is also an essential activity for every financial and non-financial firm. Market making, however, is close to prop trading. A market maker must hold a portfolio of securities it is willing to buy or sell. But banking organizations that engage in it are in jeopardy of violating the Volcker Rule; it is frequently the intent of the trader that may determine whether a particular trade is a market-making trade or a prop trade. If it's the latter, the banking organization could be subjected to a fine; this could also be a career-ending event for the trader.

So banks will be much less likely to engage in market-making after the Volcker Rule, and that will raise the costs in the market for issuers, buyers and sellers of debt securities, because the market will be less liquid and thus riskier all around. Congress recognized this in Dodd-Frank, when it exempted Treasury securities from the prop trading restrictions.

Finally, the Rule also permits banks to engage in hedging transactions, which of course it should, since hedging reduces risk. But again, a hedging transaction, in which a bank buys or sells a security to offset the risk of some other transaction, can look a lot like a proprietary trade. The rule requires the banking organization to demonstrate that hedging trades actually hedged a specific risk. In some cases, this could be difficult because of the nature of the underlying transaction, so in order to avoid violating the Volcker Rule the bank will not engage in the underlying transaction. It is important to note that the underlying transaction may not be particularly risky in itself, but attempting to hedge it may involve the bank in what might appear to be a proprietary trade, creating what might be called regulatory risk. So, to avoid this risk, banking organizations may avoid the underlying transaction, thus reducing credit for consumers or businesses.

My AEI colleague, Paul Kupiec, has pointed out that the Fed has attempted to cut back on leveraged loans because of a belief that a bubble is developing in leveraged lending. He notes that this is a major change from the past, when regulators looked at a bank's entire business and decided whether as a whole it was being well-managed. The specific investments banks made were not questioned. Now, the regulators are substituting their judgment for bankers' judgments about specific kinds of loans. This will inevitably have an effect on bank lending and the availability of credit. Nonbank SIFIs that are eventually consigned to Fed regulation will no doubt be subject to the same intrusive treatment. Can we imagine a time when the government will be approving all lending, perhaps loan-by-loan, and how different will this be from the government dictated lending that occurs in China?[11]

Cumulative effect

The cumulative effect of these and other regulatory restrictions cannot be calculated. That is one of the reasons that economists do not try to estimate the cumulative effect of Dodd-Frank on economic growth. But the effect can be seen in the results of individual financial firms. Just this past week, JPMorgan Chase, the largest US banking organization, cut back its projections for the coming year, saying that its trading profits and return on equity would be down. It noted that it would also add 3000 new compliance employees, on top of the 7000 it added last year. But the total employees of the bank are expected to fall by 5000 in the coming year,[12] so what we are seeing is that compliance costs are being substituted for the personnel that are normally the sources of revenue and profit.

Often, these negative reports are blamed on slow business growth or lack of consumer spending, but this may be confusing cause and effect. If JPMorgan Chase were not substituting compliance officers for calling officers, the calling officers would be out in the market talking to businesses and offering them credit for expansion.

[11] Paul Kupiek, "When Governments Direct Bank Credit, the Economy Suffers" *Financial Services Outlook*, March, 2014.
[12] Dan Fitzpatrick, "J.P. Morgan Dims Its Light on 2014," *Wall Street Journal*, February 26, 2014.

If what the FSB called the "SIFI Framework" is in fact extended to the rest of the financial system through decisions of the FSOC, the regulatory sclerosis that is affecting JPMorgan Chase will be extended to the rest of the financial system and then to the economy as a whole. Congress created the Dodd-Frank Act and the FSOC; it can surely indicate that it will oppose this result.

Conclusion

Congress should be wary of the FSOC's extraordinary discretionary authority. Whenever possible, the agency should be pressed to set out its standards in numerical terms, so firms and Congress will know what rules it is following and firms in danger of SIFI designations will understand what they should or should not do to avoid a SIFI designation. At the same time, Congress should rein in the tendency of the FSOC to simply implement the decisions of the FSB in the US. The FSOC's decisions on SIFI designations should be made on the basis of clear standards and guidelines about when an institution's distress can have such a substantial negative effect on the market that another financial crisis might result. It cannot be simply a matter of regulatory discretion. One first step would be to require both the FSB and the FSOC to open their meetings to observers, so that the information they have and true reasons for their decisions become clear.

If these efforts are not effective, Congress should consider repealing the authority of the FSOC to designate SIFIs. Despite the apparent appetite of both the FSB and the FSOC for placing what the FSB calls a "SIFI Framework" over asset managers, mutual funds, securities firms and hedge funds, there is no indication that these entities had any role in the financial crisis. Instead, these firms have been the key organizations that have financed American business over the last 35 years, and subjecting them to bank-like prudential regulation will do serious damage to the US economy.

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March 4, 2014

The Honorable Patrick McHenry
Chairman
Subcommittee on Oversight & Investigations
House Financial Services Committee
United States House of Representatives
Washington, D.C. 20515

The Honorable Al Green
Ranking Member
Subcommittee on Oversight & Investigations
House Financial Services Committee
United States House of Representatives
Washington, D.C. 20515

Re: The Need for Regulatory Relief for Our Nation's Credit Unions

Dear Chairman McHenry and Ranking Member Green:

On behalf of the National Association of Federal Credit Unions (NAFCU), the only trade association exclusively representing the interests of our nation's federally chartered credit unions, I write today in advance of tomorrow's hearing, "The Growth of Financial Regulation and its Impact on International Competitiveness." Credit unions and their 97 million members appreciate the subcommittee's willingness to explore how community-based financial institutions, including credit unions, are struggling under an ever-increasing regulatory burden.

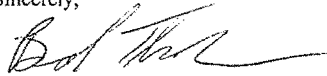
The impact of the growing compliance burden under the *Dodd-Frank Act* is evidenced in the fact that the number of credit unions continues to decline, dropping by more than 700 institutions since 2009. Credit unions didn't cause the financial crisis and shouldn't be caught in the crosshairs of regulations aimed at those entities that did. Unfortunately, that has not been the case thus far as all credit unions are subject to rule writing authority of the new Consumer Financial Protection Bureau. Accordingly, finding ways to cut-down on burdensome and unnecessary regulatory compliance costs is a chief priority of our members.

As outlined in the attached document, and first shared with Congress in February 2013, NAFCU's five point plan for regulatory relief includes several important provisions aimed at ensuring credit unions aren't subject to over burdensome, outdated, or duplicative regulation. As the subcommittee looks for ways to reduce regulatory burden moving forward, we ask that you keep in mind the need for regulatory relief for our nation's credit unions.

Thank you for the opportunity to provide additional information with respect to the overwhelming amount of regulatory burden credit unions face. We look forward to the subcommittee's review of how financial over-regulation is harming our nation's financial institutions and stand ready to provide additional input should you have questions about the impact on credit unions.

If my colleagues or I can be of assistance to you, or if you have any questions regarding this issue, please feel free to contact myself, or NAFCU's Director of Legislative Affairs, Jillian Pevo at (703) 842-2836.

Sincerely,



Brad Thaler
Vice President of Legislative Affairs

cc: Members of the Oversight and Investigations Subcommittee

Enclosure: NAFCU's Five-Point Plan for Credit Union Regulatory Relief

Learn How NAFCU's Five-Point Plan Will Bring Regulatory Relief to Credit Unions

In February 2013, NAFCU was the first trade association to call on this Congress to provide comprehensive broad-based regulatory relief for credit unions. As part of this effort, NAFCU sent Congress a five-point plan for regulatory relief that will significantly enhance credit unions' ability to create jobs, help the middle class, and boost our nation's struggling economy. The five-point plan is built on a solid framework of recommendations that provide regulatory relief through the following:

1. Administrative Improvements for the Powers of the NCUA

- Allow a federal credit union to petition NCUA for a waiver of a federal rule in favor of a state rule.
- Provide NCUA the authority to delay implementation of CFPB rules that affect credit unions and to tailor those rules for credit unions' unique structure.
- Require a cost/benefit analysis of all rules that includes a three-year look back and reevaluation of rules that cost 20 percent or more than their original cost estimate.
- Enact new examination fairness provisions to help ensure timeliness, clear guidance and an independent appeal process free of examiner retaliation.
- Improve the Central Liquidity Facility by removing the subscription requirement for membership and permanently removing the borrowing cap.

2. Capital Reforms for Credit Unions

- Direct NCUA and industry representatives to conduct a study on prompt corrective action and recommend changes.
- Modernize capital standards by directing the NCUA Board to design a risk-based capital regime for credit unions that takes into account material risks and allows the NCUA Board to authorize supplemental capital.
- Establish special capital requirements for newly chartered federal credit unions that recognize the unique nature and challenges of starting a new credit union.

3. Structural Improvements for Credit Unions

- Direct NCUA, with industry input, to conduct a study of outdated corporate governance provisions in the Federal Credit Union Act and make recommended changes to Congress.
- Improve the process for expanding a federal credit union's field of membership by allowing voluntary mergers among multiple common bond credit unions, easing the community charter conversion process and making it easier to include those designated as "underserved" within a credit union's field of membership.

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National Association of Federal Credit Unions | www.nafcu.org

4. Operational Improvements for Credit Unions

- Raise the arbitrary cap on member business loans to 27.5% or raise the exemption on MBL loans from $50,000 to $250,000, adjusted for inflation, and exempt loans made to non-profit religious organizations, businesses with fewer than 20 employees and businesses in "underserved areas."
- Remove requirements to mail redundant and unnecessary privacy notices on an annual basis, if the policy has not changed and new sharing has not begun since the last distribution of the notice.
- Allow credit unions greater authority and flexibility in how they invest.
- Provide NCUA the authority to establish longer maturities for certain credit union loans and greater flexibility in responding to market conditions.
- Provide federal share insurance coverage for Interest on Lawyers Trust Accounts (IOLTAs).

5. 21st Century Data Security Standards

- Establish national standards for safekeeping of all financial information.
- Establish enforcement standards for data security that prohibit merchants from retaining financial data, and require merchants to disclose their data security policies to customers.
- Hold merchants accountable for the costs of a data breach, especially when it was due to their own negligence; shift the burden of proof in data breach cases to the party that incurred a breach and require timely disclosures in the event of a breach.

For more information, visit **www.nafcu.org/regrelief.**

NAFCU

National Association of Federal Credit Unions | www.nafcu.org

CHAMBER OF COMMERCE
OF THE
UNITED STATES OF AMERICA

R. BRUCE JOSTEN
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March 4, 2014

The Honorable Patrick McHenry
Chairman
Subcommittee on Oversight and Investigations
Committee on Financial Services
U.S. House of Representatives
Washington, DC 20515

The Honorable Al Green
Ranking Member
Subcommittee on Oversight and Investigations
Committee on Financial Services
U.S. House of Representatives
Washington, DC 20515

Dear Chairman McHenry and Ranking Member Green:

The U.S. Chamber of Commerce would like to draw your attention to several important issues relevant to the Subcommittee on Capital Markets and Government Sponsored Enterprises hearing entitled *The Growth of Financial Regulation and Its Impact on International Competitiveness.*

This hearing will examine a broad topic that encompasses a varied set of issues that are critical to America's ability to compete in an ever expanding global economy. In fact, the Chamber recently created the Global Risk and Governance Initiative to establish a sustained dialogue with the G-20 and international regulators regarding policies for rational systems of risk management, financial services regulation, and corporate governance to facilitate a balance between competition and cross-border regulatory cooperation.

There exists a challenging environment to achieve that goal. One of the lessons of the 2008 financial crisis was the need for better communication between national financial regulators to coordinate cross-border issues. While some progress has been made, countervailing trends have emerged to threaten this progress and place American businesses at a competitive disadvantage, which include:

1. Some responses to the financial crisis, such as the Volcker Rule, place the United States at a competitive disadvantage;

2. Initiatives such as the recently enacted Foreign Bank Operations rule create nationalistic barriers inhibiting the flow of capital businesses need to grow while inviting a protectionist response from abroad that would harm our economy;

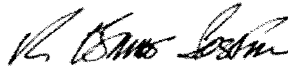
3. The cross-border application of regulations, such as the attempt by the Commodity and Futures Trading Commission's application of derivatives in markets overseas, or the French government's efforts to tax financial transactions in the United States, pose similar dangers; and

4. Potentially inconsistent international regulatory responses to innovative products such as crowdfunding can hamper the ability of entrepreneurs to sell goods and services overseas.

Effectively, federal regulators are slowly de-globalizing financial markets at the same time that businesses are engaged in global activities on an unprecedented scale. This will obstruct the flow of capital, deprive businesses of services needed to operate internationally, and restrict the ability to mitigate the risks associated with cross-border activities.

The U.S. Chamber of Commerce, the world's largest business federation representing the interests of more than three million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations, and dedicated to promoting, protecting and defending America's free enterprise system, would like to thank the Subcommittee for holding this important hearing, and looks forward to working with you on these issues, which are critical to the ability of the United States to compete in an ever increasing global environment.

Sincerely



R. Bruce Josten

cc: Members of the Subcommittee on Oversight and Investigations

Written Testimony of
Chris Brummer, J.D., Ph.D.[†]
Before the House Financial Services Committee
Subcommittee on Oversight and Investigations
Hearing on Financial Regulation and U.S. Competitiveness

March 6, 2014 2:00 pm

The competitiveness of a country's financial sector is a function of the quality and integrity of its financial services professionals, the credibility of its regulatory supervision, and its ability to meet domestic and international market needs. As such, the question of competitiveness concerns to what degree the United States enjoys a safe and vibrant capital market, and to what degree the United States has successfully promoted high quality, first-rate and compatible regulatory best practices among its leading trading partners.

Fortunately, there *has* been enormous progress in implementing the G-20 agenda for financial reform, which was embraced by the world's leading economic powers in the wake of the 2008 financial crisis. And this implementation is proceeding in a way that for the most part has been consistent and harmonious. This is an achievement that cannot and should not be overlooked, especially given the different regulatory and market infrastructures in the United States and European Union, and the varying degrees of reliance on banking and capital markets in both jurisdictions. Indeed, the list of accomplishments is in many ways unprecedented, including, and just to name a few:

- Increasing the amount and quality of capital held by banks and systemically important financial institutions
- Restraining the amount of leverage assumed by banks and non-bank financial firms
- Moving large swaths of OTC derivatives to stable, resilient and transparent pre- and post-trading environments.
- Requiring clearing for some of the most volatile financial transactions and contracts
- Outlining a framework for coordinating cross-border bank failures

This is all the more impressive when one considers the varied rule-making processes in both the United States and European Union, with the delegation of authority to independent agencies like the SEC and CFTC in the United States by the Congress as compared to more prescriptive legislative action taken by the EU Commission, Parliament, and Council.

[†]Chris Brummer is Professor of Law at Georgetown University Law Center, where he teaches securities regulation and international financial regulation. He is also Project Director for the Transatlantic Finance Initiative at the Atlantic Council and C. Boyden Gray Fellow for Global Finance and Growth, and is a senior fellow at the Milken Institute's Center for Financial Markets.

But there *are* differences, differences that though at times may appear only on the margins, can have outsized implications for financial stability and U.S. competitiveness. These are issues that I have spent some time reflecting on, and which I have summarized in a highly regarded, bipartisan report for the Atlantic Council.[1]

The topic of this hearing is competitiveness and financial regulation. Before getting into the challenges before us, it is worthwhile stating for the record that the regulation of our domestic financial system is **not** in itself a competitive disadvantage for the United States. Indeed, the financial crisis illustrated to an unprecedented degree the devastating consequences that can be wreaked on economic growth, job creation, and innovation by under-regulated domestic and international financial markets lacking comprehensive rules and sound supervision.

Instead, risks to U.S. competitiveness arise where efforts to buttress our financial system end up being inoperable with reform efforts of likeminded countries such that we end up unwittingly undermining international reforms, complicating our own attempts to better safeguard our markets, or unnecessarily hampering commerce. The challenge before us is thus how to make our reforms as prudently as possible alongside our major trading partners in ways that both 1) bolster regulators' supervisory efforts and 2) minimize the costs and operational burdens for our firms tapping foreign capital markets, and vice versa. It is also useful to think about how these twin goals can be achieved in ways that do not end up descending into games of "chicken" or "first to blink loses" with other financial authorities that can end up damaging our larger strategic interests. If done right, cooperation between the US and its key regulatory allies can enhance not only prospects for sustainable growth, but also financial stability.

Coping with regulatory diversity is, however, tough work. To understand some of these differences in substance, I think it's useful to recognize that the path of international regulatory reform has passed along the path of least resistance. We've seen this, in particular, with the G-20, where some of the easier issues were tackled first and, conversely, the more difficult issues have been saved for last.

For many people, this could be a somewhat disconcerting observation when one considers that the lower-hanging fruit involves the issue of bank capital and bank capitalization and moves along the spectrum to topics like banking structure and organization, derivatives regulation, accounting, and finally to cross-border bank resolution, which is arguably the most formidable global challenge of all.

And so, what we see are issues of convergence and divergence that roughly reflect these levels of difficulty. Regulators have, for the most part, come to what can be viewed as a consensus on the rules and standards that should relate to bank capital. It is true that there are differences in some ways with regards to what kinds of assets constitute capital, and I have some lingering concerns about trade finance, but for the most part the regimes are highly consistent with one another.

[1] The Danger of Divergence: Transatlantic Financial Reform & the G20 Agenda, *available at* http://www.atlanticcouncil.org/images/publications/Danger_of_Divergence_Transatlantic_Financial_Reform_1-22.pdf.

Instead, the difficulties have come from operationalizing the reforms. Meeting enhanced Basel III capital standards, for example, is about more than just rules; in point of fact, it requires the recapitalization of banks—a process that is taking longer in Europe than in the United States. This difference is partly because the U.S. crisis erupted earlier, and was met by a swifter policy response, and partly because the Eurozone has had to negotiate funding mechanisms for banks and cash-strapped governments among sovereign countries. These delays have, however, raised doubts in the United States about the EU's commitment to reform.

Concerns about bank structure have additionally accompanied core issues of bank capital. However, unlike capital, bank structural reform was not really a matter presented at the G-20 for serious discussion. Instead, structural reforms have been undertaken independently in the United States, as well as in Europe and other parts of the world. At this point, we now know the contours of the Volcker Rule in the United States, though it is unclear just how the EU and UK will respond. It is highly likely that they will diverge in both substance and emphasis from the Volcker Rule, choosing "stricter" approaches in some areas like scope and proceeding more leniently in other areas of substance. Meanwhile, the newly released rule on foreign banking organizations (FBOs) has found no immediate counterpart in Europe, although it has already prompted threats of retaliation by the European Union. Still, some jurisdictions in Asia have already implemented their own versions of the approach.

Returning to the G-20 agenda, derivatives were addressed at the 2009 *Pittsburgh summit.* To summarize the results as simply as possible, at that summit it was agreed to regulate the derivatives market along the lines of three basic elements: pretrade transparency, central counterparty clearing, and post-trade reporting. Limiting the analysis to just the European Union and the United States, one can conclude that both jurisdictions are actively implementing their G-20 commitments. The US has done so through Title VII of the Dodd-Frank Act and the implementing regulations promulgated by regulators such as the CFTC, whereas the EU has agreed to the European Markets Infrastructure Regulation and a review of the Markets in Financial Instruments Regulation and Directive.

Yet despite their similarities, EU and US rules are not fully compatible. To address overlaps, gaps and conflicts of law, in the summer of 2013 both jurisdictions reached (ostensible) agreement in the *Path Forward* communiqué as to how to operationalize the commitments such that they could function in a cross-border context. This process then took several steps back as to how to operationalize the high-level commitments with regards to trading infrastructure (the Swap Execution Facilities); yet even with a new substituted compliance accord reached, the smooth implementation of a cross-border framework remains to be seen.

Progress on accounting has slowed considerably. Without getting into the weeds, we see in the coordination of U.S. GAAP and IFRS a range of challenges, especially where IFRS itself has not consolidated varying approaches and multiple treatments among its own user jurisdictions. This is extremely unfortunate since varying accounting standards complicate the ability of firms and regulators to evaluate and compare financial institutions' health and compliance with key regulatory metrics (like leverage). Furthermore, the absence of a single yardstick

to measure the performance of U.S. firms compared to their international partners substantially increases costs of doing business as well as costs for accessing capital. But deeper progress, such as the harmonization or easy conversion of accounting standards, remains a distant goal.

Finally, cross-border bank resolution, arguably the most important mechanism needed to address the too-big-to-fail problem, remains elusive—but a must-have. Indeed, many of the sources of friction in and between transatlantic regulators are exacerbated by the lack of a mechanism for addressing effectively the downfall of one or more systemically important financial institutions. Much has been done to begin this process via bilateral accords, or at the least discussions, with key financial centers like the UK and Switzerland. But to the extent to which such mechanisms can be created and fully operational, many of the concerns and pressures driving geographically based or seemingly unilateral measures (such as the FBO rule) would be eased.

With that in mind, I have several modest suggestions.

First, a reinvigorated *process* of coordination and cooperation would be helpful. The G-20 agenda was broad and ambitious but also often vague as to how and when many core benchmarks were to be achieved. This is, of course, only to be expected when you have so many jurisdictions talking to one another. But the United States and the European Union, the two most demanding standard-setting jurisdictions, can do better.

In addition, there is ongoing and intensifying debate as to how formal different kinds of obligations should be and whether trade initiatives should tackle the challenges of international finance. This is an extremely complicated question, in part because it depends on just what provisions a trade agreement would include. For instance, some procedural innovations to synch administrative processes could be quite helpful, while attempts to introduce substantive rules or water down regulatory reforms could prove fatal to financial stability.

But whichever way you come out on the issue, virtually everyone agrees that traditional substitute compliance and mutual recognition programs have not typically spoken to a regulatory context in which not one but two or more, or indeed nearly *all* authorities are seeking to upgrade their financial systems. This presents a number of novel challenges, particularly where countries have a range of different goals or even varying intensities of policy preferences. For instance, one jurisdiction can be looking to tackle banker compensation (like the European Union), while the other may focus more on derivatives (like the United States), yet due to their different policy goals and intensities they may accuse the other of being "soft."

Consequently, I think it would be wise for the tools and mechanisms of cross-border diplomacy to acknowledge this challenge and begin to establish benchmarks for ensuring a synchronized approach towards tackling different issues—to quite literally keep regulators and firms on the same page. Administrative processes and priorities can be better coordinated and integrated into substituted compliance mechanisms, which would allow implementation to move apace while ensuring earlier—and ongoing—regulatory and public interactions as new challenges arise.

Recognition of "equivalence" should not comprise the finish line or conclusion of cross-border talks and information sharing.

Along these lines, and especially given its interface between financial supervision and monetary relations, the Financial Markets Regulatory Dialogue, the main meeting of EU and U.S. regulators, should be revived alongside G-20 meetings of treasury officials and central bankers. Regulators should be at the table when big market-supervisory decisions are made so that they can understand their role and the expectations of other parts of the U.S. government. This would also help with international consistency insofar as EU and U.S. regulators could be encouraged to present joint solutions and reforms for wider international consideration at the Financial Stability Board, instead of litigating them there after conflicts arise.

Finally, to make any of this happen, you need resources on the ground. Diplomacy isn't cheap, and you need to empower your regulators (and for that matter trade officials and diplomats) to do their job if you really want an efficient transatlantic marketplace. Freezing travel accounts and slashing diplomatic resources won't help U.S. competitiveness. We need to look at economic diplomacy as not a cost center, but as an investment that pays dividends for taxpayers and market participants alike.