# A LEGISLATIVE PROPOSAL TO CREATE HOPE AND OPPORTUNITY FOR INVESTORS, CONSUMERS, AND ENTREPRENEURS

## HEARING

BEFORE THE

## COMMITTEE ON FINANCIAL SERVICES

## U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED FIFTEENTH CONGRESS

FIRST SESSION

APRIL 26, 2017

Printed for the use of the Committee on Financial Services

**Serial No. 115–17**

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### Wednesday, April 26, 2017



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### Additional Material Submitted for the Record

# A LEGISLATIVE PROPOSAL TO CREATE HOPE AND OPPORTUNITY FOR INVESTORS, CONSUMERS, AND ENTREPRENEURS

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**Wednesday, April 26, 2017**

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
*Washington, D.C.*

The committee met, pursuant to notice, at 10:09 a.m., in room 2128, Rayburn House Office Building, Hon. Jeb Hensarling [chairman of the committee] presiding.

Members present: Representatives Hensarling, Royce, Pearce, Posey, Luetkemeyer, Huizenga, Duffy, Stivers, Hultgren, Ross, Pittenger, Wagner, Barr, Rothfus, Messer, Tipton, Williams, Poliquin, Love, Hill, Emmer, Zeldin, Trott, Loudermilk, MacArthur, Davidson, Budd, Kustoff, Tenney, Hollingsworth; Waters, Maloney, Velazquez, Sherman, Meeks, Capuano, Clay, Lynch, Scott, Green, Cleaver, Moore, Ellison, Perlmutter, Foster, Kildee, Delaney, Sinema, Beatty, Heck, Vargas, Gottheimer, Gonzalez, Crist, and Kihuen.

Chairman HENSARLING. The Financial Services Committee will come to order. Without objection, the Chair is authorized to declare a recess of the committee at any time.

Today's hearing is entitled, "A Legislative Proposal to Create Hope and Opportunity for Investors, Consumers, and Entrepreneurs."

I now recognize myself for 5 minutes to give an opening statement.

It has been almost 7 years since the passage of the Dodd-Frank Act. We were told it would lift our economy, but instead we are stuck in the slowest, weakest, most tepid recovery in the history of the republic.

The economy does not work for working people. They have seen their paychecks stagnate; they have seen their savings decimated. We have seen millions who remain unemployed and underemployed in an economy working at roughly half of its potential.

Dodd-Frank has been a bigger burden to enterprise than all other Obama-era regulations combined. There is a better way, and it is the Financial CHOICE Act of 2017.

This bill replaces onerous government fiat with market discipline, ends bailouts with bankruptcy, throws a deregulatory life preserver to our community financial institutions, replaces complexity with simplicity, holds both Washington and Wall Street accountable, and unleashes capital formation so the economy can move yet again for the betterment of all of our citizens.

Under the Financial CHOICE Act there will be economic opportunity for all and bank bailouts for none—again, bank bailouts for none. Perhaps that is why press reports indicate that most Wall Street banks oppose the Financial CHOICE Act.

The damage Dodd-Frank has done to consumers and business is well known to every Member, but let me remind you of just a few: 75 percent of banks used to offer free checking before Dodd-Frank became law; by 2016 only 38 percent did. Minimum balance requirements to qualify for free checking have almost quadrupled, and average monthly fees more than tripled. This helps explain why the number of households that are unbanked and underbanked is up by more than 3 million since the passage of Dodd-Frank.

Data show that there are 50 million fewer credit cards available since 2008 and the remaining options cost more now, hurting small businesses and struggling families. The Federal Reserve reports that once Dodd-Frank's qualified mortgage rule is fully phased in, an estimated one-third of Black and Hispanic borrowers will be denied mortgages due to its rigid debt-to-income ratio.

An overwhelming majority of community banks report that Dodd-Frank's regulatory burdens are preventing them from making more residential mortgage loans. And they have had to hire more staff just to deal with the legal compliance issues.

The Dodd-Frank Act represents an even more dangerous prospect, namely, politicized lending. Washington elites are now allocating our capital to fulfill their agendas, devoid of any checks and balances or due process.

And it is impossible to bring up the threat of politicized lending without bringing up the CFPB. The Financial CHOICE Act reestablishes this rogue agency as a civil enforcement agency patterned after the Federal Trade Commission, one that is responsible for actually enforcing the enumerated consumer protection laws written by Congress instead of making up its own law in an unfair, deceptive, and abusive manner.

True consumer protection is only to be had in competitive, transparent, and innovative markets which are vigorously policed for fraud and deception. That is what the Financial CHOICE Act is all about.

The bill releases financial institutions from regulations that create more burden than benefit in exchange for meeting high, yet simple capital requirements—that is, loss-absorbing capital, which is like an insurance policy against failure.

Instead of government bureaucrats overseeing banks that plan their failures, the CHOICE Act will see banks plan for their expansions by helping grow the economy for every citizen.

The Financial CHOICE Act repeals Washington's authority to designate too-big-to-fail firms—or SIFIs, as they are known going forward, and retroactively repeals previous nonbank SIFI designations.

The bill recognizes that illegal activity by bad actors at financial institutions can harm the financial well-being of consumers and society and, therefore, imposes the toughest penalty in history for financial fraud, self-dealing, and deception.

The bill repeals the misguided, complex, and unneeded Volcker Rule, as it has made capital markets less liquid, more fragile, and threatens financial stability. Even a Federal Reserve report now admits to this.

The bill would unleash opportunities for economic growth, foster capital formation, and provide Main Street job creators with regulatory relief so more Americans can go back to work at good careers and give their families a better life.

Ending the bureaucratic nightmare that is Dodd-Frank and replacing it with the simpler capital rules of the Financial CHOICE Act is imperative. America has struggled for far too long.

It is time again to hold Washington accountable; it is time to hold Wall Street accountable. It is time for economic growth for all; it is time for bank bailouts for none.

So I look forward today to our hearing, and to soon passing the Financial CHOICE Act.

I now recognize the ranking member for 4 minutes.

Ms. WATERS. Thank you, Mr. Chairman.

And thank you, to the witnesses, for being here today.

There is only one explanation for why we are here discussing yet another dead-on-arrival version of the wrong choice act. It must be that the foreclosure crisis and the Great Recession somehow weren't enough for the Majority, and so they irrationally want to clear the way for round two.

I want to be very clear for anyone who is watching: That is exactly what this bill would result in.

The wrong choice act thoroughly dismantles Wall Street reform, guts the Consumer Financial Protection Bureau, and takes us back to the system that allowed risky and predatory Wall Street practices and products to crash our economy.

During the Great Recession, because of the actions of reckless financial institutions, Americans lost $13 trillion in household wealth, 11 million Americans lost their homes, and the unemployment rate climbed to 10 percent. The impact was widespread and harmful to all.

The wrong choice act paves the path back to that kind of economic ruin by rolling back the critical safeguards we put in place in the Dodd-Frank Wall Street Reform and Consumer Protection Act to protect American consumers, investors, and the economy.

Today we have sensible Dodd-Frank rules and the Consumer Financial Protection Bureau to prevent financial institutions from peddling toxic products or abusing hardworking American consumers. Since its creation the CFPB has returned nearly $12 billion to more than 29 million consumers who have been ripped off by financial institutions.

With this financial cop on the block and with important rules of the road in place, Wall Street reform has worked. Since Dodd-Frank passage the economy has created 16 million jobs over 85 consecutive months, and business lending has increased 75 percent. Banks large and small are posting all-time record profits; community banks are out-performing larger banks; and credit unions are expanding their membership.

But here we are. And even though Wall Street reform has made them safer and they are raking in profits, that is not enough for the banks. They want to go back to the bad old days of fewer protections, and they have shamelessly undertaken a full-court press to get a long wish list of giveaways, most of which have been compiled in this bill.

Democrats are going to fight against it and stand up for Main Street. This bill must not become law. There is too much at stake for consumers and for our whole economy.

And I will now yield to Mr. Kildee, the vice ranking member.

Mr. KILDEE. Thank you, Madam Ranking Member, for yielding.

This so-called Financial CHOICE Act ends the most important aspects of Wall Street reform, which were designed and passed to prevent another financial crisis. Pushing this bill puts Wall Street ahead of Main Street once again.

The wrong choice for hardworking Americans, it puts Wall Street back in charge and does away with those very protections that were enacted after the financial crisis, and puts the economy back at risk.

And let me be clear: I and other Members on this side support improving some aspects of Dodd-Frank.

But have we forgotten the lessons of the financial crisis? This takes us back to the days where Wall Street practices nearly crippled our economy, back to the days where millions of people lost their homes, lost their jobs, saw their retirement savings wiped out. The people that I represent have not forgotten these dark days, and the committee should not forget them either.

Removing these important financial safeguards while at the same time eliminating the Consumer Financial Protection Bureau, designed to protect consumers against those abuses, is the wrong choice and this committee ought to reject that.

With that, I yield back.

Chairman HENSARLING. The Chair now yields 1 minute to the gentleman from California.

Mr. SHERMAN. Mr. Chairman, this CHOICE Act takes some good bills that passed this committee with overwhelming and bipartisan majorities, puts them together with a lot more bad bills that do not have bipartisan support, and gives Members no choice. They are ultimately going to have to vote up or down.

Mr. Chairman, please break up this bill.

You say we don't have free checking anymore. You used to pay for checking because your checking account got about 4 percent less interest than the passbook account. In a zero interest rate environment or even a very low interest rate environment, obviously banks got rid of free checking in many cases, and in other cases they are trying to get it unfreezed.

Finally, you say we don't have the economy we need. We need a better trade policy. You can't have a half-trillion-dollar trade deficit and then say, "We are going to make up for that by deregulating the banks and reinstituting the disasters that we suffered in 2008."

The idea that we can make up for bad trade policies and restore the economy by letting Wall Street do anything they want didn't work in 2008. It is not going to work now.

I yield back.

Chairman HENSARLING. The gentleman yields back.

We will now turn to our panel of witnesses.

First, we welcome the testimony of Mr. Peter Wallison. He is the Arthur F. Burns fellow in financial policy studies at the American Enterprise Institute. He previously served as General Counsel of the U.S. Treasury Department and as White House Counsel to President Reagan. He received both his B.A. and J.D. from Harvard University.

Second, Dr. Norbert Michel is a senior research fellow at the Heritage Foundation. He was previously a professor at Nicholls State University College of Business, where he taught finance, economics, and statistics. Dr. Michel holds his B.A. from Loyola University and a doctoral degree in financial economics from the University of New Orleans.

Third, the Honorable Michael Barr is a professor of law at the University of Michigan Law School, where he teaches financial regulation, international finance, and financial derivatives. He previously served as Assistant Secretary for Financial Institutions at the Treasury Department. He received both his B.A. and J.D. from Yale University.

Fourth, Mr. Alex Pollock is the distinguished senior fellow at the R Street Institute. Previously he served as a resident fellow at the American Enterprise Institute, and as the president and CEO of the Federal Home Loan Bank of Chicago. He received his B.A. from Williams College, a Master's in Philosophy from the University of Chicago, and a Master's of Public Administration from Princeton University.

Fifth, Dr. Lisa Cook is an associate professor of economics and international relations at Michigan State University. Previously, she was a senior economist on the Council of Economic Advisors. As a Marshall scholar she received her B.A. from Spelman College and a second B.A. from Oxford University; she earned a Ph.D. in economics from the University of California Berkeley.

Sixth, Ms. Hester Peirce is a senior research fellow at the Mercatus Center. She previously served as staff for the Senate Banking Committee, as well as the Securities and Exchange Commission. Ms. Peirce earned her B.A. in economics from Case Western Reserve University and her J.D. from Yale Law School.

And last but not least, Mr. John Allison is the former president and chief executive officer of the Cato Institute. Prior to his time at Cato he was the longstanding chairman and CEO of BB&T Bank. Mr. Allison graduated from the University of North Carolina Chapel Hill and received his Master's Degree in management from Duke University.

Each of you will be recognized for 5 minutes to give an oral presentation of your testimony.

I think perhaps with one exception, you have all testified here before, but as a slight refresher course, green means go, yellow means you have 1 minute left, and red means you had best wrap it up.

Without objection, each of your written statements will be made a part of the record.

Mr. Wallison, you are now recognized for 5 minutes for your testimony.

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

Mr. WALLISON. Thank you, Mr. Chairman, Ranking Member Waters, and members of the committee. Thanks for the opportunity to comment on the Financial CHOICE Act.

The act would repeal or substantially modify large portions of the 2010 Dodd-Frank Act. As outlined in my prepared testimony, there are two important things to know about Dodd-Frank: It is primarily responsible for the historically slow recovery of the U.S. economy since the 2008 financial crisis; and it was completely unnecessary.

Enacted hurriedly, Dodd-Frank misdiagnosed the financial crisis. Without serious investigation, the Obama Administration and Congress assumed or wanted to believe that the crisis was caused by insufficient regulation of Wall Street and the financial system.

In 2009, before any committee hearings, Chairman Barney Frank said that Congress would adopt a "New New Deal." He was correct. The Dodd-Frank Act was by far the most restrictive financial regulatory law since the 1930s.

If, instead of jumping to pass new regulations, Congress had stopped to consider why we had a financial crisis it would have found government housing policies were the cause. In 1992 Congress enacted the Affordable Housing Goals, which required Fannie Mae and Freddie Mac to meet certain quotas when they bought mortgages from banks.

First, the quota was 30 percent: In any year, 30 percent of the loans that Fannie and Freddie bought had to be made to borrowers who were at or below the median income where they lived.

HUD was given authority to increase these quotas and did so aggressively through the Clinton and the Bush Administrations. By 2008 the quota was 56 percent, meaning that more than half of all mortgages they acquired in any year had to be made to borrowers at or below the median income.

The purpose of the goals was to increase mortgage credit for these borrowers, but it had the effect of forcing Fannie and Freddie to reduce their underwriting standards. Although they had traditionally accepted only prime loans, which require 10 to 20 percent downpayments, they couldn't find enough of these loans among borrowers who met the quota.

By the mid-1990s they were accepting loans with 3 percent downpayments; and by 2000, loans with zero downpayments.

What Congress did not understand when it adopted the goals was that Fannie and Freddie, which were by far the largest buyers in the market, set the underwriting standards for everybody else. So their reduced underwriting standards spread to the wider market. Banks and others made these risky loans to compete with lenders who were also making risky loans and selling them to Fannie and Freddie.

By 2008 more than half of all mortgages in the United States were subprime. And of these, 76 percent had been bought by Government agencies, primarily Fannie and Freddie.

That shows without question that the government created the demand for these loans. Risky loans, in turn, created an unprecedented 10-year housing bubble between 1997 and 2007. When the bubble deflated, housing and mortgage values fell 30 to 40 percent nationwide, causing losses to many financial firms and banks that held mortgages or mortgage-backed securities. Fannie and Freddie themselves became insolvent and had to be bailed out with $180 billion in taxpayer funds.

Because Congress did not know what really caused the crisis, it was led to adopt a series of unnecessary restrictions in the Dodd-Frank Act, detailed in my prepared testimony. Among them are: first, costly regulations on community banks, which prevented the growth of small business and the employment small business produces, causing 7 years of stunted economic and employment growth.

Second, the creation of the FSOC, with the power to designate firms as SIFIs; among other things, this caused G.E. to close down G.E. Capital, which had been a successful lender to small business and other growth companies.

Third, an unnecessary orderly liquidation authority that will make it likely to be difficult for very large financial firms to find financing in the future.

Fourth, authority for the Fed to finance failing clearinghouses, which would pave the way for another financial crisis.

And fifth, the Volcker Rule, which has drastically reduced liquidity in the financial markets, creating the potential for another financial crisis.

The CHOICE Act can't be enacted too soon, Mr. Chairman.

Thank you for your attention.

[The prepared statement of Mr. Wallison can be found on page 143 of the appendix.]

Chairman HENSARLING. Thank you.

Dr. Michel, you are now recognized for your testimony.

**STATEMENT OF NORBERT J. MICHEL, SENIOR RESEARCH FELLOW, FINANCIAL REGULATIONS AND MONETARY POLICY, THE HERITAGE FOUNDATION**

Mr. MICHEL. Thank you.

Chairman Hensarling, Ranking Member Waters, members of the committee, thank you for the opportunity to testify today. I am a senior research fellow in financial regulations at the Heritage Foundation, but the views that I express in this testimony are my own and they should not be construed as representing any official position of the Heritage Foundation.

My testimony argues that Dodd-Frank needlessly increased borrowing costs and that removing this excess burden will markedly increase sustainable economic growth. Dodd-Frank worsened the too-big-to-fail problem, expanded the command-and-control type of financial regulations that have harmed people for decades, and pointlessly addressed issues that had nothing to do with the 2008 financial crisis.

My remarks will provide one example of each of these three Dodd-Frank failures.

The first is the new Dodd-Frank resolution process that keeps large failing financial firms out of bankruptcy after Federal regulators certify that no viable private alternatives exist. This is unequivocally the wrong approach.

The very theory behind a legal bankruptcy process is that it provides for orderly resolution of a distressed firm. It offers a financial timeout so that the company can remain a viable business while staving off a mad rush of creditors trying to get their claims settled first.

Bankruptcy provides protection to debtors, which is why creditors don't like bankruptcy. So it is no surprise that over time these protections have been whittled down.

The main problem with the Bankruptcy Code after 2005 was that it provided nearly all derivative and repo agreement counterparties safe harbors from key bankruptcy protections, such as the automatic stay. These safe harbors were justified on the grounds that they would prevent counterparties from running, thus worsening a systemic crisis, but that theory has now been proven wrong.

The Financial CHOICE Act implements an improved process—bankruptcy process—for large financial firms by adopting the Financial Institution Bankruptcy Act of 2016, legislation that subjects derivatives and repos to an automatic 48-hour stay. The temporary stay is a welcome improvement, and the elimination of the safe harbor and all other bankruptcy safe harbors or derivatives and repos would be optimal.

The second major policy mistake is that Dodd-Frank created an unaccountable Federal agency based on a flawed concept of consumer protection. I am referring, of course, to the Consumer Financial Protection Bureau and so-called abusive acts and practices.

The United States did not need and does not need either. The CFPB is unaccountable to the public in any meaningful way and raises serious due process and separation-of-powers concerns.

Most importantly, there was no shortage of consumer protection prior to the Dodd-Frank Act. Title X of Dodd-Frank created the CFPB by transferring enforcement authority for 22 specific Federal statutes to the new agency. These Federal statutes were already layered on top of State laws and local ordinances, and this framework has for decades outlawed deceptive and unfair practices even in financial products and services.

The CHOICE Act greatly improves the status quo by making the CFPB Director removable at will, putting the agency through the regular appropriations process, eliminating the abusive behavior concept, and relegating the CFPB to an enforcement-only agency. These changes would provide an enormous benefit to U.S. citizens, but Congress can do even better by eliminating the CFPB and consolidating its enforcement authority at the Federal Trade Commission.

The third major policy mistake that I will discuss is the Durbin Amendment. Section 1075 of Dodd-Frank implemented price controls on the interchange fees charged in debit card transactions, and it did so based on the premise that banks and card networks had colluded to fix prices. If, in fact, banks and card networks are guilty of these actions then merchants and any other aggrieved parties have a remedy in Federal court.

The issue is actually quite simple. Long before 2010 Congress had done its job by creating anti-trust law. It should never have jumped into the middle of a legal dispute as if it were the Judicial Branch.

Congress should repeal the Durbin Amendment and restore the rule of law, letting the courts decide if, in fact, there was collusion and price-fixing.

Thank you for your consideration, and I am happy to answer any questions that you may have.

[The prepared statement of Dr. Michel can be found on page 112 of the appendix.]

Chairman HENSARLING. Mr. Barr, you are now recognized for 5 minutes for your testimony.

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

Mr. BARR. Thank you, Mr. Chairman, Ranking Member Waters, and distinguished members of the committee. It is my pleasure to appear before you today.

The Dodd-Frank Act was passed in response to the worst financial crisis since the Great Depression. In 2008 the United States plunged into a severe financial crisis that shuttered American businesses and cost millions of families their jobs, homes, and livelihoods.

While American families have not forgotten the pain of the financial crisis, a kind of collective amnesia appears to be now descending on Washington. Many seem to have forgotten the causes of the crisis and the brutal consequences for American families.

Instead of offering hope and opportunity to American families, the legislation being considered by this committee would needlessly expose taxpayers, workers, businesses, and the American economy to fresh risks of financial abuse and financial collapse. That is not a risk we can or should take.

While the draft legislation has many serious flaws, I want to focus here on three key problems: first, weakening oversight of the financial system; second, eliminating orderly liquidation; and third, undermining consumer and investor protection.

First, weakening oversight of the financial system. The proposed legislation would weaken oversight of the financial system by eliminating the ability of the Federal Reserve to supervise systemically important nonbank financial companies, undermining the Financial Stability Oversight Council, abolishing the Office of Financial Research, and fundamentally weakening oversight of banks.

The designation of systemically important nonbank financial institutions is one of the cornerstones of the Dodd-Frank Act, and a key goal of reform was to create a system of supervision that ensured that if an institution posed a sizeable risk to the financial system it would be regulated, supervised, and have capital requirements that reflected its risk, regardless of its corporate form, whether a bank holding company, investment bank, insurance conglomerate, finance company, or whatever. Shadow banking gets a free pass today.

The bill would also weaken Fed oversight of the biggest banks. The Fed provides for a graduated, tailored system of enhanced prudential measures that increases in stringency with the size of the firm.

None of these enhanced measures apply to about 95 percent of banks, the category commonly described as community banks, those with under $10 billion in assets. Exempt are more than 6,000 banks in communities all across the country.

Yet, to benefit huge Wall Street titans the proposed legislation offers up a simple option to be exercised at the discretion of Wall Street firms. A 10 percent leverage ratio gets big firms like Goldman Sachs and Wells Fargo out of heightened supervision by the Fed.

That is a big mistake. It lets Wall Street choose whatever approach is the least constraining even if it means bigger risk for the rest of us. That is choice for Wall Street, pain for American families.

None of these changes will help hometown banks. Instead, small banks could benefit from safe harbor rules and plain-language versions of regulations that do apply to them, as well as longer exam cycles and streamlined reporting requirements.

Second, eliminating orderly liquidation. At the height of the crisis Lehman collapsed in bankruptcy, AIG was bailed out, and President Bush and Congress stepped in to pass the Troubled Asset Relief Program.

In response, Dodd-Frank authorized an orderly liquidation authority so that our economy would never again be exposed to those horrible choices. Whatever the merits of bankruptcy reform, the bill would foolishly rely solely on the hope that bankruptcy judges could manage the failure of a firm like Lehman.

Orderly liquidation has three essential features not replicable in bankruptcy: first, it is part of an ongoing system of supervision; second, the FDIC can provide liquidity; and third, the FDIC can coordinate globally to deal with the failing financial firms. Bankruptcy just can't match that.

Last, undermining consumer and investor protection. Congress created the consumer agency to protect people from harmful and abusive financial practices. In just 6 years the agency secured $12 billion in relief for more than 29 million consumers. Yet, the bill would cripple the agency, needlessly harming American families.

In sum, the proposed legislation crushes investor hope, it mocks investor opportunity, and it undermines the transparency, honesty, and trust essential for capital formation.

Thank you very much.

[The prepared statement of Mr. Barr can be found on page 93 of the appendix.]

Chairman HENSARLING. Mr. Pollock, you are now recognized for 5 minutes for your testimony.

**STATEMENT OF ALEX J. POLLOCK, DISTINGUISHED SENIOR FELLOW, THE R STREET INSTITUTE**

Mr. POLLOCK. Thank you, Mr. Chairman, Ranking Member Waters, and distinguished members of the committee.

Of the many provisions in the CHOICE Act, my discussion will focus on three key areas: accountability; capital; and congressional governance of the administrative state.

Mr. Barr mentioned community banks. We should hear from them.

A good summary of the results of the Dodd-Frank Act is supplied by the Independent Community Bankers who say, "Community banks need relief from suffocating regulatory mandates. The exponential growth of these mandates affects nearly every aspect of community banking. The very nature of the industry is shifting away from community investment and community-building to paperwork, compliance, and examination."

Now, that is certainly not what we want, but it is what we have because when Dodd-Frank was enacted the urge to overreact was strong and Dodd-Frank expanded regulatory bureaucracy in every way. This was in spite of the remarkably poor record of the government agencies as they helped inflate the housing bubble—a vivid lesson of crisis so well pointed out by Peter Wallison—and in spite of the obvious fact that the regulatory agencies have no superior knowledge of the financial future, as all of us know, because nobody does.

Accountability is a central concept to every part of the government. To whom are financial regulatory agencies accountable? Who is their boss?

The answer to both these questions is, of course, the Congress.

All of these agencies of the government, populated by unelected employees with their own ideologies, agendas, and ambitions—and the CFPB is the best example of that—must be accountable to the elected representatives of the people who created them, can dissolve them, and have to govern them in the meantime. All must be part of the separation of powers and the system of checks and balances, and this includes the Federal Reserve, as appears in the CHOICE Act.

As the president of the New York Federal Reserve Bank testified on the 50th anniversary of the Fed, "Obviously the Congress which set us up has the authority and should review our actions at any time they want to and in any way they want to." And that seems to me entirely correct.

Under the CHOICE Act such reviews would happen at least quarterly. The chairman mentioned in his opening statement that people have seen their savings decimated. I would like to suggest that for the Federal Reserve reviews with Congress, the Congress should also require the Fed to produce a savers' impact statement quantifying and discussing the effects of its monetary policies on savers and saving.

The most classic and most important power of the legislature is, of course, the power of the purse. The CHOICE Act, accordingly, puts all the financial regulatory agencies under the democratic discipline of congressional appropriations. This notably would end the anti-constitutional direct grab of public funds which was granted to the CFPB and which was designed precisely to evade the democratic power of the purse.

I believe the CHOICE Act is an excellent example of the Congress asserting itself at last to clarify that regulatory agencies are derivative bodies accountable to the Congress. They cannot be sovereign fiefdoms—not even the dictatorship of the CFPB and not even the money-printing activities of the Federal Reserve.

Turning to banking, the best-known provision of the CHOICE Act is to allow banks the very sensible choice of having substantial equity capital—to be specific, a 10 percent or more tangible leverage capital ratio—in exchange for the reduction in onerous and intrusive regulation. Such regulation becomes less and less justifiable and less and less sensible as capital rises, and more capital for less intrusive regulation is a rational and fundamental tradeoff.

It seems to me the 10 percent leverage capital ratio, conservatively calculated, as proposed in the CHOICE Act, is a fair and workable level.

As a final comment, the CHOICE Act makes positive changes to the FSOC, but FSOC or anybody's forecasts of the unknown financial future are hard to get right and are unreliable. So higher capital is a better protection than another 10,000 pages of regulations.

I hope the committee will promptly advance the CHOICE Act, and thank you for the chance to be here.

[The prepared statement of Mr. Pollock can be found on page 137 of the appendix.]

Chairman HENSARLING. Dr. Cook, you are now recognized for your testimony.

**STATEMENT OF LISA D. COOK, ASSOCIATE PROFESSOR, ECONOMICS AND INTERNATIONAL RELATIONS, MICHIGAN STATE UNIVERSITY**

Ms. COOK. Chairman Hensarling, Ranking Member Waters, and members of the committee, thank you for the opportunity to testify today about the Financial CHOICE Act of 2017.

In the winter of 2008, when I was teaching macroeconomics at Michigan State University, I looked out my window one evening and saw a line of students snaking around the corner and down the street from the building across the way. It was not a typical line of boisterous students waiting to purchase something like football tickets. The mood was somber and no one was talking.

I approached a colleague to ask what was happening. He said it was a line for the food bank.

Students who lost their jobs and funding were going hungry. No wonder the scene was so jarring. It was straight out of Dorothea Lange's iconic photos of the Great Depression.

Many of these students had to drop out of MSU to support their families. And this was happening in my lifetime, on my campus, to my students and their families.

It was also happening to many students and families across the country.

Recall that the recession began in December 2007. This is the time when the auto industry was bleeding jobs. It lost 31 percent of its workforce between 2008 and 2009.

In Michigan the number of foreclosures nearly doubled between 2008 and 2009, and that was after having quadrupled between 2005 and 2008.

With one in seven jobs tied to the auto industry, the country was more broadly losing more than 700,000 jobs per month. Ultimately, the economy would shrink by 8.9 percent that quarter—the last quarter of 2008.

Anyone witnessing this would have said "never again" to the job losses, "never again" to the disruption in families and communities, and "never again" to the irresponsible lending and financial practices accompanying these undesirable outcomes.

Among those irresponsible financial practices was that banks were placing bets with public money. If they won, bank profits would soar and bank managers and owners would be paid; if they lost, American taxpayers would pay through deposit insurance or direct government bailouts.

The banking system, the banking business model, and their impact on people and the economy all required the examination. The Dodd-Frank Wall Street Reform and Consumer Protection Act was one legislative response intended to reassure taxpayers and to signal to regulators and financial institutions that this would never happen again.

As a law constraining lending and therefore economic growth, my calculations suggest that this is not the case. If higher capital requirements constrain lending and, therefore, economic growth, we should see a fall in both since the passage of Dodd-Frank in 2010.

Instead, we see both increasing. According to the latest data available, commercial and consumer loans grew between 0.5 percent and 12 percent annually since 2012. Household debt at the end of 2016 stood at $12.6 trillion, which is only 0.8 percent shy of its $12.6 trillion peak in the third quarter of 2008. The economy has expanded 0.2 percent and 6.7 percent each quarter since the first quarter of 2011.

Does the Federal Reserve require more oversight? No.

The kinds of provisions being proposed in the Financial CHOICE Act resemble financial reforms implemented in many of the emerging markets in developing countries I have advised or researched to disastrous effect and would undermine the credibility of the Federal Reserve.

This would be okay if we were a small island nation with no financial transactions and no interaction with the outside world. But we are the largest economy with extensive financial ties to the rest of the world, and this would not be appropriate for us.

In conclusion, this body should say "never again" to the wild, bleak days of unfettered consumer and bank finance. It should say "never again" to the losses in houses, firms, communities, hope, and opportunity that the recent financial and economic crisis brought. It should declare "never again" by engaging in thoughtful financial reform and rejecting many provisions of the Financial CHOICE Act.

[The prepared statement of Dr. Cook can be found on page 109 of the appendix.]

Chairman HENSARLING. Ms. Peirce, you are now recognized for your testimony.

**STATEMENT OF HESTER PEIRCE, DIRECTOR, FINANCIAL MARKETS WORKING GROUP, AND SENIOR RESEARCH FELLOW, MERCATUS CENTER, GEORGE MASON UNIVERSITY**

Ms. PEIRCE. Chairman Hensarling, Ranking Member Waters, and members of the committee, thank you for the opportunity to be part of today's hearing.

As Dr. Cook's poignant description of the financial crisis illustrates, what the financial system does and how it is regulated really matters for the rest of the economy. And so it makes sense periodically to look at the financial system and look at how it is regulated and take another look to see whether it is working as it should.

I think that improvements can be made and the CHOICE Act offers a number of improvements that will make the financial system work better for the rest of the economy. I will talk about some of the improvements today.

First of all, good rules require good process. Without good process and without accountability you don't get good rules.

The CHOICE Act makes a number of improvements to make sure that rules that are imposed on our economy are done through notice and comment rulemaking. It also takes an important step of requiring that the financial regulators conduct economic analysis.

This exercise is designed to ask, "What problem are we trying to solve," to look at different potential solutions to solve those problems, and then to look at the costs and benefits associated with each of those potential solutions; and to build into a rulemaking metrics so that you can go back 5 years later and say, "Is this working as we intended it to work? Is it achieving the goals that we intended it to achieve?"

And the Financial CHOICE Act also builds on the economic analysis requirement by then requiring that Congress take a look at rules when they are final and consider again whether they want those rules to go into effect. The value of doing this, especially with an economic analysis in hand that might alert Congress to unintended consequences, is huge. This gives an important measure of accountability.

Another important measure of accountability is the new requirement that financial regulators be appropriated as other agencies are. It is very important to have this level of accountability.

Another important piece of the Financial CHOICE Act is the attempt to shut off avenues for bailouts.

One such example is the elimination of Title VIII of Dodd-Frank. Title VIII was the companion to Title VII, which deals with over-the-counter derivatives. Title VII moved a lot of over-the-counter derivatives into central clearinghouses, and as the drafters of Dodd-Frank realized, doing this might just create the next too-big-to-fail entity.

And so the solution to that concern was to create the Federal Reserve as backstop for these clearinghouses. That creates terrible incentives.

So eliminating the backstop will force regulators and market participants to concentrate on risk management and to also think about the important questions of recovery and resolution. What happens when there is a problem at a clearinghouse? There are some discussions of this issue already, but taking away Title VIII would focus the mind on these discussions further.

And then another important part of financial regulation, which the CHOICE Act recognizes, is the need to allow the capital markets to work. We need to allow investors and companies to meet in the capital markets in ways that are mutually beneficial, and the CHOICE Act opens up new avenues for investors and companies to come together.

It also addresses another important problem, which is that many companies don't go public anymore, which means that investors can't participate in the growth unless they are accredited. The CHOICE Act makes a change in this by allowing more investors to qualify as accredited, but it also looks at the problem of why companies aren't going public, and it seeks to reduce some of the burdens associated with being public. These burdens are not associated with a benefit to investors, and so the CHOICE Act pulls them back.

The bottom line is that regulatory reform needs to work for consumers, investors, and Main Street companies. That is the objective of financial regulatory reform. And I believe the CHOICE Act has many elements that further these objectives.

Thank you very much.

[The prepared statement of Ms. Peirce can be found on page 130 of the appendix.]

Chairman HENSARLING. Mr. Allison, you are now recognized for your testimony.

**STATEMENT OF JOHN A. ALLISON, FORMER PRESIDENT AND CHIEF EXECUTIVE OFFICER, CATO INSTITUTE**

Mr. ALLISON. Thank you, and good morning. I appreciate being asked to testify.

At the time of the most recent financial crisis I was the longest-serving CEO of a major financial institution in the United States: BB&T. My company went through the financial crisis without a single quarterly loss. I had the unique experience of being in a key decision-making position in a bank during the last three financial crises: the early 1980s; the early 1990s; and the most recent crisis.

Unfortunately, in my view government policy unquestionably was the cause of the financial crisis. Two primary components of the government action created the crisis.

First was housing policy, which Peter Wallison described well. Second were errors by the Federal Reserve—two categories: one, monetary policy; and two, regulatory policy.

In terms of monetary policy, in the early 2000s we were having a minor correction that we needed. Unfortunately, in response, the Federal Reserve created negative real interest rates. You could borrow less than the rate of inflation which was a huge incentive for people to borrow.

It created bubbles in housing, but it also created bubbles in the commodities market, in the stock market, and in car finance that led to the failure of the car industry. You can't have all those bubbles without the Federal Reserve making mistakes on monetary policy.

On regulatory policy the Fed incented risk-taking. You could have half as much capital for a loan to a subprime lender as you could for Exxon. Nothing could incent risk-taking more than that.

In addition, the Federal Reserve and other regulatory agencies did a terrible job handling this crisis in comparison to the other two. They made two meta-mistakes.

First, they created a huge amount of ambiguity. In the past they had strategies. This time was totally arbitrary.

They saved Bear Stearns, failed Lehman Brothers; they failed Wachovia, they saved Citigroup. When Washington Mutual failed they covered the uninsured depositors and they took it out of the hide of the bond-holders instead of out of the FDIC insurance fund. Markets can't deal with ambiguity.

Secondly—and this is huge and under-discussed—how they handled the credit issue was big during this crisis. In the past what they did was cause small banks that were in trouble or big banks that were in trouble to fail. They let the bad banks fail but they let healthy banks like BB&T keep doing their lending.

This time they saved the unhealthy banks and forced the healthy banks to stop making loans. It was bizarre.

What happened? BB&T was forced to put thousands of borrowers out of business that we would not have put out of business, that would be creating jobs today. But unfortunately, tragically, they have continued with this pattern after the correction.

It has particularly been destructive in what I call venture capital small business lending, because they are obsessed with mathematical modeling. In venture capital small business lending, a lender makes a judgment of the individual's character, not just the numbers.

That is what I started out doing in the banking business. And fortunately, I helped a number of companies get started that have created hundreds of thousands of jobs.

We can't make those kind of loans today.

That doesn't start out as a big loan because it doesn't get to a big loan until the company gets big. So these loan growth numbers are very distorted because what is happening—you can study the numbers—is there has been a massive increase in assets going to large companies and the government at the expense of small companies and lower-income and moderate-income consumers.

Dodd-Frank has caused consolidation in the industry—it has deprived startups of capital; it has destroyed innovation; it has led to less competition; deterred small business, low-income, and average consumers; and slowed economic growth.

For those of you who are concerned about safety and soundness, why would you believe regulators know how much risk we ought to take? They just caused this last crisis.

In my career, regulators always overreact. They encourage too much risk in good times, and too little risk in bad times, which is what they are doing today. They don't have any magic wand.

Markets do a much better job of risk management. I think it is ironic that the regulators have actually increased systems risk by trying to reduce risk at individual institutions. Some banks should be failing. Businesses are failing all the time. They are forcing everybody to take the same risk, which increases systems risk.

Capital is a far better protector of risk. Highly capitalized banks very seldom fail, primarily because it puts some real skin in the game. You know, I had a lot of BB&T stock. I cared how BB&T did.

When people put capital in the game, they care. And if you allow institutions to have little capital, like Citigroup basically had no capital when they effectively failed, they are going to take a lot of risk.

I think it is ironic that the institution that caused the biggest trouble, the Federal Reserve, has more power out of this crisis. And I also think it is ironic that a lot of people who are concerned about consumers are on the same side as Wall Street banks.

Listen, the Wall Street banks love Dodd-Frank because they have achieved regulatory capture. In my career they always capture the regulators, and that is exactly what they have done in this case.

Thank you for listening.

[The prepared statement of Mr. Allison can be found on page 90 of the appendix.]

Chairman HENSARLING. Thank you, Mr. Allison.

And thank you all, members of the panel.

The Chair now yields himself—

Mr. CLEAVER. Mr. Chairman?

Chairman HENSARLING. —5 minutes for questions.

Mr. CLEAVER. Mr. Chairman, a parliamentary—

Chairman HENSARLING. Who seeks recognition?

For what purpose does the gentleman from Missouri seek recognition?

Mr. CLEAVER. A parliamentary—

Chairman HENSARLING. The gentleman will state his inquiry.

Mr. CLEAVER. Mr. Chairman, because a lot of people are coming in and out trying to go to other committee hearings, I am just—well, first of all, let me thank you for having the hearing. We have had other major pieces of legislation, that have gone through didn't go through regular order, so I appreciate this.

But this is a huge piece of legislation, and I am just hoping that we could have more than just one hearing—

Chairman HENSARLING. If the gentleman would state his point of order?

Mr. CLEAVER. The point of order is—

Chairman HENSARLING. Parliamentary inquiry.

Mr. CLEAVER. Yes. I'm sorry. It was a parliamentary inquiry.

And my inquiry is will there be additional hearings due to the significant nature of this legislation and how huge the bill is? We had—I can't remember—40-something, I think, hearings on Dodd-Frank and—41—and I would hope that we could have—we probably don't need 41, but I hope we can have more than just this hearing.

Chairman HENSARLING. I am not sure the gentleman has stated a proper parliamentary inquiry. Nonetheless, by the chairman's count, over the last 3 Congresses we have now had 145 different hearings on the Dodd-Frank Act and aspects of the CHOICE Act.

Having been here during Dodd-Frank, I don't remember a single hearing on the combined Dodd-Frank Act, but I assure the gentleman from Missouri that we expect to have even further hearings in this Congress to monitor all aspects of banking, of financial capital, the Dodd-Frank Act, and the CHOICE Act.

So, yielding to—

Ms. WATERS. Will the gentleman yield? Will the gentleman—

Chairman HENSARLING. For what purpose does the ranking member seek recognition?

Ms. WATERS. To seek a clarification of whether the gentleman asked about Dodd-Frank or the CHOICE Act. Are you saying you have had 145 hearings on CHOICE? Are you combining the two? What are you referring to?

Chairman HENSARLING. Again, the gentlelady doesn't pose a parliamentary inquiry. So if the gentlelady wishes to pose a parliamentary inquiry, the Chair will entertain it.

Ms. WATERS. Thank you very much, Mr. Chairman. I shall continue with the gentleman's question about whether or not there will be additional hearings based on the complexity of the wrong choice act?

Chairman HENSARLING. Okay. Well, again, by our count, we have had a 145th hearing on the problems of the Dodd-Frank Act, and I plan to have dozens more hearings on the negative impact of Dodd-Frank on the American people and the economy, and the Minority will certainly be noticed on these hearings.

The Chair now yields himself 5 minutes for questions.

Mr. Wallison, since the passage of the Dodd-Frank Act, the big banks have become bigger and the small banks have become fewer, as I think you well know. Something I am particularly concerned about is a Federal Reserve report entitled, "Bailout Barometer," which indicates that since the financial crisis and the passage of Dodd-Frank, a whopping 62 percent of total liabilities of the financial system are now backstopped by the Federal taxpayer, either implicitly or explicitly.

If I recall right, that is up about a third since the crisis. I am thinking specifically of Title I and Title II, the OLA and SIFI designation process of Dodd-Frank.

Has the designation of too-big-fail-to firms made the economy more stable or less stable, in your opinion?

Mr. WALLISON. In my view, it has made the economy less stable. There are so many reasons why a firm that is declared to be a SIFI is going to cause difficulties for our economy, one of which, of course, is that it gives the impression that the government has declared this firm to be too-big-to-fail, which means that the firm will then be treated by the market as though lending to that firm is without possible adverse consequences, just like Fannie Mae and Freddie Mac, which were, many of us said for many years, treated as backed by the government even though formally they were not.

Because these firms are seen as too-big-to-fail, they will be able to get credit for their activities without having to take the kinds of steps that the market would normally require them to take under market discipline to reduce their risks.

So simply designating firms as SIFIs does increase the potential risk in the economy and in the financial system, and that is one of the reasons why I oppose the designation process. There are several others, but that is one.

Chairman HENSARLING. Dr. Michel, under Title II of Dodd-Frank, the orderly liquidation authority gives the FDIC new broad, sweeping discretionary powers in bailing out financial institutions. It is my understanding that under Dodd-Frank we could look at another AIG-like bailout, where foreign banks could receive 100 cents on the dollar. Is that your understanding, and did you have any concerns on this regarding the orderly liquidation authority?

Mr. MICHEL. That is my understanding. That is a big concern.

I think from a broader perspective, if you want to end bailouts you don't formalize a process where the government can say, "There is no other private alternative so the FDIC is going to handle this." And somehow that is supposedly not a government bailout, not government-funding.

It just doesn't make any sense if you want to end that process, so I have major concerns with that.

Chairman HENSARLING. Mr. Allison, you have the most banking experience on this panel. You mentioned earlier that you were speaking of the role that capital really played in financial stability.

Basel III sets up a risk-weighted asset regime, versus the simple leverage ratio of the CHOICE Act. In your decades of experience as a banker and living through three different financial panics, can you kind of contrast and compare the two different models?

And I believe I have seen FDIC data that indicates that 98 percent of all banks at at least a 10 percent simple leverage ratio survived the second-worst financial crisis in America's history, which I suppose would suggest some level of financial stability. But could you expound on your views here, please?

Mr. ALLISON. Yes, sir.

First, I think Basel can be gamed. Before the financial crisis these banks were doing all the risk modeling, the banks that got in trouble, and they gamed the system. And you could easily game the system by how you use the mathematics, what probabilities you put on certain kinds of losses.

Second, it is self-defeating because it puts more capital in certain kind of assets, which means banks are getting more of those assets which drives the risk up in the assets. And the classic example is subprime lending. Banks were required to have half as much capital in subprime loans so you had a lot of subprime lending.

In Europe no capital was required for loans to Greece so Greece got a lot of money.

So when you try to risk-weight the assets you defeat the outcome. For example, up to a few months ago energy lending had less capital and now it has more capital after the fact. The regulators always figure it out after the fact.

Chairman HENSARLING. My time has expired.

The Chair now yields to the ranking member for 5 minutes.

Ms. WATERS. Thank you very much, Mr. Chairman.

Mr. Pollock, in his statement, said that the community banks and States need relief from suffocating regulatory mandates. And I am concerned about whether or not Mr. Pollock and others who talk about community banks are as concerned about community banks as they are about the too-big-to-fail banks.

Mr. Barr, let me ask you, the wrong choice act 2.0 would eliminate restrictions on mergers, acquisitions, and consolidations of banking organizations that choose the off-ramp to regulation as long as the banking organization maintains a quarterly leverage ratio of at least 10 percent.

Would this provision, in addition to the other de-regulatory efforts under the wrong choice act 2.0, potentially allow the largest banks to grow exponentially larger and even more interconnected, which would leave the banking system open to greater vulnerabilities that would trigger another financial crisis?

Mr. BARR. Yes. I believe that provision will further increase concentration at the very top of the financial sector.

It will permit the very largest firms to grow significantly bigger. It may stifle competition both in the mid-sized market and the smaller market, and I believe it will increase systemic risk.

Ms. WATERS. So this is not about protecting community banks. This is about allowing the biggest banks in this country to have that kind of off-ramp.

Ms. Cook, the wrong choice act 2.0 would provide a so-called off-ramp for banks of all sizes, including the trillion-dollar banks on Wall Street, to opt out of all enhanced prudential standards under Dodd-Frank for stronger capital, liquidity, and risk management, as well as Basel III capital and liquidity requirements if they meet a 10 percent leverage ratio requirement. Because regulators recently noticed that they are working—regulators have already said that they are working on simplifying capital requirements for community banks.

Is it appropriate to roll back these important rules for Wall Street at this time? What are we doing here?

Ms. COOK. I didn't quite hear the end of your question but I think I got the gist of it.

Certainly giving the supervisors and the regulatory authorities less power, having them collect less data, I think would be detrimental to our financial system not just in the United States but to avert the next global financial crisis. Again, I was saying that the provisions of the CHOICE Act would be appropriate if we were a small island nation that didn't interact financially with other nations, but for the largest financial system for the largest economy in the world this would be inappropriate.

Ms. WATERS. Mr. Barr, getting back again to this discussion about community banks, we hear a lot about wanting to protect community banks, wanting to get rid of the regulations that are causing them so much pain. But we find they are doing quite well. Their profits are up, et cetera, et cetera, et cetera.

Would it be reasonable to conclude that this is really about the big banks in America and providing them the opportunity to not have the oversight and regulation that we have put together in Dodd-Frank reform that would avoid another recession, almost depression, that we went through?

Mr. BARR. Yes, I completely agree with that. I think if the issue were a focus on community banks we would be debating in front of us a bill on community banking. But that is not the bill we are debating.

We are debating a bill that takes on really all the post-financial crisis reforms, that weakens oversight of the biggest banks, it weakens oversight of the shadow banking system, it makes it much more difficult for consumers to get their day in court, it blocks consumer protection that helps families across the country. So this is not a community banking bill that we are discussing today.

Ms. WATERS. And does this open up the door for more acquisitions and reduces the big banking community to instead of five or six banks maybe three in this country?

Mr. BARR. I wouldn't want to guess about the exact structure, but it certainly eases restrictions at the very largest firms to engage in merger and acquisition activity irrespective of concerns about financial stability. And the other measures that are undertaken in the bill suggest significantly less oversight of those firms with respect to stress testing and the process for resolution planning.

So I do think that the very largest firms are going to benefit a great deal under this legislation.

Ms. WATERS. You were around when we went through the meltdown in 2008 and you know how scary it was. And we did not know what to do. We ended up with this bailout. Should we go through that again? Do we have to go through that again with—

Mr. BARR. Mr. Chairman, I see I am out of time. May I respond?

Chairman HENSARLING. Quickly.

Mr. BARR. I don't think we can afford to go through that kind of crisis again, and the orderly liquidation authority and the prudential measures put in place were designed to prevent the kind of problems of bailouts in the future. I think it would be a mistake to repeal them.

Ms. WATERS. Thank you very much.

I yield back.

Chairman HENSARLING. The gentlelady yields back.

The Chair now recognizes the gentleman from New Mexico, Mr. Pearce, chairman of our Terrorism and Illicit Finance Subcommittee, for 5 minutes.

Mr. PEARCE. Thank you, Mr. Chairman.

And thanks to each one of you for your presentations today.

Mr. Allison, you appeared to be in the eye of the hurricane while the hurricane was going on. I am going to refer a question. There are two different narratives that always pop up when we are in these kinds of hearings.

One is well-stated by Mr. Wallison, where he describes in his text that the enactment in 1992 of the Affordable Housing Goals caused the underwriting that Fannie and Freddie were compelled to take those on. If that underwriting had not been available then the implication is that banks would have stayed in their lane, but since they could get rid of the loans then the system just got out of control.

The other narrative is that the big banks were somehow evil and then without any support at all just went out and did these things on their own.

You were in the eye of the hurricane. Can you give a perspective on how this actually developed—a brief perspective, please?

Mr. ALLISON. Yes, sir.

There is no question that government policy caused it. Freddie and Fannie were the giant providers of credit in the marketplace;

they dominated the market because they had government implicit guarantees so they had the lowest cost of capital.

BB&T had been a mortgage portfolio lender requiring a 20 percent downpayment. We were driven out of that business, as were most other banks.

The regulators wanted banks, they wanted Wall Street, to do subprime lending. But a lot of people who blame the banks were the people who actually forced banks to do subprime lending because we didn't want to do that, most of us, because we were lending other people's monies and banks really shouldn't be doing subprime lending.

Mr. PEARCE. And then the big banks, seeing the opening, said in order to get more of these loans in this area we will give bonuses. But if the banks could not have gotten rid of those loans then how many of the big banks would have had incentives for—where they were going to eat the loan if they couldn't resell them to a government-backed enterprise?

Mr. ALLISON. They wouldn't have.

Mr. PEARCE. Yes. Okay. Thank you. I appreciate it.

Mr. Wallison, you say that Fannie and Freddie were—you hint that they were compelled. Were they actually compelled through legislation, or pressure, or how, that Fannie and Freddie changed their underwriting standards? How did that compulsion look and feel? Was it legislation?

Mr. WALLISON. The Affordable Housing Goals was legislation. The Department of Housing and Urban Development was given authority to raise the goals. The original goals were 30 percent of all mortgages they bought in, in any year, had to be made to people who were at or below median income where they lived. HUD raised those goals to 56 percent.

Now, you can say Fannie and Freddie could have ignored that, but they couldn't. These regulations from HUD were binding on Fannie Mae and Freddie Mac, so they had to find those mortgages.

Mr. PEARCE. Okay, so—

Mr. WALLISON. You can't find prime mortgages if more than half of all mortgages you are allowed to buy are made to people who are below median income.

Mr. PEARCE. Okay, so of the two narratives, that the evil institutions caused it and greed caused it, versus the government regulators and congressional law, that is clear.

Now, we also hear, Mr. Allison, that the community banks have exceptions. There are exceptions to the rule. Mr. Barr said that in his testimony.

Why don't those exceptions work out? Because my bankers, the community bankers in rural New Mexico with 4,000 and 5,000 people in a town, are livid about Dodd-Frank and livid about the CFPB. Why aren't those exceptions in place? I know they are written into the law, but how does that work out?

Mr. ALLISON. Community bankers are adamantly opposed to Dodd-Frank, and I know many of them, and the reason is it is nice to say the regulators can make an exception, but if you are a regulator and you make an exception and your bank gets in trouble, you will get blamed. So in fact, most of the Dodd-Frank provisions are hurting community banks.

And you can raise the level and all that, but the community banks are not going to really be exempt because the regulators are just human beings. They don't want to get in trouble if their bank gets in trouble, so they go and apply basically the same rules to community banks they provide to big banks.

Mr. PEARCE. One of the witnesses, and I forget which one, talked about having firefighters put out fires, and it made me think about the forest in New Mexico. The Forest Service regulating the forest began to quit cutting trees. They stopped cutting trees about 60 years ago or whenever.

And so typically trees in New Mexico are about 50 trees per acre; now we have 5,000 stems per acre, and the fires break out and they are catastrophic fires, and so the Forest Service now says we need more firefighting money. What we needed is to stop letting the trees grow to start with. And so it looks like a very close parallel to what should have been done here.

I yield back, Mr. Chairman. Thank you.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentlelady from New York, Mrs. Maloney, ranking member of our Capital Markets Subcommittee.

Mrs. MALONEY. Thank you.

I think it is important that we remember why we passed Dodd-Frank in the first place. We did it because our country experienced the worst financial crisis since the Great Depression: 8 million people lost their jobs; 6 million people lost their homes. The crisis destroyed over $5 trillion in wealth for the middle class—their savings, their pensions, they just evaporated. And overall, over $13 trillion in household wealth in this country was lost.

But with better regulation and with the tools that we put in place in Dodd-Frank, we can prevent this type of devastating financial crisis from happening again. So it is important not to go backwards, which the wrong choice act does.

So my first question is to Professor Barr.

One of the main ways this bill, in my opinion, goes backwards is by repealing Dodd-Frank's orderly liquidation authority. I find this provision deeply, deeply, deeply troubling.

The creation of the resolution authority for large nonbank financial companies like AIG and Lehman was one of the most bipartisan ideas in Dodd-Frank. In fact, it was originally proposed by the Republican-appointed Treasury Secretary, Hank Paulson, and it was supported by the Republican-appointed Fed Chair, Ben Bernanke, and the Republican-appointed FDIC Chair, Sheila Bair.

It is important to remember that the FDIC has long had the authority to resolve commercial banks outside of the bankruptcy process. And all Dodd-Frank did was give the FDIC the authority to do the same thing for large nonbank financial institutions.

This was very important because when many of the big nonbank financial institutions were on the verge of collapse, we had only two choices: chaotic, disorderly bankruptcy, like Lehman, which went under; or a bailout, like AIG. Neither was a good choice.

Dodd-Frank gave the regulators a third option: an orderly wind-down that prevents a government bailout but does not harm the overall broader markets.

But now the Majority has somehow convinced themselves that this longstanding FDIC authority is some type of evil new taxpayer bailout. In their minds, allowing the FDIC to take away a failing financial firm, fire the management, wipe out the firm's shareholders, impose losses on the firm's creditors, and completely liquidate the firm, that, in the Majority's mind, somehow constitutes a bailout.

So my question is, Professor Barr, is the orderly liquidation authority in any way, shape, or form a bailout?

Mr. BARR. No, it is not. The orderly liquidation authority actually is the opposite. It provides a realistic chance of winding down a firm or a set of firms in a financial crisis to avoid the kind of bailouts and also chaos we had in the fall of 2008.

And so if you look overall at the legislation we are considering now, the Financial CHOICE Act, in my judgment, would move toward bailouts, move us away from the system of orderly liquidation that was put in place in Dodd-Frank. I think that is quite dangerous both for taxpayers and to the financial system.

Mrs. MALONEY. I agree. So I want to ask you again, what would happen if the Majority is successful in erasing the orderly liquidation authority?

Mr. BARR. I think that it would make it more likely that in the next financial crisis Congress and the President would be faced with the same horrible choices they faced in 2008, and I think it will mean that we will see more bailouts and more chaos in financial markets. So it will be the worst of both worlds.

We are going to get more taxpayer bailouts and more harm to the economy, and that is why I think it would be a serious mistake to repeal orderly liquidation.

Mrs. MALONEY. And the living wills. If the orderly liquidation authority is repealed, making a traditional bankruptcy the only option for a failing financial institution like AIG and Lehman, would that make living wills more important—would it make them more important or less important?

Mr. BARR. I think it would make it even more important to have a very robust resolution planning process with living wills, with simplification of holding company structures, and with the other sets of supervision undertaken.

Mrs. MALONEY. So why in the world would the Majority want to make bankruptcy the only option?

Chairman HENSARLING. Brief answer.

Mr. BARR. I believe that it would be a serious mistake to rely only on the bankruptcy courts. I think it should be an option, but not the sole option for dealing with a failing firm.

Chairman HENSARLING. The time of the gentlelady has expired.

The Chair now recognizes the gentleman from Missouri, Mr. Luetkemeyer, chairman of our Financial Institutions Subcommittee.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

I ask unanimous consent to enter into the record statements from the Electronic Payments Coalition and the Independent Community Bankers of America, and I have a statement, as well.

Chairman HENSARLING. Without objection, it is so ordered.

Mr. LUETKEMEYER. And it is kind of interesting that the Community Bankers—they represent 6,000 community banks—support the CHOICE Act, which, if Professor Barr is really interested in the big banks going through and supporting something, they do not support the CHOICE Act, and I haven't spoken to a single one that supports this. And you wonder why they would want to give up their implicit guarantee from the Federal Government. So I don't know where that statement came from, but it defies the facts.

With that, Mr. Allison, you have testified with regards to the capital ratio here a couple of times already this morning, and I want to just follow up with regards to something that Mr. Barr said again. He said that the CHOICE Act offers a simple option to be exercised at the discretion of Wall Street firms at a 10 percent leverage ratio, that it takes big firms like Goldman Sachs and Wells Fargo, out of the heightened supervision of the Fed.

If you actually look at what happens if they get to that point, you are looking at $430 billion that is added to the capital structure of these big banks. Do you think that is a giveaway to Wall Street?

Mr. ALLISON. I do not.

Mr. LUETKEMEYER. Do you think that this improved capital leverage ratio would be detrimental to financial stability and economic growth?

Mr. ALLISON. I think it would substantially reduce financial risk far more than more regulations, and I think it would be good for growth because banks would be more rational when allocating capital to the most productive ends because they would be lending more of their own money.

Mr. LUETKEMEYER. Thank you.

Mr. Pollock, you also mentioned some things with regards to this. It would seem to me that it would—any time you put the private sector dollars on—or at risk versus the taxpayers' dollars at risk, that would seem to me to be a preferential situation than what the capital leverage ratio, this 10 percent ratio, actually does because suddenly if the owners of the institution have their own money at risk they are going to be a little bit more, I would think, discretionary about how they run that institution, versus if they know that the taxpayers are going to bail them out regardless of what decision they make it would, I would think, enhance risky behavior.

Can you comment on that?

Mr. POLLOCK. Congressman, I completely agree. I talked about that as accountability, putting up more capital. There is also the issue, as Mr. Allison said, of "skin in the game" in your own business, being actually at risk in the business you do. There are provisions in the act which give relief to the small lenders who actually operate on a skin-in-the-game basis in their mortgage lending, which I think is a very good idea.

Mr. LUETKEMEYER. I know that Mr. Allison also made a comment with regards to the community banks and regulations, and on your testimony you also made that comment that it would be very beneficial to help them be able to survive. I assume that is what you think?

Mr. POLLOCK. I think that without question, intrusive and extensive regulation falls disproportionately heavily on smaller organizations. That is true every place, but it is also true with banking. The bigger banks can create bureaucracies to face off against the government bureaucracies; the smaller banks are strangled by that same bureaucracy, and that is in their own words, as you point out, Congressman.

Mr. LUETKEMEYER. Mr. Michel, one of the things that Dodd-Frank did was give the authority of the unfair, deceptive, and abusive acts and practices situation to—authority, anyway—to the CFPB. The key word there is "abusive." Has anybody ever defined what "abusive" is? Has the CFPB ever defined what "abusive" is?

Mr. MICHEL. No. And Director Cordray has actually said that it would be a bad idea for them to define abusive practices and said that we should just look at these things on a case-by-case basis. So we know that they are not unfair, we know that they are not undeceptive, but they are something else and we will figure that out as it happens.

Mr. LUETKEMEYER. Wow. That is like putting police in charge and then saying, "Well, they can decide what is a crime and what is not a crime." Is that basically a good analogy?

Mr. MICHEL. Yes. That is hardly the rule of law, yes.

Mr. LUETKEMEYER. I know we have a bill to do just that very same thing. And in this CHOICE Act is something to basically do that, as well.

Mr. Wallison, before I go away here, you make a couple of comments with regards to the slow economy and part of it being done as a result of Dodd-Frank. Former Fed Chair Alan Greenspan last week made the comment that if we did away with Dodd-Frank it would spur the economy. Would you like to just—a quick 10-second comment on that?

Mr. WALLISON. I didn't hear his comment, but I would say that the problem is that Dodd-Frank has caused such a decline in the number of small banks that it is very hard for small businesses that rely on small banks to get the kind of financing that would keep our economy going.

Mr. LUETKEMEYER. Okay. Thank you.

I yield back.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from California, Mr. Sherman.

Mr. SHERMAN. Mr. Chairman, I reiterate my plea that we vote on these bills separately so that members of this committee have a choice. There are 12 bills that the CHOICE Act has swallowed up that have the support of half or more of the Democrats and half or more of the Republicans of this committee, and we ought to be moving those bills separately.

Of particular importance are the Preserving Access to Manufactured Housing Act and the Mortgage Choice Act. These bills will pass this committee overwhelmingly if we bring them up separately.

We are told that it is the government's fault, overregulation. But you cannot say that overregulation caused the panic of 1814, the panic of 1819, the panic of 1837, the panic of 1839, the panic of 1857, the panic of 1861, the panic of 1873, the one of 1893, or October 2000—rather 1907. And overregulation did not cause the Great Depression, nor did it cause the 2008 Great Recession.

We are told that Fannie and Freddie were making loans that the private sector, at least those not subject to HUD regulations, would never make. But it was the credit rating agencies that gave AA and AAA ratings to Alt-A loans that Freddie and Fannie wouldn't touch, and to loans that did not meet Fannie and Freddie's standards.

And, Mr. Chairman, your bill eliminates the last vestiges of already unenforced Franken-Sherman to regulate the credit rating agencies. As long as they have a high rating to bad bonds, whether they are mortgage or otherwise, portfolio managers almost have to buy them.

How does a portfolio manager say, "Well, the guy across the street is getting a 7 percent return on AA-rated bonds but I prefer a 6 percent return because I don't trust the credit rating agencies?" How am I supposed to invest in Vanguard if T. Rowe Price is giving me half a percent more and their bond portfolio is AA-rated, just as the Vanguard one is?

The problem we have, the problem that this committee has not fixed, is that the credit rating agency is the only game where the umpire is elected and paid by one of the teams, namely the issuer of the bonds. As long as that happens, you can blame Fannie and Freddie for bonds they never touched that got AA rated, that portfolio managers on pain of being fired had to buy to match other portfolio managers, and we didn't do anything about it.

Mr. Barr, this discussion of a 10 percent capital rate, meaning basically no regulation—do you think it makes sense to allow a business model in which you get a lot of capital or money through FDIC-insured deposits and you are free, as long as you have 10 percent capital, to buy Zimbabwe bonds, high-risk bonds, super high-yield bonds? Would we be opening things up to a business model of 10 percent capital and extreme high-risk debt instruments?

Mr. BARR. I do think it is a mistake to rely on only one form of capital rule. There is not any perfect capital rule.

The 10 percent leverage requirement has a positive attribute for firms where it raises their equity position, but it has lots of downsides as a sole tool, and one of those downsides is that without a measure of the riskiness of assets you are incentivizing the firm both to move items off the balance sheet and also to engage in riskier lending activity, and I think both of those are a problem. And it would also remove the full set of heightened supervision that is enhancing the safety of the firms.

Mr. SHERMAN. All right. Thank you.

And I want to focus on this issue of bailouts. I opposed the first five drafts of Dodd-Frank because they provided permanent unlimited bailout authority. We got rid of those provisions. We do have orderly workout authority.

But, Mr. Chairman, we will have another bailout if we have another 2008 as long as there is an institution big enough to call the White House and say, "We are going down and we are taking the whole economy with us." You know. You were there. You opposed it. I opposed it. But this Congress will pass a bailout bill under those circumstances.

The way to deal with this is the Sanders-Sherman approach: Break up every institution that is over 2 percent of GDP. Otherwise it is just bandaids, trying to pretend we won't have a bailout when we allow too-big-to-fail to exist.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Michigan, Mr. Huizenga, chairman of our Capital Markets Subcommittee.

Mr. HUIZENGA. Thank you, Mr. Chairman.

And I would like to start by asking unanimous consent to enter into the record a letter of support from Duff and Phelps, one of the leading firms in mergers and acquisitions and valuations, specifically on Section 822.

Chairman HENSARLING. Without objection, it is so ordered.

Mr. HUIZENGA. Thank you.

And I want to get to Ms. Peirce here on couple of things. I was intrigued as you were talking about sort of the Title VII and Title VIII, but we may need to revisit that at another time.

What I liked is you used a phrase, I think, where we need to have people meet in the marketplace, is I think the phrase that you used, or something like that. And what we have seen is, I believe, less access to the financial opportunities that are out there that have occurred. And on March 22nd the Capital Markets Subcommittee held a hearing where we had a witness testify that 2016 was one of the slowest IPO years since 2008, and I am curious if you could comment on that.

Ms. PEIRCE. Sure. I think it is a big problem that companies—it is understandable that companies are waiting longer to go public. It is very expensive to be public and so many are choosing not to. And when you become public you subject yourself to litigation risk, and many worry about that.

I think efforts that will lower the cost of being a public company while still ensuring that investors are protected are very important. There are a number of these included in the bill—

Mr. HUIZENGA. Wait a minute. Do you think we can do both?

Ms. PEIRCE. I think it is possible to do both, and I think—

Mr. HUIZENGA. Because if you listen to the rhetoric from the other side it is one or the other.

Ms. PEIRCE. And I think that is what has led us to the place we are in, which is we think of protecting investors in a very specific way, which is just making sure that investors never get harmed. But we never think about the opportunities that we shut them out from participating in. So as a company is growing we want to let investors be part of that growth.

Mr. HUIZENGA. And we are not talking necessarily accredited investors. What happens after an IPO is our retirement funds, us as individuals, no matter what your income or net worth is, are able to go in and take advantage of an opportunity. Isn't that right?

Ms. PEIRCE. Yes. That is why we really need to preserve—it is fine for companies to raise money privately, but we really need to preserve and protect our public markets, as well.

Mr. HUIZENGA. I am concerned that we are not doing that. We have half the number of public companies that we did 20 years ago, and we have only slightly more public companies than we did in 1982 right now. And we have a number of folks who have given testimony in front of this committee at different times about income disparity, and I wholeheartedly agree that that is a problem.

Having a less-than-robust—that may be the polite D.C. way of putting it—economy out there I believe is part of that, and it was not long ago, less than a month ago, that I asked Chair Yellen about the effects and influences on regulation, on our recovery and how shallow it has been, how long it has been, how weak it has been. She literally—look it up on YouTube—stammered and hemmed and hawed for about 3 or 4 seconds and then said she disagreed with that.

We saw just this week former Chairman Greenspan came out and precisely hit the nail on the head by saying we have gone and had this over-regulatory burden, and I see Dr. Cook's reaction is not exactly in favor of that. But this sort of this rosy outlook of where the economy is can't be a straight-faced analysis if you look at the income disparity. And it only seems that when it is in defense of the past Administration that you have people talking about what a great economy we have going on.

In my last minute here I have the Securities and Exchange Commission I believe is the police officer, the cop on the beat that is out there making sure that investors are protected. What we have them doing now under Dodd-Frank and under other so many provisions, though, is we frankly have them being road maintenance. They are filling in the potholes and checking the streetlights when we have them going out and doing things like figuring out rules for CEO pay ratio, rules for having conflict minerals.

Can you explain to me how in the world that is advantageous to protecting an investor when we are out there doing that, when the SEC is required to protect investors; maintain orderly, fair, and efficient markets; and facilitate capital formation?

Ms. PEIRCE. Yes. I think with any requirement that you place on public companies it not only places a requirement on public companies but, as you point out, it requires the SEC to engage in areas in which it doesn't have particular expertise in, is very difficult. The pay ratio rule is one example of a rule that is very difficult to implement in a way that will be meaningful for investors.

Mr. HUIZENGA. And, Mr. Chairman, I think that shows it just pulls their focus away from what they really need to be concentrating on.

With that, I yield back.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from New York, Mr. Meeks.

Mr. MEEKS. Thank you, Mr. Chairman.

And first I want to associate myself with some remarks from the gentlewoman from New York, Carolyn Maloney, because I think what she said was exactly right. Often, people forget where we have come from and what took place in 2007 and 2008, the number of jobs that were lost, how people were devastated, and why that—and that it was, in fact, a Republican Administration that then, on a transition, worked with a Democratic Administration to try to help fix this problem, which is why we came up with Dodd-Frank as opposed to doing nothing at all, so that we can make sure that we protect our system.

In fact, if we are serious about doing this, that is a matter in and of itself because that showed a Republican Administration during a transition making recommendations to a Democratic Administration also on how we can resolve some issues to make sure that we don't get in this—in the worst recession and get out of the worst recession since the Great Depression.

And when we talk about the—in the Obama Administration the economy, as my colleague just talked about, the reason why we did talk about it is because we talked about where we have come from. You just don't change things overnight, and it took hard work to make sure that we got out of losing 700,000 jobs a month to the place where we were at least gaining jobs again, gaining 200,000 to 300,000 jobs a month.

Surely all of us would like it if the past Administration would have said, "We want to gain more jobs," and we would need to do that over time. But yes, I would be rejoicing also as I did as we started beginning to reverse the depths of the recession that we were in.

Now, the other issue that I want to bring up quickly in the time that I have left, Mr. Barr, is this world is interconnected like never before. And I believe in your testimony you talked about how the United States led internationally in regards to Dodd-Frank so that we could make sure that we have some uniformity, et cetera, and therefore there were some agreements internationally.

So my question to you is, can you tell us whether or not the wrong choice act would cause the U.S. to go back on its word on international agreements and how that will affect us, if you will?

Mr. BARR. You are absolutely right. The U.S. really led the effort globally for financial reform really from the start—beginning in the end of the Bush Administration and continuing into the Obama Administration, shaped a global financial structure that made sense for reducing risk in the system.

And I do believe that moving backwards, as the CHOICE Act would do, on orderly liquidation, on designation of nonbank firms in particular, would be a retreat from the global system that has developed in the wake of the crisis to deal with this problem.

Mr. MEEKS. Let me just ask you this because we have folks who are looking at this and screaming, et cetera: Just break that down for me. Break it down in layman's terms so that the average person who is listening—so if we get out of these international agreements, what kind of impact would that have on the average American citizen? That is who I am focused on, what kind of impact would that have on them? Can you, so that they could understand what you are talking about?

Mr. BARR. I think it exposes families to enormous risk of financial abuse in the marketplace. It exposes them to the risk and harm of another financial crisis that was, as Dr. Cook suggested, so brutal for American families in terms of lost incomes, lost jobs, even the ability to have enough food to eat. So if you get these things wrong it can have a brutal impact on how people try and live their daily lives every day.

Mr. MEEKS. Let me go to Dr. Cook quickly because on that same part, Dr. Cook, knowing that you have reviewed the CHOICE Act, what parts of the CHOICE Act—and I know there are a lot that you can choose from, et cetera, but maybe there are one or two in the time that I have left that you might be able to single out—what parts of the CHOICE Act will go directly to the heart of hurting the average American citizen, the middle-class and the low-income households?

What do you think will most be going directly to them? Because that is who I am focused on. I don't care what party you are from, the middle class of America, the low-income who needs the most help. How would this hurt them?

Ms. COOK. I think all of the provisions that weaken the CFPB and weaken the authority of the Federal Reserve to monitor and have oversight and make sure that we don't have the Wild West that we had before the financial crisis, I think this is the most onerous part. We aren't even collecting the information or not allowing—these provisions wouldn't allow collecting the information we need critically to input into our models or even know, understand what is happening in the economy.

We need this information in a timely way, and I think anything that undermines that authority is not a good thing.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Wisconsin, Mr. Duffy, chairman of our Housing and Insurance Subcommittee.

Mr. DUFFY. Thank you, Mr. Chairman.

I think this has been a fascinating debate today and I appreciate the witnesses being here. But it is the conversation that I am hearing some on the Democrat side say, "Well, Dodd-Frank is looking out for the little guy, and the previous system we used to have was to the benefit of the big guy." And maybe to quote Mr. Barr, he said the CHOICE Act now is going to help the Wall Street titans.

I don't know if the panel can see this, but to your left and to your right there are quotes that come up—and behind you are quotes that come up—from Wall Street CEOs. Articles have been written about the CHOICE Act and Dodd-Frank.

And I think it is interesting that the Wall Street titans, Mr. Barr, are in opposition to the CHOICE Act and they are in support of Dodd-Frank. And if I was also to talk to my community bankers, my little credit unions that serve rural Wisconsin, that like to have money from their community go to bankers in their community to then make decisions that benefit their community—those shops, those banks, those credit unions, they are closing up or they are consolidating and the decisions aren't made in that community anymore but they are made in Chicago, or Minneapolis, or Milwaukee, or Green Bay, but no longer in that community.

So I would look at Dodd-Frank and think: The big titans, the big guys, they like it. The little guys, they are getting crushed by Dodd-Frank, which is the exact opposite of what my friends say was supposed to happen.

I would also argue the Democrats, my friends, say that the bigger the bank, the riskier it is to the economy, the more systemic the risk. Does anybody have an opinion whether big banks have gotten bigger since Dodd-Frank or smaller during Dodd-Frank?

Mr. Wallison, do you have an opinion on that?

Mr. WALLISON. Well, the numbers speak for themselves. Yes, the big banks are much bigger—

Mr. DUFFY. Have gotten bigger.

Mr. WALLISON. Much bigger, of course.

Mr. DUFFY. Because they are more—do sometimes complex rules and regulations help big guys, the big titans, and hurt the little guys? Is that a philosophy that you believe in?

Mr. WALLISON. Jamie Dimon, who is the chairman of JPMorgan Chase, the biggest bank in the United States, called regulation a moat, and he is correct about that, because it keeps competition from challenging his bank.

Mr. DUFFY. So Dodd-Frank protects him?

Mr. WALLISON. It weakens the smaller institutions.

Mr. DUFFY. Are you saying that Dodd-Frank actually protects them from competition?

Mr. WALLISON. Yes, it protects them from competition.

Mr. DUFFY. Helping the big titans on Wall Street.

Mr. WALLISON. Yes. It is easy to see, Congressman, because they have all kinds of lawyers and compliance officials and so forth to handle—

Mr. DUFFY. Economies of scale.

Mr. WALLISON. —regulation and spread it over a $2 trillion bank, and the small banks do not, so they are harmed by Dodd-Frank.

Mr. DUFFY. I think one of the most interesting factors when you look at the breakdown of where does the—where do the big titans believe Mr. Barr on Dodd-Frank versus reform in the CHOICE Act there is—look at the Presidential election. Where did big banks and Wall Street give their money? Did they give it to Hillary Clinton, who supported Dodd-Frank, or did they give it to Donald Trump, who wanted to do away with Dodd-Frank?

They voted with their money, and they gave most of their money, Mr. Wallison, to whom? Do you know?

Mr. WALLISON. I think the statistics show that they gave most of it their money by far to Hillary Clinton.

Mr. DUFFY. To Hillary Clinton, yes. So this argument that Dodd-Frank helps the little guy and hurts the big guy is absolutely false. It is a great narrative, but it doesn't work.

You would think that when you have a financial crisis you might actually wait for the Financial Crisis Inquiry Commission, which I think you served on, Mr. Wallison, to come out with its report before you decide, what do we do to fix what caused the crisis, because we now know and now we are going to legislate.

Dodd-Frank passed before the commission even came out with its report. So now the opposition to the CHOICE Act is astonishing to me.

I just want to—Mr. Wallison, I keep asking you questions here, but was it your testimony that government policy created the crisis in housing finance?

Mr. WALLISON. That is exactly right, and it is almost incontrovertible because if you look at the data you can see very clearly that as the Department of Housing and Urban Development required Fannie Mae and Freddie Mac to buy more and more mortgages that were subprime mortgages, that spread to the entire housing finance system. This weakened the system substantially, and when the housing bubble—created by these low underwriting standards—collapsed, we had the financial crisis.

Mr. DUFFY. One more quick question: So if government policy helped created the crisis, is it fair to say that Dodd-Frank doubled down on more government policy? Yes or no?

Mr. WALLISON. That is what we are seeing.

Mr. DUFFY. Absolutely.

I yield back.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentlelady from New York, Ms. Velazquez.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Mr. Barr, I agree with you. There seems to be a case of policy-making amnesia going around this room. I was here in 2008 as our Nation stood on the edge of financial calamity and ruin.

Try telling the victims of the Wells Fargo account scandal that we need less financial oversight, not more. Try telling hardworking families who were preyed upon with deceptive mortgages or cascading overdraft fees that this bill is the right choice for them.

My position is that this legislation before us is the wrong choice for consumers, for small businesses, and our entire community.

Mr. Barr, I am deeply concerned about the impact the CHOICE Act will have on consumers in my district. According to a report from the New York City Comptroller, since 2011 the CFPB has helped more than 23,000 New Yorkers.

For example, in October 2016 a Brooklyn resident filed a complaint against Navient with the CFPB regarding student loan repayment. Because of the Bureau, Navient was compelled to respond and the individual was granted relief. Further, using its enforcement authority, the CFPB sued Navient partially on the basis of complaints just like this to seek relief for other impacted borrowers.

If the CHOICE Act is enacted it will make it harder for the CFPB to work with a company to help resolve a specific issue and severely restrict its ability to take enforcement actions on a person's behalf. So, Mr. Barr, how will consumers like the one I just mentioned continue to be protected in situations like this?

Mr. BARR. I think that the CHOICE Act would bring us back to a situation that we had before the financial crisis where there were insufficient ways to protect American families. In fact, in many ways it would make it worse than what we had before.

I think the act would cripple the new Consumer Bureau and there wouldn't really be anybody standing up for American families on issues like the Wells Fargo scandal, or payday lending, or other abuses in the marketplace. So I think it would be quite a tragedy to see that happen.

Ms. VELAZQUEZ. Thank you.

Mr. Barr, the CHOICE Act repeals the Department of Labor's fiduciary duty rule and makes it extremely difficult for the SEC to ever move forward with its own conflict-of-interest rule. Can you explain how these changes will continue to put Americans at the mercy of unscrupulous financial advisors?

Mr. BARR. I think that if you are offering investment advice you ought to have the same high standard of care of fiduciary duty, where if you are offering individual investment advice to a consumer the consumer can rely on the fact that you are looking out solely for their best interest. That is what the fiduciary duty rule would do, and repealing it would be a horrible mistake.

Ms. VELAZQUEZ. Thank you.

Dr. Cook, the CHOICE Act repeals the Volcker Rule, Dodd-Frank's ban on speculative trading and certain investments in hedge funds and private equity funds at banking entities with access to the Federal safety net. Doesn't this repeal expose taxpayers to losses associated with banks' proprietary trading, which amplifies the costs associated with the crisis?

Ms. COOK. That is exactly right. And as I was saying earlier, with respect to the guarantee that is given any bank, especially if it has depositors, if it is playing with public money then certainly it gets all of the upside and doesn't feel the pain on the downside. So certainly this repeal, I think, would not be appropriate for American consumers.

Ms. VELAZQUEZ. Thank you.

Mr. Chairman, I yield back.

Chairman HENSARLING. The gentlelady yields back.

The Chair now recognizes the gentlelady from Missouri, Mrs. Wagner, chairwoman of our Oversight and Investigations Subcommittee.

Mrs. WAGNER. Thank you, Mr. Chairman.

And thank you all for appearing here today to discuss the merits of the CHOICE Act and the ways that it will help bring accountability to Washington while opening up the economy for Main Street back home.

Something that I specifically want to discuss is the level that the U.S. has outsourced its decision-making and regulation-setting to the international level since the financial crisis.

Mr. Pollock, you reference in your written testimony a September 2014 letter from Mark Carney, Chairman of the FSB, to then-Treasury Secretary Lew regarding whether Berkshire Hathaway should be designated as systemically important. Now, I understand that letter has been made classified by Treasury, but I agree with you, sir, that your statement that the letter should be made available to Congress as well as documents about any possible agreements and decisions made at the FSB level.

Mr. Pollock, going forward should Congress demand the same level of disclosures and transparency regarding these decisions made at FSB as we would in the case of other international economic and trade negotiations in which the U.S. engages?

Mr. POLLOCK. Congresswoman, I think that is a very important provision in the CHOICE Act, just as you say, and that the issue of whether American government agencies like the Fed and the Treasury make deals in international settings, which they then feel compelled to follow when they get back into the American process, is a very important issue. We don't want the International Financial Stability Board telling the United States what to do, in my opinion. So I fully support the transparency and reporting required in the CHOICE Act of the financial regulators, and of course that includes the Fed and the Treasury.

Mrs. WAGNER. Besides the CHOICE Act and the provisions that we have regarding that kind of transparency and accountability, what can Congress do to prevent further outsourcing of U.S. regulatory priorities in international bodies do you think?

Mr. POLLOCK. Congresswoman, I think in general the accountability of regulatory bodies called for in the CHOICE Act, where Congress carries out its duty as the elected representatives of the people to oversee what the bureaucratic agencies are doing, fits in with understanding what may be going on internationally and guiding it.

Mrs. WAGNER. Thank you very much. I couldn't agree more. It is important that the best interests of the U.S. are being represented at the international level with full accountability, full transparency, and disclosure.

Moving on, last week the President signed an Executive Order halting the FSOC's ability to designate nonbank SIFIs while they review the designation process. Through the Oversight and Investigations Subcommittee, which I Chair, we have published a staff report and held a hearing that has shown this process has been both arbitrary and inconsistent in the past.

Mr. Pollock, could you please comment on the prudence of last week's Executive Order?

Mr. POLLOCK. Congresswoman, I remember the hearing very well, which you chaired, and at which I had the honor to speak. I think what the staff study found is quite true, that the FSOC's decisions were inconsistent, arbitrary, and capricious, as the judge said. And it is because the decisions are fundamentally political, judgmental decisions that they shouldn't be delegated to a committee. FSOC is not even a committee of agencies—although it would be under the CHOICE Act—but a committee of individuals who happen to head agencies.

So I think what the Executive Order said, and what the CHOICE Act would provide here, and what your hearing showed, are all correct.

Mrs. WAGNER. Political and judgmental. Sir, should FSOC even have authority to designate these firms? And how does the CHOICE Act help curtail this power that seems to enshrine this status of too-big-to-fail for certain firms?

Mr. POLLOCK. Congresswoman, I concur with the idea they should not have such authority and that we would be better off moving in the direction of the CHOICE Act where they would not have it.

Mrs. WAGNER. Mr. Wallison, should FSOC have this designation authority for nonbank SIFIs?

Mr. WALLISON. Certainly not. FSOC should not have that authority. It has abused that authority so far and it will continue to do so if it is left with that authority.

Unfortunately, they have been implementing in the United States decisions of the Financial Stability Board in Europe.

Mrs. WAGNER. Absolutely correct. Thank you very much for your testimony.

I yield back.

Chairman HENSARLING. The time of the gentlelady has expired.

The Chair now recognizes the gentleman from Missouri, Mr. Clay, ranking member of our Financial Institutions Subcommittee.

Mr. CLAY. Thank you, Mr. Chairman, and thank you for conducting this hearing.

Let me thank all of the witnesses for being here.

We have heard a lot of bank-and-forth from my friends on the other side as well as from the witnesses here, but let me see if I can inject some of the facts before we move forward.

And I have a letter here from the CEO of an American bank, a community bank, who said that, "The lending and credit markets are on a hot streak. Credit card lending is higher than it has been in 6 years and just hit a record high of $996 billion at the end of last year.

"Auto loans peaked at over $1 trillion in the fourth quarter of 2016, up from $634 million in the same quarter of 2010. Mortgage rates fell to 3.65 percent by the end of 2016, down from 4.69 percent in 2010.

"The recession caused by 2008's financial collapse tore apart these industries, left millions of Americans out of work, and obliterated any and all trust in the country's largest financial institutions. We are finally seeing true recovery and growth again under the watchful eye of careful regulatory oversight and in the wake of years of careful policymaking designed to encourage recovery while preventing the country from ever experiencing a crisis of that scale again.

"Yet, even as we watch this progress continue, some Federal lawmakers insist that regulations formed in the wake of the crisis are holding markets back—claims which fly in the face of reality. These lawmakers are demanding a rollback of the Dodd-Frank Reform Act despite the protections it offers to both consumers and our national economy.

"The opponents of oversight and regulation insist the red tape of Dodd-Frank's reforms are driving up mortgage and credit costs for consumers even though the costs are consistently hitting record lows.

"An American Banker piece published recently used the figures above to dispel these falsehoods about the lending industry, proving Dodd-Frank is not holding back opportunities for consumers. In reality, interest rates on mortgages are at a long-term low point; mortgages are being given more freely than at any point since the crisis. Auto lending is already well above pre-recession levels, and auto loan rates are lower than they were in 2010."

And then he goes on to say, "It is difficult to argue with the point that scrapping Dodd-Frank would make it easier for banks to issue credit and loans. However, the protections offered under this law are the only thing standing between consumers and the predatory lending practices which fomented the greatest economic crisis in 70 years.

"Dodd-Frank helps prevent any small handful of banking institutions from holding the keys to the country's economy by limiting investments by banks and forcing accountability to Federal regulators. We are preventing the rebirth of too-big-to-fail institutions."

And this is from the CEO of Amalgamated Bank, which I would like to submit and have it included in the record.

Chairman HENSARLING. Without objection, it is so ordered.

Mr. CLAY. Thank you.

Mr. Barr, do you agree with the writer of this letter?

Mr. BARR. I don't know all the details in the letter itself, but in the biggest-picture sense, yes. I think the lending markets are quite healthy in the United States today, and one of the reasons for that, in comparison to, say, Europe, is that we took swift action in the wake of the crisis to reform and build capital. And I think all of our panelists are saying that more capital is good. We have differences beyond that.

Mr. CLAY. Thank you so much for your—

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Kentucky, Mr. Barr, chairman of our Monetary Policy and Trade Subcommittee.

Mr. BARR OF KENTUCKY. Thank you, Mr. Chairman.

And thanks to all our witnesses for your testimony.

I would note that a number of our witnesses are either lawyers or law professors, and I want to ask you a little bit about Article 1 powers in the Constitution as it applies to the Dodd-Frank law.

As you all well know, Article 1 Section 1 of the Constitution provides that all legislative power shall be vested in the Congress, and we know in law school that they teach us in constitutional law that is known as the non-delegation doctrine, which has been interpreted creatively by the judiciary to allow for delegation to unelected, unaccountable Executive Branch officials over time.

That practice has exploded under the Dodd-Frank law. And in fact, most law is now written by unelected bureaucrats, as opposed to elected representatives of the people here in Congress.

My question to Mr. Pollock and Mr. Wallison: Does the massive delegation of authority to Federal bureaucrats concern you?

Mr. WALLISON. I will go first.

Yes, quite a bit, actually. Take, for example, what the FSOC is supposed to do. The FSOC is supposed to determine whether a particular company at some time in the future, in a time unknown—that could not possibly be known—could, if it collapsed or had material financial distress, cause a financial crisis. In other words, they are being asked to make a decision about something that no one can possibly know.

So of course they struggled with all of this, and when they finally designated MetLife, MetLife went to court and the judge—a district judge here in the city—looked at it and said, "This is not possible. This is arbitrary and capricious."

That is the kind of decision that the Dodd-Frank Act has given to the Executive Branch—and that, to me, is a delegation of legislative authority. Congress should have made those decisions.

Mr. BARR OF KENTUCKY. And, Mr. Pollock, in answering that question, why is it important that key policy judgments be made by those who define legal rules and not by those who enforce the rules?

Mr. POLLOCK. It is the most fundamental constitutional idea, as you suggested in your comments, Congressman, that it is the elected representatives of the people who make law. As I said in my testimony, the regulatory agencies are derivative bodies—derived from the Congress, responsible to the Congress. I am delighted to see the CHOICE Act having the Congress step up to carry out its governance responsibility of these agencies.

Mr. BARR OF KENTUCKY. Ms. Peirce, I appreciate your testimony that good rules require good process. And in reference to the structure of the CFPB under Dodd-Frank, and in reference to the D.C. Circuit decision in PHH, can you tell us a little bit about why the structure of the Bureau and insulating that Bureau from political accountability, why that is a bad idea and how that may produce anti-consumer policies?

And in answering that question could you respond to the refrain we hear from the apologists of Dodd-Frank, the defenders of Dodd-Frank, that, "Oh, we need to insulate the Bureau and the Director from political accountability; it needs to be an independent agency."

Ms. PEIRCE. Yes. The notion that independent of accountability will produce better regulation is false. The PHH case is actually a great example because the underlying facts of that case are fairly stark, so even if you take away the constitutional concerns and look at what was actually done in the case, changing the law midstream, essentially, and applying a retrospective penalty that increased dramatically when it got to the Director's level shows the kind of due process concerns that you can have.

So the idea that one man is going to be able to make consumer decisions for all the consumers in the country is troubling, especially when that person doesn't experience the circumstances that a lot of people experience and doesn't have the limited options that people have. And so from his perspective he may not understand that constraining the options even further is making life even more difficult for people.

Mr. BARR OF KENTUCKY. Let me ask the question this way: Is the public interest—is the interest of the consumers best served by the people's representatives or by those who are fundamentally unaccountable to the people?

Ms. PEIRCE. I think that is what you need to have. You need to have appropriations and you need to have other powers so that Congress can monitor what the agency is doing and bring in the public interest.

Mr. BARR OF KENTUCKY. Thank you for your testimony.

I yield back.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Georgia, Mr. Scott.

Mr. SCOTT. Thank you very much. Mr. Chairman, I was an original cosponsor of Dodd-Frank, and I remember that we had exactly 41 hearings before the House passed its version of Dodd-Frank. But today it seems to me, unless I can be corrected, we have only a single hearing on this issue, and I assume this is it.

I happen to believe that the American people deserve much better than this. This CHOICE Act goes underneath all of the elements of our complex, complicated financial system, and to give it only one day, one hearing, is not fair to the American people.

It doesn't take a historian to remember the amount of jobs we lost. Sometimes we lost as much as 600, 700 jobs a month. Retirement savings of American citizens, millions went down the drain. And the amount of foreclosures was devastating.

And the thing that disturbs me is that this should be a very definitive Republican and Democratic partnership working together. And let me remind the committee and the people of this Nation who might be listening, every major piece of public policy that has been sent forth has had both Democrats and Republicans working on it together.

Social Security started way back, but we had people working on it together. Even our highway system, the interstate highway system, by a Republican President, Dwight David Eisenhower, but they were Democrats and Republicans working together.

I could go on to cite even the Civil Rights Act. It was Democrats and Republicans. And need I say, if it weren't for Everett Dirksen we would never have been able to pass some of this legislation.

So I just wanted to set the stage on that because I don't think there has been any Democrat on this side of the aisle who has reached over to that side of the aisle and worked together. And I want to appeal to the chairman that before we move this bill out, to have some additional hearings, and I think the American people certainly deserve that.

But I do have some very, very pressing concerns. One is the capital requirements, Title I under this act, to bring about this area of accountability and to simply base it upon certain data that has been collected that might not be the case—the off-ramp, audits deemed the Fed, which would handcuff the Fed.

So in my last minute, Dr. Cook and Mr. Barr, you all touched upon this. Am I right about what I am saying?

Dr. Cook, and then Mr. Barr?

Ms. COOK. You are absolutely right about what you are saying. There is a lot of forgetfulness about the effort that went into fighting this financial crisis.

And I am not sure I understand from the conversation. There is a lot of disparagement of economists and expertise and people who have been working on these tools for a long time.

I guess I am the only macroeconomist here. Maybe I feel under siege.

We work very hard. These people who are being described as bureaucrats who are undemocratically making these decisions, they are just Ph.D. economists who want to do a good job, who think about the spirit of public service. So I think that they would be interested in making sure that the system was safe and sound and stayed that way.

Mr. SCOTT. Thank you.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Florida, Mr. Posey, for 5 minutes.

Mr. POSEY. Thank you, Mr. Chairman.

Mr. Wallison, an important yet perhaps overlooked provision of the CHOICE Act would limit donations made pursuant to settlement agreements to which certain departments or agencies are a party. Section 393 of the Financial CHOICE Act would prohibit Federal financial regulators from using settlement proceeds to make payments to third parties who are not harmed by the wrongdoing that led to the settlement.

That seems like a no-brainer, and I think the vast majority of American people believe that when the government enters into these settlement agreements, those funds are reserved solely to compensate the actual victims.

But as we learned from the previous Administration, that is not always the case. Over $3 billion—"billion" with a "B"—in settlements has been pilfered from victims and sent to special interest groups since 2014.

For example, the National Council of La Raza, the controversial left-wing advocacy group, received $1 million in grants under a mortgage lending settlement despite not being harmed by the activity in question. Community development groups and other political allies of the previous Administration have also benefitted from these settlements, receiving de facto Federal funding without the approval of Congress.

Because enforcement agencies cannot unilaterally disperse settlement proceeds to third parties, they have instead directed the banks to donate funds to various groups as terms of their settlement agreements. And even worse, the previous Administration actually incentivized companies to donate to unharmed third-party groups by doubling the credit such donations would have toward paying down their settlement obligations.

In these situations the consumers, the victims of the alleged wrongdoing, end up losing because funds would have otherwise gone to them.

Mr. Wallison, beyond the moral and ethical questions of this practice, can you discuss the constitutionality of these settlement slush funds and whether or not this practice violates, at least in principle or spirit, the appropriations power reserved for Congress and, therefore, the separation of powers? And finally, do you believe this provision in the CHOICE Act is an appropriate step toward correcting this problem?

Mr. WALLISON. Yes, Congressman, I do. I think this is something that this committee should be quite concerned about.

There was an investigation by The Wall Street Journal last year—a very thorough investigation—to find out what happened to over $100 billion in settlements that the government had made with the large financial institutions, and they found that $45 billion of that went to the victims but they could not determine and did not determine how it went to the victims, because I suspect that there weren't lawyers from the Justice Department standing on street corners taking applications. I suspect that what happened is that most of this money went to people who said they represented the victims and would make sure that the victims were suitably reimbursed.

I think this is a serious problem because that money should have belonged to the American people and should have been appropriated by Congress. And I am quite unhappy with the way that whole process was looked at by the previous Administration.

Mr. POSEY. Yes. I know I tried to get copies of some consent decrees to try and follow the money and the Justice Department refused to provide me the information. To this day I am still unable to get it. I am glad The Wall Street Journal at least could get some of it.

Dr. Michel, in keeping with the important check that the power of the purse provides Congress, the CHOICE Act would subject the CFPB to regular appropriations. As you know, currently the CFPB requisitions money from the Federal Reserve to fund its operations. Congress cannot review or direct how the CFPB uses that money.

What inherent problems are there with allowing an agency to avoid Congress' power of the purse? And conversely, what are the benefits of ensuring agencies must justify their spending to the people's representatives in Congress during the appropriations process?

Mr. MICHEL. I think it is important to know that any and all Federal agencies should be directly accountable to the people through their elected representatives. So any process that keeps them—or that puts anything in between that and that slows that process down or makes that process more difficult is bad.

The FTC is a good example historically of an agency that was reined in by Congress through the appropriation process when they were doing what they were not supposed to be doing, and I could envision how that could happen again with something like the CFPB, were it the case that those protections were in place. And it is very important. It is the only mechanism that the people have.

Mr. POSEY. Thank you.

Thank you, Mr. Chairman.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Massachusetts, Mr. Lynch.

Mr. LYNCH. Thank you very much, Mr. Chairman, and to the ranking member, as well.

And thank you, to our witnesses, for your willingness to help the committee with its work.

I have to admit, I am very concerned with this bill that we are discussing today. I have to say that the Financial CHOICE Act of 2017 is probably the worst bill that I have seen in my time in Congress. And I am not new.

But it is a compendium of just bad, bad ideas. It is actually breathtaking in the naked purpose of this bill, to benefit the big banks in this country at the expense of the American taxpayer.

I have to give you credit, Mr. Chairman and my colleagues on the other side of the aisle. I have never seen so many bad ideas jammed into one bill. This is really an accomplishment. I am not sure you should be proud of it, but the bill is what it is.

This essentially repeals Wall Street reform, okay? And I was here when the market went in the toilet, and I am familiar with the reasons why it did so. I am a Democrat who voted against the bailout because there were folks in my district who didn't even have a bank account and we had to give the people who caused the problem billions and billions of dollars at their expense.

And now we are going to go back and do the same thing again. And we are just about out of the—there are some towns in my district that haven't yet climbed out of the last recession and we are paving the way to the next one. It is just a very, very bad idea.

So this bill repeals the Volcker Rule, which stops banks from gambling with taxpayer money and depositors' money. It repeals the orderly liquidation authority, which was a mechanism that we adopted to prevent future bailouts and which would allow any mega financial company to fail in a way that didn't damage the wider economy.

Mr. Barr, I appreciate you being here and your thoughtfulness, as well as Dr. Cook.

Mr. Barr, as you know, Section 901 of this legislation repeals the Volcker Rule. And there is a study that was authored by the International Monetary Fund which disclosed that 73 banks identified currently as systemically important by the Basel Committee on Banking Supervision account for nearly two-thirds of global assets, according to this study. These institutions pose management challenges and are very, very difficult to regulate, supervise, and resolve in an orderly manner in the event of a failure.

And I ask you, what would the repeal of the Volcker Rule do to the ability of regulators to manage the risks in the financial system due to the proprietary trading, and sponsoring hedge funds, and other risky activities? What would that do?

Mr. BARR. I think it would make it much harder to manage those firms, harder to supervise them, and harder to resolve them if they got into trouble. So I think these kind of structural barriers that slow down the transmission of risk from one institution to the other can be effective as long as you are sure to regulate the shadow banking system and not say, "Well, as long as it is going on over there we don't care about it."

So if you have a system that really regulates both banks and shadow banks, I think those kinds of structural separations can be quite useful, including the Volcker Rule.

Mr. LYNCH. Thank you.

Dr. Cook, do you have any thoughts on that?

Ms. COOK. No more than what my colleague has said.

Mr. LYNCH. Okay.

The same people who tried to kill the Consumer Financial Protection Bureau want to put the funding necessary for that agency subject to the appropriations process. So they have already tried to kill it; now they want the ability to defund it.

Any idea what the ramifications of that might be if that were to come to pass, as this bill suggests, Mr. Barr?

Mr. BARR. I think it would be a mistake to put the CFPB under appropriations. I think the system we have for the OCC and the Fed and the FDIC insulating it from the appropriations process is appropriate, and I think the CFPB should be treated the same.

Mr. LYNCH. Dr. Cook, do you have any feelings on that?

Ms. COOK. I just agree.

Mr. LYNCH. Okay. Very good.

All right. I have 20 seconds left. I just want to say what a horrible bill this actually is.

It is amazing. I hope that people are paying attention in their home and they understand what is going on in this committee. It affects every home and business in America today, and you should pay attention to this stuff.

Thank you. I yield back.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from California, Mr. Royce, chairman of the House Foreign Affairs Committee.

Mr. ROYCE. Thank you, Mr. Chairman.

Mr. Allison and Dr. Michel, I just want to follow up on the questioning from my colleague, Mr. Duffy. And my primary concern, I will just explain here, has to do with the regulatory weight that we have placed on community banks, on smaller financial institutions, on the credit unions, and so forth.

And simply due to economies of scale we have put them at a significant disadvantage so that the smaller the institution, the larger the disadvantage, which is a backwards equation. And I think any of us who have talked to our local community banks understand this.

And my question for you is, what is the real-life impact thereby on a borrower seeking a loan? We were all onboard, of course, with increased underwriting standards, no more low-doc or no-doc loans. But it seems that we have moved closer to what we would all consider a utility model here.

We are not letting bankers be bankers. We have moved to sort of a utility model that puts increased regulatory burden on local banks and credit unions—they are not the ones that created the crisis—while at the same time taking away the one advantage that they had over their competition because they knew their own customers. So if they were going to be allowed to be bankers they could work out the loans. Not when you have this kind of regulatory environment.

So let me ask that question: How does the current regulatory environment created by the current version of Dodd-Frank affect constituents in Southern California who are seeking a loan?

Mr. ALLISON. There is no question that it makes it more difficult for banks to do their traditional what I call small business venture capital lending, which was the core of their business. That is where they—you look at the financial information, but you judge an individual, the market, and the idea.

The Federal Reserve has put intense pressure on mathematical modeling, which a lot of these loans don't make it, and a lot of loans that I made that have turned out very successful wouldn't have happened.

In addition to the direct cost, I grew up in a small bank and the CEO has to do a lot of this regulatory stuff himself. And the CEO provides a disproportionate amount of the intellectual talent in a small bank, and if he or she is spending her time—their time doing regulation instead of out in the community looking for opportunities to make the community grow then you have a really serious misallocation of resources, and you see that in a lot of small communities today.

Mr. ROYCE. Or if you have performing assets.

Mr. ALLISON. Yes.

Mr. ROYCE. And the regulatory approach here says, "Write them off."

Mr. ALLISON. Definitely. And it hurts the growth in those communities. I think it is a big problem for small communities.

Mr. ROYCE. There is another aspect to this that I have worried a lot about, and that is because of the economies of scale they are going to be ripe for being bought by the larger financial institutions. Wouldn't that over time—and I think this was Mr. Waller's argument some years ago; I heard him lay out this case that if we are worried about over-leverage, why would we create a situation where the burden on the smaller institutions is such that they are going to be bought out by larger institutions who then will be in a position without the competition to further over-leverage? And that is the kind of over-leverage we were really worried about in the first place.

Let me ask you about that.

Mr. ALLISON. Yes, sir. I think that definitely happens.

And one of the ironies, we have made it so hard for banks to start because ultimately what has been happening in the community banking industry is some community banks are getting—

Mr. ROYCE. So that is why we are not seeing any new banks or credit unions.

Mr. ALLISON. They can't get started.

Mr. ROYCE. Yes, yes.

Well, a quick follow up. My colleague, Mr. Williams, has introduced a bill that would encourage greater use of CFPB 1022 exemption authority. Do you believe that Director Cordray has correctly interpreted the Bureau's authority and used it appropriately to prevent over-burdening small community banks, smaller credit unions?

Mr. ALLISON. No. In theory community banks are supposed to be exempt, but in practice they are not, and that is just the way regulators act. They are not going to exempt community organizations.

Mr. ROYCE. I was going to ask Ms. Peirce, I was hoping you could also put to rest the idea that the AIG was a failure only of Federal regulation of the financial products unit. You have researched the role AIG securities lending program and the failure of State regulation on this front had, and maybe you could opine on that for just a second?

Ms. PEIRCE. Yes. AIG was about much more than just derivatives, which people like to portray it as. There was a failure of the State insurance regulators, as well. And so the solution in Dodd-Frank was not appropriately tailored for the actual problem at AIG.

Mr. ROYCE. Thank you.

Thank you, Mr. Chairman.

Chairman HENSARLING. The time of the gentleman has expired.

The gentleman from Minnesota, Mr. Ellison, is recognized for 5 minutes.

Mr. ELLISON. All right. Thank you, Mr. Chairman.

Thank you, to the ranking member.

Mr. Wallison, I have a question to you. On your role as a member of the Financial Crisis Inquiry Commission you continually claimed that Fannie Mae and Freddie Mac were responsible for the financial crisis. My question to you is—I would like to ask you about a July 13, 2011, report published by the Committee on Oversight and Government Reform.

The report was entitled, "An Examination of Attacks Against the Financial Crisis Inquiry Commission," and I ask unanimous consent to submit the report for the record.

Chairman HENSARLING. Without objection, it is so ordered.

Mr. ELLISON. On page 11 of the report it says that you used your position on the commission to promote a theory supported by Representative Issa and put forth by Edward Pinto, a resident fellow at the American Enterprise Institute, that was ultimately rejected as flawed by every other member of the commission—namely, that government housing policy was the primary cause of the government's economic crisis. The report also notes that your fellow Republican commissioners thought you were really just a "parrot for Pinto."

I guess my question is, you are offering your testimony here so that, I guess it could be believed, but how do you react to your fellow members of the commission making the observations that they made about your work?

Mr. WALLISON. I don't want to really refer to my work, but I can refer to the commission and I think my work will stand up over time. You can also look at my book on the subject, "Hidden in Plain Sight"—

Mr. ELLISON. Okay. Thank you for your answer.

Mr. WALLISON. —which—

Mr. ELLISON. I think that is—

Mr. WALLISON. Wait a minute. Wait a minute. I do think—

Mr. ELLISON. No, it is my time, and you have sufficiently answered. Thank you.

Mr. WALLISON. Am I not entitled to answer what you just—

Mr. ELLISON. You have answered.

Chairman HENSARLING. The time belongs to the gentleman from Minnesota.

Mr. ELLISON. Thank you.

Also, Mr. Wallison, was your compensation at the time you served on the commission or after your service tied in any way to you magnifying the beliefs of Mr. Pinto?

Mr. WALLISON. No.

Mr. ELLISON. Okay.

Also, did you receive a warning from the General Counsel that you violated the confidentiality requirements to serve on the Financial Crisis Inquiry Commission?

Mr. WALLISON. I received a statement by the members of the commission that I had not observed the confidentiality requirements of the commission at one point.

Mr. ELLISON. Okay. And how do you respond to the observation that you had confidentiality expectations that you didn't meet?

Mr. WALLISON. I don't think they were applicable to me.

Mr. ELLISON. Okay.

Dr. Cook, could you talk about the—there has been a lot of discussion around the role that Fannie and Freddie played in the financial crisis of 2008. And as I look at the CHOICE Act—or the wrong choice act—I couldn't find anything that addresses Fannie and Freddie directly. Did you see anything?

Ms. COOK. I have seen something. Bostic and coauthors, in I think it was 2012, had a paper—an extensive paper, so this is

Raphael Bostic, who is now the president of the Atlanta Fed, but a colleague from the University of Southern California, who looked into this in depth to see what the role was, and it didn't—it said that it didn't have an outsized role in forcing this financial crisis. So I think that I would agree with what you are intimating by your question.

Mr. ELLISON. Okay. But in the bill that is before us—and I would encourage Mr. Barr to offer his views—I was looking through the bill. I try to read all the bills. I didn't see any provisions directly bearing on Fannie and Freddie.

If it is such an enormous problem and it caused so much damage, you would think that it would focus on—the CHOICE Act—the wrong choice act would focus on it, and yet I did not see where the CHOICE Act addresses fixing the problems of Fannie and Freddie.

Mr. Barr, would you like to comment on this?

Mr. BARR. I am not aware of any provision of the act that takes on the question about the future of Fannie Mae and Freddie Mac. There are—

Mr. ELLISON. Well, wait a minute.

Mr. BARR. —things around the edges.

Mr. ELLISON. It is a huge problem and it caused all the catastrophe. Shouldn't they be the central focus of this legislation?

Mr. BARR. I was surprised that it was not a central part of any approach here.

Mr. ELLISON. That is all the time I have and I want to thank the entire panel, including you, Mr. Wallison.

Thank you very much.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Illinois, Mr. Hultgren.

Mr. HULTGREN. Thank you, Mr. Chairman. And I just want to say thank you for all of your work, Mr. Chairman, in getting us to this point.

And I want to thank everyone on the panel for being here, as well.

Before I get into my questions, Mr. Wallison, I wanted to see if you wanted a minute to respond to anything from the previous question. I wanted to offer that first, if there is anything that you want to respond; you weren't given much of a chance to answer.

Mr. WALLISON. I wasn't.

Unfortunately, the Financial Crisis Inquiry Commission was a poorly run operation and all of us, the members, did not see all the data that the staff of the commission had. We did not get a copy of the report until—the final report, until 9 days before it was supposed to be published.

After the commission ended I was able to go back and look at some of the files that they had, and I found that much of the material they had in their files and the material that they ignored supported the position I had been taking all along, which was that the financial crisis was caused by government housing policy.

I have since written a paper that is available on the AEI website, and anyone could have a look at that to see how the commission distorted the facts in order to achieve something that they wanted the—they wanted Congress to follow up.

Mr. HULTGREN. Thanks.

I do want to direct my first question to Ms. Peirce, if I may. I understand there is some consternation regarding Section 844 of the CHOICE Act. I would like to use this opportunity to clear up some of those concerns.

One purpose of this provision is to update the resubmission thresholds and holding requirements for shareholder proposals to prevent only those proposals with very little or no support from continuing as a nuisance every year after they have already been denied by the vast majority of other shareholders.

For example, I can't believe investors need for Boeing to adopt health care reform proposals, for Mondelez to report on gender equality through the entire supply chain, for McDonald's to educate the American public on the benefits of genetically modified products, or for Archer Daniels Midland to adopt and implement a comprehensive sustainable palm oil policy.

These social objectives, for which I agree there could be some merit in addressing, have nothing to do with investor protection or capital formation.

The resubmission thresholds in the CHOICE Act I think are reasonable. They were actually proposed by SEC staff in 1997 under the leadership of a Democratic appointee, Arthur Levitt.

The Association for Corporate Secretaries testified in the Capital Markets Subcommittee last year that, "The so-called failure rate under the 3-6-10 threshold of 1997 would compare to current voting patterns under 5, 15, 25 percent."

So all of that, am I missing something here? Is there—the purpose of our securities law is for job creators to constantly respond to proposals with almost no support? Shouldn't the SEC be focused on capital formation and real investor protection, not social issues? And furthermore, from an investor protection standpoint, if people feel very strongly about these social issues don't they have the choice to invest in other companies that they feel are addressing these concerns?

Ms. PEIRCE. Yes. Shareholder proposals have become a big consumer of resources, both of SEC staff and of company resources. And ultimately shareholders pay the cost, and so putting in—revisiting the resubmission thresholds is one way to make sure that investors are not paying for companies to respond to these each year.

Mr. HULTGREN. Ms. Peirce, on page two of your written testimony regarding administrative procedure you highlight some of the reforms the CHOICE Act proposes for the SEC. In general, can you discuss the importance of the rule of law for accountability in the investigation and enforcement process of this agency? Furthermore, wouldn't it be logical to also make identical reforms to the CFTC?

Ms. PEIRCE. Yes. I think due process is not only valuable for the target of an enforcement proceeding, but also for our country as a whole to know that when an agency pursues an individual for a violation that it is following all the proper procedures and affording all the proper protections. And so I think that some of the changes that the CHOICE Act makes do this and could be extended to other agencies, as well.

Mr. HULTGREN. Mr. Wallison, there has been some concern about the lack of clarity between proprietary trading and permitted activities such as market-making and hedging. How do you draw the distinction between proprietary trading and market-making and hedging, and what are the consequences of not having the clear distinction between the banned proprietary trading and permissible market-making? Have any of the regulators addressed these concerns?

Mr. WALLISON. The problem is that you cannot draw a line effectively between proprietary trading and market-making. That caused many years of dispute among the regulators who were supposed to draft the appropriate regulation.

They finally put one out, but it still hasn't solved that problem. The two look very much alike when you consider what they are. And as a result, banks, in an excess of caution, have stopped doing what they should do to make markets.

Mr. HULTGREN. My time has expired. I yield back. Thank you, Mr. Chairman.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Maryland, Mr. Delaney, for 5 minutes.

Mr. DELANEY. Thank you, Mr. Chairman.

My questions are for Mr. Wallison, but before I start I want to comment on Mr. Allison's testimony, which I thought was very thoughtful. I have long thought that in the rating of banks the "C" in CAMELS and the "M" in CAMELS should be way over-weighted relative to the other categories because capital does solve many problems.

I am not sure I agree with your conclusions. I don't think the reason we have had such tepid economic growth is because of banking regulations.

Recognizing, however, that we should be doing things to provide relief to community banks, and parts of FSOC I think are overreaching, and there are clear things we should be doing to this regulation to get more at the spirit of what you laid out in your comments. But I thought they were very thoughtful.

And, Mr. Wallison, I think my question to you kind of ties into my colleague from Minnesota's question, which is the reason we are not fixing Dodd-Frank, which is what in my judgment we should be doing, any time we do a transformative piece of legislation, whether it be health care or financial regulation, the Congress should sign up for 10 years of fixes, right, because we shouldn't presume we got it right on the day we drop the bill, and we haven't been able to do that with Dodd-Frank.

And I think the CHOICE Act is also a step backwards in that direction. I would much rather this committee be focused on fixes to Dodd-Frank as opposed to repealing it.

But the repeal seems to be based on two premises: first, that Dodd-Frank has caused us to have reduced economic growth since it was put in inception. I don't buy that argument. I think U.S. banks have generally done pretty well. They have gained market share relative to their foreign competitors; liquidity in U.S. markets is quite strong.

However, small community banks have clearly been, in my opinion, hurt by the law and they are not providing credit at the levels they could in the market. But if you look at the percentage of the market small community banks have, and even if you were to assume they were to be providing 50 percent more credit, it wouldn't move the needle that much, in my judgment.

But the other premise is that somehow the government caused the financial crisis and, therefore, if that is true then the government shouldn't be responding to it. And that is where I have issues with your testimony because you seem to believe that the reason the financial crisis occurred was because of the U.S. Government. And you said that in your testimony.

And so my question to you is, 19 of the 20 largest financial institutions that existed in the United States right before the financial crisis either failed or required a massive injection of government capital—19 of 20. It is hard to trace what actually caused the financial crisis, but it is clear that one thing was a main contributor to it, and that is that the market—the private market, whether it be the credit rating agencies, risk managers in private financial institutions—and the government, whether they be regulators or these quasi-government institutions, Fannie and Freddie, had a view that mortgage securities were as safe as U.S. Treasuries because they were treated almost interchangeably on the balance sheets of these financial institutions, which caused excess leverage in the system.

How is that the fault of the U.S. Government?

Mr. WALLISON. This is a very complicated question, but—

Mr. DELANEY. No, it is a simple question: How did the government somehow kind of put the private market in a trance that mortgage securities were as safe as U.S. Treasuries? How is the government responsible?

Because clearly the market thought that because they leveraged them accordingly, they repackaged them accordingly, and they treated them accordingly. How was that the government's fault?

Mr. WALLISON. The underwriting standards of Fannie and Freddie were forced down by the Affordable Housing Goals. When you reduce underwriting standards you cause a bubble to start growing. Let me give you an example of that.

Mr. DELANEY. So you think the private market doesn't have any responsibility for determining whether underwriting standards have been reduced and whether, in fact, mortgages are riskier? You think that is the government's problem?

Mr. WALLISON. Fannie and Freddie set the underwriting standards for the housing finance market because they were by far the largest buyers of mortgages. So if you wanted to compete in that market you had to make the kinds of mortgages that Fannie and Freddie wanted. That is why the underwriting standards of the entire market declined.

Mr. DELANEY. So it is the government's fault that market participants engaged in irrational business practices for competitive gains?

Mr. WALLISON. It wasn't irrational because Fannie and Freddie were buying these mortgages. They were happy to buy them. And you could profit from making these mortgages and selling them to Fannie and Freddie and also FHA—

Mr. DELANEY. But a lot of mortgages were bought by things other than Fannie and Freddie. They were bought by securitized instruments.

Mr. WALLISON. Yes, that is—

Mr. DELANEY. At the peak of the financial crisis 18,000 securitizations had received a AAA rating. Only eight corporations in the world had a AAA rating. So it took the history of the world and all the corporations in the world and eight of them made it to a AAA, yet 18,000 mortgage securitizations had a AAA rating.

Mr. WALLISON. Well, now you are talking about the rating agencies. That is a whole other story. But the fact is that the—they used a model—

Mr. DELANEY. But you are assuming the government made the rating agencies misunderstand—

Ms. WATERS. Mr. Chairman, unanimous consent for the gentleman to have 1 more minute?

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Florida, Mr. Ross.

Mr. ROSS. Thank you, Mr. Chairman. I thank you very much for holding this important hearing.

I firmly believe that we must enact many of the important reforms contained in the CHOICE Act. We need to unlock financial growth and opportunity once again in this country.

I support the provisions of this bill that increase accountability of both Washington and Wall Street. For example, I support repealing the Department of Labor's flawed and misguided fiduciary rule.

I support the provisions of this bill that would help financial institutions, especially smaller institutions that have had too many burdens placed on them over the years. I support the provisions that require the restructuring and accountability of the CFPB.

Yet, there is a provision of this bill that I must express my concerns about, and that is the provision that would repeal debit reform. I have heard directly from a broad spectrum of the retail community in my district, and even from my manager at Publix Supermarket in my hometown where I shop, about the need to maintain debit reform.

Just last night I had the opportunity to sit down with an old friend, Wogie Badcock, III, who is the executive vice president of public affairs for Badcock Home Furniture and More. Wogie is in the room today and he is here because of the importance of this debit reform to his family furniture business, which was started in 1904 by his grandfather.

The savings that they have realized from debit reform has allowed them to hire more employees, open more new stores and distribution centers, and even pass along some of the savings to consumers, benefiting consumers. In fact, since the enactment of debit reform Badcock Home Furnishing and More has used those savings to open up more than 30 stores in the last 5 years across the Southeast. This is significant.

With that in mind, Mr. Chairman, I would like to take a moment to enter the attached letters from the Food Marketing Institute, the National Retail Federation, the Merchants Payments Coalition, and a joint trade letter into the record that represents 170 national, State, and local trade associations and 900—

Chairman HENSARLING. Without objection, it is so ordered.

Mr. ROSS. Thank you, Mr. Chairman.

I now would like to move on.

For you, Mr. Wallison, I find it really interesting that here we have on FSOC one member—a voting member who has insurance expertise and yet is ignored, is so much ignored that we create this idea that somehow or another in the nonbank financial institutions, such as an insurance company, that they are going to be the subject of a run on an insurance company that is going to lead to the demise.

Would you not agree, then, that we should allow for the best system that we have, which is our State system of regulation, to continue to be that which not only protects our consumers but also allows for solvency and capital requirements to make sure the best products are available for our consumers and not have FSOC being that faux umpire?

Mr. WALLISON. The State system of insurance regulation has been very successful over time. I don't see any reason we would have to change that.

Mr. ROSS. I agree. Well, go ahead.

Mr. WALLISON. As I said earlier, I think the FSOC was simply implementing the decisions of the Financial Stability Board in Europe, which declared AIG, Prudential, and MetLife to be GSIIs.

Mr. ROSS. Yes.

Mr. WALLISON. As a result, they simply put those into effect—

Mr. ROSS. They just rubber-stamped them.

Mr. WALLISON. They were rubber-stamping what the FSB was—

Mr. ROSS. Yes. And we know what the courts have said. And that is good, and I think that is what is very good about this bill is it does away with that.

But let me get back to something that my colleague from Maryland, Mr. Delaney, was just talking about, and that is rating agencies. When we look at too-big-to-fail, when we look at organizations that are so large that they are going to be subject to bailouts from the government, would not a rating agency consider that in terms of them giving them their rating, so much so that they would consider it to the detriment of one that was too small and allowed to fail, that the bigger one, the too-big-to-fail, would have an unfair competitive advantage?

Mr. WALLISON. Yes. That is exactly what happened with Fannie Mae and Freddie Mac—

Mr. ROSS. Exactly.

Mr. WALLISON. —which were not supposed to be.

Mr. ROSS. —mortgage-backed securities and they knew they were backed by the Federal—full faith in the credit of the Federal Government, so why not give them a AAA rating? Why not give them what they want because the Federal Government stands behind it?

And if that doesn't create a disincentive for a strong economy, I don't know what does. It creates the moral hazard that we are here today trying to correct with the CHOICE Act.

Mr. WALLISON. You are completely right.

Mr. ROSS. Thank you. You should tell my wife that sometime.

[laughter]

Mr. Allison, you mentioned earlier in your testimony—and I appreciate your experience in the banking industry, I really do, because I think you did something that was tremendous with regard to the financial meltdown: You withstood it. You withstood it strongly. You didn't have any damage because you did it right.

You had capital requirements. You knew what to do.

But you also mention in your testimony that the regulatory burden imposed by the Dodd-Frank Act has a negative impact on lower-income Americans. Can you expand on this in 10 seconds?

Mr. ALLISON. To the degree that consumer banks are focused on regulations instead of taking care of their customers—or big banks are focused on regulations instead of their customers—the customers get worse service and pay higher prices. At the end of the day, all cost gets passed to the customer.

Mr. ROSS. Thank you.

My time is up.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Texas, Mr. Green.

Mr. GREEN. Thank you, Mr. Chairman.

Friends, if you like kickbacks you will love the CHOICE Act because it will allow hardworking Americans to go into a lending institution to acquire a loan and receive an indication that he or she has qualified for a loan at 8 percent when they actually qualified for a loan at 5 percent.

Dodd-Frank ended what was called the yield spread premium, which allowed hardworking people to qualify for loans at a lower rate and be put in a loan at a higher rate, and the person doing it suffered no consequences at all because it was lawful. So if you like that kind of kickback scheme you will love the wrong choice act.

It allowed people to find themselves in a circumstance where they were paying more for a loan than they should have been, there were more defaults than we should have had. It was a bad circumstance that Dodd-Frank eliminated, the so-called yield spread premium, but it really was just another kickback.

If you want to see a real setback then choose the CHOICE Act because the CHOICE Act would allow investment bankers to take your money that you have deposited in a bank, go out to Wall Street and gamble with it, and if they make a profit they get to keep it. They will call it proprietary trading. They will get to keep that profit. And if they lose then the FDIC bails out the bank.

It is a bad bill. It allows hardworking Americans to be ripped off with impunity.

Ms. Cook, would you kindly give your explanation in terms of how the so-called yield spread premium, the kickback, had an impact on hardworking Americans?

Ms. COOK. One manifestation of that was when this was used to put especially African-Americans and Hispanics into mortgages that were actually lower—in lower-quality mortgages than they deserved from their credit score and other information that would have gone into a mortgage decision. So this was absolutely rampant.

We are still finding more cases of that from this period, but yes, it was used in a widespread way.

Mr. GREEN. And actually there is no way to really measure how much damage it did. There is no way to adequately determine the suffering. I see a person of the cloth here. You have no way of knowing how much suffering took place because of this so-called yield spread premium that the CHOICE Act will again allow.

Mr. Barr, explain if you would for us as tersely as possible how allowing investment bankers to take money that hardworking Americans have deposited and use that money on Wall Street, make a profit and keep it—would you explain, please?

Mr. BARR. The Volcker Rule is really designed to try and separate out different kinds of risk in the financial system, so prop trading, short-term trading contributed to some of the problems that the largest firms had, and therefore, when they failed the American people were the ones who ended up suffering from that failure. So that reform, along with other structural reforms, is designed to make it less likely that families will get crushed.

Mr. GREEN. And less likely that deposits that hardworking people place in banks will end up in the hands of an investment banker on Wall Street with a gamble that may or may not succeed, true?

Mr. BARR. I think that it is a bigger reform than that. That is, it is designed to really push that risk all the way outside the bank holding company to really try and separate out the risk so families aren't crushed in the future if we have a huge crisis.

Mr. GREEN. And that is what the Volcker Rule did with—

Mr. BARR. Correct.

Mr. GREEN. —Dodd-Frank. But that is being eliminated, true?

Mr. BARR. Correct.

Mr. GREEN. Okay. Quickly, I remember how bad it was when we were going through the crisis in 2008. It was such that banks would not lend to each other. The banks refused to lend to each other. We had to pass Dodd-Frank and we still need it.

I yield back.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from North Carolina, Mr. Pittenger.

Mr. PITTENGER. Thank you, Mr. Chairman. Thank you so much for hosting this very important hearing of one of many scores of hearings we have had with multiple individuals who have come to testify from the private sector as well as from the academic world, those who have had vast experience.

And I thank each of you for joining us today.

Mr. Allison, I would make special note of my friend from North Carolina, a graduate of North Carolina.

Mr. ALLISON. Thank you.

Mr. PITTENGER. If I recall, you graduated with high honors and the notoriety of the academic institution is only matched by the prowess on the basketball field, so—

Mr. ALLISON. Well, I agree.

[laughter]

Mr. PITTENGER. As well as your education at Duke.

But more important to me of that is 38 years that you have had in the banking business right there at BB&T, and to serve 20 years as the CEO for that institution. And as I have watched you from a close distance, from Charlotte, a major financial center, those of us in Charlotte have the utmost respect for you as the quintessential banker, one who really understood the business, the one who understood the customer, one who valued the importance of good banking.

I was a banker, served on a board of a community bank for 10 years, from the time we chartered until the time we sold the bank. Like you, we were favored with a disciplined approach. We knew our customer and we had very low losses.

You, of course, suffered through the 1980s and the 1990s with great success. You went through this last decade without a loss quarter. That is remarkable.

And so what you bring to the table, to me, really far surpasses all the regulators, the bureaucrats, people, frankly, I think who have good intentions, who come with the right spirit of wanting to address a real problem. But we get down to the bottom line. We get down to the real world of banking.

And for us it was knowing your customer. And you knew your customer. I went in to see you on several occasions just to talk and learn from you during that period of time.

But what I want to ask you today is, what is the impact of what has happened as a result of Dodd-Frank on the broader context. What has happened to that entrepreneur? What has happened to that small business guy who is trying to get started? What is the impact of that in terms of our economy in the future?

Here we are tepidly moving along at 1.5 percent. This is the only period of time since World War II that we never could reach 3 percent. We have had an average of 3.5 percent for the last 100 years in this country of economic growth, and we are just barely moving along.

Look at the future, where we are with our country and where that growth is going to come from, and what is impeding that growth, and how this plays a role into that. Kindly speak to that, if you would.

Mr. ALLISON. Well, unquestionably, healthy banking systems lead to healthy economies. And community banking, even when it is done in a larger organization, is what spurs entrepreneurial activity, because we are basically small business venture capital lenders.

And I saw this—to concretize it—that at BB&T our board, once Dodd-Frank passed, we spent 9 or 10 hours a day on regulation and none on running our business. The regulators forced us to get rid of our community banking model. We were a very decentralized organization, which is one reason we went through the financial crisis without any losses. We had local decision-making with people who understood the markets.

The regulators forced us to centralize our lending authorities just like the banks that failed. So they absolutely forced the model that hadn't worked because they were all academics and they knew all about mathematics; they just never made a loan, and they didn't understand what banks do, and even larger banks that serve their communities.

And the irony is that a handful of Wall Street banks have been the big winner.

Mr. PITTENGER. While I have a few seconds left, give us a forecast for the future. What is going to happen if we don't fix this problem right now?

Mr. ALLISON. You are going to have a lot more consolidation in the industry and basically community banking as a successful business is not going to continue. But I keep hearing people here say community banks are doing so well. Look at their low stock prices—

Mr. PITTENGER. What is going to be the impact on the economy if we don't help this entrepreneur?

Mr. ALLISON. I think it is going to be stuck in slow growth. I think if you don't have entrepreneurship you don't have growth.

Mr. PITTENGER. Thank you, sir.

My time is—

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentlelady from Wisconsin, Ms. Moore, ranking member of our Monetary Policy and Trade Subcommittee.

Ms. MOORE. Thank you so much, Mr. Chairman, and Ranking Member Waters.

And I want to thank this distinguished panel.

I am the last Member on our side here so I apologize in advance for having you suffer through some of the inquiries along the same lines. But I do appreciate getting some clarification on some things.

Mr. Wallison, you and I have talked before about your perspectives and about your views on—your minority views with regard to the financial crisis and its causes. One of the comments that you have made, not only that the fault of this was Freddie and Fannie and CRA, but then you double down today to say that you had done research afterwards and found that your book, which I will be happy to look at, bore all these things out.

And you essentially blamed it on predatory borrowers. Now, I don't know about other people in this room but I have only—I am 66 as of last Tuesday and I have only bought 2 homes in my entire life. And the only reason I have a second house is because I was a State Senator and I didn't live in the district and I had to move when I won the State Senate seat. I sold that house to my daughter.

People don't go and sit down and buy a house every day. So it is amazing to me that you don't think credit default swaps or lax underwriting or CRA rating agencies are at fault, that you think it was predatory borrowers.

But having said that, let me move on and just say that for one thing I—Mr. Chairman, without objection, I would like to enter into the record a letter from former Representative Barney Frank, the former chairman of this committee, his letter to his constituents on the economic crisis.

Chairman HENSARLING. Without objection, it is so ordered.

Ms. MOORE. Thank you.

One of the things that Barney Frank points out in his letter is that from 1991 until 2006, when Democrats took over the Majority, they were trying desperately to stop predatory lending. And that is what we have found is that there is a lot of predatory lending that was involved. It was not predatory borrowers; it was predatory lending.

I also heard you say that Freddie and Fannie underwrote bad loans. Freddie and Fannie do not underwrite loans. They were scammed, as well.

Mr. Barr, let me ask you something. This CHOICE bill proposes to repeal Title I of Dodd-Frank, which governs the role of the clearinghouses. Can you talk to us about the systemic risk that may be involved if we were to pass this bill and to undo Title I, which deals with the clearinghouses?

Mr. BARR. The legislation would dismantle, basically, the process for overseeing and designating financial market utilities, including derivatives clearinghouses, payments and settlement systems, basically the essential backbone of our economy. So it would remove the ability to impose heightened standards; it would remove the ability to provide liquidity in events of distress. And I think that would be a horrible mistake.

It is consistent with the mistake that is made in the other part of the bill that repeals the authority to designate shadow banking firms like Lehman Brothers and AIG—

Ms. MOORE. And what—the impact. I have 1 minute left, so—

Mr. BARR. It will crush the economy.

Ms. MOORE. It will be like when Henry Paulson showed up that day and said, "Give me $700 billion." I don't want to go through that again.

All right. So Title I will be eliminated under this legislation.

Also, if we don't have the Volcker Rule, this will allow federally-backed funds to trade, and it would create some sort of moral hazard. Do you agree with that, if we were to eliminate the Volcker Rule?

There has been discussion of that earlier. Some clarification about what is proprietary trading and what is market-making. I agree we need to hone in on that distinction. But do you think eliminating the Volcker Rule is a good idea?

Mr. BARR. I think that would be a mistake. I agree with you that clarification of the lines, what is clearly in, what is clearly out—gray areas might be handled with capital rules. So I think there are ways of implementing the Volcker Rule more efficiently, but I would not eliminate it by any stretch.

Ms. MOORE. And by the way, 85 percent of all these nonperforming loans were done by non-CRA and non-FDIC-insured banks. Thank you.

Chairman HENSARLING. The time of the gentlelady has expired. For what purpose does the ranking member seek recognition?

Ms. WATERS. Mr. Chairman, I seek unanimous consent to enter into the record 108 letters from groups opposing all or part of the CHOICE Act.

Chairman HENSARLING. Without objection, it is so ordered.

The Chair now recognizes the gentleman from Pennsylvania, Mr. Rothfus, for 5 minutes.

Mr. ROTHFUS. Thank you, Mr. Chairman.

I thank the panel for helping us today understand these various issues.

My first questions are going to go to Mr. Wallison and Mr. Pollock.

As you know, under Section 165 of the Dodd-Frank Act, firms that are subject to the Fed's heightened prudential supervisions or provisions are required to prepare and submit resolution plans or living wills that demonstrate how they can be resolved under the Bankruptcy Code without posing a risk to U.S. financial stability.

Dodd-Frank authorizes the Fed and the FDIC to restrict the business activities of a firm submitting a living will if the firm cannot demonstrate that it can be resolved in a safe and orderly manner under the Bankruptcy Code. If necessary, the Fed and the FDIC, after consulting with the FSOC, may even order a firm to divest assets or operations.

Mr. Wallison, your colleague, Paul Kupiec, has pointed out that the living will process outlined in Section 165 of the Dodd-Frank Act is a recipe for government command and control of private enterprise. He writes, "Living wills are a gateway for regulators to change the company itself. If companies' living wills are not to regulators' liking, regulators can require the institutions to restructure, raise capital, reduce leverage, divest, or downsize. Thus, rejecting a living will gives regulators an opening to restructure the companies themselves.

"This type of regulatory discretion is not uncommon in the world, but it is usually found in banana republics and countries where the government runs the banking system. Such unconstrained authority opens up all sorts of avenues for partiality and government intrusion into a financial institution's operations."

Mr. Wallison, do you share Mr. Kupiec's concern that the vast discretion granted to Federal regulators under Dodd-Frank's living will regime is essentially a license for those regulators to decide the proper size, scale, and business model of private sector enterprises?

Mr. WALLISON. Yes. It seems pretty clear that the legislation allows the regulators to permit or to stop certain kinds of activities by companies that would otherwise be helpful to the market and perfectly legal. So yes, this is a major impairment of the freedom of companies to try to develop markets and serve those markets.

Mr. ROTHFUS. Is this setup consistent with your view of how our free-market economy should operate?

Mr. WALLISON. It is completely inconsistent with how the market should operate, and that is one of the reasons why I oppose it.

Mr. ROTHFUS. Mr. Pollock, do you agree with Mr. Wallison's assessment? If so, will the Financial CHOICE Act provide benefits to firms and the market?

Mr. POLLOCK. Yes, I do agree with him and with Mr. Kupiec. A theme of the Dodd-Frank Act is granting wide, unfettered discretion to regulatory agencies outside of notice and comment rulemaking to impose judgment and subjective views. The living wills are a great example of that. The stress tests, if I may say so, are another example where you can regulate through regulatory proceeding without rules and without laws.

Mr. ROTHFUS. Mr. Pollock, previously Senator Phil Gramm testified before this committee that the Fed and the FDIC have almost total discretion in deciding whether a plan is acceptable. Are you aware of any other industry in the Nation that is subject to such requirements and micromanagement by the Federal Government?

Mr. POLLOCK. I am not.

Mr. ROTHFUS. I am glad my colleague from Wisconsin mentioned the former chairman, Mr. Frank.

Mr. Wallison, do you recall a time in maybe 2003 when Barney Frank said he wanted to roll the dice on the housing market?

Mr. WALLISON. Yes, I do very well.

Mr. ROTHFUS. Do you know if he was ever held accountable? Did anything in Dodd-Frank ever hold him accountable or anybody who wanted to roll the dice in the housing market?

Mr. WALLISON. No, I am afraid that was not done.

Mr. ROTHFUS. Okay.

Dr. Michel, I was at a Women in Business lunch last week in Pittsburgh where most of the attendees were small-business owners, executives, and entrepreneurs. Much of the discussion centered on the difficulties that many women face in pursuing their goals, and we had a great discussion about regulations in Washington.

At one point one of the attendees stood up and suggested that regulations were not a problem and challenged those in attendance to identify specific regulations that hurt their business. Immediately—immediately—a woman jumped on that opportunity and she said there—she was an executive with a community bank in the area. She told us that regulatory burdens for her firm were over the top in every respect.

Thanks to the CFPB and its mortgage disclosure rules it now took her customers twice as long to close on a home—6 weeks to 12 weeks. Disclosure documents had also nearly tripled in length, leading to increased cost and customer confusion.

How do the reforms in the Financial CHOICE Act provide consumers relative to the CFPB with the protections they deserve while supporting the growth of a vibrant financial sector?

Chairman HENSARLING. Very brief answer, please.

Mr. MICHEL. Okay. Well, very brief, I—

Chairman HENSARLING. If a brief answer is not possible—

Mr. MICHEL. No, I—

Mr. ROTHFUS. We will follow up—

Mr. MICHEL. I'm sorry, yes.

Mr. ROTHFUS. We will follow up.

Mr. MICHEL. Thank you.

Chairman HENSARLING. The Chair wishes to advise all members and our panel that we expect Floor votes somewhere in the next 15 minutes. Shortly thereafter we will recess. I believe two votes will be pending on the Floor at that time so we will recess for approximately 30 to 40 minutes, at which time our panel can take a needed break.

The Chair now recognizes the gentleman from Washington, Mr. Heck, for 5 minutes.

Mr. HECK. Thank you, Mr. Chairman, very much.

So from where I sit I thought that the Great Recession, the global financial crisis, was the worst financial crash or panic certainly of my lifetime, not having lived through the Great Depression. It obviously came, I think we would all acknowledge, as a surprise to a lot of bankers and regulators.

And as a consequence, it caused a lot of people to do some serious introspection and reevaluation of their thinking, most notably including in 2008 the former Chair of the Federal Reserve, Alan Greenspan, who testified before the House and made the following statement: "I made a mistake. I made a mistake in presuming that the self-interest of organizations, specifically banks and others, were such that they were best capable of protecting their own shareholders and their equity in their firms."

More recently than 2008 he said, "I have come around to the view that there is something more systematic about the way people behave irrationally, especially during periods of extreme economic distress, than I had previously contemplated."

Those are obviously big statements and big changes from the vantage point of Chairman Greenspan, who had previously believed, as we all know, that regulators should absolutely defer to markets, which were made up, he thought at the time, of rational, self-interested actors.

So I have read all your testimony today and, frankly, I wish there was more discussion of the lessons learned from the financial crisis and the Great Recession, because I think it is really important that we not go through that again, not have all that net worth wiped out, not have all that unemployment created.

So I am going to ask each of you, beginning with Mr. Allison, very, very briefly, if I may, to follow the model of Chairman Greenspan very succinctly and tell me what you learned from the financial crisis that conflicted with your earlier beliefs.

Mr. ALLISON. I learned that government policy, even well-intended, can be incredibly destructive. Affordable housing, which was really subprime lending, had very positive thoughts behind it and it was incredibly destructive and driven by government policy, including by Alan Greenspan, by the way.

Mr. HECK. Thank you, Mr. Allison. Banks played no role in lending money to people who shouldn't have been—

Mr. ALLISON. Banks made mistakes too.

Mr. HECK. They are not government. The banks weren't government. They loaned money to people that they shouldn't have.

Mr. ALLISON. They were regulated.

Mr. HECK. I call it the fog-of-mirror test.

Mr. ALLISON. They were regulated.

Mr. HECK. Ms. Peirce?

Ms. PEIRCE. I learned that when you put institutions into a system where a lot of their decisions are being driven by regulation they often behave differently than you would expect a self-interested institution to behave.

Mr. HECK. "They made me do it."

Dr. Cook?

Ms. COOK. I believe that the monetary authorities should have as much flexibility and as many tools as they can to fight the next financial crisis, and they don't need to be micromanaged.

Mr. HECK. Mr. Pollock?

Mr. POLLOCK. Having for decades studied financial cycles, Congressman, I learned that this cycle was like the others—severe, but there have been other severe cycles. And I agree that mistakes are key. Mr. Greenspan made an incredible mistake in deciding to set off a housing boom in the early 2000s. That is part of the government's responsibility.

Mr. HECK. And the private sector played no role in it.

I am always amazed—I have to interrupt and say I am always amazed that there are ideological points of view that seek to attribute and allocate 100 percent of the culpability to the three parties to this. It amazes me.

Did the government not catch this, not intervene? Yes.

Did the private sector, in the form of the banks, loan money to people that they should not have? Yes.

Did people seek loans that they could not support? Yes.

There is plenty of blame to go around, and I just have to say that when we refuse to acknowledge that there is lots of culpability to go around here, it frankly impedes our progress in preventing it again.

Mr. Barr?

Mr. BARR. I agree with the last statement you just made. What I was going to say is that I think all the gatekeepers and safeguards in the system broke.

So all of our private sector safeguards broke down: the capital provision broke down; lawyers didn't do their jobs; credit rating agencies didn't do their jobs; supervisors didn't do their jobs; bankers didn't do their jobs; and borrowers didn't do their jobs. We had just a disastrous consequence when all of that broke down.

Mr. HECK. Thank you.

I don't have enough time left for the two of you, and I apologize.

But I am going to ask one quick question, ask you to raise your hands. Raise your hand if you think that the problem of the last 10 years is too much investigation of financial crimes and abuses? Who thinks there is too much investigation of financial crimes and abuses?

[No hands were raised.]

Thank you, Mr. Chairman. I yield back the balance of my time.

Mr. ROTHFUS [presiding]. The gentleman's time has expired.

The Chair recognizes the gentleman from Colorado, Mr. Tipton, for 5 minutes.

Mr. TIPTON. Thank you, Mr. Chairman.

And I thank the panel for taking the time to be here.

Mr. Allison, listening to you, I thought it was really interesting—you were talking about CEOs of banks now being compliance officers, not being able to actually do the business that they want to be able to do to be able to loan to the communities. And you are in North Carolina, is that correct?

Mr. ALLISON. Yes, sir.

Mr. TIPTON. I have a couple of comments out of Colorado, small community banks out of Colorado. One stated to me, "We have shut down the majority of our mortgage group from 15 to 4 people because the business model no longer made sense. People lost jobs because the cost of the regulatory burden was too much."

Another gentleman, a banker in Durango, Colorado, stated, "We want to be able to have the ability to be flexible with products in dealing with customers, but because of Dodd-Frank it is not, 'How can we help the customer;' it is now a matter of, 'How can we not get in trouble with compliance?'"

In terms of dealing with our small community banks, do you think it would be important for us to be able to actually tailor rules and regulations to be able to meet those needs of the small community banks rather than the one-size-fits-all mentality of Dodd-Frank?

Mr. ALLISON. I absolutely do, and I think you have to take away the structure that is there or the community banks are going to get stuck with the big bank regulations.

Mr. TIPTON. When we are going down that road of actually sculpting it we had had Chair Yellen, and she kept talking about the trickle-down effect. So there seems to be unanimous opinion that our small community banks are really being bound by Dodd-Frank's action.

Under Section 546 of the CHOICE Act, it includes my bill, the TAILOR Act, and this legislation would require that financial regulators examine the unintended effect of unnecessarily burdensome compliance requirements. Do you believe that this would achieve a more balanced approach to right-size regulatory framework?

Mr. ALLISON. I think it would be very helpful.

Mr. TIPTON. Good.

Mr. Pollock, I thought it was interesting listening to some of the comments that we have had in regards to the impact of regulators in terms of policy that is going through. Is there anything that was required in Dodd-Frank when it came to actually doing a cost-benefit analysis, in terms of how rules and regulations were put into place and how it would impact?

Mr. POLLOCK. I don't believe so, Congressman, and it is certainly not a theme of Dodd-Frank, but it is a theme of the CHOICE Act, I think a very good one. It is fundamentally important that things be looked at in terms of benefits and costs. Even if there is quite a bit of uncertainty, confronting the uncertainty is extremely important.

Mr. TIPTON. Right. We often hear from some of our friends that really being able to have a cost-benefit analysis is just a tactic to be able to put the brakes on regulators. Do you see it that way?

Mr. POLLOCK. I see it as a logical requirement for rational action, Congressman.

Mr. TIPTON. Mr. Wallison, do you have any comments on that?

Mr. WALLISON. No. I think that is exactly—I agree completely, as usual, with Mr. Pollock's position on these things.

Mr. TIPTON. Okay.

Mr. Pollock, then, I will go to you again. In the absence of an explicit statutory requirement, having financial regulators conduct an economic analysis and a retrospective review of their regulations, would that be an important thing to do?

Mr. POLLOCK. I think it is a great idea, which is in the CHOICE Act, Congressman. We all ought to be doing that. We were talking a minute ago about reviewing our mistakes, and we should review our past actions for what was right and what was wrong. And if it was wrong that gives us a chance to fix it.

Mr. TIPTON. All right.

And just to go back to you, Mr. Allison, a little bit more on the community banks, listening to some of the questions from our Democratic colleagues, regulatorily were banks put in a position if they did not make a loan they were going to be in violation and if they did not make the loan they were going to be in violation? Did you find experiences like that?

Mr. ALLISON. Absolutely. There was tremendous pressure to do subprime lending.

Yes, some banks got greedy and made mistakes. Ironically, those were the banks that were saved, like Citigroup, in my view. And they were big banks.

And that was a mistake because what that does is encourage those banks to continue. They should be allowed to fail.

I think the CHOICE Act would be much more effective at dealing with bank failures. And I do not agree with the systematic risk. Citigroup could have gone broke and BB&T would have been happy; it would have been a good day.

So Citigroup has been saved 3 times during my banking career. That is how we got too-big-to-fail banks. The community banks always get hit with penalties because the really big banks do bad things and get bailed out.

Mr. TIPTON. All right.

Thank you. My time has expired, Mr. Chairman.

Mr. ROTHFUS. The Chair would like to advise the committee that votes have been called. We intend to go through two more sets of questions.

Right now, we have Mr. Williams and Mr. Poliquin on deck. We will be taking a brief recess then to finish up the votes.

And I recognize the gentleman from Texas, Mr. Williams.

Mr. WILLIAMS. Thank you, Mr. Chairman. And one could argue—

Mr. ROTHFUS. Will the gentleman suspend?

For what purpose does the ranking member seek recognition?

Ms. WATERS. Mr. Chairman, pursuant to clause 2(j)(1) of rule 11 and clause d(5) of rule three of the rules of this committee I am submitting for your consideration a letter signed by all of the Democrats of the Financial Services Committee notifying you of our intent to hold a Democratic hearing, also known as a minority day hearing, on the Financial CHOICE Act before a committee vote on this measure. I look forward to working with you to determine the date, time, and location of such a hearing.

Mr. ROTHFUS. The demand being properly supported, the continued hearing day will be scheduled with the concurrence of the ranking member and members will receive notice once the day is scheduled.

The Chair recognizes the gentleman from Texas, Mr. Williams, for 5 minutes.

Mr. WILLIAMS. Thank you, Mr. Chairman.

I guess with what we have heard today with this testimony is that the Consumer Financial Protection Bureau is one of the most unacceptable and most unaccountable agencies in the history of the United States. So what happens when you create an agency that is not only unaccountable to Congress but unaccountable to the American taxpayer?

Let me give you a few examples.

First, you get an agency that uses strong-arm tactics to encourage payments or settlements, often using faulty studies to justify enforcement. That is what happened to Ally and others who found themselves in the crosshairs of the CFPB.

Second, you have an agency that is growing by leaps and bounds with no end in sight. According to the CFPB's own strategic plan, the fiscal year budget estimate for 2017 is $636 million, a 5 percent increase from last year.

Third, you get rules that are thousands of pages. The proposed rule on payday lending is 1,341 pages, not to be outdone by the rule on prepaid accounts, totaling 1,689 pages long.

And finally, you have an agency that hides behind their consumer complaint database. Although the CFPB received just 0.06 percent of their overall complaints on the above-mentioned prepaid cards, the Bureau ignored more than 5,000 public comments—in this book right here, okay, they ignored that—expressing support for these products and issued the rule anyways, all at the expense of the consumer.

So this is what Dodd-Frank gave us, Mr. Chairman, and that is why it is so important to fix this disastrous law.

Now, Dr. Michel, let me begin with you. As we have talked about, the very structure of the CFPB rule was unconstitutional late last year. The court rules in order to bring the agency within constitutional bounds the President must be able to remove the Director at will.

Do you agree with the D.C. Circuit opinion that the lack of accountability Dodd-Frank provided the CFPB was so great that it violated the separation of powers embedded in the Constitution?

Mr. MICHEL. Yes, I agree, and the PHH case is a great example. You have a Director who can't be removed, who decided on which case he wanted to enforce, which company he wanted to go after, decided which statutes did and didn't apply, decided that it would be an ALJ proceeding, decided that he didn't like the ruling, decided he could double the fine.

Mr. WILLIAMS. Okay.

Mr. MICHEL. All of these things.

Mr. WILLIAMS. All right. Another question: Would making the agency's Director removable at will by the President provide accountability to the agency?

Mr. MICHEL. That would be an improvement, yes.

Mr. WILLIAMS. All right.

Again, Dr. Michel, the FTC has been enforcing consumer protection for decades before the CFPB existed without ever conducting supervision. Isn't that right?

Mr. MICHEL. Correct.

Mr. WILLIAMS. Okay. Do you believe that the FTC has been effective in protecting consumers through enforcement actions without supervision power?

Mr. MICHEL. Yes.

Mr. WILLIAMS. Okay. And do you believe the CFPB would be effective at protecting consumers as a civil enforcement agency that has investigative and enforcement authority rather than supervisory authority?

Mr. MICHEL. Yes, especially when it comes to the banking industry. They don't need any more supervisors.

Mr. WILLIAMS. Thank you.

Would you comment on that, Mr. Wallison?

Mr. WALLISON. Yes. I agree that they don't need any more supervisors.

Every agency of the Executive Branch ought to be accountable to the President. Otherwise, our elections mean nothing.

You elect a President, and if Congress has the power to say, "This person cannot be removed from office," they are saying the election of the President had no meaning. It did not make that person accountable in any way.

So this is what is at stake in the CFPB case.

Mr. WILLIAMS. And just in closing, Mr. Allison, when the public hears people in your industry and even in my industry—I am a car dealer—say that since this legislation you have literally had to hire more compliance officers and loan officers, that is a true statement, isn't it?

Mr. ALLISON. Absolutely.

Mr. WILLIAMS. And who is affected by that?

Mr. ALLISON. The consumer. The consumer always pays.

Mr. WILLIAMS. Right.

I yield my time back, Mr. Chairman. Thank you very much.

Mr. ROTHFUS. The Chair recognizes the gentleman from Maine, Mr. Poliquin, for 5 minutes.

Mr. POLIQUIN. Thank you, Mr. Chairman. I appreciate it.

Thank you, everyone, for being here today.

I represent some of the hardest-working, most honest people in America up in Maine's 2nd District. Maine is vacation land. Now, if you folks have not planned your vacation to Maine, it is a good time to consider that because we are booking up quickly and we have staff here to help anybody out if they need that help.

Mr. Allison, we have about 500 small towns in our State. And in these small towns you often have a community bank, a credit union, maybe a local insurance agency or a retirement fund manager. And these folks, these little institutions are the pillars of our community.

I love to travel around our district. I am a business professional. Like you folks, this is not my profession in politics. I am here to help, but I love to talk to folks who grow our economy and create jobs. I love to do it.

And without exception, Mr. Allison, they tell me what Mr. Williams and Mr. Tipton have already talked about, which is their major problem is this compliance and this paperwork. They are spending more time filling out paperwork than they are selling money.

Mr. ALLISON. Absolutely.

Mr. POLIQUIN. I remember a conversation I had with a loan officer up in the Machias Savings Bank way down east in Maine when you—right before you hit Canada you take a left, right down there. And they are saying this is just driving up the cost of the business that we have and they can't get this—the money out they need to families that want to grow and businesses that want to grow and hire.

So my question, Mr. Allison, is in your opinion—you have 30 years' experience in the banking business—does this CHOICE Act help with that problem such that small community banks and credit unions, and what have you, are going to be relieved of some of this burden of compliance and instead get in the business of lending money to our families?

Mr. ALLISON. Absolutely. I think the CHOICE Act would be very beneficial in that regard.

Mr. POLIQUIN. We have roughly 26 small community banks in Maine. And they are traditional: they take in deposits, Mr. Allison, and they provide checking accounts and savings accounts and lend out money.

They do not package these mortgages and sell them in the secondary market. Bangor Savings Bank and the Community Credit Union in Lewiston, they did not cause this recession.

Don't you think it is a good idea to make sure to back up what Mr. Tipton said, that the regulations, the rules that these bureaucrats in Washington come up are tailored to specifically the size and the type of institution and the complexity of an institution instead of otherwise?

Mr. ALLISON. Absolutely. And it is ironic that Dodd-Frank was supposed to penalize the very large banks, the Wall Street banks, and it has actually helped them and it has actually hurt the community banks, which did not cause this crisis.

Mr. POLIQUIN. Great. We are batting a thousand.

Let me ask you another question, sir. FSOC currently continues to deliberate on whether or not nonbank financial institutions should be designated as too-big-to-fail and therefore come under a whole other set of regulations and rules that drive up cost, reduce product offering, and so forth and so on.

Now, if you or I are in the investment management business—we run pension mans, retirement assets—and your—I hate to say this—your performance is lackluster and mine is good. Your client is going to leave you and come to me.

But guess what? The assets are held by Roger down the street in a custodial bank, so if you get into trouble or I get into trouble but the assets are held here, does that represent a systemic risk to our economy?

Mr. ALLISON. Absolutely not.

Mr. POLIQUIN. Of course it doesn't.

What advice would you give this committee when it comes to FSOC's ability to designate those nonbank financial institutions that represent no systemic risk to our economy—what advice would you give them with respect to the CHOICE Act?

Mr. ALLISON. I absolutely don't think that they ought to be able to designate them. And I think also those companies ought to be allowed to fail if they get in trouble. That is good.

Mr. POLIQUIN. Which brings me to my next point and my last point: The CHOICE Act ends the requirement for taxpayers to bail out big Wall Street banks if they take too much risk and get into trouble. I happen to think that is a great thing.

Now, we have a Bankruptcy Code that deals with this. Do you think that Code, the existing laws we have now, could handle this problem?

Mr. ALLISON. I think we need some modification to the Bankruptcy Code, but I think the Bankruptcy Code would be much better than what has been proposed in the Dodd-Frank law.

Mr. POLIQUIN. Okay. And does the CHOICE Act accommodate that end?

Mr. ALLISON. Yes.

Mr. POLIQUIN. Thank you, Mr. Allison, very much.

Mr. Chairman, I yield back my time. Don't forget the trip to Maine this summer.

Mr. ROTHFUS. The gentleman yields back.

Votes have been called. This is a two-vote series. The committee will reconvene immediately after this vote series.

The committee stands in recess.

[recess]

Chairman HENSARLING. The committee will come to order. The Chair now recognizes the gentlelady from Utah, Mrs. Love, for 5 minutes.

Mrs. LOVE. Thank you. Thank you, Mr. Chairman, and thank you for all of our Members who are here, and our witnesses who are here for this hearing. I really appreciate it. I want to start off with Mr. Wallison.

You may have noticed a slide being displayed over the course of this hearing that cites the Federal Reserve data indicating that commercial and industrial loans are up 75 percent since Dodd-Frank became law. The graph represents trends for loans and leases and bank credits for all commercial banks through December 2016.

So in your opinion, in your experience do you think that that figure is entirely accurate?

Mr. WALLISON. No. Actually I don't understand that.

Mrs. LOVE. Okay. So in what ways do you think that there is room for nuances in explaining that trend?

Mr. WALLISON. For one thing, all of the data that we have seen shows that banks have not yet reached the point where they were in 2008—the banking system as a whole—except for the very largest banks, which are doing quite well. But in terms of return on equity and return on assets, banks in general are still below where they were in 2008.

In addition, and this is the most devastating fact about this whole situation: There were 25 new banks in 2009; there were 9 in 2010; there were 3 in 2011; and since then there have been either zero or one in all the subsequent years.

Now what does that say? That says that the banks cannot make a profit. Otherwise people would be forming new banks. So we have a serious problem here with this legislation. We have to get this out, and we have to start relieving the pressure on our community banks.

Mrs. LOVE. Do you have that graph that we can pull up? Does staff have that other graph that we pulled up, where we separated large banks and small banks? There we go, right there. Can you look at the one before Dodd-Frank, please.

When we took the data and we separated between large banks and small banks, the data before showed that small banks, you can see the difference between small banks and large banks. Now look at the data after. Which tells me that large banks are doing okay and small banks are the ones that are providing less access to credit for those who need it in their communities.

Mr. WALLISON. That is right. In my prepared statement I have a couple of charts that show exactly that—that the loans from the large banks have been going up and the loans from the small banks have been going down. Large loans have been going up and small loans have been going down, all consistent completely with the idea that the small banks are gradually going out of business because of the regulation, and the large banks are taking up whatever new business there is.

Mrs. LOVE. I am being as fair as I possibly can here. Who are the people that small banks lend to versus the people that large banks lend to?

Mr. WALLISON. The large banks are not lending to the very smallest businesses. They are lending to the larger small businesses. But the really troublesome part is the startups, because in our economy, fortunately, and this has always been true, everything starts from the bottom. And the little companies that develop over time are the ones that eventually become the big companies and displace in many cases the big companies.

The startups are in the most trouble now because the smaller banks lend to the startups, but they make what would be called character loans. They are making it to people whom they know in the community, and those loans are not being made anymore because bank the examiners are stopping them from doing it.

Mrs. LOVE. Let me tell you, the people that I represent are actually getting less access to credit because of the burdensome regulations that are being imposed on our small bank communities. Now people may say that this is not really about small banks and large banks, and we are not really here to help small banks.

But I am telling you right now, when you get Jennifer Jones, who can't get a loan from her small bank in her community to expand her school, that affects middle- to lower-income families. When you get Brett Madson in Sanpete County, who has a turkey farm, and can't get access to the credit that he needs in order to get the tools that he needs to farm his turkeys, that affects the people in his community.

Goldman Sachs is not in Sanpete County. JPMorgan Chase is not in Saratoga Springs. And all of the banks that give them access to credit are closing their doors every day.

Chairman HENSARLING. The time of the gentlelady has expired. The Chair now recognizes the gentleman from Arkansas, Mr. Hill.

Mr. HILL. I thank the chairman. Thank you for holding this hearing. I was particularly pleased about the CHOICE Act, because it really has one of the first innovative proposals that we have seen in the regulatory in terms of ideas in some time.

And I want to thank Mr. Allison and certainly my friend Tom Hoenig at the FDIC for being the inspiration behind it, and that is this off-ramp provision for banks that hold tier 1 capital at 10 percent, tier 1 leverage ratio of 10 percent.

I was looking at all of the banks at the end of the year in Arkansas, and three quarters of our community banks—we have 103 community banks in Arkansas—meet that 10 percent leverage ratio. There are several others that are quite close. The median ratio for the State was 11.16 in tier 1 leverage ratios.

So I really do think that this is an important step to reward high capital with a more modest footprint of complexity in how we do prudential regulation.

Mr. Allison, have you been able to identify sort of in your own thinking about this, because you have done a lot of thinking on this point, do you like the 10 percent leverage ratio number that we have selected? Do you think that sort of represents a sweet spot between capitalization and financial stability, while at the same time facilitating bank continued growth and profitability?

Mr. ALLISON. I do. I think it is a reasonable number. Defining that number is part art and part science, but the important thing is you have to have a fair trade-off. What Dodd-Frank asks is for banks to have a lot of capital and a lot of regulation. They can't stay in business, and the regulators have chosen more regulation because they like to regulate, right? It is their job.

I think we would be much better off with more capital and less regulation, so that is what makes it work economically.

Mr. HILL. I am really reminded, knowing of your past CEO-ship of BB&T, I am really reminded of Jim Grant's quote last year in his newsletter, where he said that because of Chair Yellen's desire to have macro-prudential regulation, Grant postulated there is just no rule for micro-prudentialism. That is, what CEOs and boards of directors are supposed to do.

And he said, do you think there would be any difference in outcome if all management at the bank didn't show up one day and just the regulators were there?

Mr. ALLISON. I think all the banks would fail fairly quickly, in my opinion.

Mr. HILL. Thank you for that.

If I could turn to Ms. Peirce because I want to switch gears from capital formation to the ideas of capital formation for another challenge that we have tried to address in this bill, which is a loss of our public companies. About 50 percent of our public companies we have lost. This means there are fewer opportunities for people's 401(k) plans, fewer opportunities for individual investors to participate in economic growth.

And one of those barriers is this regulatory cost of being public, and one of those issues is the burden of the governance process and access to the proxy. Do you think the current $2,000 ownership threshold for submitting a shareholder proposal is still in today's age a reasonable threshold? And also, in the holding period, is a one-year holding period requirement for submitting that proposal reasonable?

Ms. PEIRCE. Yes, I think it is time to revisit those thresholds because shareholder proposals have become very costly to companies and to the SEC in processing them. So it seems to make sense to take a look. Shareholders obviously pay every time a company has to respond, so we need to look again and see what reasonable thresholds would be.

Mr. HILL. Thank you.

Mr. Wallison, one thing I have heard from regulators off the record, and from bankers of all sizes, community banks and then large, complex institutions, is the issue that the Volcker Rule, no matter how well-intended, just isn't working. What are your thoughts about the burdens to institutions of all sizes, and is that rule, you think, misdirected?

Mr. WALLISON. The Volcker Rule is a really serious problem. And first of all, it applies to much more than just insured banks. It applies to all firms affiliated with banks in any way. So they are all covered by these restrictions. The trouble is that it not only affects their ability to buy and sell securities as market makers, it also affects hedging. The banks have to do hedging in order to protect themselves against losses on the various things that they are invested in.

Unless they can show that the hedge is actually related to something they have invested in, they are in danger of being charged with proprietary trading. In order to put on a hedge, the hedge must be related to something, some kind of security bought for their own accounts, which sounds like proprietary trading.

So the banks are likely to become much more risk averse, even the largest banks as well as the medium-sized and small ones, when they have to comply with the rule.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Minnesota, Mr. Emmer.

Mr. EMMER. I thank you, Mr. Chairman, and I want to thank you for holding this hearing. Earlier today it was suggested that it is wonderful that this is regular order but we hope we are going to have more than one hearing on this. It ignores the fact that many of the concepts that are in the CHOICE proposal have been debated and discussed now for years.

And to Representative Love's point, when she had those graphs put back up on the screen, if we think back to 2008, there were roughly 8,000 community banks in this country and roughly 8,000 credit unions. A year after the crash there were roughly 8,000 community banks and roughly 8,000 credit unions. They did not cause the crash.

And yet, here we are a little more than 6 years after Dodd-Frank was passed and we are down to about 6,000 each and we are not growing at all. It is pretty clear that Dodd-Frank has been a problem to the capital generator for the small recesses, as Mr. Wallison was talking about.

Nobody, as I have heard today, is talking about some of the specific organizations created in Dodd-Frank and I would like to touch on one, and maybe start with you, Mr. Wallison. The Financial Stability Oversight Council (FSOC), another one of these very interesting organizations that was created, for a guy who is new to Congress, off the books. It is not under the appropriations process or the supervision of Congress. It works off the books.

Mr. Barr states in his written testimony that the FSOC, as it is known in the alphabet soup of Washington, in making its SIFI determinations, has established a system that again, in Mr. Barr's words, "provides for a sound, deliberative process, protection of confidential and proprietary information, and meaningful and timely participation by affected firms."

Mr. Wallison, do you agree with this assessment of the FSOC's process?

Mr. WALLISON. I am afraid I can't agree with that. We didn't know very much about the process until the MetLife case, when MetLife actually challenged its designation. They described what they were permitted to see, and what the FSOC had as evidence for their being designated. They were restricted from seeing a lot of the things that anyone who is in a normal kind of investigative situation like that would be permitted to see.

So the FSOC is not only non-transparent for those of us outside, it is not even transparent for the people who are inside and being designated. So you cannot call this a fair process, and I am afraid it is more like a "Star Chamber" than anything else.

Mr. EMMER. I am glad you brought that up because another one of the quotes has to do with—I think in his written testimony Mr. Barr notes that members of the FSOC are not beholden to their agencies but rather, "participate based on their individual expertise and their own assessments of the risks in the financial system."

It's very interesting that when we talk about their expertise, they express and are heard based on their expertise, especially when we look at the MetLife situation. When the guy with expertise in insurance was completely ignored within the Star Chamber, as you refer to it, is there really a deliberative process that goes on in the FSOC?

Mr. WALLISON. There are two big problems. First of all, you might be an expert in securities, but you are the only securities expert who is sitting on the Council, and there are three bank experts sitting there, too. So the banks have more votes than other parts of the financial system.

Another part of this, so troubling to me and to anyone who is concerned about the Constitution, is that the people who are sitting on the FSOC Board are all appointed by the same President. Ordinarily, in agencies that are commissions, you have a bipartisan arrangement. So a commission, when it speaks, is speaking on a bipartisan basis.

But when you appoint only the person who is the chairman of an agency, that person probably was appointed by the President in power, and all of the members are sitting around the table and they are looking at one person, the Chairman, who is the Secretary of the Treasury and a very close person, a very close advisor to the President of the United States.

So when the Secretary says, this is what we should do, these people are not going to be exercising their individual abilities and skills. What they are going to be doing is simply following the direction that they are getting from the Secretary.

Mr. EMMER. And it looks like I am going to run out of time, but I was going to ask Ms. Peirce if putting them under the congressional supervision and appropriations process might not solve some of these problems, short of getting rid of it. But I see my time has expired, so I apologize.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from New York, Mr. Zeldin.

Mr. ZELDIN. Thank you, Mr. Chairman, and I appreciate your leadership on behalf of those hard-working constituents in the 1st Congressional District of New York on Long Island trying to obtain a home loan for a new house, or to obtain a car loan, or to be able to access free checking for that small business in my district, trying to access more capital.

I appreciate all the witnesses for being here today. In my district there are a lot of small business owners and entrepreneurs who have that next great product or idea and are struggling to access capital when it comes time to get their businesses off the ground.

These innovators are being forced out-of-State, or worse, out of the country to find a more favorable regulatory climate. These firms are often pre-revenue, having just enough cash on hand to keep the lights on. So without access to private capital, growing their business and hiring is impossible.

Most of these emerging firms are also pre-IPO and need to attract the ground-level investors that make going public and to grow, create more jobs possible. Unfortunately, major obstacles have been put in place by Dodd-Frank and other onerous laws and regulations that made it harder for these entrepreneurs to hire, grow, and make money.

Ms. Peirce, I would like to start with you. What provisions in the CHOICE Act, and in particular Title IV, will most help small and emerging companies to grow and create jobs?

Ms. PEIRCE. I think there are a number of provisions that will be helpful, including making it easier for venture capital funds and for angel investors to invest in small companies. I think that also once the company—when a company is looking for investors, it needs to look for accredited investors if it is a private company generally. The bill would expand the types of people who can qualify as accredited investors, which is a much-needed change.

Mr. ZELDIN. Mr. Allison, would you like to add anything to that?

Mr. ALLISON. I think the biggest thing is the opt-out will allow community banks to go do what we did at BB&T, which is do venture capital lending for small businesses that are really too small for even the smallest end of the private capital market.

That is a very low-risk market long-term if you do it right, and we had thousands of success stories and created hundreds of thousands of jobs, and we can't do that anymore.

Mr. ZELDIN. I thank you both, and I appreciate your perspective. There was a comment made earlier that I wouldn't want anyone to take the wrong way, as if there aren't other economists on this panel with a broad breadth of experience capable of talking macro economics.

Dr. Michel, what have been the macro economic impacts of the hundreds of new regulations imposed by Dodd-Frank?

Mr. MICHEL. So we estimated part of that, with a standard sort of look at banking risk, or I should say banking cost, excess borrowing cost, and we came up with a 22 basis point increase since Dodd-Frank. A colleague of mine at Heritage and I use that—that is the we—and we use that in a macro, standard macro economic approach to pull that excess borrowing cost back out of the economy.

And it estimated around 1 percent increase per year in GDP. It had up to I think about a $340 billion dynamic revenue effect. It had a 3 percent per year average increase in the capital stock. This is not a model that was designed to model Dodd-Frank. This is just the standard macro approach. So quite significant cost, quite significant impact.

Mr. ZELDIN. Mr. Allison, do you want to add anything to that?

Mr. ALLISON. I don't have a concrete measure, but there is no question that we have had less innovation. You can just look at the start-up numbers for new businesses. In the shift in employment where new businesses and small businesses are getting a smaller and smaller share of the economy, and a lot of jobs unfortunately in the big businesses are entry-level jobs.

So the shift has impacted the quality of jobs, not only the quantity of jobs. And the creation of innovative jobs.

Mr. ZELDIN. Thank you, Mr. Allison. I going to yield the remainder of my time to Mr. Emmer to finish his question for Ms. Peirce.

Mr. EMMER. Thank you. Ms. Peirce, so the question quite simply is, by putting something like the Financial Stability Oversight Council under the supervision of Congress and in the appropriations process, could we solve some of the issues?

Ms. PEIRCE. Yes, certainly appropriations will be helpful in making FSOC more accountable. Taking away its designation powers is also an important step.

Mr. EMMER. Thank you very much. I yield back.

Mr. ZELDIN. I yield back to the Chair the remainder of my time.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Georgia, Mr. Loudermilk.

Mr. LOUDERMILK. Thank you, Mr. Chairman, and I thank everyone on the panel for being here. We have an opportunity to correct what I believe was one of the greatest wrongs done to the economy and the American people.

I want to talk a little bit about stress tests. My doctor wanted to do a stress test, but he told me after the last couple of weeks dealing with healthcare legislation that if I am still walking, I am probably pretty good.

Dealing with the stress test, the committee has had some testimony and hearings we have had here that often regulators are punishing banks for failing to meet requirements that are never stated.

Mr. Allison, has the Fed lacked transparency around the stress test process?

Mr. ALLISON. The stress test in theory can be useful, but what has happened is there has been an incredible waste of resources around stress tests because the regulators started out saying they wanted banks to come up with their own stress test, but at the end of the day they want everybody to have exactly the same stress test.

The irony is that type of stress testing increases risk, because if everybody risk weights the same assets the same, you get systematic errors. A concrete example of this is very recently in energy lending, which a few years ago was supposed to be low risk and now it is high risk. And low risk weighting encouraged more energy lending and actually increased risk.

So stress test, banks doing mathematical models, is okay independently. However, when they are forced by regulators, the tests lead to bad outcomes. You can probably imagine that in medicine, it's the same kind of thing.

Mr. LOUDERMILK. I know that the Fed recently exempted most banks from the qualitative part of the CCAR stress test. Should we expand that to all banks?

Mr. ALLISON. I would say so because the qualitative is totally a subjective judgment on the regulators' part and they won't tell you what it is. I know at my company they had to spend a whole bunch of money making the qualitative side better, even though the bank was ranked as one of the lowest-risk banks in America.

Mr. LOUDERMILK. Mr. Pollock?

Mr. POLLOCK. I fully agree. I think the qualitative part, which is indeed purely subjective and political, should be eliminated.

Mr. LOUDERMILK. Ironically, Fannie and Freddie both passed those stringent stress tests right before they failed in September of 2008. Even former Chair Ben Bernanke stated it was difficult to predict future economic turmoil. Are the stress tests really a reliable tool for predicting future downturns?

Mr. ALLISON. I think not. I think they can be a tool if they are taken in context, but we have done a bunch of studies at Cato that show the more complex a model is, and the stress test models are very complex, the more likely it will be wrong.

Rules of thumb models, like debt service to income in the mortgage business, are much better than complex mathematical models, which stress tests are, because in the models, the forest gets lost for all the trees.

Mr. LOUDERMILK. Mr. Pollock?

Mr. POLLOCK. Paul Kupiec at AEI did a study recently of stress tests showing that their outcomes were wildly inaccurate.

Mr. LOUDERMILK. Thank you.

Dr. Michel, let us talk about the CFPB and the massive amount of data that they have been collecting, and the potential of cybersecurity risk. Now I also serve on the Science, Space, and Technology Committee in the last Congress, which led some investigations into some cybersecurity breaches.

We had the Inspector General at one of our hearings and I asked the Inspector General—this was after the OPM data breach—if he would rate, on the elementary school rating scale, the Federal Government's cybersecurity posture. He said it was a "D minus." The only reason he didn't give it an "F" is because of the minor changes that were made at the OPM after their breach.

How concerned should we be with the mass collection of data with the CFPB, and what is our risk of exposure, not only just to bad players in this Nation but foreign entities?

Mr. MICHEL. I am not a cybersecurity expert by any stretch, but I am concerned that they are collecting so much data, principally because I still don't really see exactly what they are doing with it. You have a lot of stuff that is being collected that is just sitting there in many respects with no clear purpose, as far as I can tell.

Do you want me to elaborate for just a second?

Mr. LOUDERMILK. Sure.

Mr. MICHEL. The payday lending stuff is a great example. You have millions and millions of things in this database on all these people, and if you look at the number of complaints on payday lending, it amounts to about a 10th of a percent of transactions in the industry. Yet that has all been pushed aside. That would dictate to a rational person that maybe this isn't such a big problem.

Instead, they come out with a rule and they openly say that this could kill off 85 percent of the industry. Those two things don't mesh at all. So I don't understand what the purpose is of collecting all that data.

Chairman HENSARLING. The time of the gentleman has expired. At this time, the Chair wishes to thank Mr. Wallison for his testimony today, and Mr. Wallison, you are now excused from the panel.

The Chair now recognizes the gentleman from Ohio, Mr. Davidson.

Mr. DAVIDSON. Thank you, Mr. Chairman, and Mr. Wallison, thank you for being here. Thanks for the things that you have addressed with the FSB, and particularly the shortchanges they have done on American sovereignty. So that is a particular concern. I have enough questions for other folks. Thanks for being here.

And really, thank you all. I have learned a lot and reaffirmed many things that I have already learned about the impact of Dodd-Frank, both from your testimony today and from your prior work. So, thank you.

Mr. Allison in particular, I appreciate your clarity, here today, in your books, and in your work at Cato. And you all have sounded the alarm for some of the misses and perhaps unintended consequences of Dodd-Frank.

While I have myriad concerns about the negative impact on families, farms, and businesses, I am particularly concerned about due process. These protections are some of the most important in our Bill of Rights.

Ms. Peirce, you have talked a fair bit about some of those concerns with respect to the SEC. Under Dodd-Frank, do respondents in SEC administrative proceedings have the same rights as defendants do in Federal district court?

Ms. PEIRCE. No, the two systems are different, and some have argued that there are some issues with the administrative proceedings and have called on the SEC to make changes. I don't think the SEC has made enough changes yet to equal out the two.

Mr. DAVIDSON. Does the mismatch create the potential for different legal interpretations of the same or similar laws, and potentially create inconsistent enforcement outcomes?

Ms. PEIRCE. It does. There is a potential that you could get different outcomes depending on which forum you are in.

Mr. DAVIDSON. Do you believe that a respondent can receive a fair outcome when the SEC serves as prosecutor, judge, jury, and many times ultimately the appellate body?

Ms. PEIRCE. I think that the SEC can run its system well. I think it will run it better if people have the option of going to court if they prefer, which is what the CHOICE Act would allow.

Mr. DAVIDSON. Thank you for that. And I just wanted to open up to the panel some of the concerns that you may have with respect to due process that you have seen as a consequence of Dodd-Frank changes.

Mr. ALLISON. I think one general thing is that any regulated company, particularly now, really doesn't have practical access to the court system because by the time the courts decide, you are already out of business. And under the doctrine the court has, they think the regulator is right. You have to prove the regulator is wrong—it is like being assumed guilty and you have to prove your innocence, and that is very hard to do.

Mr. DAVIDSON. This is fundamentally a consequence of the Chevron doctrine.

Mr. ALLISON. Yes.

Ms. PEIRCE. A lot of the regulation is not even being done through rules that could be challenged in court. It is being done through supervision, which is a big problem in the bank regulation side.

Mr. BARR. I think if you look by contrast at the way in which the court system has actually gotten involved in Dodd-Frank compliance issues, it has been quite extensive. The fact of the matter is, in the PHH against CFPB case, which is challenging its constitutionality, that is a case involving whether the CFPB followed proper procedure with respect to its internal operations.

And the court seemed quite aggressive about enforcing that. I think you can see it in the MetLife case, you can see it in the case brought against the SEC.

Ms. PEIRCE. But I—

Mr. DAVIDSON. I want to highlight—this is pretty late in the game and fairly consequential. If you look at PHH, look at the valuation of their company and what happened, they have been decimated basically by fiat.

Mr. BARR. I think if you look at the way in which the court system is overseeing—

Ms. PEIRCE. I would also—

Mr. BARR. —agencies, it is quite—

Mr. DAVIDSON. Ms. Peirce, would you please?

Ms. PEIRCE. So I would say that it is fine to cite PHH and MetLife, but those are the two companies that were able to fight because they had the resources and the courage to do so. But often it is just not worth the regulatory risk to take the fight to court. So you just suffer with the consequences.

Mr. DAVIDSON. Thank you for pointing that out. I think we are at about a 90 percent conviction rate, which is a little shocking. It basically says, yes, cave or else.

Dr. Michel, were you going to say something?

Mr. MICHEL. I was just going to add Allied to that equation. It is an example of just kind of giving up and going ahead. You have no reason, you have no contact with the borrower at all, and you are accused of racial discrimination, and you know that the race of the borrower was never even—

Mr. DAVIDSON. Particularly when automotive lenders were explicitly excluded, carved out—

Mr. MICHEL. And you still find yourself with the choice of going to court or settling to get this over with.

Mr. DAVIDSON. Thank you all. Mr. Chairman, I yield back.

Chairman HENSARLING. The gentleman yields back.

The Chair now recognizes the gentleman from Tennessee, Mr. Kustoff.

Mr. KUSTOFF. Thank you, Mr. Chairman, and thank you all for being here today.

Since the enactment of Dodd-Frank almost 6, 7 years ago, to me it is incredible that we have had very few new banking starts in this country.

Mr. Allison, if I could, with your banking experience could you talk from a practical and procedural standpoint. Today, if you wanted to start a new bank, which I can tell from your expression that you are not particularly interested in doing, what are the real-world hurdles and challenges that Dodd-Frank presents to somebody who would want to start a new bank today?

Mr. ALLISON. First, the biggest challenge is that regulators don't want you to start a bank. So they are going to come up with every obstacle they can dream of to start a bank.

And secondly, when you do your cost analysis and your profit analysis, you are going to say, I can't make any money because I am going to have to hire an army of compliance people before I can make my first loan. So I am going to be embedded with a cost structure radically higher than a traditional community bank startup has.

This is very interesting. The ability to sell your bank, it sounds like that will consolidate the industry. But actually, it encourages startups because a lot of banks are built to run for 25 or 30 years, kind of the life expectancy of the board and the management, and then to be sold.

So the fact we have made it hard for people to sell their banks, ironically, has not kept banks from being sold. It has kept banks from being started because that is the payback. I can't get a high enough return in the short term, but 10 or 15 or 20 years from now I will be able to sell the bank, and that is kind of when my management talent is going to run out and I am not going to be able to hire enough people to replace me. That is the mindset.

Mr. KUSTOFF. The converse: Let's assume that we get the CHOICE Act passed in toto, the way that it is written now. Can you predict what that would do for new bank starts in this country?

Mr. ALLISON. I would predict a significant increase in the number of new bank starts. Pretty radical, because all they have to meet is the 10 percent equity requirement, which is really not that hard, and then they will have the option in the future if they do well to sell it.

And that is kind of the carrot out there so I think you will see a significant increase in the number of startups. And I think that will be good for the economy.

Mr. KUSTOFF. Thank you, Mr. Allison.

Dr. Michel, you and I had the opportunity I believe to talk earlier at our subcommittee hearing. I do want to ask you if I could about the CFPB for a moment and the consumer complaint database, if we could.

The way I understand it is, when complaints are submitted to the database, we have seen that the facts are not verified. In other words, the complaints are submitted, but there is no verification.

So somebody could submit a complaint. It may be valid; it may not be valid; or it may be partially valid.

Could you talk about how the CFPB could ensure the validity of these claims before they are submitted and placed in the public domain?

Mr. MICHEL. Sure. Just find out what happened before you put it on the public database. The FTC has a similar model, where those things are kept internally and they verify the complaints internally. This isn't supposed to be about public shaming and finding out later, oh, we made a mistake. What purpose does that serve if we are talking about protecting people?

Mr. KUSTOFF. And following up on that, do you believe or have an opinion as to whether the CFPB should remove these complaints from the public domain rather than keep the database as is?

Mr. MICHEL. Sure. Again, I don't see any public purpose to having all of that raw complaint information public because it is counterproductive.

Mr. KUSTOFF. How would the CFPB go about verifying these complaints once they are submitted?

Mr. MICHEL. If we have a Federal agency that is an enforcement agency and they are doing their job, when they receive a complaint, they check it out. They verify it. They talk to the person who filed the complaint, they talk to the company that the complaint is filed against, and they go and actually investigate what happened. I don't think anybody would have a problem with that.

Mr. KUSTOFF. Do you have any idea how many complaints have been submitted to the CFPB?

Mr. MICHEL. I have not looked lately. I know that it was millions at some point. I don't know—I could not give you a number now, no. I have not looked lately.

Mr. KUSTOFF. And again, none of those complaints have been verified. They are submitted—

Mr. MICHEL. They were simply submitted raw complaint data, yes. And I don't have the error rate off the top of my head either, but I know that they have made some statements about how many of those were not actually verified complaints.

Mr. KUSTOFF. Thank you, Dr. Michel. I yield back my time.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentlelady from New York, Ms. Tenney.

Ms. TENNEY. Thank you, Mr. Chairman, and thank you, panel, for a great discussion.

I come from a very rural area in central New York, where we had wonderful old names of old community banks—United National, Savings Bank of Utica, Homestead Savings, Herkimer County Trust, Marine Midland Bank, which was a little bit larger bank. All those have gone. We do have one solid community bank left called the Bank of Utica, and we have a, well, a regional bank called Adirondack Bank.

But so many of these regulations have caused us to lose our banks. In fact, there haven't been any new banks created, de novo banks created in New York State since Dodd-Frank was passed.

My concern as a small business owner who has relied on many of these great relationships—I know some of you mentioned character lending—throughout the years, and honestly, I can go into my bank and hand my checkbook to the teller and go back and talk to the bank president, who is in the same room. And I know that is a quaint situation that doesn't happen often.

And these banks, some have been excluded from regulation, but many of them can't even compete in the big market because they don't have the compliance. And I think Ms. Peirce mentioned really significant, so many of them just either stop lending to their customers, force their customers into having second mortgages or putting themselves into credit cards to get financing because they don't want to face litigation. And it is so expensive. They can't afford the compliance cost. It is a very similar situation as it is for us as a small business owner in the area.

I just thought what I would like to do is talk to you about the ability of a regulator to—and for us to look at sort of Chevron that was referenced by my colleague, with the over-expansion of the Executive Branch and how Dodd-Frank has caused over 400 different rules just to implement it, and thousands of pages, 2,300 pages or whatever it is. And how we can roll that back and come up with a way, using economic factors, to put some restraints on regulators.

I would love to know if you could just comment on that, Mr. Michel, start first and we will work the panel. Because to me I think that is really where we are going with this. The regulations have proven to be so much burden for—

Mr. MICHEL. I know this isn't on the table at the moment, but I am not a fan of independent regulatory agencies. I think that is a problem. You are supposed to be accountable to the people who have been elected, and there should be more direct rules that come directly from Congress and there shouldn't be so much discretion. And that would be one way against that.

Passing a law that gives the regulator a great deal of discretion to come up with a rule, and it ends up looking almost nothing like what was initially discussed, is incredibly poor policy. So not having those independent agencies with the ability to do that is a way around that.

And I think with the CHOICE Act, you can play around with the model that is here, you have a much higher equity requirement with a much bigger regulatory relief component and that way get away from doing some of these things.

Ms. TENNEY. Thank you.

Mr. Pollock, do you have a comment on that?

Mr. POLLOCK. Congresswoman, first I would like to say on the small banks going down in number, which they obviously are, one of the reasons is that there are few new banks being created. We ought to have as a policy at all times the encouragement of new capacity and new entrants, which we don't have. Especially in times of trouble, when you most need new entrants, the regulatory philosophy is to cut off new entrants.

On the general question of more accountability in regulatory activity, it is essential, in my opinion, for the cost of the regulation and the effects, as we have been discussing, of the regulation to be explicitly taken into account and compared to whatever benefits we think there are.

On mortgage loans in particular, we have had very heavy regulatory and legal risks imposed, and the result is for little banks, talking about less than a billion dollars in assets, mortgage loans in those banks have been falling since 2011. Anybody who has tried to get a mortgage knows why. The regulations have made it extremely painful, even for quite good credits, to go through the process.

Ms. TENNEY. Yes, thank you. I appreciate that. As a former bank attorney, I used to be able to do maybe 10, 15 residential closings a day. I could probably only do three now just because of burdensome paperwork.

And again, I know Mr. Barr is anxious to answer, but I think I am losing my time here, so I want to say thank you to the panel for really great work today. It is really an honor to have you here and talk about the CHOICE Act. And we are excited about getting it passed. Thank you.

Chairman HENSARLING. The time of the gentlelady has expired.

The Chair now recognizes the gentleman from Indiana, Mr. Hollingsworth.

Mr. HOLLINGSWORTH. Good afternoon. Thanks so much for being here. As she said, I really appreciate everybody's investment of time and all the great comments and conversation that we have had.

There has been a lot of discussion throughout the course of the day about banks taking exceptional risk inside their trading book that has caused losses that have been covered by the taxpayer and that is why we need the Volcker Rule.

Dr. Michel, would you care to comment on that and whether the true issue that caused the crisis was in the trading book or was it in the loan book?

Mr. MICHEL. I would love to comment on that. Thank you. So first of all, this started off in the wholesale trading market—or I'm sorry, the wholesale funding market, so this has nothing to do with the banks really in that sense at all.

Secondly, if we are talking about risk, banks take risks every day. Commercial loans are risky. A portfolio of commercial loans is riskier than a commercial portfolio of stocks. This makes no sense at all.

Prior to Dodd-Frank, you had the Fed, the FDIC, and the OCC with all the ability in the world to stop any of those large banks from trading, doing proprietary trading, doing any of the securities investment that they wanted. Type I securities, Type II securities, Type III, all of these things are codified.

This is the biggest nothing burger ever. This is just a waste of time, effort, energy, and money, period.

Mr. HOLLINGSWORTH. Excellent. Thank you. Thank you for that.

One of the things I also wanted to talk about, Dr. Cook, you had mentioned earlier today and talked about—gave a great, stirring introduction about how this will never happen again and how we made sure that this will never happen again.

I guess my question is, does Dodd-Frank slaughter the business cycle? Do we expect that we will never have another downturn again now?

Ms. COOK. Excuse me. I didn't go that far.

Mr. HOLLINGSWORTH. I got a "C" in macro-economics, by the way.

Ms. COOK. Wait, wait, let me be clear. To try to stem the irresponsible practices that were happening before. But I just want to be careful, as was stated in my prepared remarks, this is not perfect. Dodd-Frank is not perfect.

Mr. HOLLINGSWORTH. I guess in that—I think what you were trying to get at was not that we slaughter the business cycle but hopefully we can dampen the amplitude of the ups and downs. Is that kind of what you were trying to convey in your introduction?

Ms. COOK. No. Still focused on financial practices. Now we keep working as macro-economists on trying to—and we thought we had it figured out before the recent crisis.

Mr. HOLLINGSWORTH. Can you determine what is irresponsible and what is responsible behavior? Who gets to determine that?

Ms. COOK. So the Federal Reserve, all of the regulators can.

Mr. HOLLINGSWORTH. So regulators determine what is responsible and irresponsible lending. So this is really—and Dodd-Frank is government pushing capital in certain directions and out of other directions, and determining who should be the recipients of loans and who shouldn't be the recipients of loans. So government-directed capital is the answer to the crisis in your mind?

Ms. COOK. Oh, not at all. No, no.

Mr. HOLLINGSWORTH. More regulation is not more government direction of capital?

Ms. COOK. No, I want to be clear. When I say irresponsible, I don't mean it as—you are making it as a technical term. I want to make sure that I am saying this because it is not—this isn't something that a standard, that you are looking at a banking law and saying, this is responsible, or these are the characteristics, these are the criteria for responsible and irresponsible banking.

But I want to make sure that we understand that the crises, the recessions that are the deepest we know from economic research are the ones that are fueled by bad financial practices, by financial crises. That is what I don't want to see happen again. The Great Depression, this Great Recession, and what is happening in Europe, we certainly don't want that to happen again.

Mr. HOLLINGSWORTH. I guess back to Dr. Michel, I wanted to talk a little bit about Title VII and better understanding how Title VII might certainly, under Dodd-Frank, begin to change the way clearinghouses are structured and offer them with Title VIII some additional avenues. Can you talk a little bit about that?

Mr. MICHEL. So on VII, with the clearing mandate, I would go back to—this isn't quite as—maybe I don't have as strong feelings as I do on Volcker, but this is another one that is a really bad idea. If counterparties wanted to have these derivatives cleared and clearinghouses wanted to clear these things, that was already happening.

Mr. HOLLINGSWORTH. Right.

Mr. MICHEL. And that is a progressive thing over time. As those things become more standardized and more accepted, that is what happens.

To mandate it is a very bad idea and we end up concentrating all the risk in the clearinghouses.

Mr. HOLLINGSWORTH. Exactly.

Mr. MICHEL. And then Title VIII, and say, here you have a direct line to the Fed.

Mr. HOLLINGSWORTH. We have just basically opened another avenue towards more bailouts and more opportunities for bailouts through Dodd-Frank.

Mr. MICHEL. Absolutely.

Mr. HOLLINGSWORTH. Instead of how it was sold originally.

Mr. MICHEL. Absolutely.

Mr. HOLLINGSWORTH. Thank you. I appreciate the time, and I appreciate all of you today.

Mr. MICHEL. Thank you.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from New Jersey, Mr. Gottheimer.

Mr. GOTTHEIMER. Thank you, Mr. Chairman, and thank you to the panel for being here today.

If I could start with you, Mr. Allison. With the benefit of almost 7 years of experience now we can only identify areas where Dodd-Frank could be improved without compromising the core regulatory framework that has been put in place.

One such area for potential improvement is Section 619 of Dodd-Frank that inhibited speculative investments. Former Fed Governor Tarullo highlighted this in his parting remarks earlier in April. What do you think of his assessment, and what are some of the tweaks that could be made to keep our regulations smart but also keep our regulators adequately focused on protecting the safety and soundness of the banks and consumers?

Mr. ALLISON. I think you have to look at a bank at a meta-level, not at the parts. And regulators, Governor Tarullo in particular, likes to look at the parts. And I think that is a poor way to do it.

If you look at the Canadian banking system, their regulators evaluate the whole organization and they have had much smaller, lower failure rates than we have. I think our kind of regulation tends to focus on these little parts and add them together instead of asking the macro questions, including the basic philosophy of the bank. Is it a high risk taker or not?

Mr. GOTTHEIMER. Thank you very much. I appreciate that.

Related to that, Section 619 requires that five regulatory agencies examine traders' intent to effectuate the rule of prohibitions. Is that inherently difficult for regulators and the banks?

Mr. ALLISON. I would say so. I don't think they have the skill set to do it, would be my view.

Mr. GOTTHEIMER. Thank you very much.

Mr. Barr, do you think the OCC's failure to sufficiently address Wells Fargo's bad sales practices more than a decade ago shows that the agency may have been putting its consumer protection mission in a subordinate role to its other mission of improving the profitability of the bank?

Mr. BARR. I do think that the failure was rather significant, and it was one of the reasons—the basic problem of the lack of prudential agencies' attention to consumer issues was one of the main reasons for bringing those authorities together under the new Consumer Financial Protection Bureau.

I think the recent report on Wells Fargo reinforces that it was a good idea to bring those authorities together under the CFPB, to give it the power to protect American families and to really have as a core mission and a set of expertise protection of consumers.

So I think it reinforces the choice made in Dodd-Frank and frankly undermines the choice made in the CHOICE Act.

Mr. GOTTHEIMER. So you would say what happened with the big account scandal, it is what the mission of the CFPB, it meets its mission in that case.

Mr. BARR. Yes, I do think you want a consumer agency that can stop the kind of abuses we saw at Wells Fargo and at payday lenders and in other markets, where there have been significant problems with taking advantage of consumers repeatedly over time.

I think that is one of the core reasons you need the consumer agency to have supervisory power and not take it away, as the CHOICE Act would do. So I think having an agency that has supervisory authority and rule-writing authority, and enforcement authority across the market is really important to creating a level playing field for consumers and for banks and non-banks alike.

Mr. GOTTHEIMER. Thank you so much. I yield the balance of my time.

Chairman HENSARLING. The gentleman yields back.

The Chair now recognizes the gentleman from Michigan, Mr. Trott.

Mr. TROTT. Thank you, Mr. Chairman.

Dr. Michel, let's talk about Title II of Dodd-Frank. Some of my friends today have offered a couple of arguments as to why OLA is better than a bankruptcy solution. First, they have suggested that the FDIC has it covered. There is no need to worry about taxpayers being at risk again.

And the second argument is that the FDIC will do a better job than a bankruptcy judge at resolving a failed financial institution.

So let's look at the first argument. How has the government done at maintaining insurance programs and ensuring they are solvent in the event of a claim? For example, how have they done on the National Flood Insurance Program? I think it is $24 billion in the hole. How have they done on the Pension Guarantee Corporation? I think it is $79 billion in the hole. Or for that matter, how have they done on FHA?

So do you think, based on the government's track record, that they are going to do a good job at making sure the FDIC has the money in the event of a failure?

Mr. MICHEL. Do I think so?

Mr. TROTT. Yes.

Mr. MICHEL. No.

Mr. TROTT. Well, let's assume that the examples I just gave—yes?

Mr. MICHEL. I was going to say, I would throw in the FSLIC, back from the S&L crisis, and then I would throw in the FDIC from the recent crisis because without TARP you have an FDIC bailout. But I'm sorry, go ahead.

Mr. TROTT. I only have 5 minutes.

Mr. MICHEL. I'm sorry.

Mr. TROTT. Just kidding. So let's assume all these examples are just an aberration though, and that the orderly liquidation fund is adequate to cover a failure of the top 6 financial institutions, which would total about $10 trillion.

So taxpayers might not be funding that if the money is there, but indirectly wouldn't consumers still have to pay a price because all the healthy financial institutions have to pay for the failure of their competitors, and ultimately that cost is going to be passed on to consumers in higher fees?

Mr. MICHEL. That is exactly right. These assessment fees, somebody pays for those, and ultimately customers pay for at least a part of those.

Mr. TROTT. Let's assume that they don't have the money, so they can go under section 210 and borrow $10 trillion from the Treasury. Would you agree that at that point taxpayers are in the crosshairs again?

Mr. MICHEL. Very much so.

Mr. TROTT. So indirectly or directly, the first argument fails because taxpayers are going to be exposed. Let's look at the second argument. So the FDIC is going to do a better job than a bankruptcy judge, so these—because they have more knowledge and experience. So these are the same folks who were in charge before the last crisis, right?

Mr. MICHEL. That is correct.

Mr. TROTT. But now they are all a whole lot smarter. Let's look at transparency. Let's compare the FDIC folks sitting in a closed room versus a bankruptcy judge sitting in an open court. Which is going to be more transparent and lead to a fairer result?

Mr. MICHEL. I would go with the open court.

Mr. TROTT. Oh, you are answering all the questions right. It is really something.

Let's talk about predictability. So you have a bankruptcy judge who has years of precedent, case law, previous decisions, and attorneys, creditors, and shareholders can look at that. Which is going to lead to a more predictable result, a bankruptcy court that has years of precedent, or the FDIC, that every now and then has to deal with a financial institution that fails?

Mr. MICHEL. Bankruptcy court, again.

Mr. TROTT. I spent a lot of time in my previous career in bankruptcy court representing creditors, and by and large my clients thought it was a fair, predictable, transparent result. But a lot of times they didn't really like the result because a lot of times they didn't get any money.

Sometimes there was no money in the bankrupt estate for them, or they were deemed to be unsecured creditors. Sometimes the money given to them was deemed to be a fraudulent transfer or a preference. But that risk in the bankruptcy proceeding kept some integrity in the process.

So my question is, don't you think having a bankruptcy process where creditors and shareholders are at risk versus the taxpayers is going to lead to a better decision-making process at the banks and financial institutions because of the threat of the bankruptcy court giving them zero?

Mr. MICHEL. Yes. I don't see how there can be any doubt, honestly. And I hear the criticism that, well, if we do that, you won't have as many of these repos and you won't have as many of this broad money, as much of this broad money. I am kind of flabbergasted because that is exactly the point.

Mr. TROTT. It is kind of like the bond ratings for Fannie and Freddie's mortgages, isn't it?

Mr. MICHEL. Yes.

Mr. TROTT. Thank you.

Mr. Allison, I really enjoyed your opening statement. I thought your comments and perspective, the real-world perspective was refreshing. My only caution it is probably too much common sense for us here in Washington, but it was certainly interesting to hear your comments.

And I am going to put up on the screen, if it is here somewhere, I would appreciate the staff helping me out. That is a puzzle of all the different regulations that affect financial institutions. So I want you to just to comment in the 30 seconds I have left, what all those regulations have done to the banking industry, which in turn what that has done to the small business community, which in turn what it has done to what we all care about most here. Democrats or Republicans alike agree on one thing. We all would like to see more jobs created in this country.

What has that done to job creation in this country?

Mr. ALLISON. It has made banks less efficient, it has made them less able to provide the credit that drives the economy. It has reduced innovation, creativity, and it has made a lot less good jobs. It has reduced the number of good jobs in America.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair wishes to advise all Members that votes are pending on the Floor. We have two Members remaining in the queue. Without objection, the remaining two Members will be afforded 3 minutes apiece.

The gentleman from North Carolina, Mr. Budd, is now recognized for 3 minutes.

Mr. BUDD. Thank you, Mr. Chairman.

And Dr. Michel, let's talk about price controls, which are put into place on the theory or belief that the market for a good or service just isn't working. So we have a long history of trying to do that in our country.

Mr. MICHEL. Indeed.

Mr. BUDD. Nixon tried that in 1971, Carter in 1980. And if you look at it recently outside of our country, the Venezuelan food prices controls, they were unsuccessful and are unsuccessful.

So Dr. Michel, is the Durbin Amendment, which is a price cap, is it helping the American public or is it failing like these other attempts?

Mr. MICHEL. It is failing like other price controls always do. Somebody finds a way around it, somebody finds another way to get the money that they lose from the price control. And we see that already. It ends up not helping the people it supposedly is going to help. Not that I believe that, that they really wanted to help the people they say.

Mr. BUDD. So about those people that we are talking about, the consumers.

Mr. MICHEL. Yes.

Mr. BUDD. In terms of the effect on their pocketbooks, the Richmond Fed has said that a sizable fraction of merchants raise their prices or debit restrictions as their cost of accepting these debit cards increase. However, few merchants reduce prices or debit restrictions as these costs decrease.

So take ideology out and history out just for a second. The bottom line, the practical cost of the Durbin Amendment price control is that consumer pocketbooks, these people we are talking about, are you saying they have been hurt in terms of increased banking costs? And they haven't seen any other relief in prices. Is that correct?

Mr. MICHEL. The evidence ranges from unaffected to harmed. Yes, that is correct.

Mr. BUDD. So these that we are supposed to help, these consumers, but it didn't, why is that?

Mr. MICHEL. The idea that we were going to get rid of a regulation for a small group of large retailers, and those retailers were going to just pass that cost directly back, cost savings directly back to their consumers is fantasy. And then there would be no other impact, with nobody who has lost the revenue trying to pick it up from somewhere else. It is not practical.

Mr. BUDD. Mr. Allison, so from my hometown, you mentioned something about at the end of the day, somebody pays. Would you care to reiterate on that?

Mr. ALLISON. The Durbin Amendment has been particularly bad for low-income consumers. Banks were providing free checking accounts. The way they were doing that was with debit card fees that merchants were paying. The Durbin Amendment is a huge subsidy for big merchants, for Walmart at the expense of low-income consumers. The low-income consumers are the big losers.

Now the way the banks have been hurt, banks invested billions of dollars to develop the technology to make this system work. Banks have lost part of the incentives of technology for new things that consumers might benefit because it might be stolen by legislation. Price controls never work.

Mr. BUDD. Thank you. In my remaining time, a quick question. So have the prices for merchants that do a lot of small ticket items—

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from West Virginia, Mr. Mooney, for 3 minutes.

Mr. MOONEY. Thank you, Mr. Chairman. Recently, proponents of the Dodd-Frank Act have rolled out numerous anecdotes and favorable data to prove that with Dodd-Frank in place the economy is growing, banks are both profitable and lending.

But what you don't hear about is the overall regulatory costs imposed by Dodd-Frank that are weighing down our economy. A current analysis by the American Action Forum found that compliance with the Dodd-Frank Act has cost $36 billion and 73 million hours of paperwork, the equivalent of almost 37,000 employees working full-time on paperwork for 1 year.

As I travel my district in West Virginia, with small community banks and small towns, the pain that I hear from folks who work at banks that they have to hire full-time employees just to do paperwork and pay them salaries, money that could otherwise have been lent to buy a home or start the American dream of owning your own business is evident.

So Dr. Michel, has Dodd-Frank helped "lift the economy" since it was enacted in 2010?

Mr. MICHEL. No, and I wouldn't have believed that to begin with. We have done some analysis. We have done, as far as I can tell, one of the first real macro economic modeling analyses of this very question. And we do show that it had a significant impact, I think I mentioned before of about 1 percent per year in GDP. That would be the loss associated with the increased costs. That would be the gain from removing it.

You have a significant decrease to the capital stock in the Nation. And there is a dynamic effect on that in terms of the revenue effect that we have on the budget and just on the economy in general.

Mr. MOONEY. Thank you. A quick follow up, what have been the macro economic impacts of the hundreds of new regulations imposed by the Dodd-Frank Act?

Mr. MICHEL. Unfortunately, the part that we do is very narrow. Or I shouldn't say unfortunately, but I should say that the part that we looked at was a very narrow look. So I would imagine it is much worse. I don't have the macro analysis because I can't—it is almost intractable, the problem.

We are talking about over 400 rules, we are talking about rules that span the entire financial spectrum. Macro economic models can't really handle a lot of that stuff very easily, so you have to start doing a lot of subjective manipulation, I will call it, and we didn't want to get into that.

So I suspect that it is pretty severe. I would add that a lot of the stuff where everybody talks about how we have had the worst recession since the Great Depression, well, yes, and a lot of that actually happened after we started doing all of this stuff. So that doesn't get a pass.

Mr. MOONEY. Thank you. Thank you all for your testimony today.

Mr. Chairman, I yield back.

Chairman HENSARLING. The gentleman yields back.

I want to thank our witnesses for their testimony today.

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 ask our witnesses to please respond as promptly as they are able.

This hearing stands adjourned.

[Whereupon, at 3:06 p.m., the hearing was adjourned.]

# A P P E N D I X

April 26, 2017

**The Committee on Financial Services**

**For testimony on April 26, 2017, 10:00 a.m.**

# A Legislative Proposal to Create Hope and Opportunity for Investors, Consumers, and Entrepreneurs

**John A. Allison**

I was the longest serving CEO in the US of a major financial institution, BB&T, at the time of the recent financial crisis. BB&T went through the financial crisis without experiencing a single quarterly loss. I had the unique experience and perspective of leading BB&T's lending business during the severe correction of the early 1980s and was CEO during the early 1990s recession.

The Federal Reserve's monetary and regulatory policies were major contributors to the 2007-2009 Great Recession. On the regulatory side an excessive focus on Sarbanes Oxley, the Patriot Act, and the Privacy Act created a total lack of safety and soundness regulation. Investors, rightly so, assumed bank regulators were controlling industry risk and the investors were lulled to sleep. Without the perception that regulators knew what the risk were, investors would have studied the industry far more carefully. The market was fooled by banking regulators.

In addition, the implementation by the banking regulators of the BASEL capital standards increased leverage (less capital) in large financial institutions. Using extremely complex mathematical models, large banks, with support from the banking examiners, convinced themselves they could take high risk with little capital because they could manage the risk. In addition, banking regulators were motivated to underestimate risk for political purposes. A financial institution was required to hold half as much capital for an affordable housing (subprime mortgage) as for a loan to Exxon. In Europe, banks were not required to hold any capital for a loan to Greece.

The financial industry regulators seriously mishandled the 2007-2009 economic correction which is continuing to negatively impact economic growth. The regulators made the correction far worse than it needed to be. During the early 1980's and 1990's recessions the bank examiners let unhealthy banks and savings and loans fail. However, they did not interfere with healthy banks' lending practices. They allowed healthy financial institutions with rational lending standards to continue to make loans and support their customers and also to finance good customers who were leaving unhealthy banks. Unfortunately, this time, the examiners forced healthy institutions like BB&T to unnecessarily put out of business many small businesses who we would have supported and who would be in business today. These businesses would be creating good jobs and economic growth. The regulators destroyed many entrepreneurs unnecessarily.

The banking regulators tightened lending standards at exactly the wrong time. They closed the barn door after the horse was out of the barn. These very tight lending standards remain in place for venture capital small business loans. Venture capital small business loans are when the lender while considering the financial projections primarily makes the loan based on a judgement of the borrower and the concept. In the current regulatory environment, while existing slow growing small businesses can often obtain financing, small business startups are frozen out of the market and highly innovative aggressive expansion plans for existing small firms will not be financed significantly slowing the growth of the firms.

I began my banking career as a small business/middle market lender. I was fortunate to help a number of small businesses which have expanded significantly and created thousands of jobs. These loans which were critical to the growth of these firms could not be made today. Bernie Marcus, the founder of Home Depot, has told me on several occasions that he could not have started and grown Home Depot in the current regulatory environment.

The lack of small business venture capital funding from banks and the inability of banks to finance the expansion of more aggressive entrepreneurs has slowed innovation (in all industries except technology) and thereby significantly reduced competition. Because of the lack of competitive pressure existing firms are not motivated to invest for the future. They would rather cut cost and buy back shares of stock. The effect is to slow the growth in productivity which ultimately determines economic wellbeing because we cannot consume more than we produce. In the financial services industry firms are focused on compliance instead of innovation and productivity.

One tragic irony is that by tightening lending standards the Federal Reserve has undermined its monetary policy. They cannot get the money supply to grow because the velocity of money (the money multiplier) has slowed because bank's are only making loans to large businesses. The Federal Reserve is effectively subsidizing large firms.

Unfortunately, Dodd Frank and the related regulatory regime has not only slowed economic growth, it has not effectively dealt with the issues which caused the financial crisis. The "too big to fail" problem has not been solved.

We all want a safe and sound financial system. However, history shows that it is naïve to believe that excessive regulation will accomplish this goal. The Federal Reserve economist and the banking regulators did not foresee the recent financial crisis. In fact, they made the crisis much worse by using Basel capital rules and risk weighting assets for political not economic reasons (affordable housing, Greek debt). Why would anyone believe regulators will not make the same mistake in the future or the opposite mistake which they are making today by requiring excessively tight standards for small business loans? Markets participants make mistakes, but they pay the price. Government regulators force all firms to make the same mistakes and the whole economy to pay the price.

History has consistently shown that the best method to reduce the risk of bank failures is strong capital positions. During the recent correction, which was the worst recession since the Great Depression, very few properly capitalized banks failed. In my 40 plus year career, I do not know of a single case where banking regulators knew a bank was in trouble before we did and few cases where properly capitalized banks could not handle economic corrections.

By far the most important aspect of this proposed legislation is the provision which allows properly capitalized banks to opt out of the regulatory nightmare which is paralyzing the industry and slowing innovation, creativity and thereby economic growth. Lower income individuals are the most negatively damaged by this sad situation.

For those primarily focused on safety and soundness, there can be a debate about which is the best capital standard. However, it is enlightening to note that after massive regulatory cost and intrusion over almost 9 years, a number of the largest financial institutions have leverage ratios of less than 8%. If I were CEO of one of these very complex institutions, I could not sleep at night with this low of leverage ratio. I will state with certainty after many years in the banking industry that raising these institutions leverage ratio to 10% would reduce the risk of the banks failing far more then hiring 5000 or 10000 more regulators to micromanage the companies. It is important that the capital ratio be reasonably simple and understandable or large banks will game the system.

Also, for those who want to break up large banks logically raising capital requirements is a far more rational approach then arbitrarily deciding on a maximum size. Economic analysis will force the banks to decide to divest business segments which do not earn satisfactory returns which will significantly enhance the allocation of resources in the economy.

However, there must be a tradeoff between regulatory cost and stronger capital. Financial institutions cannot survive with the stifling cost of Dodd Frank and higher capital. Interestingly, the regulators know this even those they will not admit it. Why have they not insisted on more capital already? Because they know the regulatory cost/capital equation implied in Dodd Frank will not work. They have chosen more regulation over more capital because that is their job and expands their perceived importance.

The opt out provision instead of a forced strategy is an optimal concept. I believe that markets will quickly conclude that those institutions which do not opt out are weak. Who would voluntarily participate in the regulatory quagmire of Dodd Frank? The opt out process will increase capital in the industry thereby reducing risk. The reduced regulatory cost will make financial intermediaries far more efficient and encourage innovation in the industry. Core financial institutions, such as community banks, will be able to get back to their business of growing their communities.

There are no examples of healthy economies without healthy banks.

Resume:

UNC-Chapel Hill: BS in Business Administration, Phi Beta Kappa, 1971

Duke University: Masters in Management, 1974

CEO BB&T: 1989-2008 (Joined BB&T in 1971)
Chairman BB&T: 1989-2009

Distinguished Professor of Practice: Wake Forest University 2009-2012

President and CEO Cato Institute 2012-2015

Executive in Residence: Wake Forest University 2015-Present

Six Honorary Doctorate Degrees

**Testimony of**
**Michael S. Barr**
**The Roy F. and Jean Humphrey Proffitt Professor of Law**
**University of Michigan Law School**
**Before the**
**United States House Committee on Financial Services**
**Hearing on the Financial Choice Act of 2017**
**April 26, 2017**

Chairman Hensarling, Ranking Member Waters, distinguished members of the Committee, it is my pleasure to appear before you today.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 was passed in response to the worst financial crisis since the Great Depression. In 2008, the United States plunged into a severe financial crisis that shuttered American businesses, and cost millions of families their jobs, their homes and their livelihoods. The crisis was rooted in years of unconstrained excesses and prolonged complacency in major financial capitals around the globe. The crisis demanded a strong regulatory response in the U.S. and globally as well as fundamental changes in financial institution management and oversight world wide. The U.S. has led these reforms, both domestically and internationally.

In the U.S., the Dodd-Frank Act was designed to reduce the risk of future crises, and to reduce the harm to the real economy should such a crisis occur again. The Act created the authority to regulate Wall Street 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 through the Volcker Rule and other measures, regulate repo and other short-term funding markets, and beef up banking supervision and increase capital; to require central clearing and exchange trading of standardized derivatives, and capital, margin and transparency throughout the derivatives market; to regulate payments, settlement, clearance and other systemic activities; to improve investor protections; and to establish a new Consumer Financial Protection Bureau to look out for the interests of American households.[1]

While those American families have not forgotten the pain of the financial crisis, a kind of collective amnesia appears to be descending on Washington. Many seem to have forgotten the causes of the financial crisis, and the brutal consequences for American families. Instead of offering hope and opportunity to American families, the legislation being considered by this Committee would needlessly expose taxpayers, workers, businesses and the American economy to fresh risks of financial abuse and financial collapse.

That's not a risk we can or should take.

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[1] See Michael S. Barr, Howell E. Jackson, and Margaret E. Tahyar, Financial Regulation: Law and Policy (Foundation Press 2016), pp. 58-63.

While the draft legislation has many serious flaws, I want to focus here on three key problems: (1) weakening oversight of the financial system, (2) eliminating orderly liquidation, and (3) undermining consumer and investor protections. My testimony is not meant to be comprehensive, but illustrative of the many flawed provisions in the bill.

## I. Weakening Oversight of the Financial System

### a. Eliminating non-bank designations, undermining the Financial Stability Oversight Council, and abolishing the Office of Financial Research.

The Financial Stability Oversight Council (FSOC) has authority to designate systemically important firms and financial market utilities for heightened prudential oversight by the Federal Reserve; to recommend that member agencies put in place higher prudential standards when warranted; and to look out for and respond to risks across the financial system. In support of FSOC, the Office of Financial Research (OFR) provides financial system-wide data on risks throughout the market.

Proposed legislation puts that all at risk.

One of the major problems in the lead up to the financial crisis was that there was not a single, uniform system of supervision and capital rules for major financial institutions. The federal financial regulatory system that existed prior to the Dodd-Frank Act largely developed in the context of the banking system of the 1930s. Major financial firms were regulated according to their formal labels – as banks, thrifts, investment banks, insurance companies, and the like—rather than according to what they actually did. An entity that called itself a "bank," for example, faced tougher regulation, more stringent capital requirements, and more robust supervision than one that called itself an "investment bank." Risk migrated to the less well-regulated parts of the system, and leverage grew to dangerous levels.

The designation of systemically important non-bank financial institutions is a cornerstone of the Dodd-Frank Act. A key goal of reform was to create a system of supervision that ensured that if an institution posed a sizeable risk to the financial system, it would be regulated, supervised, and have capital requirements that reflected its risk, regardless of its corporate form. To do this, the Dodd-Frank Act established a process through which the largest, riskiest, and most interconnected financial firms could be designated as systemically important financial institutions and then supervised regulated by the Federal Reserve. The FSOC has developed detailed interpretive guidance and a hearing process that goes beyond the procedural requirements of the Act, including extensive engagement with the affected firms, to implement the designation process outlined in Dodd-Frank. The approach provides for a sound deliberative process; protection of confidential and proprietary information; and meaningful and timely participation by affected firms. The FSOC has already designated a number of firms under this authority.

Critics of designation contend that it fosters "too big to fail," but the opposite is true. Regulating systemically important firms reduces the risk that failure of such a firm could destabilize the U.S. financial system and harm the real economy. It provides for robust supervision and capital requirements, to reduce the risks of failure, and it provides for a mechanism for the FDIC to wind down such a firm in the event of crisis, without exposing taxpayers or the real economy to the risks of their failure. 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 developed globally.

Other critics argue that the FSOC should be more beholden to its member regulatory agencies, but again, the opposite is true: Congress wisely provided for its voting members, all of whom are confirmed by the Senate, to participate based on their individual expertise and their own assessments of risks in the financial system, not based on the position of their individual agencies, however comprised. Members must individually attest to their assessments in the FSOC's annual reports. The FSOC has the duty to call on member agencies to raise their prudential standards when appropriate, and member agencies must respond publicly and report to Congress if they fail to act. This system of checks and balances requires that FSOC members leave their agency's "turf" at the door, and focus on system-wide risks and responses. If anything, the FSOC's powers should be strengthened, so that fragmentation in the financial regulatory system does not expose the United States to enormous risk, as it did in the past.

Some critics contend that certain types of firms in certain industries or under certain sizes or with certain levels of leverage should be categorically walled off from heightened prudential supervision, but such steps will expose the United States to the very risks we faced in the lead up to the last devastating crisis. The failure of firms of diverse types and diverse sizes at many points in even very recent memory—from Lehman and AIG to Long Term Capital Management—suggest that blindspots in the system should at the very least not be intentionally created in advance by the Congress. The way to deal with the diversity of sizes and types of institutions that might be subject to supervision by the Federal Reserve is to develop regulation, oversight and capital requirements that are graduated, dynamically responsive, and tailored to the types of risks that such firms might pose to the financial system, as the Federal Reserve and other agencies have been doing. FSOC and member agencies also have other regulatory tools available with respect to risks in the system for firms not designated for Fed supervision, including increased data collection and transparency, collateral and margin rules for transactions, operational and client safeguards, risk management standards, capital requirements, or other measures.

Some critics complain that the FSOC's work is too tied to global reforms by international bodies such as the Financial Stability Board (FSB). But global coordination is essential to making the financial system safe for the United States, as well as the global economy. The United States has led the way on global reforms, including robust capital rules, regulation of derivatives, and effective resolution authorities. These global efforts, including designations by the FSB, are not binding on the United States. Rather, the FSOC, and U.S. regulators, make independent regulatory judgments about domestic implementation based on U.S. law. U.S. regulators follow the normal notice and comment process when developing financial regulations. The FSB itself has become more transparent over time, adopting notice and comment procedures, for example, but it could do more to put in the place the kind of protections that the FSOC has established domestically.[2]

As with designation, global coordination—and independent regulatory judgment—is essential to capital rules. Strong capital rules are one key to a safer system. Before the crisis, the financial system was woefully undercapitalized, and that the system was saved only with a massive infusion of taxpayer-funded capital, and a wide variety of unprecedented guarantees, liquidity provision and other backstops by the FDIC, the Federal Reserve, and Treasury. 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 even stronger leverage and capital requirements 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. We need to continue to insist that European capital standards and derivatives regulations are strong—and enforced even-handedly across the board.

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 (FSB), and pursuing strong global reforms on capital, derivatives, resolution, and other matters.

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. While the process of reaching global agreement has at times been quite messy, divisive, and incomplete, the last thing we need is to hamstring global cooperation or U.S. regulation. These mechanisms should be strengthened and improved, not ignored or weakened.

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[2] *See* Michael S. Barr, *Who's in Charge of Global Finance?*, GEORGETOWN JOURNAL OF INTERNATIONAL LAW 45, no. 4 (2014): 971-1027.

Strong U.S. financial rules are good for the U.S. economy, American households and businesses, and 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 that crushes the U.S. economy.

Why would anyone want to poke out the eyes of financial regulators by eliminating the Office of Financial Research, an agency with no regulatory turf, but with the sole mission of informing regulators, markets and the public about evolving financial risks? The proposed legislation would mindlessly eliminate an agency dedicated to fostering transparency, improving science and knowledge, and exposing harmful practices.

b. Hollowing Out Supervision of Bank Holding Companies

The Federal Reserve has supervisory authority, as it has long had, over bank holding companies. The Fed is directed under section 165 of the Dodd-Frank Act to provide for a graduated system of regulation, with increasing stringency, depending on the risk that the firm poses to the financial stability of the United States, based on its nature, scope, size, scale, concentration, interconnectedness or other factors. The Fed may tailor these more stringent prudential standards for individual firms or categories of firms, based on a similar set of factors regarding risk.

These enhanced prudential measures include risk-based capital requirements and leverage limits, liquidity requirements, risk management, resolution planning, credit exposure reporting, concentration limits, and annual stress tests.

The Fed is not required under this provision to apply these more stringent standards to bank holding companies with assets under $50 billion. Annual firm-led stress tests, however, are required for financial institutions between $10 and $50 billion in size, and the Fed must itself stress tests firms over $50 billion in size, in addition to such financial firms semi-annual firm-led stress tests. Publicly traded bank holding companies with $10 billion or more in assets must establish risk committees. (I should also note that under the Dodd-Frank Act, the Federal Reserve may, upon recommendation of the Financial Stability Oversight Council, raise the threshold above $50 billion for certain prudential standards, those involving contingent capital, resolution planning, concentration limits, enhanced public disclosures and short-term debt limits.)

None of these enhanced measures apply to about 95% of banks, the category commonly described as community banks, those under $10 billion in assets. Thus exempt are more than 6,000 banks in communities all across the country.

Graduated standards are already at work. Fed stress testing applies to the largest firms in the country, the 31 firms with assets of $50 billion and above. Such firms represent a wide variety of risk profiles, business strategies, sizes, specializations, and include both foreign and domestic firms. The largest, most complex financial institutions face the most stringent standards, as provided for under the Dodd-Frank Act. The Fed, for example, imposes a supplementary leverage ratio, a counter-cyclical capital buffer, and detailed liquidity coverage rules only on 14 firms with over $250 billion in assets. The very largest U.S. banks on a global basis, currently eight bank holding companies, are subject to even tougher standards, including capital surcharges, more stringent leverage ratios, and long-term debt requirements.

Stress testing is a central and innovative risk management tool used since the financial crisis by both regulators and practitioners. Stress testing attempts to capture the effects of macro shocks on the balance sheets and activities of firms. Unlike fixed capital ratios, of either the risk-based or leverage ratio type, stress testing seeks to understand how macro shocks would deplete capital. Moreover, the stress tests are not as easy for financial institutions to game as fixed capital rules. It would be a serious mistake to exclude bank holding companies from stress testing based merely on meeting a fixed capital ratio, or to otherwise hamstring stress testing by the Fed.

In my view, the Fed's graduated approach to supervision and regulation makes sense. Some have argued that the size threshold for heightened prudential standards should be substantially increased, while others have argued that banks should not be subject to any heightened standards unless they are specially designated as systemic. Both approaches, in my judgment, are mistaken.

First, as to size, some have mistakenly said that the Dodd-Frank Act describes firms with only $50 billion in assets as systemic. But that is simply not the case. Congress set the $50 billion threshold, and another threshold for other measures at $10 billion, to provide a floor under which smaller firms would know that they are not subject to the new sets of rules. But the rules were not meant to only apply to the very few largest firms in the country. They are not intended to apply only to systemically important firms.

They are designed to work in a graduated, tailored way to increase the resiliency of the financial system as a whole. Risks aggregate across the financial system, including from institutions of a variety of sizes and types. It is the very anti-thesis of macro-prudential supervision to focus only on the very largest handful of financial firms and to ignore risks elsewhere in the system. The public interest is in the health of the financial system as a whole. Moreover, smaller financial institutions themselves face risk from larger institutions and from activities across the system as a whole. Understanding those risks is essential if we are to have a safer financial system than the one we had before the financial crisis. We must not intentionally blind regulators to these risks in advance.

Second, as to the idea of designation, others have argued that bank holding companies should have to be designated for heightened supervision by the same process the FSOC uses for non-bank firms. But that runs counter to the purpose of nonbank designation. Bank holding companies should not be required to be designated for heightened supervision. Bank holding companies are already supervised by the Fed, and the Fed already has authority to impose heightened prudential supervision on such firms, on a graduated basis, as they increase in size and complexity.

The reason for the designation process, under section 113 of the Act, for nonbank financial institutions is that such institutions were not subject to meaningful, consolidated supervision by the Fed at all. In the lead up to the Financial Crisis, firms such as Lehman Brothers and AIG could operate with less oversight, more leverage and riskier practices. Recognizing that policing the boundaries of financial regulation is critical to making the financial system safer, fighting regulatory arbitrage, and providing oversight of shadow banking, the Dodd-Frank Act established a process for bringing such non-bank financial institutions into the system of regulatory oversight.

It makes little sense to require designation of firms that are already supervised by the Fed, and it will dramatically slow down and disrupt the Fed's existing oversight system. It will make the financial system weaker, not stronger.

The proposed legislation offers up a simple option, to be exercised at the discretion of Wall Street firms—a 10% leverage ratio gets big firms like Goldman Sachs and Wells Fargo out of the heightened supervision of the Fed. That's a big mistake, not just because it will incentivize firms to take on riskier activities, but also because it will blind the Fed to future risks. It adds another layer of complexity to the existing set of capital rules. It benefits only the biggest banks subject to the Fed's heightened supervision. It lets Wall Street firms choose whatever approach is least constraining for them, even if it means bigger risks for the rest of us. That's choice for Wall Street, pain for American families.

None of these changes will help truly small, home-town banks. There is undoubtedly much that could be done to reduce regulatory burden on the smallest banks. Small banks could benefit from clear safe harbor rules and short, plain-language versions of regulations that do apply to them. The Fed can continue to improve its tailored and graduated approach to supervision. Strong, compliant small banks should have longer examination cycles and streamlined reporting requirements. Regulators and the industry should come together in a task force to come up with better ways to implement the goals of the Bank Secrecy Act and related rules to make it more likely that we catch terrorists and criminals, with lower regulatory burden. And we need a level playing field for small business lending, so community banks can compete with non-bank providers to provide safe, transparency, consumer-friendly loans to small businesses and entrepreneurs.

II. Eliminating Orderly Liquidation

The Financial Crisis produced the worst economic recession in the United States since the Great Depression, leading to the near-total collapse of the global financial system, wiping out retirement savings, and costing millions of American families their jobs, homes and livelihoods. At the height of the crisis, Lehman collapsed into disorderly bankruptcy, causing panic throughout the financial system, American International Group (AIG) was bailed out by the government, prompting widespread revulsion and exposing taxpayers to extreme risks, and President George W. Bush and Congress stepped in to pass the Troubled Asset Relief Program, which, though essential to stem the panic, was one of the most reviled economic enactments in modern memory.

In response to the crisis, Congress passed Dodd-Frank, to help make the financial system safer and fairer. The Act strengthened oversight of the largest banks, provided a mechanism to ensure supervision of firms like Lehman and AIG that had escaped Fed regulation, created tough new rules for derivatives trading, and bolstered consumer and investor protection. One key measure the Act contained is the Orderly Liquidation Authority, which for the first time provided the FDIC with the tools it needs to deal with the failure of failure of a systemically important firm.

Why is Orderly Liquidation important? When a traditional bank or thrift depository institution is either failing or on the verge of failure, the FDIC has long had the authority to step in to guide the failing institution through a process that limits collateral damage, and protects taxpayers and the broader economy as a whole. As the Financial Crisis demonstrated, though, with respect to failing non-bank institutions like Lehman Brothers or AIG, or complex bank holding companies, the only available options were bankruptcy or government bailouts, both of which proved unacceptable.

Under the Orderly Liquidation Authority, the FDIC now has the capacity to deal with the potential failure of a major financial conglomerate in an orderly fashion that limits collateral damage to the system. Shareholders and other providers of regulatory capital and long-term convertible debt to the firm will be forced to absorb any losses.

The FDIC has made significant progress in developing a strategy under the Dodd-Frank authorities, known as the "single point of entry," which would permit the holding company of a financial conglomerate to be resolved without necessarily disrupting the ability of its operating subsidiaries—bank, broker-dealer, or other parts—to function. Firms are required to hold sufficient long-term debt at the holding-company level to facilitate an orderly winding down of the holding company while permitting operating subsidiaries of the firm to continue to operate. Management can be terminated and the compensation of culpable managers can be clawed back. Critical assets and liabilities of the firm can be transferred to a bridge institution so that the firm can be resolved without causing cascading collapses in the financial system. In the event that the firm's internal capital and long-term debt are insufficient to support restructuring and ongoing operations, liquidity can be obtained through Treasury borrowing that is automatically repaid from the sale of assets of the failed firm or, if necessary, from a preauthorized, ex post assessment on the largest financial firms—not by taxpayers. In this manner, the resolution authority allows the government to resolve the financial conglomerate without exposing the system to a sudden disorderly failure that puts the whole financial sector at risk.

When Lehman Brothers entered into bankruptcy in September 2008, it caused a seismic shock in our financial system. The complicated web of Lehman's financial obligations left balance sheets worldwide exposed to a cascade of default risk, and contagion spread the risk throughout the financial system. It would be foolish to rely *solely* on the hope that bankruptcy judges, even if the House-passed bill were to become law, could manage the failure of a financial institution of the size, complexity, and interconnectedness, and cross-border exposures and activities of Lehman, AIG, or the largest U.S. bank holding companies, insurance conglomerates, or investment banks.

Orderly Liquidation has three essential features: First, supervision, planning, and management. Resolution of a failing firm is part of an integrated system of ongoing supervision by the Fed and FDIC, including stress tests, living wills, pre-placed capital and convertible debt. It relies on management of resolution by an expert agency with a large, dedicated and experienced staff. Supervisors, seeing deep financial stress at a firm, can put the firm into resolution, restructure its capital and debt, and create a bridge institution for its ongoing operation—before it is too late.

Second, the availability of FDIC-provided liquidity in a crisis, backed by the firm's assets, when private sector lenders are likely to balk. Without that, resolution is a fool's errand, likely to spark widespread panic. Taxpayers are fully protected by the firm's collateral and by automatic assessments on the largest financial institutions should such assets prove insufficient.

Third, global coordination with foreign regulators, based not only on pre-negotiated legal memorandums of understanding, but also war gaming, communications, and, most importantly, the development of a trusted relationship earned over time.

Bankruptcy, even if reformed, cannot replicate these three essential features.

The proposed legislation under consideration by the Committee would eliminate OLA, blind the FDIC by removing it from the living will process, and take other measures to weaken Federal Reserve oversight of Wall Street firms, both banks and non-banks. To eliminate OLA is to consciously forget key lessons of the Financial Crisis. It is to carelessly throw away a useful and necessary tool and blind oneself to the amount of risk the failure of large, complex financial institutions pose to our financial system. Without OLA, a central and known problem that contributed to our last financial crisis will become a core problem of our next one. We have enough work still to do on the path of reform without undermining our progress thus far.

III. Undermining Consumer and Investor Protection

a. Weakening the Consumer Financial Protection Bureau

Congress created the Consumer Financial Protection Bureau (CFPB) to protect people from harmful and abusive financial practices. And that is exactly what the consumer bureau has done; in just six years, the agency has secured nearly $12 billion in relief for more than 29 million consumers.

Yet the consumer bureau has been under perpetual attack by many in the financial sector and by a significant number in Congress, with calls to fire the Bureau's Director and to weaken the agency. Proposed legislation before the Committee would cripple the agency, through a wide-ranging set of procedural changes, blocking its ability to regulate payday lending, auto finance, payment cards, unfair, deceptive, or abusive acts or practices, and barring the consumer agency from taking on abusive practices in arbitration agreements, agreements that often block a consumer from getting her day in court.[3] That would be a profound mistake.

The Financial Crisis of 2008 stripped millions of Americans of their livelihoods. Many consumers lost everything—their jobs, their money, their homes—in a matter of months, days, even hours. And those most affected were those that needed the most protection. The young, the elderly, our nation's service members and veterans, minority households and, in fact, all working families across our nation were brutally assaulted by the crisis.[4]

In an effort to curb the abusive practices that abounded pre-crisis, the Dodd-Frank Act created the Consumer Financial Protection Bureau. President Barack Obama appointed Richard Cordray as the Director of the Bureau and after a lengthy review, the Senate overwhelmingly confirmed him on a bi-partisan basis, 66-34.

Under the direction of Cordray, Ohio's former Attorney General, longtime champion of consumers, and a man of deep integrity, the CFPB has made huge strides in bringing to light and fighting abusive and deceptive behavior of financial institutions.

Through its supervision, enforcement, and rule-making, the CFPB is helping consumers get a fair shot in a financial system that too often seems to ignore basic values of trust and honesty.

To date, the CFPB has recovered $11.7 billion from credit card banks, payday lenders and other financial firms, providing relief for approximately 27 million consumers. The CFPB has also imposed $440 million in civil penalties to punish wrongful conduct and deter future harms.

The CFPB has created a consumer complaint database to ensure that consumers are heard. This complaint process provides consumers with a forum for comparing financial companies and helps the Bureau pinpoint the most dangerous practices. Consumers have filed nearly a million complaints through the system. The CFPB handled over 26,000 consumer calls every month, and over 3,500 companies have responded to consumer complaints submitted through the database.

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[3] For background on arbitration clauses, see Michael S. Barr, *Mandatory Arbitration in Consumer Finance and Investor Contracts,* NEW YORK UNIVERSITY J. OF LAW AND BUSINESS vol. 11-4: 794-817 (2015).

[4] See, e.g., Michael S. Barr, NO SLACK: THE FINANCIAL LIVES OF LOW INCOME AMERICANS, Brookings Institution Press, 2012; Michael S. Barr and Daniel Schaffa, *Nothing Left to Lose?,* Washington Center on Equitable Growth Working Paper 2016-09 (Sept. 2016), http://equitablegrowth.org/working-papers/nothing-left-to-lose/.

The CFPB has made significant progress in protecting and empowering consumers that are among the most vulnerable to financial manipulation, including students, veterans and military families, and the elderly.

The CFPB has put together a toolbox to help students make informed choices about loans and payments. One resource in this toolbox is the Financial Aid Shopping Sheet, which the CFPB created together with the Department of Education to help students understand the types of loans they would qualify for. The CFPB has also fought against bad practices, including by recovering $480 million for students at for-profit chains who were deceived into taking predatory loans.

The CFPB has helped veterans and military families, who are too often taken advantage of, especially during overseas deployments of loved ones. The CFPB protects servicemembers from by practices by payday lenders and has recovered over $100 million in refunds. It has provided military families with materials to help educate them about financial services, including payday loans and mortgages. Through both enforcement and education, the CFPB has made significant strides to ensure the financial safety of our military servicemembers.

Older consumers are much more susceptible to financial abuse, and the CFPB has helped to shield the elderly from deceptive practices. According to a survey conducted last year, 6.8 million American citizens aged 65 or older—approximately 17% of America's senior citizens—have been "taken advantage of financially." Many older Americans may not even realize that they have been deceived. The CFPB has collaborated with the Federal Deposit Insurance Corporation to create the Money Smart for Older Adults, which help equip senior citizens with tools to detect and prevent financial exploitation. The CFPB has released other tips to protect the elderly from financial fraud and manipulation, and its enforcement actions are protecting older Americans from abuse.

American consumers cannot afford to see the CFPB weakened or its director fired.

Now some are arguing that the consumer agency's structure is unconstitutional, and the legislation being considered by this committee would strip the Director of removal protections designed to preserve the agency's independence. I recently joined others in filing an amicus brief in support of the consumer agency. The crux of the constitutionality question is this: Can an independent agency be run by a single director, or must it be run by a multi-member commission? The constitutional question is part of a broader fight that began during the debate over Dodd-Frank itself over whether to create the new consumer agency at all.

Opponents charge that the consumer bureau is too powerful because it is independent from the White House—its director can only be removed "for cause," unlike some agency heads, who work at the pleasure of the President, such as the Secretary of Housing and Urban Development. This question of the President's ability to remove the head of an independent agency may seem obscure, but it has some notoriety as a legal question, owing to a landmark 1935 case stemming from when Franklin D. Roosevelt tried to fire a Federal Trade Commission official. The Supreme Court held then that Congress could protect independent agencies from presidential impulses by including a "for-cause" removal provision in an agency's enabling statute.

There is no one-size-fits-all approach to creating a new agency, and Congress has properly experimented with a wide variety of agency designs since America's founding. Currently, a range of structures and organizational features exist across government agencies. Some, like the CFPB, the Office of the Comptroller of the Currency, and the Social Security Administration, are run by a single director, while others have commission structures of different shapes and sizes. Some agencies have fixed terms for directors and statutory removal protections, while others do not. Agencies are funded through a wide variety of mechanisms, including fees, fines and penalties, deposit insurance premiums, earnings on reserves, revolving funds, and permanent spending authorizations; in fact, most federal spending today does not occur through annual appropriations.

To promote the accountability and effectiveness of the consumer bureau, Congress established it as an independent agency with a single director. Congress also provided that the director could not be removed except for good cause. And as Congress has with other bank regulators such as the Federal Deposit Insurance Corporation, it provided the consumer agency with a funding stream without requiring annual congressional appropriations.

In other words, Congress sought to make the consumer bureau truly *independent*—to minimize the risk that the agency would be "captured" by the financial firms it regulates through pressure on Congress or on the President.

However, Congress wanted to make sure the consumer bureau would be, nonetheless, accountable to the public through their elected officials and other means.[5] As such, it has been subject to regular scrutiny by Congress, including regular reporting and more than 60 hearings thus far at which representatives of the agency have testified. And there are many other ways the agency is held accountable: unlike other bank regulators, it is subject to a statutorily imposed budget cap; it must undergo Government Accountability Office audits and Federal Reserve Board Inspector General oversight; it is subject to the strictures of the Administrative Procedures Act; by statute it must use cost-benefit analysis; and, as with other agencies, the bureau's actions are reviewable by the courts. Uniquely, the consumer agency's rules are subject to a potential veto by other regulators on the Financial Stability Oversight Council. The consumer bureau shares enforcement with state attorneys general, and must coordinate with the Federal Trade Commission and bank regulators, providing another check on its actions.

[5] See Michael S. Barr, *Accountability and Independence in Financial Regulation: Checks and Balances, Public Engagement, and Other Innovations,* LAW & CONTEMPORARY PROBLEMS 78(3): 119-128 (2015, symposium issue).

The consumer bureau is also directly accountable to the public in a number of ways. The bureau's consumer complaint database allows the public the opportunity to provide input directly into the agency's decision-making process. The bureau is required to consult with the public and small businesses; to establish and consult with advisory boards, including those representing military families, veterans, and older Americans; to have a public ombudsman for student loans; and to conduct regular public reviews of markets and its regulations. The agency has also held 38 public field hearings around the country since its inception.

These measures provide constitutionally sufficient and effective accountability to the public. Congress should not re-write the Dodd-Frank Act to make the CFPB's director removable at will, continually call for the Director's removal, subject it to annual appropriations, curtail its supervisory, enforcement or rule-writing authorities, or otherwise hamstring its ability to protect American consumers. The Consumer Financial Protection Bureau should be allowed to do its job.

b. Investor Protections

In the lead-up to the financial crisis, investors were mis-led by broker-dealers who sold them mortgage-backed securities and other investments that made little sense for them, but were advantageous to Wall Street firms. Retirement savers were offered products based on sales incentives to brokers, rather than their own needs. Managers of financial companies saw huge bonuses even as they drove their companies were driven off a cliff. Voices of reason and shareholder advocates were shunted to the side, while irresponsible behavior helped to crush the U.S. economy.

Proposed legislation under consideration today would stifle American investors, limit their voice, and expose American workers once again to abuse.

Remarkably, the proposed legislation would abolish the Department of Labor's fiduciary duty rule, which was designed to protect American workers from conflicted investment advice. Repeal of the rule would eat into the retirement savings of hard-working Americans and expose them to risks from products peddled to them more to pad the wallets of brokers than to meet the true investment needs of retirement savers. Investment advisors and brokers providing investment advice should meet the same high standard of care, one focused solely on the interests of their clients and customers.

The proposed legislation would limit shareholder's ability to vote annually on "say on pay" resolutions regarding management compensation, and burden proxy advisory firms working to give investors a "say on pay." The bill would also make it harder for shareholders to submit proposals for management reform, and burden the ability of shareholders to vote on boards of directors, such as the hotly contested fight expected over the Wells Fargo board, in the wake of the Wells Fargo fraud scandals.

The bill, through a variety of provisions, would reduce transparency and accountability in credit ratings, making it easier for credit rating agencies to dupe investors with flimsy ratings methodologies.

The bill would repeal authority for the SEC to restrict mandatory pre-dispute arbitration clauses, exposing investors to abuse without any right to their day in court.

Doubling down on a flawed strategy recently taken under the Congressional Review Act, the bill would eliminate the duty of oil and gas companies to report on their payments to foreign governments and the duty to be transparent about the use of minerals fostering conflict in Africa.

The proposed legislation would eliminate the designation of Financial Market Utilities (FMUs) and the authority to impose heightened prudential requirements on such entities. These FMUs are the essential plumbing of the financial system. They connect our financial markets and institutions and are responsible for managing the flow of trillions of dollars a day in transactions in payments, settlement and clearance systems. They are essential for the smooth functioning of every U.S. financial market—derivatives, securities, payments, and foreign exchange. Weakening oversight of FMUs will expose every financial institution in the United States to risks throughout the financial network.

The bill would eliminate prohibitions on conflicts of interest in securitizations, and by repealing the Volcker Rule, unleash bank holding companies to engage in proprietary trading and hedge fund investments without prudential safeguards. Structural reforms, including the Volcker Rule, are important for several reasons.

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 can be used to help clarify lines of authority, 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. The core banking services upon which everyday economic life depends would be better protected.

Third, paying attention to structure will help to resolve companies when they get into distress. As discussed above, the FDIC is developing a "single point of entry" model for resolution that would allow it to wind down a complex financial conglomerate by separating it into a holding company with "resolution-ready" capital and equity, while permitting solvent subsidiaries to continue to operate. Structural reform will make it much more likely that such resolution plans would work in a crisis.

The US has long used the bank holding company structure to try to separate banking from other financial activities within a complex group. Recent reforms under the Dodd-Frank Act strengthened the wall between banks and other parts of a financial group, and pushed proprietary trading and significant hedge fund investing outside the group entirely.

None of these approaches is perfect, 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 has permitted a wide range of financial activities within bank holding companies, but has also insisted structural safeguards.

Ring fencing by itself, of course, will not bring financial stability. We had forms of ring fencing before the crisis, as in the US, where it blinded regulators to the dangers of shadow banking. As a result, 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 reforms to derivatives, repo and other markets. Ring fencing is no excuse to avoid regulating non-bank firms and markets that can pose a risk the financial system.

The proposed legislation hamstrings SEC enforcement against bad actors and frees fraudsters to prey on investors once again. It also weakens clawback provisions designed to keep executive officers focused on sound accounting company-wide.

In sum, the proposed legislation crushes investor hope, mocks investor opportunity, and undermines the transparency, honesty, and trust essential for capital formation.

## IV. The Path of Reform

The Dodd-Frank Act laid a firm foundation for a more resilient financial sector, one that works for American families, instead of exposing us all to needless risk and harm. Since enactment, a new and highly effective Consumer Financial Protection Bureau has been built from scratch. New rules governing derivatives have been implemented to bring trading out of the shadows and reduce risk through central clearing, capital and margin requirements. A resolution authority has been put in place to deal with failing firms so we are no longer faced with the devastating consequences of the failure of a firm like Lehman Brothers or the untenable bailouts of firms like AIG. Regulators have the ability to designate large firms for supervision by the Fed, so the financial sector can no longer avoid stringent regulation just by altering their corporate form. The largest firms have to hold a lot more equity capital as a buffer against losses, and the Volcker Rule, heightened prudential supervision, stress tests and other measures are reining in risk.

The U.S. financial system is more resilient than it was in 2008. But there's still much work to do.[6]

[6] See, e.g., Michael S Barr, *The Financial Crisis and the Path of Reform,* 29 YALE J. ON REG. 91-119 (2012); Michael S. Barr, ed., FINANCIAL REFORM: PREVENTING THE NEXT CRISIS, The Russell Sage Foundation Journal of the Social Sciences, Vol. 3:1 (Jan. 2017).

We need to keep pushing for stronger reforms of the largest, most complex banks and other financial institutions. Stress testing and new capital rules have dramatically increased the levels of capital at the largest firms, but we do not yet know whether these levels are sufficiently robust to withstand a severe financial crisis. A bank liability tax could help further reduce incentives to take on risky short-term debt. Shadow banking activities, repo and securities financing transactions, and short-term funding need to be made safer with strong margin and collateral rules. We need to better align manager's incentives with financial stability, by putting banker bonuses at risk when a firm's capital level drops below specified levels or when the firm is hit with fines or sanctions.

More broadly, Fannie Mae and Freddie Mac remain in conservatorship without a decision about long-term housing finance; money market mutual funds remain susceptible to runs; certain high-frequency trading strategies and market structure problems threaten financial stability and undermine the fairness of our markets; and critical investor protection authorities have gone unused.

To be clear: the financial system is safer, consumers and investors better protected, and taxpayers more insulated, than they were in 2008—by a lot.

But that is not enough. We need to stay on the path of reform to make the financial system safer, fairer, and better harnessed to the needs of the real economy. We must not roll back the essential reforms put in place in the wake of the financial crisis. We must not weaken the independence of agencies and make them more prone to industry capture. Rather, we need to keep pushing for a financial system that works for all of us.

Testimony of Dr. Lisa D. Cook
Associate Professor of Economics and of International Relations
Michigan State University
Before the House Committee on Financial Services
April 26, 2017

Chairman Hensarling, Ranking Member Waters, and eminent Members of the Committee, thank you for the opportunity to testify today about the Financial CHOICE Act of 2017.

Americans are still hurting from the significant slowdown in economic activity that started in December 2007, the worst financial and economic crisis since the Great Depression. Recall that From my research on foreclosure in Michigan, I know that Michigan was particularly hit hard by the foreclosure crisis due to mass layoffs in the auto industry in the mid-2000's and weak regulation of the mortgages. The fall in earnings rendered families incapable of meeting their mortgage payments, which set off a chain of events at Bear Stearns and which ultimately led to the financial crisis.

The irresponsible lending practices that characterized this period and a welter of agencies overseeing consumers proved to be unsustainable. In the wake of this crisis, this body passed the Dodd-Frank Wall Street Reform and Consumer Protection Act, which attempted to address weaknesses in the financial system, with respect to macroprudential regulation and consumer protection.

It is laudable and warranted that this body is concerned about robust economic growth, the smooth functioning of the financial system, and vigilance in the protection of consumers and is now reviewing the Dodd-Frank Act. The problems it attempts to address were a long time in the making. It is very complex and, like most complex legislation, imperfect. Much criticism has been leveled against various aspects of the Dodd-Frank Act, which the Financial CHOICE Act seeks to undo.

One charge against the Dodd-Frank Act is that higher capital requirements – through capital ratios and risk-weighted ratios – constrain lending activity and, therefore, economic growth. More capital on hand when lenders lend means that more of their money is at risk than before Dodd-Frank.

If higher capital requirements constrained lending and therefore economic growth, we should see a fall in both since the passage of Dodd-Frank in 2010. Instead, we see both increasing.

According to the latest data available, commercial and consumer loans grew between 0.5 percent and 12 percent annually since 2012.[1] Household debt at the end of 2016 stood at

[1] https://www.federalreserve.gov/releases/h8/Current/

$12.6 trillion, which is 0.8 percent below its peak of $12.6 trillion in the third quarter of 2008.[2] The economy has expanded between 0.2 percent and 6.7 percent since the first quarter of 2011.[3]

It has also been suggested that regulation pertaining to consumer protection is onerous and should be scaled back. The recent evidence does not suggest that regulators should be less vigilant in protecting consumers. The Consumer Financial Protection Bureau has been critical in bringing to light and punishing abusive and illegal behavior by banking institutions, such as in the case of Wells Fargo, whose employees opened over two million fake accounts, engaged in discriminatory lending practices, and participated in illegal student-loan servicing practices.[4] Indeed, with respect to my own industry of higher education, the CFPB has been instrumental in putting the student debt crisis on the country's radar screen, as well as pursuing scams and abusive practices in student-loan servicing.[5] It appears that the CFPB has been very active in ensuring consumer protection in the financial services sector and that this should be at least sustained, if not augmented.

Some critics of Dodd-Frank believe that measures constraining the activities banks can engage in are burdensome and diminish economic growth. Some of these measures included constraints on lending activity, especially related to financial derivatives. The lack of regulation of derivatives prior to the crisis and the size of the market, over $400 trillion in 2015, suggest that the Commodity Futures Trading Commission's work, which was empowered by the Dodd-Frank Act, is and will continue to be important to financial stability.[6]

A fourth critique of Dodd-Frank is that the Federal Reserve's activities are too far-reaching and deserve more oversight. As a macroeconomist who has researched or advised various countries on financial crises and reform, this criticism of the Federal Reserve is difficult to understand. Preventing financial crises and restoring safety and soundness to the financial system should be addressed by the Federal Reserve system experts in monetary policy and macroeconomics and who have a broad sense of the financial linkages throughout the economy. Fighting fires requires the expertise of firefighting professional who have a sense of not just individual homes, structures, and property but also of the terrain, regional water resources, and the like. I saw this first hand in the Rockridge-Oakland Hills fire of 1991 when fire officials had to quickly address public safety concerns, as well as individual homeowner

[2] https://www.newyorkfed.org/newsevents/news/research/2017/rp170216
[3] https://fred.stlouisfed.org/series/A191RP1Q027SBEA
[4] See testimony of Richard Cordray, April 5, 2017, https://www.consumerfinance.gov/about-us/newsroom/written-testimony-of-cfpb-director-richard-cordray-before-the-senate-committee-on-banking-housing-and-urban-affairs-20160407/ and Lisa D. Cook, http://knowledge.wharton.upenn.edu/article/how-the-wells-fargo-scandal-will-reverberate/.
[5] https://www.consumerfinance.gov/about-us/newsroom/cfpb-halts-student-loan-debt-relief-scam/
[6] See https://www.gsb.stanford.edu/insights/anat-admati-are-banks-safe-now.

concerns. Experts in fighting wildfires and financial fires should be given as many tools as possible to combat fires and prevent them from spreading.[7]

To be sure, there are features of financial regulation that can be refined for the purpose of promoting financial reform. Some reporting requirements under are likely burdensome to the smallest banks. While close monitoring and supervision of systemically important banks is still a major concern, it may be worth this body's considering whether some reporting requirements may be streamlined without compromising bank stress tests. Particular attention may be given to smaller banks with capital under $1 billion, such as community banks. Indeed, simpler and tiered Basel III capital requirements may be in order.

Certainly, as this example illustrates, the evidence suggests that continued financial reform is needed along with vigilance in execution of the provisions of financial reform. What is less desirable is completely rolling back measures in the Dodd-Frank Act and putting the American people, and their hopes and opportunities, at risk again.

[7] See comments of current and former Federal Reserve Bank Chairs Janet Yellen and Ben Bernanke on the role of economists in resolving crisis in the past and in the future:
https://www.federalreserve.gov/newsevents/speech/files/yellen20160826a.pdf and
https://www.federalreserve.gov/newsevents/speech/bernanke20100924a.htm.

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*CONGRESSIONAL TESTIMONY*

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# Regulatory Reforms to Create Hope and Opportunity for Investors, Consumers, and Entrepreneurs

## Testimony before the Committee on Financial Services, United States House of Representatives

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Chairman Hensarling, Ranking Member Waters, and Members of the Committee, thank you for the opportunity to testify at today's hearing. My name is Norbert Michel and I am a Senior Research Fellow in Financial Regulations and Monetary Policy at The Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

The 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act spawned approximately 400 separate rulemakings across the financial sector, and was the most extensive financial regulatory bill since the 1930s.[1] It expanded the existing authority of the federal regulators who missed the 2008 financial crisis, created new federal agencies, and dramatically altered the regulatory framework for several distinct sectors within the financial industry.[2] Dodd–Frank failed to adequately address the causes of the crisis, imposed unnecessarily high compliance burdens on firms, worsened the too-big-to-fail problem, and contributed to the unusually sluggish recovery. It extended command-control-type regulation well beyond the banking sector even though this approach has repeatedly failed to keep the banking system sound.

My Heritage Foundation colleague, Salim Furth, and I have used a standard macroeconomic model to quantify the benefits of reducing one of the likely effects of Dodd–Frank: excess borrowing costs.[3] After estimating that these excess borrowing costs are 22 basis points, we estimate that removing this "investment wedge" would have a measurable positive impact on the economy, and that legislation repealing Dodd–Frank would have a budgetary impact that triggers a dynamic score from the Congressional Budget Office.

Our estimates of this Dodd–Frank "repeal" scenario predict that, on average from 2017 to 2026, removing the investment wedge would increase gross domestic product (GDP) 1 percent per year, increase the capital stock by almost 3 percent per year, and decrease the federal debt ratio by nearly 1 percent per year. The model estimates between $64 billion and $340 billion in 10-year revenue gains from removing the investment wedge, and revenue gains between $202 billion and $817 billion over a 20-year horizon.

Ideally, Congress would repeal the Dodd–Frank Act and focus, instead, on policies that improve private incentives in financial markets, increase competition in financial markets, and reduce the ability for private financial firms to mitigate losses with government backing.[4] This testimony focuses on three aspects of the financial regulatory framework that Congress should focus on to strengthen private financial markets and help spur sustainable economic growth. Specifically, it argues that Congress should (1) require

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[1] Ayesha Javed, "Six Years On, 30% of Dodd–Frank Rules Yet to Be Finalized," Bloomberg, July 28, 2016, https://www.bloomberg.com/enterprise/blog/six-years-30-dodd-frank-rules-yet-finalized/ (accessed March 10, 2017).

[2] For a title-by-title examination of Dodd–Frank, see Norbert J. Michel, ed., *The Case Against Dodd–Frank: How the "Consumer Protection" Law Endangers Americans* (Washington, DC: The Heritage Foundation, 2016), http://thf-reports.s3.amazonaws.com/2016/The%20Case%20Against%20Dodd-Frank.pdf.

[3] Norbert J. Michel and Salim Furth, "The Macroeconomic Impact of Dodd–Frank—and of Its Repeal," Heritage Foundation *Issue Brief* No. 4682, April 13, 2017, http://www.heritage.org/sites/default/files/2017-04/IB4682.pdf.

[4] For additional policies that accomplish these goals, see Norbert J. Michel, ed., *Prosperity Unleashed: Smarter Financial Regulation* (Washington, DC: The Heritage Foundation, 2017), http://www.heritage.org/government-regulation/report/fixing-the-regulatory-framework-derivatives, and Michel, *The Case Against Dodd–Frank: How the "Consumer Protection" Law Endangers Americans*.

all failing financial firms to go through bankruptcy; (2) eliminate the Consumer Financial Protection Bureau; and (3) repeal the Durbin Amendment.

**Improvements to Bankruptcy Law**

Largely due to systemic risk concerns, the current regulatory framework holds depository institutions and certain large financial institutions out of the Chapter 11 bankruptcy proceedings available to non-financial firms. These financial institutions are given special resolution processes under the premise that it will help protect taxpayers, keep financial markets stable, and prevent financial crises from spreading to the broader economy. This policy is a mistake that should be corrected by allowing all firms, banks included, to go through bankruptcy.[5] Aside from the lack of evidence that these special resolution procedures can prevent systemic risks from spreading to the broader economy, there is no objective way to differentiate the economic impact of large failing financial institutions from those of large non-financial firms.

Furthermore, the core idea behind the Chapter 11 bankruptcy process that is open to non-financial firms is that those proceedings will create an orderly wind down of the company, enabling the distressed firm to remain in business and pay its creditors what they are owed over time in an equitable and orderly manner. The process is designed to avoid a mad rush of creditors seeking the money the failed firm owes them in a chaotic manner. The fact that banks have insured depositors is entirely consistent with this type of orderly resolution process.

There has never been a clear economic reason that this process would create systemic problems if it were open to financial firms, and a main problem with the pre-2008 crisis framework was that the bankruptcy code included special exemptions (safe harbors) for derivatives and repurchase agreements (repos). These safe harbors from core bankruptcy provisions distorted financial markets leading up to the 2008 crisis because they gave derivative and repo users preferred positions relative to other types of creditors. The safe harbors were justified on the grounds that they would prevent systemic financial problems, but that theory proved false in 2008.[6]

A firm (the debtor) that files for bankruptcy protection under Chapter 11 of the U.S. Code literally makes this filing to gain protection from creditors who may seek control of the firm's assets because they fear nonpayment. The court creates an "estate" that consists of virtually all of the debtor's assets as of the petition date. To ensure that the estate remains a viable business, the bankruptcy filing triggers a provision known as the automatic stay, a kind of financial time-out. The stay even prohibits secured creditors from selling or seizing the collateral (cash or securities) they hold, and it remains in effect until a bankruptcy judge—sort of a referee in the process—says otherwise. The debtor and the creditors then begin a coordinated effort to resolve the debtor's financial situation equitably across similar creditors.

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[5]Given the current system of federally backed deposit insurance administered by the Federal Deposit Insurance Corporation (FDIC), bank resolutions would likely require some form of special resolution procedures in combination with bankruptcy-type procedures. These resolution processes are beyond the scope of this testimony. For additional information, see Mark Calabria, "Deposit Insurance, Bank Resolution, and Market Discipline," in Michel, *Prosperity Unleashed: Smarter Financial Regulation*.

[6]This section is based largely on Norbert J. Michel, "Fixing the Regulatory Framework for Derivatives," in Michel, *Prosperity Unleashed: Smarter Financial Regulation*; the chapter includes many additional citations of supporting evidence.

The automatic stay is a key part of the process but it is one of several key components. The following is a list of other key bankruptcy provisions.

- **A set off provision.** Creditors generally have to seek the court's permission to set off what they owe the debtor against any amounts the debtor may owe them.
- **A prohibition on preferential transfers.** The debtor (or a court-appointed trustee) can generally force creditors to return any preferential transfers. For instance, a creditor may have to return a payment made within 90 days of bankruptcy if that payment would have made the creditor better off than had the transfer not been made. The amount would have to be returned to the estate so that it would improve the collective position of the creditors.
- **A prohibition on fraudulent (and constructive) conveyances.** Sales or transfers of assets at less than fair value within two years of the filing date can be reversed to benefit all creditors.
- **Nullification of ipso facto clauses.** Creditors are generally prohibited from terminating their contracts with the debtor simply because the firm filed for bankruptcy protection. In fact, even if a contract includes a clause that makes the debtor's bankruptcy a default (an ipso facto clause), the clause is generally not enforceable.

Many creditors do not like these protections because a bankruptcy filing strips them of contractual rights that they would normally have. Naturally, all creditors of a failing firm want their money first, before the value of the aggregate claims necessarily declines. So it is no surprise that these protections have been whittled down through time, and that there are various safe harbors from these bankruptcy provisions. Interestingly, derivatives and repo counterparties have one of the best deals of any group: They have safe harbors from all five of the key protections discussed above, leaving them in a preferred position relative to ordinary creditors.

These counterparties were given the safe harbors under the theory that doing so would help mitigate systemic risk. Essentially, the idea was that the safe harbors were necessary to prevent counterparties from "running," so as to prevent the derivatives markets from "seizing up" (perhaps because of rapidly declining asset prices). Lobbyists began making very vague arguments to this effect in the 1980s, and safe harbors expanded slowly until 2005. The 2005 Bankruptcy Abuse Prevention and Consumer Protection Act expanded these safe harbors for essentially any derivative or repo user, and turned all sorts of mortgage-related securities into, for legal purposes, repos.

As a result, starting in 2005, any derivative or repo user enjoyed safe harbors from all five of these key bankruptcy protections. Thus unlike ordinary creditors, derivatives and repo counterparties, could, for example, terminate their contract immediately upon a debtor filing bankruptcy, and seize and sell collateral. Proponents of these special exemptions have argued that safe harbors allow counterparties to quickly cancel contracts and enter new hedges (with other counterparties), thus ensuring their financial health and avoiding financial market distress.

A major problem with this story, aside from the empirical record, is that even systemic risk concerns cannot possibly justify blanket safe harbors for the entire market.[7]

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[7]The Federal Deposit Insurance Corporation (FDIC) has for decades implemented a special failure-resolution process for banks that imposes a one-day stay on a bank's derivative and repo counterparties, making the case for economy-wide safe harbors even less compelling.

At best, only the largest counterparties would get safe harbors, a fact that makes it clear safe harbors necessarily provide preferential treatment to certain creditors over others.[8] Furthermore, the evidence does not support that this preferential treatment works to mitigate systemic risk—it shows the opposite. As the 2008 crisis was unfolding, Bear Stearns's counterparties ran before Bear was even considering bankruptcy, AIG's counterparties increasingly demanded additional collateral for its Credit Default Swaps (CDS), and JP Morgan seized $17 billion in securities and cash (collateral) from Lehman before the bankruptcy filing *and* demanded an additional $5 billion.

Lehman effectively had no choice but to come up with the additional collateral, thus worsening its liquidity position, because it knew that it could not file for protection to get the collateral back. The lead attorney in the Lehman bankruptcy case also testified to Congress that the lack of an automatic stay contributed to confusion at the outset of the filing. Aside from the added incentive to run, the safe harbors likely induced firms to rely more heavily on derivatives and repos than they would have in absence of the special protections. For instance, Bear Stearns's liabilities consisted of only 7 percent repos in 1990, but by 2008 they consisted of 25 percent repos. Data also show that the portion of total investment bank assets financed by repos doubled between 2000 and 2007.

Whether the growing market led to legislative action to further support the market, or whether the legislative amendments to the bankruptcy code led to the growing market is irrelevant. Regardless, the market would not have supported such high increases in leverage without the special protections, which is precisely why the safe harbors should not be provided. The safe harbors also lead to more subtle adverse effects, such as diminishing the incentive to monitor counterparties and to prepare (or even file) for bankruptcy.

It is certainly true that eliminating these safe harbors may cause firms to rely less on these short-term debt instruments, and to price in higher risks than they do currently. This outcome is not a market failure: It is precisely how competitive markets function when the participants have the proper incentives to monitor their risks. The Financial CHOICE[9] Act implements an improved bankruptcy process for large financial firms by adopting the text of H.R. 2947, the Financial Institution Bankruptcy Act of 2016. This change would improve the status quo by subjecting derivatives and repos to an automatic 48-hour stay. Such an improvement is welcome, but the complete elimination of the exemption and all safe harbors that derivatives and repos enjoy would be optimal. Such a change would strengthen private markets by maximizing the benefits of increased competition and lowering reliance on government preferences that mitigate private firms' financial losses.

**The Consumer Financial Protection Bureau**

Title X of Dodd–Frank created the CFPB by transferring enforcement authority for 22 specific consumer financial protection statutes to the new agency and by codifying

[8] In 1983, Fed Chair Paul Volcker suggested a safe harbor was necessary to protect the repo market given that repos were a main tool of monetary policy. Volcker also argued that limiting these special protections to repo transactions of $1 million or more would suffice, thus avoiding the need to provide broad exceptions to existing bankruptcy laws.

[9] The acronym CHOICE stands for Creating Hope and Opportunity for Investors, Consumers and Entrepreneurs.

a new, ill-defined type of consumer protection. The fact that Title X transferred these statutes shows that there was no shortage of consumer financial protection prior to the creation of the CFPB. Given that the authority for approximately 50 rules and orders stemming from more than 20 federal statutes was divided among seven federal agencies, all layered on top of state-based consumer-protection laws, perhaps consolidating federal authority in one agency could have improved consumer-protection enforcement.

The CFPB's proponents never made the case, however, that creating another federal agency would provide such an improvement. Regardless, Dodd–Frank created the CFPB by going well beyond simply consolidating enforcement authority for these federal statutes. Dodd–Frank consolidated some federal consumer financial protection authority in the CFPB,[10] gave the CFPB supervisory authority, expanded the concept of consumer protection, and gave the CFPB a controversial structure dissimilar from the typical federal agency.

**Pre-Dodd–Frank Consumer-Protection Framework.** Prior to the late 1960s, consumer protection in credit markets was largely a function of state government.[11] In 1968, Congress began to move further into the long-standing province of the states in regulating consumer transactions with passage of the Consumer Credit Protection Act (CCPA).[12] Title I of the CCPA, the Truth in Lending Act (TILA), mandated disclosure of credit charges "clearly and conspicuously" as specified by the Federal Reserve System.[13] As declared by Congress, the purpose of the TILA was to "assure a meaningful disclosure of credit terms"[14] rather than dictate the conduct of lenders or the content of loans agreements. The TILA is still a major component of federal consumer-protection law,[15] but it is just one of many statutes passed after 1968. The following list describes the major federal consumer financial protection statutes enacted in the 10 years following the TILA.[16]

- **The 1970 Fair Credit Reporting Act (FCRA).**[17] The main purpose of the FCRA was to "require that consumer reporting agencies adopt reasonable procedures for

[10]In creating the CFPB, Congress transferred consumer financial protections from the Federal Reserve, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Department of Housing and Urban Development. See 12 U.S. Code § 5581 (delineating the transfer of consumer financial services functions to the CFPB), and Federal Trade Commission, "Consumer Finance," 2016 (explaining that the FTC shares authority with the CFPB to enforce the consumer-protection laws with respect to non-bank financial institutions ranging from mortgage brokers to debt collection firms), https://www.ftc.gov/news-events/media-resources/consumer-finance (accessed March 27, 2017).

[11]Thomas A. Durkin, Gregory Elliehausen, Michael Staten, and Toddy Zywicki, *Consumer Credit and the American Economy* (Oxford, England: Oxford University Press, 2014), p. 417.

[12]Consumer Credit Protection Act (CCPA) of 1968, Public Law 90–321.

[13]The Federal Reserve's implementing regulation for TILA is known as Regulation Z. The Dodd–Frank Act transferred authority for enforcing Regulation Z, now found at 12 C.F.R. Part 226, to the CFPB.

[14]15 U.S. Code § 1601.

[15]Budnitz, "The Development of Consumer Protection Law."

[16]A more complete list of consumer-protection statutes transferred to the CFPB is in Dodd–Frank Title X, Subtitle H.

[17]The Fair Credit Reporting Act, codified to 15 U.S. Code § 1681, was Title VI of Public Law 91–507. This law, commonly referred to as the Bank Secrecy Act of 1970, required, among other things, "insured

meeting the needs of commerce for consumer credit, personnel, insurance, and other information in a manner which is fair and equitable to the consumer."[18]

- **The 1974 Real Estate Settlement Procedures Act of 1974 (RESPA).**[19] The RESPA was passed largely to see that borrowers "are provided with greater and more timely information on the nature and costs of the settlement process and are protected from unnecessarily high settlement charges."[20]
- **The 1974 Equal Credit Opportunity Act (ECOA).**[21] The ECOA was intended to promote adequate disclosure of information to and about credit consumers, and also to shield protected classes of consumers from discrimination when applying for credit.[22]
- **The Privacy Act of 1974.**[23] The Privacy Act established a code of fair information practices to govern the collection, maintenance, use, and dissemination of information about individuals that is maintained in systems of records by federal agencies.
- **The 1974 Fair Credit Billing Act.**[24] The Fair Credit Billing Act amended the TILA "to protect the consumer against inaccurate and unfair credit billing and credit card practices."[25]
- **The 1975 Home Mortgage Disclosure Act of 1975 (HMDA).**[26] A primary goal of the HMDA was to "provide the citizens and public officials of the United States with sufficient information to enable them to determine whether depository institutions are filling their obligations to serve the housing needs of the communities and neighborhoods in which they are located."[27]
- **The 1978 Electronic Fund Transfer Act of 1978 (EFTA).**[28] The purpose of the EFTA was to protect individual consumers engaging in electronic fund transfers, such as transfers through automated teller machines, point-of-sale terminals, telephone bill-payment plans, and remote-banking programs.[29]

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banks to maintain certain records," and "certain transactions in United States currency be reported to the Department of the Treasury."

[18]Fair Credit Reporting Act § 602; 15 U.S. Code § 1681(b).

[19]Public Law 93–533, 88 Stat. 1724, codified to 12 U.S. Code § 2601.

[20]12 U.S. Code § 2601 et seq.

[21]The Equal Credit Opportunity Act (ECOA) was Title V of Public Law 93–495, an act which, among other things, established a National Commission on Electronic Fund Transfers. The ECOA is codified at 15 U.S. Code § 1691.

[22]For an overview of policy concerns, see John Matheson, "The Equal Credit Opportunity Act: A Functional Failure," *Harvard Journal on Legislation*, Vol. 21 (1984), p. 371, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1874297 (accessed September 30, 2016).

[23]Public Law 93–579, 88 Stat. 1896; 5 U.S. Code § 552a.

[24]The Fair Credit Billing Act was Title III of Public Law 93–495, and it is codified to 15 U.S. Code § 1601.

[25]Fair Credit Billing Act § 302; 15 U.S. Code § 1601(a).

[26]The Home Mortgage Disclosure Act of 1975 was Title III of Public Law 94–200, codified to 12 U.S. Code § 2801.

[27]Home Mortgage Disclosure Act § 302(b).

[28]15 U.S. Code § 1693 et seq.; the Electronic Funds Transfer Act was Title XX of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (Public Law 95–630; 92 Statute 3641).

[29]Dodd–Frank transferred rulemaking authority under the EFTA from the Fed Board of Governors to the CFPB.

For decades, this combined state-federal legal framework governed the offering of consumer credit and outlawed *deceptive* and *unfair* practices in financial products and services. Even Senator Elizabeth Warren (D–MA), the intellectual architect of the CFPB, has acknowledged this fact, stating "credit transactions have been regulated by statute or common law since the founding of the Republic."[30] Simply put, there was no dearth of consumer-protection law in financial markets.

**Radical Shift in Consumer Protection.** For decades prior to the financial crisis, consumer-protection laws required disclosure of key mortgage terms and prohibited deceptive and unfair practices. The Federal Trade Commission (FTC) was the primary federal consumer-protection agency outside banking, while banking regulators were primarily responsible for consumer protection in depository institutions. Under this framework, it was illegal for businesses to engage in *deceptive* or *unfair* practices when marketing their offerings to consumers. The Federal Trade Commission Act (15 U.S. Code 41 et seq.) was amended in 1938 to prohibit "unfair or deceptive acts or practices."[31] Federal banking regulators, including the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve Board, the Comptroller of the Currency, and the National Credit Union Administration, had authority to enforce unfair or deceptive acts or practices in or affecting commerce under their statutes in a manner consistent with carefully crafted FTC limiting principles applicable to *unfairness* and *deception*.[32]

Title X of Dodd–Frank empowers the CFPB "to exercise its authorities under Federal consumer financial law for the purposes of ensuring that, with respect to consumer financial products and services, consumers are protected from unfair, deceptive, *or abusive* acts and practices."[33] (Emphasis added.) The statute does not define the term *abusive*, but it characterizes as abusive any action that materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or service, or takes unreasonable advantage of any of the following:

1.) A lack of understanding on the part of the consumer of the material risks, costs, or conditions of the product or service;
2.) The inability of the consumer to protect its interests in selecting or using a consumer financial product or service; or,
3.) The reasonable reliance by the consumer on a covered person to act in the

[30]Elizabeth Warren, "Unsafe at Any Rate," *Democracy Journal* (Summer 2007), http://democracyjournal.org/magazine/5/unsafe-at-any-rate/ (accessed March 27, 2017).
[31]See, generally, Federal Trade Commission, "Bureau of Consumer Protection," https://www.ftc.gov/about-ftc/bureaus-offices/bureau-consumer-protection (accessed November 4, 2016).
[32]See 15 U.S. Code § 45(n) (defining "unfairness"). See also Federal Trade Commission, FTC Policy Statement on Unfairness, 104 F.T.C. 949, 1070 (1984), https://www.ftc.gov/public-statements/1980/12/ftc-policy-statement-unfairness (accessed March 31, 2017), and Federal Trade Commission, FTC Policy Statement on Deception, 103 F.T.C. 110, 174 (1984), https://www.ftc.gov/public-statements/1983/10/ftc-policy-statement-deception (accessed March 31, 2017). See also, e.g., FDIC Compliance Manual, Chapter 7 (Federal Trade Commission Act, Section 5 Unfair or Deceptive Acts or Practices), https://www.fdic.gov/regulations/compliance/manual/7/VII-1.1.pdf (accessed March 31, 2017).
[33]Dodd–Frank, Section 1021, 12 U.S. Code § 5511.

interests of the consumer.[34]

The agency has issued neither guidance nor rules to define abusive practices, but, presumably, such practices are something other than unfair or deceptive practices. Furthermore, CFPB officials have not shown much willingness to provide clarity—even when asked explicitly to do so by Congress. During a 2012 hearing of the House Financial Services Committee, for example, when asked by lawmakers to define "abusive," CFPB Director Richard Cordray said:

> the term abusive in the statute is...a little bit of a puzzle because it is a new term.... We have been looking at it, trying to understand it, and we have determined that that is going to have to be a fact and circumstances issue; it is not something we are likely to be able to define in the abstract. Probably not useful to try to define a term like that in the abstract; we are going to have to see what kind of situations may arise.[35]

Under this framework, financial firms must operate under a vague legal standard to which they might never be able to adhere. Aside from the near impossibility of complying with such an unclear standard for abusive acts or practices, there is no objective way to measure a consumer's ability to understand terms and conditions of financial products and services.[36] Forcing financial firms into such a role, where they are effectively required to verify consumers' understanding of terms rather than merely disclosing relevant information, goes well beyond the long-established consumer-protection framework. This change is based on a hostile view of free enterprise, puts little faith in individuals' ability to understand their world, and comes dangerously close to absolving one party—the borrower—in a financial contract from any real responsibility.

The Obama Administration and congressional Democrats regularly blamed the financial crisis on firms that exploited consumers, thus flooding the market with mortgages that lenders knew would not be repaid.[37] Because deliberately deceiving borrowers was illegal under existing law, this narrative relied on the claim that consumers could not understand that these mortgages were dangerous. One problem with this explanation is that it falsely assumes that mortgage contracts themselves are dangerous, thus mitigating the counterparties' responsibility to uphold their contractual obligations.

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[34]Dodd–Frank, Section 1031, 12 U.S. Code § 5531.

[35]"How Will the CFPB Function Under Richard Cordray," transcript of hearing before the Subcommittee on TARP, Financial Services, and Bailouts of Public and Private Programs, Committee on Oversight and Government Reform, U.S. House of Representatives, January 24, 2012, http://oversight.house.gov/wp-content/uploads/2012/06/01-24-12-Subcommittee-on-TARP-Financial-Services-and-Bailouts-of-Public-and-Private-Programs-Hearing-Transcript.pdf (accessed March 31, 2017).

[36]See Katz, "Title X and the Consumer Financial Protection Bureau: Limiting Americans' Credit Choices"; Todd Zywicki, "The Consumer Financial Protection Bureau: Savior or Menace?"; and Diane Katz, "The CFPB in Action: Consumer Bureau Harms Those It Claims to Protect," Heritage Foundation *Backgrounder* No. 2760, January 22, 2103, http://www.heritage.org/housing/report/the-cfpb-action-consumer-bureau-harms-those-it-claims-protect#_ftn11.

[37]See, for example, U.S. Department of the Treasury, "Financial Regulatory Reform: A New Foundation—Rebuilding Financial Supervision and Regulation," June 17, 2009, p. 55, https://www.treasury.gov/initiatives/wsr/Documents/FinalReport_web.pdf (accessed March 25, 2017).

Another problem is that it assumes borrows cannot understand which products and services are good for them, but that regulators and elected officials can.

In the words of Oren Bar-Gill and Elizabeth Warren, the academic architects of the CFPB, borrowers suffer "cognitive limitations" and borrowers' "learning is imperfect."[38] This explanation is fatally flawed because it ignores that regulators and elected officials must suffer from the same cognitive limitations as borrowers. Ignoring this fact, it necessitates that federal regulators—not lenders and borrowers—determine which types of loans are acceptable, thus restricting both the supply and demand sides of credit markets, as well as individuals' freedom to enter into contracts of their choosing.

**Unaccountable Structure Inconsistent with Rule of Law.** Dodd–Frank gave the CFPB wide-ranging supervisory, enforcement, and rulemaking authority over banks and non-bank financial firms.[39] With so much overlapping authority prior to Dodd–Frank, it is difficult to argue that adding yet another regulatory agency could have improved the pre-Dodd–Frank framework. Not only did Dodd–Frank give the CFPB the power to regulate terms and marketing of virtually every consumer credit product, even those already regulated, under the guise of an ill-defined new type of consumer protection, but it made the CFPB a relatively unaccountable regulatory agency. No other federal regulatory agency possesses the same combination of structural features as the CFPB.

Although nominally a part of the Federal Reserve Board, the CFPB is not accountable to the Fed. Technically, the CFPB is classified as an executive agency, but it is more like an independent agency within another independent agency. Rather than an agency headed by a multimember, bipartisan commission, the CFPB is headed by a sole director, appointed for a five-year term by the President, removable only for cause (malfeasance or dereliction of duty), rather than *at will*.[40] Additionally, the CFPB's budget is completely outside the standard Congressional appropriations process and, instead, statutorily set to a fixed percentage of the Federal Reserve's operating budget.[41]

Its actions are also insulated from judicial review by statutorily mandated *Chevron* deference, which requires courts to defer to the CFPB's interpretation of any ambiguous statutory provisions under its jurisdiction, in preference to any competing

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[38] Oren Bar-Gill and Elizabeth Warren, "Making Credit Safer," *University of Pennsylvania Law Review*, Vol. 157, No. 1 (November 2008), https://www.law.upenn.edu/live/files/112-bargillwarren157upalrev12008pdf (accessed December 21, 2016).

[39] Dodd–Frank §§ 1022, 1024, 1025, and 1026, codified at 12 U.S. Code §§ 5512, 5514, 5515, and 5516.

[40] In a recent case, a federal court asked the CFPB to identify all "historical or current examples it could find of independent agencies headed by a single person removable only for cause." The Bureau was able to identify only three examples: the Social Security Administration, the Office of Special Counsel, and the Federal Housing Finance Agency (created in 2008). See *PHH Corporation, Et Al., Petitioners V. Consumer Financial Protection Bureau, Respondent*, U.S. Court of Appeals, District of Columbia Circuit, October 11, 2016, p. 29, https://www.cadc.uscourts.gov/internet/opinions.nsf/AAC6BFFC4C42614C852580490053C38B/$file/15-1177-1640101.pdf (accessed April 22, 2017).

[41] This was 12 percent in FY 2015 for a total of $618.7 million. See CFPB, "Financial Report of the Consumer Financial Protection Bureau," November 16, 2015, http://files.consumerfinance.gov/f/201511_cfpb_report_fiscal-year-2015.pdf (accessed February 22, 2016).

interpretations by other agencies.[42] CFPB proponents deny any lack of accountability by pointing out that the Financial Stability Oversight Council (FSOC) can veto the CFPB's rules, but the FSOC's oversight authority is very narrow.

The Dodd–Frank Act authorizes any member agency of the FSOC to petition the FSOC to set aside a regulation provided that the agency follows specific conditions set forth in Section 1023 of Dodd–Frank.[43] For example, Treasury, as a member agency of the FSOC, can petition the FSOC to set aside a final rule provided the FSOC decides "that the regulation or provision would put the safety and soundness of the United States banking system or the stability of the financial system of the United States at risk."[44] A member of the FSOC can petition the FSOC for a 90-day stay of a rule (or to set aside such rule) provided that the member:

> (A) In good faith attempted to work with the Bureau to resolve concerns regarding the effect of the rule on the safety and soundness of the United States banking system or the stability of the financial system of the United States;[45] and
> (B) Files the petition with the Council not later than 10 days after the date on which the regulation has been published in the Federal Register.[46]

Any veto of the CFPB rule would then require the approval of two-thirds of the members serving on the FSOC. It is clear that the CFPB was designed to evade the checks and balances that apply to most other regulatory agencies. The recent PHH[47] and Ally Financial cases exemplify why so much authority should not be given to any type of independent regulatory agency and how doing so can harm competitive private markets without any clear benefit.

In the case of PHH, a financial firm offering a full range of residential mortgage services, the CFPB selected a company for investigation, and then alleged that the company had violated Section 8 of RESPA by taking reinsurance fees as kickbacks. Despite previous Housing and Urban Development Department guidance that suggested PHH's practices were fully within the rules and regulations, the CFPB inserted its own interpretation of the law and assigned an administrative law judge (ALJ) to an

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[42]Todd J. Zywicki, "The Consumer Financial Protection Bureau: Savior or Menace?" *George Washington Law Review*, Vol. 81, No. 3 (April 2013), p. 856, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2130942 (accessed August 16, 2016). Also see Paul Larkin, "The World After Chevron," Heritage Foundation *Legal Memorandum* No. 186, September 8, 2016, http://www.heritage.org/research/reports/2016/09/the-world-after-chevron; Diane Katz, "The CFPB in Action: Consumer Bureau Harms Those It Claims to Protect," Heritage Foundation *Backgrounder* No. 2760, January 22, 2013, http://www.heritage.org/research/reports/2013/01/the-cfpb-in-action-consumer-bureau-harms-those-it-claims-to-protect; and Diane Katz, "Consumer Financial Protection Bureau: Limiting Americans' Credit Choices," Heritage Foundation *Backgrounder* No. 3102, April 28, 2016, http://www.heritage.org/research/reports/2016/04/consumer-financial-protection-bureau-limiting-americans-credit-choices.

[43]Section 1023(f) authorized the FSOC to prescribe procedural rules to implement this section of Dodd–Frank, but the FSOC has not issued these rules.

[44]Dodd–Frank, § 1023(a).

[45]Dodd–Frank, § 1023(b)(1)(A).

[46]Dodd–Frank, § 1023(b)(1)(B).

[47]PHH corporation was founded in 1946 by Duane Peterson, Harley Howell, and Richard Heather. See https://www.linkedin.com/company/phh-corporation (accessed April 24, 2017).

administrative proceeding rather than initiate a federal court case. The CFPB asserted that the statute of limitations did not apply to administrative proceedings.

After the ALJ's ruling, the CFPB Director decided the ALJ's penalty was too lenient, and he imposed an additional $103 million fine on top of the ALJ's $6.4 million fine. PHH fought the CFPB in court, and a three-judge panel of the Circuit Court of Appeals for the District of Columbia ruled in favor of PHH. The court also ruled that the bureau's single-director model is unconstitutional.[48] The decision states that the unilateral power wielded by CFPB Director Richard Cordray "represents a gross departure from settled historical practice" and "poses a far greater risk of arbitrary decision making and abuse of power, and a far greater threat to individual liberty, than does a multi-member independent agency."[49] The Court further ruled:

> The U.S. government's executive power to enforce federal law against private citizens is essential to societal order and progress, but simultaneously a grave threat to individual liberty. The Framers understood that threat to individual liberty. When designing the executive power, the Framers first separated the executive power from the legislative and judicial powers. To ensure accountability for the exercise of executive power, and help safeguard liberty, the Framers then lodged full responsibility for the executive power in the president of the United States, who is elected by and accountable to the people.[50]

The PHH incident is a clear-cut case of an unaccountable federal agency flouting the basic principles of the rule of law. Private firms—financial or otherwise—cannot safely operate in such an environment without the expectation of being wrongly persecuted by the government that is supposed to protect all of its citizens from such actions.

The CFPB's enforcement actions concerning Ally Financial provide another example of why federal agencies should not be given such independence.[51] In this instance, the CFPB fined Ally for discriminating against minority borrowers even though Ally had no direct contact with the borrowers and despite the fact that the CFPB's method for discovering such racial discrimination did not actually identify the race of the supposedly harmed individuals.[52] No federal agency should be empowered

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48For a full timeline of events, including regulatory rulings that predate the PHH case by decades, see Amy Tankersly, "CFPB v. PHH, explained," Housing Wire, October 25, 2016, http://www.inman.com/2016/05/19/cfpb-v-phh-explained/ (accessed April 22, 2017). Also see Diane Katz, "Court Ruling Reins in Unaccountable Financial Regulation Agency," Daily Signal, October 11, 2016, http://dailysignal.com/2016/10/11/court-ruling-reins-in-unaccountable-financial-regulation-agency/?_ga=1.129240399.234929671.1471295889.

49*PHH Corporation, Et Al., Petitioners V. Consumer Financial Protection Bureau*, p. 9.

50*PHH Corporation, Et Al., Petitioners V. Consumer Financial Protection Bureau*, p. 3.

51The problems in this case are magnified by a separate legal overreach known as disparate impact. See Roger Clegg and Hans A. Von Spakovsky, "Disparate Impact Isn't Enough," *National Review*, March 22, 2014, http://www.nationalreview.com/article/373958/disparate-impact-isnt-enough-roger-clegg-hans-von-spakovsky (accessed April 22, 2017).

52See AnnaMaria Andriotis and Rachel Louise Ensign, "U.S. Government Uses Race Test for $80 Million in Payments," *The Wall Street Journal*, October 29, 2015, https://www.wsj.com/articles/u-s-uses-race-test-to-decide-who-to-pay-in-ally-auto-loan-pact-1446111002 (accessed April 22, 2017), and Yuka Hayashi, "Consumer Watchdog Pushed Discrimination Case on Vulnerable Firm: Report," *The Wall Street Journal*, to take these kinds of actions against American citizens, and allowing federal regulators such independence harms the very foundation of free enterprise.

There is no doubt that adequate consumer financial protection existed prior to the 2008 financial crisis—unfair and deceptive practices were illegal. At best, a case can be made for consolidating the various consumer financial protection statutes under one existing federal agency, such as the FTC. However, no compelling case can be made that a new federal agency was—or is—needed to protect consumers from financial fraud. The CHOICE Act greatly improves the status quo by (among other things) making the CFPB director removable at will, putting the agency through the regular appropriations process, eliminating the abusive behavior concept, and relegating the CFPB to an enforcement-only agency. Ultimately, Congress should eliminate the CFPB.

**The Durbin Amendment**

Congress can further strengthen private markets and maximize the benefits of increased competition by repealing Section 1075 of the Dodd–Frank Act, known as the Durbin Amendment.[53] The Durbin Amendment represents a major policy mistake because, among other deficiencies, it amounts to Congress adjudicating a legal dispute, a role for which it is ill-suited. More than a century ago, with the 1890 Sherman Act, Congress fulfilled its role by creating the basic legal framework for resolving anticompetitive price-fixing disputes.

Congress simply is not designed to be a finder of fact in legal disputes, and there is absolutely no good reason that federal courts should not adjudicate any such dispute over interchange fees. Repealing the Durbin Amendment would be a victory for the rule of law that is consistent with the separation of powers created by the Constitution. The Durbin Amendment also represents a serious policy mistake because it implements price controls, an often-imposed government policy that invariably fails to help the people politicians seek to help.

Section 1075 of Dodd–Frank required the Federal Reserve Board of Governors to cap the debit card interchange fees that large banks charge.[54] These fees, charged to merchants every time consumers swipe their debit cards, have long been a source of controversy. Since the 1980s, as the volume of card transactions increased, retailers have complained that the fees are too high because large banks and card network companies collude to fix prices.[55] Retailers are currently engaged in an antitrust class action lawsuit

November 24, 2105, https://www.wsj.com/articles/consumer-watchdog-pushed-discrimination-case-on-vulnerable-firm-report-1448404301 (accessed April 22, 2017).

[53]See Norbert J. Michel, "Repealing the Durbin Amendment: A Vote for the Rule of Law," Heritage Foundation *Issue Brief* No. 4644, January 4, 2017 http://thf-reports.s3.amazonaws.com/2017/IssueBriefs/IB4644.pdf.

[54]Section 1075 amended The Electronic Fund Transfer Act (15 U.S. Code § 1693 et seq.).

[55]The share of U.S. consumer expenditures paid for with cards increased from approximately 3 percent in 1986 to 25 percent in 2000, and the controversy over debit card interchange fees grew during this period. James Lyon, "The Interchange Fee Debate: Issues and Economics," *The Region*, Federal Reserve Bank of Minneapolis, June 1, 2006, https://www.minneapolisfed.org/publications/the-region/the-interchange-fee-debate-issues-and-economics (accessed December 23, 2016). Lyon notes that debit and credit cards represented less than 20 percent of noncash payment transactions in 1995, and they exceeded 40 percent of noncash transaction volume by 2003. Also see Brian W. Smith, Abbott B. Lipsky Jr., Andrew J. Robinson, and William J. Rinner, "Why the Market Should Set Credit Card Interchange Fees," Legislative Comment

over *credit* card interchange fees, and it is likely a similar suit would have been filed over *debit* card interchange fees had the Durbin Amendment not been enacted.[56]

**Basic Overview of Interchange Fees and Durbin.** When retail consumers swipe their debit (or credit) card to make a purchase, it triggers a series of transactions that involve the following clients:

- The retail customer (the cardholder);
- The retail store (the merchant);
- The cardholder's bank (the card-issuing bank);
- The merchant's bank; and
- The network platform (the card association, often Visa, MasterCard, Discover, or American Express).[57]

When a retail customer swipes his card to make a purchase, he signals the merchant's bank to estimate whether he (the cardholder) has enough funds to make the purchase. This electronic information is sent, via the network platform, back to the cardholder's bank, which either authorizes or denies the sale. When the cardholder's bank approves a purchase, it keeps a percentage of the sale amount and then sends the remainder, via the network platform, to the merchant's bank. The network platform and the merchant's bank also keep a percentage of the sale amount for their services.

Collectively, these percentages are referred to as *interchange fees*, and they typically sum to approximately 2 percent.[58] However, the total fees in a debit transaction actually consist of separate fees charged by distinct parties in the transaction. For instance, the card-issuing bank typically charges an "interchange transaction fee."[59] Separately, the card network typically charges both the issuer and the acquiring bank

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in Bank Accounting and Finance, October–November 2008, pp. 39–44, https://www.mastercard.com/us/company/en/docs/Interchangefees.pdf (accessed December 23, 2016).

[56]See *In re Payment Card Interchange Fee and Merchant Discount Antitrust Litigation*, Case 12-4671, Document 1556-1, June 30, 2016, https://www.paymentcardsettlement.com/Content/Documents/Second%20Circuit%20Opinion.pdf (accessed December 29, 2016). Litigation began in 2005, and a federal appeals court recently threw out a $7.25 billion settlement. See Robin Sidel, "Battle Over Cards Heats Up as Court Rejects Visa, MasterCard Deal With Retailers," *The Wall Street Journal*, June 30, 2016, http://www.wsj.com/articles/visa-mastercard-class-action-settlement-rejected-by-u-s-court-1467300658 (accessed December 29, 2016).

[57]As of 2012, in addition to Visa and MasterCard, there were 13 debit card network operators. See Zhu Wang, "Debit Card Interchange Fee Regulation: Some Assessments and Considerations," Federal Reserve Bank of Richmond *Economic Quarterly*, Vol. 98, No. 3, 3rd Quarter 2012, pp. 159–183, https://www.richmondfed.org/~/media/richmondfedorg/publications/research/economic_quarterly/2012/q3/pdf/wang.pdf (accessed December 23, 2016).

[58]In other words, merchants typically keep about 98 percent of the retail price the customer agreed to pay. See Richard Epstein, "Durbin's Folly: The Erratic Course of Debit Card Markets," *Competition Policy International*, Vol. 7, No. 2 (Fall 2011), http://econ.as.nyu.edu/docs/IO/22936/Epstein_02272012.pdf (accessed December 23, 2016).

[59]Federal Reserve Brief for The Respondent in *Opposition, National Association Of Convenience Stores (NACS) et al., v. Board of Governors of Federal Reserve System*, November 2014, https://www.justice.gov/sites/default/files/osg/briefs/2014/11/24/14-200_nacs_v_federal_reserve.pdf (accessed April 22, 2017).

"network processing fees," known as "switch fees," and the acquirer generally charges the merchant what's known as a "merchant discount."[60]

The merchant discount is typically the difference between a transaction's gross amount and the amount the acquiring bank credits to the merchant's account. In general, the merchant's discount reflects the full value of the interchange fee and all other fees to process the transaction. However, the merchant discount was, historically, far from a flat percentage. For instance, prior to the Durbin Amendment, card networks offered small ticket merchants, those with a high volume of low dollar transactions, special volume discounts.

In this framework, merchants *voluntarily* contract to accept cards in their stores, and many choose to contract with Visa and MasterCard networks because doing so provides access to a large customer base. Many large retail merchants have long complained that they have little ability to negotiate these fees, and some have even argued that card networks and issuing banks are price-fixing cartels that use "market power to set excessively high interchange fees."[61]

In 2011, Senator Durbin echoed these complaints in a letter to Wells Fargo Chief Executive John Stumpf. According to Durbin, "interchange fee rates are uniformly and centrally fixed by the card network companies Visa and MasterCard on behalf of Wells Fargo and thousands of other banks."[62] Rather than allow the existing regulatory agencies and courts to decide the veracity of these serious legal charges, Senator Durbin introduced a bill to adjudicate the dispute by implementing price controls.[63] In a 2011 press release Senator Durbin explained that he learned about the issue years ago from a friend, identified as a "grassroots businessman," who told him "these credit card companies and their banks are killing us."[64]

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[60]*National Association Of Convenience Stores (NACS) et al., v. Board of Governors of Federal Reserve System*, U.S. Court of Appeals, District of Columbia Circuit, No. 13–5270, Decided March 21, 2014, http://caselaw.findlaw.com/us-dc-circuit/1661023.html (accessed April 22, 2017).

[61]Zhu Wang, "Debit Card Interchange Fee Regulation." See also Renee Haltom and Zhu Wang, "Did the Durbin Amendment Reduce Merchant Costs? Evidence from Survey Results," Federal Reserve Bank of Richmond *Economic Brief*, December 2015, https://www.richmondfed.org/-/media/richmondfedorg/publications/research/economic_brief/2015/pdf/eb_15-12.pdf (accessed December 23, 2016).

[62]Richard J. Durbin, "Letter to Wells Fargo CEO John Stumpf," October 19, 2011, http://www.durbin.senate.gov/newsroom/press-releases/letter-to-wells-fargo-ceo-john-stumpf (accessed December 21, 2016).

[63]The core provisions of federal anti-trust law are found in the 1890 Sherman Act and the 1914 Clayton Act, both of which have been refined over time through amendment. The Department of Justice and the Federal Trade Commission enforce federal anti-trust law, and price fixing is one of the behaviors traditionally deemed unlawful. See Alden F. Abbott, "A Brief Overview of American Antitrust Law," paper given at The Competition Law & Policy Guest Lecture Programme, The University of Oxford Centre for Competition Law and Policy, January 2005, https://www.law.ox.ac.uk/sites/files/oxlaw/cclp_l_01-05_1.pdf (accessed December 23, 2016).

[64]News release, "Response to *The Wall Street Journal*'s Editorial on Swipe Fee Reform," Senator Richard Durbin (D–IL), March 17, 2011 http://www.durbin.senate.gov/newsroom/press-releases/response-to-the-wall-street-journals-editorial-on-swipe-fee-reform (accessed April 22, 2017).

The Durbin Amendment amended the Electronic Fund Transfer Act[65] by adding a new section 920 regarding debit card interchange fees.[66] The statute now requires the Federal Reserve to set debit card transaction fees so that they are "reasonable and proportional to the cost incurred by the issuer with respect to the transaction."[67] The statute also exempts from these price caps any card-issuer who, "together with its affiliates," has assets of less than $10 billion.[68] In other words, small banks that issue debit cards are ostensibly exempt from the price controls.

The Fed's final rule, issued in July 2011, stipulates that an "issuer may not charge or receive any interchange transaction fee that exceeds the sum of $0.21 plus 5 basis points (0.05 percent) of the transaction's value."[69] The $0.21 represents the base amount, and it corresponds to the per transaction allowable cost, excluding fraud losses.[70] The 5 basis points are an *ad valorem* amount that corresponds to the average per transaction fraud losses of the median card issuer, as estimated by the Federal Reserve.[71]

Price caps were *not* applied to the fees charged by the card networks. The interchange fee on the typical transaction is now approximately half the pre-Dodd–Frank fee, but early evidence suggests that the Durbin Amendment has had "limited and unequal impact" on reducing merchants' overall cost of accepting debit cards.[72] The Durbin Amendment also imposed routing restrictions on debit card transactions, as well as reporting requirements for card issuers and networks.

In particular, the Section 920(b)(1) required the Federal Reserve to promulgate a rule that prohibits card issuers and networks from restricting the number of networks on which any debit transaction can be processed to only one network (or less than two affiliated networks).[73] In contrast to the interchange fees, small banks are not exempt from the Durbin Amendment's routing restrictions. The Durbin Amendment clearly represents an attempt to settle a debit-card-merchant dispute by taking the side of the retail trade associations against large banks.

**The Case for Repealing Durbin.** Proponents have portrayed the Durbin Amendment as consumer-friendly, but it defies all logic and reason that large merchants, as a return favor to Congress for capping the debit-card interchange fees, would simply pass billions in savings on to retail consumers. Furthermore, debit-card interchange fees only represent one of many types of fees banks charge, so there is no reason to expect banks to refrain from making up any lost revenue by charging customers higher fees for other services. It is hardly surprising that early research suggests that banks have tried to do just that. For instance, evidence shows that banks have:

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[65] 15 U.S. Code § 1693 et seq.
[66] Federal Reserve System, "Debit Card Interchange Fees and Routing; Final Rule," *Federal Register*, Vol. 76, No. 139 (July 20, 2011), pp. 43394–43475, https://www.gpo.gov/fdsys/pkg/FR-2011-07-20/pdf/2011-16861.pdf (accessed April 22, 2017).
[67] Section 1075(a)(2), 15 U.S. Code § 1693o–2.
[68] Section 920(a)(6)(A), 15 U.S. Code § 1693o–2(a)(6)(A).
[69] Federal Reserve System, "Debit Card Interchange Fees and Routing; Final Rule," p. 43420.
[70] Ibid., p. 43422.
[71] Ibid., p. 43424.
[72] Haltom and Wang, "Did the Durbin Amendment Reduce Merchant Costs?"
[73] Federal Reserve System, "Debit Card Interchange Fees and Routing; Final Rule," p. 43394.

(1) Reduced the availability of fee-free current accounts. The total number of banks offering free current accounts fell by 50% between 2009 and 2013. In comparison, fee-free banking actually increased at banks not subject to the Durbin Amendment.
(2) More than doubled the minimum monthly holding required on fee-free current accounts between 2009 and 2012, from around \$250 to over \$750.
(3) Doubled average monthly fees on (non-free) current accounts between 2009 and 2013, from around \$6 to more than \$12.[74]

Separately, Federal Reserve research shows that, even though the interchange fee on the typical transaction is now approximately half the pre-Dodd–Frank fee, the Durbin Amendment has had "limited and unequal impact" on reducing merchants' overall cost of accepting debit cards.[75] Not only has the cost of accepting debit cards failed to decline for many merchants, it has actually *increased* for some.[76]

Price controls are always destined to end badly and the Durbin Amendment is no exception. It is terrible public policy and it is little more than a giveaway to a special interest group. Congress should never have passed the Durbin Amendment because it is a legislative body ill-suited to adjudicate legal disputes. Of the three branches of the U.S. government, the judicial branch—not Congress—was set up for exactly this purpose. Congress already did its job by writing the nation's anti-trust laws, so it should repeal the Durbin Amendment to help restore the proper separation of powers between the three branches of the U.S. government. Repealing the Durbin Amendment—as the CHOICE Act does—would also help to strengthen private markets by allowing competitive forces, rather than government bureaucrats, to dictate how the debit-card interchange fees can be efficiently and effectively applied.

**Conclusion**

The 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act was the most extensive financial regulatory bill since the 1930s. Rather than address the true causes of the financial crisis, it expanded the authority of the federal regulators who missed the 2008 financial crisis. It created new federal agencies, imposed unnecessarily high compliance burdens on firms, codified many of the too-big-to-fail actions used during the crisis, and contributed to the unusually sluggish recovery because it came at exactly the wrong time.

My Heritage Foundation colleague and I estimate that one aspect of Dodd–Frank—excess borrowing costs—imposes a 22 basis point burden on the economy, and that removing this added cost would have a measurable positive impact on the economy.

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[74]Todd J. Zywicki, Geoffrey A. Manne, and Julian Morris, "Price Controls on Payment Card Interchange Fees: The U.S. Experience," George Mason Law & Economics Research Paper No. 14-18, October 15, 2014, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2446080 (accessed April 22, 2017).
[75]Renee Haltom and Zhu Wang, "Did the Durbin Amendment Reduce Merchant Costs? Evidence from Survey Results."
[76]Ibid.

Our estimates of this Dodd–Frank "repeal" scenario predict that, on average from 2017 to 2026, removing Dodd–Frank's investment wedge would increase GDP 1 percent per year, increase the capital stock by almost 3 percent per year, and decrease the federal debt ratio by nearly 1 percent per year, providing up to $340 billion in 10-year federal revenue gains.

Ideally, Congress would repeal the Dodd–Frank Act and focus, instead, on legislation that improves incentives, increases competition, and lowers the reliance on government backing of losses in financial markets. This testimony has described three policies that Congress could enact to strengthen private financial markets in this manner that would help spur sustainable economic growth: (1) requiring all failing financial firms to go through bankruptcy; (2) eliminating the Consumer Financial Protection Bureau; and (3) repealing the Durbin Amendment. Each of these actions would improve private incentives and maximize the benefits of competitive forces to strengthen financial markets so that citizens can produce sustainable economic growth that provides widespread wealth-building opportunities in the U.S.

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Reforming the Financial System So It Works for the Rest of the System

Hester Peirce
*Director, Financial Markets Working Group, Mercatus Center at George Mason University*

April 26, 2017

House Committee on Financial Services
Hearing: A Legislative Proposal to Create Hope and Opportunity for Investors, Consumers, and Entrepreneurs

Chairman Hensarling, Ranking Member Waters, and members of the committee:

Thank you for the opportunity to be part of today's discussion about how to improve our financial regulatory system. Carefully crafted financial reform will strengthen the regulatory system's ability to protect consumers, enhance financial stability, and ensure that the financial system can support a dynamic, innovative, prosperity-enhancing economy. I will focus on several parts of the broader financial reform package you are considering today. The following themes run through my assessment of how these reforms will affect financial markets and the people who rely on them:

- Strong procedures for establishing and reviewing regulations and appropriate regulatory accountability can help to ensure that regulators are performing their jobs as effectively as possible;
- Eliminating avenues for bailouts can improve regulatory effectiveness; and
- Efforts to expand and add flexibility to investors' and companies' access to the capital markets, which are at the heart of the US economy, can help to support innovation and economic growth.

I briefly discuss each of these points below.

## I. IMPROVING THE REGULATORY PROCESS AND REGULATORY ACCOUNTABILITY

Sound regulatory process and appropriate accountability are necessary prerequisites for sound regulation. In this, financial regulation is no different than any other type of regulation. Nevertheless, financial regulators too often have neglected thorough process—including seeking notice and comment and performing economic analysis—in favor of expediency. Changes in the statutory requirements on and accountability mechanisms for financial regulators would help them write better rules and more effectively enforce them.

A. Administrative Procedure

The Administrative Procedure Act requires agencies to follow certain procedures in imposing binding obligations. Sometimes regulators use less formal methods—such as guidance documents—to regulate the industry and thus avoid having to comply with requirements for formal regulations such as the notice-and-comment process and economic analysis.[1] The Creating Hope and Opportunity for Investors, Consumers, and Entrepreneurs (CHOICE) Act recognizes this problem by requiring the Securities and Exchange Commission (SEC) to seek notice and comment on guidance documents. The CHOICE Act also prevents the SEC from using pilot programs to effect permanent regulatory changes.

The CHOICE Act also introduces procedural reform in the enforcement context. One such reform would establish an advisory committee for the SEC on enforcement policies and practices. The recommendations of this committee will be valuable not only to the SEC, but also to other financial regulators, some of which operate with less transparency and fewer procedural protections than the SEC. In the meantime, SEC reforms such as requiring transparency regarding enforcement practices, expanding opportunities for parties to present their positions in person, and allowing parties to opt out of administrative proceedings and into district court will help to assure the public of the objectivity of the SEC's enforcement program without compromising the SEC's ability to successfully bring enforcement actions. Again, other financial regulators would benefit from similar reforms.

B. Economic Analysis

A key area in which procedural reform is needed is economic analysis. Financial regulators have a poor record in performing and using economic analysis to formulate rules.[2] Critics of economic analysis often point out that it would slow down rulemaking and that quantifying costs and especially benefits is difficult. Although these observations are true, asking what problem needs solving, considering alternatives, thinking through costs and benefits, and soliciting input from the public are essential to designing effective regulations. It is worth the up-front investment to ensure that a regulation will effectively achieve its intended objective.

The Volcker Rule, which the CHOICE Act would eliminate, illustrates the danger of failing to conduct careful economic analysis before a rule is adopted. That provision of Dodd-Frank is intended to get banks out of proprietary trading and sponsorship of private funds. Regulators struggled to write the rule, and the financial industry has struggled to implement it. Regulators did not perform a rigorous economic analysis to guide their rule writing.[3] Many observers now worry that the rule is unduly complex, costly for regulators and financial institutions, and potentially harmful to market liquidity, particularly during times

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[1] For a discussion of the use of rulemaking methods other than notice and comment at one financial regulator, see, for example, Hester Peirce, "Regulating through the Back Door at the Commodity Futures Trading Commission," *Harvard Journal of Law and Public Policy*, Federalist Edition (2014): 321–93.

[2] For a discussion of the use of economic analysis by financial regulators, see Hester Peirce, "Economic Analysis by Federal Financial Regulators," *Journal of Law, Economics & Policy* 9, no. 4 (2013): 569.

[3] Hester Peirce, "The Volcker Rule Will Increase the Likelihood That Banks Will Default," *RealClearMarkets*, March 26, 2014.

of market stress.[4] A careful economic analysis could have probed these problems and highlighted potentially superior alternatives to the Volcker Rule for congressional consideration.[5]

The CHOICE Act would make important reforms to the regulatory process that could assist agencies in regulating the financial markets effectively. Key changes for enhancing the quality and usefulness of economic analysis include requiring agencies to conduct robust regulatory analysis, ensuring that data and assumptions are available to the public, setting out in advance the metrics to be used in a retrospective analysis of the rule, and allowing for judicial review of the analysis.[6] These provisions guide agencies through the steps of identifying the problem and formulating an appropriate solution and lay the groundwork for a meaningful review of a regulation once it has been in place for several years.

Additional CHOICE Act provisions build on these economic analysis provisions. Rules for which the quantitative costs outweigh the quantitative benefits—in other words, rules that are anticipated to cost more than they are worth—require special justification and approval. And, importantly, Congress has a role in reviewing rules before they take effect. For a major rule (one that imposes $100 million in effects or is otherwise significant) to take effect, the CHOICE Act requires congressional approval. With the benefit of the agency's economic analysis, Congress may conclude that—perhaps contrary to expectations when the authorizing legislation was passed—the rule is more costly, less beneficial, or less effective than alternative approaches. Allowing Congress this opportunity addresses a frequent problem that agencies conducting rulemaking encounter—a statutory mandate may force their hand by directing them to pursue a particular regulatory solution regardless of whether that solution is the best one available. The CHOICE Act congressional review provision would provide an opportunity for agencies to alert Congress about potentially problematic rulemakings.

C. Public Accountability of Regulators

Public accountability is an important component of regulatory effectiveness. Absent such accountability, regulators may undertake initiatives that are not consistent with society's priorities. Although it is understandable from a public-choice perspective that agencies seek to avoid the vicissitudes of congressionally determined funding, the appropriations process

[4] For a sample of concerns about the Volcker Rule, see Jack Bao, Maureen O'Hara, and Alex Zhou, "The Volcker Rule and Market-Making in Times of Stress" (Finance and Economics Discussion Series 2016-102, Federal Reserve Board, Washington, DC, September 2016); Matthew P. Richardson and Bruce Tuckman, "The Volcker Rule and Regulations of Scope," in *Regulating Wall Street: Choice Act vs. Dodd-Frank*, ed. Matthew P. Richardson et al. (New York: NYU Stern School of Business, 2017); Daniel K. Tarullo, "Departing Thoughts," Bank for International Settlements, April 4, 2017.

[5] For a discussion of simpler, higher capital as an alternative, see Stephen Matteo Miller and J. W. Verret, "No Need for Title VI with Simpler, Higher Capital," in *The Case Against Dodd-Frank: How the "Consumer Protection" Law Endangers Americans*, ed. Norbert J. Michel (Washington, DC: Heritage Foundation, 2016).

[6] Experience with the SEC illustrates that the availability of judicial review can be a very useful way of ensuring that analysis is done well. See Jerry Ellig, "Improvements in SEC Economic Analysis since *Business Roundtable*" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, 2016).

serves a valuable role in helping regulatory agencies to effectively set their priorities.[7] The CHOICE Act, by bringing more financial regulators into the appropriations model that is standard for nonfinancial agencies, will provide needed guidance for these regulators in determining how to spend their resources.

Clear jurisdictional lines also can contribute to public accountability. The Department of Labor's (DOL) fiduciary rule, for example, has led to substantial changes in markets regulated by the SEC.[8] The CHOICE Act, by repealing the rule and requiring the DOL to defer to the SEC, would return responsibility over this important capital markets issue to the SEC. Eliminating Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), which is the subject of the next section, would also clarify jurisdictional lines of authority by removing the Federal Reserve's supplemental role in clearinghouse regulation, which blurs lines of regulatory responsibility for these important entities.

## II. ELIMINATING AVENUES TO BAILOUT

When regulators and market participants do not anticipate that bailouts will be available if a financial institution runs into problems, they have strong incentives to be careful in monitoring and managing risk. The recent experience with Fannie Mae and Freddie Mac shows the danger of the opposite state of affairs. The CHOICE Act takes an important step in ending a potential source of bailouts by eliminating Title VIII of Dodd-Frank, which relates to the regulation of so-called financial market utilities (FMUs) and companies engaged in payment, clearing, and settlement activities. Among other things, Title VIII allows the Financial Stability Oversight Council (FSOC) to designate these entities and activities as systemically important and therefore subject them to heightened regulatory oversight. Because of the breadth with which key terms in Title VIII are defined, the title offers regulators open-ended discretion to regulate large swaths of the financial system.[9] It also offers an avenue for potential bailouts.

Title VIII was added to Dodd-Frank largely as a companion to Title VII's over-the-counter derivatives reforms. In mandating that standardized derivatives be cleared, Dodd-Frank also promised to increase the footprint and complexity of clearinghouses. As a result, clearinghouses could be the source of future turbulence in the financial system.[10] In

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[7] See, for example, Hester Peirce and Vera Soliman, "In Washington, 'Austerity' Is a 67% Budget Increase," *RealClearMarkets*, February 11, 2015.

[8] See, for example, Mark J. Warshawsky and Hester Peirce, "Response to Presidential Memorandum on Fiduciary Duty Rule" (Public Interest Comment, Mercatus Center at George Mason University, Arlington, VA, April 17, 2017).

[9] For a discussion of the breadth of Title VIII caused by its open-ended language, see Colleen Baker, "The Federal Reserve as Last Resort," *University of Michigan Journal of Law Reform* 46, no. 1, (2012): 105–108.

[10] I outlined my concerns about clearinghouses under the Dodd-Frank regulatory mantle here: Hester Peirce, "Derivatives Clearinghouses: Clearing the Way to Failure," *Cleveland State Law Review* 64, no. 3 (2016): 589.

response to these worries, some observers favor an explicit role for the Federal Reserve in backing clearinghouses.[11]

Title VIII embodies the view of the Federal Reserve as an essential component of the clearing system by allowing the Federal Reserve to offer designated FMUs accounts and services, including access to the discount window. Even the label "financial market utility" conveys a sense that clearinghouses are quasi-public entities.[12] Title VIII thus encourages markets to look to the Federal Reserve as a backstop for FMUs, an expectation that could impair the critical risk management function these entities play.[13]

Removing Title VIII would underscore the need for the primary regulators of clearinghouses to regulate these entities carefully and, even more importantly, for clearinghouse owners and members to focus on clearinghouse risk management and recovery in the event of a problem.[14] The CHOICE Act's directive to the SEC and Commodity Futures Trading Commission that they must coordinate in regulating the derivatives markets should help to improve regulation of derivatives markets, including central clearinghouses. The committee should consider whether additional changes to the clearing mandate are necessary to ensure that these markets can be properly regulated.[15]

## III. REFORMING CAPITAL MARKETS REGULATION

One of the notable features of the US financial system is the variety of ways that people with innovative ideas can raise money to bring those ideas to fruition. Not only can a company seek a bank loan, but it can raise money through the equity and bond markets. These nonbank avenues for funding work most effectively if they are built to suit the needs of investors and companies. The SEC historically has focused much of its attention on large companies. Smaller companies, which are an important part of our economy and of many Americans' lives, have been forced to fight for the capital markets' scraps through an awkward set of exemptions. And the SEC has viewed its capital formation and investor protection missions as adverse, rather than complementary.

The Jumpstart Our Business Startups (JOBS) Act, which became law five years ago, directed the SEC to craft new capital-raising avenues for small companies and give investors

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[11] See, for example, Ben S. Bernanke, "Clearing and Settlement during the Crash," *Review of Financial Studies* 3, no. 1 (1990): 133, 150, which argues (based on a study of the 1987 stock market crash), that the Federal Reserve is an essential backstop for clearing.

[12] See, for example, Norbert J. Michel, "Fixing the Dodd-Frank Derivatives Mess: Repealing Titles VII and VIII," in *The Case Against Dodd-Frank*, ed. Michel, 139.

[13] For a discussion of the role that clearinghouses play and the tools they use to manage risk, see Robert Cox and Robert Steigerwald, "A CCP is a CCP is a CCP" (Policy Discussion Paper No. 2017-01, Federal Reserve Bank of Chicago, April 2017).

[14] See, for example, Hester Peirce, "Clearing, Recovering, and Resolving" (Report, Series on Financial Markets and Regulation, Brookings Institution, Washington, DC, February 27, 2017).

[15] See, for example, Hester Peirce and Vera Soliman, "Rethinking the Swaps Clearing Mandate," in *Reframing Financial Regulation: Enhancing Stability and Protecting Consumers*, ed. Hester Peirce and Benjamin Klutsey (Arlington, VA: Mercatus Center at George Mason University, 2016).

greater opportunity to participate in funding companies of all sizes and stages of growth. The JOBS Act changes were generally positive steps,[16] but additional reform is needed to ensure that the capital markets effectively serve companies, investors, and the economy.[17]

A number of pieces of today's legislation would add flexibility that companies and investors need to enter into mutually and socially beneficial arrangements. The CHOICE Act addresses a number of issues that have blocked companies and investors from working together to build a stronger, more dynamic economy. These issues fall into several categories—limited options for companies seeking investor capital, high regulatory costs for public companies, and regulatory limitations on secondary market liquidity. The CHOICE Act takes steps to address each of these issues.

The CHOICE Act's changes to the JOBS Act would increase the options to companies seeking capital privately or through public offerings, and the changes would expand opportunities for investors and employees to participate in companies' prosperity. Examples include making available to more companies the JOBS Act's balanced approach to capital-raising under Regulation A and its test-the-waters provision. Prior to the JOBS Act's changes to Regulation A, that provision languished unused by companies,[18] so it is important to revisit different avenues for raising capital frequently to ensure their continued usefulness. Along similar lines, the CHOICE Act's crowdfunding provision restores the potential for crowdfunding to be a way for everyday investors to share in the prospects of early-stage companies. The micro-offering provision creates a legal avenue for entrepreneurs to do what they naturally would do (often without realizing that securities laws apply)—allow friends and associates to invest. The CHOICE Act also allows more investors to qualify as accredited, a label that allows them access to a broader array of investments. Because many investors prefer to invest through pools, the relief afforded to pooled investment vehicles and their advisers by the CHOICE Act could also be instrumental in expanding small businesses' access to capital. Many valuable ideas are provided to the SEC each year by the Government-Business Forum on Small Business Capital Formation. The CHOICE Act makes it more likely that the forum's recommendations will result in reform by requiring that the SEC consider them.

Regulatory obligations are properly calibrated when the benefits these regulations provide to investors outweigh the costs they impose. The investors in a company that is not yet earning revenue, for example, may not want to pay for the company to comply with the Sarbanes-Oxley Act's auditor attestation requirement. The CHOICE Act addresses this issue by exempting low-revenue companies from this requirement and expanding the exemption for small issuers. Additional CHOICE Act changes designed to rebalance

[16] Thaya Brook Knight, "A Walk Through the JOBS Act of 2012: Deregulation in the Wake of the Financial Crisis" (Policy Analysis No. 790, Cato Institute, Washington, DC, May 3, 2016).
[17] For a roadmap to thinking about potential change, see David R. Burton, "Offering and Disclosure Reform," in *Reframing Financial Regulation*, ed. Peirce and Klutsey.
[18] See Rutherford B. Campbell, "Regulation A: Small Businesses' Search for 'A Moderate Capital,'" *Delaware Journal of Corporate Law* 31, no. 1 (2006): 77.

regulatory requirements to meet investor needs include elimination of nonmaterial but costly reporting obligations, such as conflict mineral disclosures.

Investors are more likely to invest in companies for which there is a secondary market for shares. For large companies, an investor does not have to worry about finding a buyer. However, for smaller companies, lack of secondary-market liquidity is a substantial deterrent to potential investors. The CHOICE Act seeks to address these concerns by, among other things, creating the regulatory framework for venture exchanges.

As the committee considers additional changes in this area, it is important to remember that investors' well-being cannot be viewed on an investment-by-investment basis. Instead, as SEC acting chairman Michael Piwowar has noted, diversification reduces an investor's risk.[19] The SEC has not traditionally viewed investor protection in such a holistic fashion. As a result, investors have been completely shut out of whole categories of investments. Affording investors and companies the freedom to choose regulatory structures that offer the desired mix of information and accountability will allow our capital markets to better serve the economy. Too often, securities regulation has usurped investors' and companies' ability to choose options that work well for them. The CHOICE Act would help to facilitate these mutually beneficial arrangements.

## IV. CONCLUSION

Thank you for the opportunity to participate in today's hearing. Americans are weary of financial regulation after nearly a decade of intense work in the wake of the 2008 financial crisis. Nevertheless, the financial system continues to need work. Procedural and structural reforms will help regulators perform their jobs effectively and serve the public. Closing off routes to bailouts will sharpen the incentives for market participants to develop effective methods to monitor and manage their own and others' activities while acting consistently with their own and the public's interest. Finally, opening up new avenues to capital raising and properly tailoring regulatory obligations will make it possible for new and growing companies to serve their customers and add to the dynamism of the American economy. The CHOICE Act includes numerous provisions that further these objectives.

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[19] Michael S. Piwowar, "Remarks at the 'SEC Speaks' Conference 2017: Remembering the Forgotten Investor" SEC, February 24, 2017. Piwowar explained: "By holding a diversified portfolio of assets, investors reap the benefits of diversification. That is, the risk of the portfolio as a whole is lower than the risk of any individual asset. The correlation of returns is the mathematical key. When adding high-risk, high-return securities to an existing portfolio, so long as the returns from the new securities are not in perfect positive correlation with the existing portfolio, investors may reap higher returns with little to no change in overall portfolio risk. In fact, if the correlations are low enough, the overall portfolio risk can even decrease. As such, excluding certain investors from diversification options deprives them of important risk mitigation techniques."

Testimony of

Alex J. Pollock
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To the Committee on Financial Services
United States House of Representatives

Hearing on "A Legislative Proposal to Create Hope and Opportunity for Investors, Consumers, and Entrepreneurs"

April 26, 2017

Accountability, Capital and Governance of the Administrative State

Mr. Chairman, Ranking Member Waters, and Members of the Committee, thank you for the opportunity to be here today. I am Alex Pollock, a senior fellow at the R Street Institute, and these are my personal views. I have spent more than four decades working in and on banking and housing finance, including twelve years as President and CEO of the Federal Home Loan Bank of Chicago and eleven years focused on financial policy issues at the American Enterprise Institute, before joining R Street last year. I have experienced and studied many financial crises and their political aftermaths, starting when the Federal Reserve caused the Credit Crunch of 1969 when I was a bank trainee.

My discussion will focus on three key areas of the proposed CHOICE Act. All deal with essential issues and in all three the CHOICE Act would create major progress for the financial system, for constitutional government, and for financing economic growth. These areas are Accountability, Capital, and Congressional Governance of the Administrative State.

The CHOICE Act is long and complex, but there are a very large number of things to fix—like the Volcker Rule, among many others-- in the even longer Dodd-Frank Act.

A good summary of the real world results of Dodd-Frank is supplied by the "Community Bank Agenda for Economic Growth" of the Independent Community Bankers of America. "Community banks," it states, "need relief from suffocating regulatory mandates. The exponential growth of these mandates affects nearly every aspect of community banking. The very nature of the industry is shifting away from community investment and community building to paperwork, compliance and examination." I think this observation is fair.

The Community Bankers continue: "The new Congress has a unique opportunity to simplify, streamline and restructure." So it does, and I am glad this Committee is seizing the opportunity.

In November, 2016, Alan Greenspan remarked, "Dodd-Frank has been a—I wanted to say 'catastrophe,' but I'm looking for a stronger word." Although the financial crisis and the accompanying recession had been over for a year when Dodd-Frank was enacted, in the wake of the crisis, as always, there was pressure to "do something" and the tendency to overreact was strong. Dodd-Frank's something-to-do was to expand regulatory bureaucracy in every way its drafters could think of—it should be known as the Faith in Bureaucracy Act. This was in spite of the remarkably poor record of the government agencies, since they were important causes of, let alone having failed to avoid, the housing bubble and the bust. Naïve faith that government bureaucracies have superior knowledge of the financial future is a faith I do not share.

Accountability of the Administrative State

Accountability is a, perhaps *the*, central concept in every part of the government. To whom are regulatory agencies accountable? Who is or should be their boss? To whom is the Federal Reserve, a special kind of agency, accountable? Who is or should be its boss? To whom should the CFPB be accountable? Who should be its boss?

The answer to all these questions is of course: *the Congress.* We should all agree on that. All these agencies of government, populated by unelected employees, must be accountable to the elected representatives of the People, who created them, can dissolve them, and have to govern them in the meantime. All have to be part of the separation of powers and the system of checks and balances which is at the heart of our constitutional order. This also applies to the Federal Reserve. In spite of its endlessly repeated slogan that it must be "independent," the Federal Reserve must equally be accountable.

But accountability does not happen automatically: Congress has to assert itself to carry out its own duty for governance of the many agencies it has created and for its obligation to ensure that checks and balances actually operate.

The CHOICE Act is an excellent example of the Congress asserting itself at last to clarify that regulatory agencies are derivative bodies accountable to the Congress, that they cannot be sovereign fiefdoms—not even the Dictatorship of the CFPB, and not even the money-printing activities of the Federal Reserve.

The most classic and still most important power of the legislature is the power of the purse. The CHOICE Act accordingly puts all the regulatory agencies, including the regulatory part of the Federal Reserve, under the democratic discipline of Congressional appropriations. This notably would end the anti-constitutional direct grab from public funds which was originally granted to the CFPB—and which was designed precisely to evade the democratic power of the purse. It is sometimes objected that appropriations "inject politics" into these decisions. Well, of course! Democracy is political. Regulatory expansions are political, all pretense of technocracy notwithstanding.

The CHOICE Act also requires of all financial regulatory agencies the core discipline of cost-benefit analysis. It provides that actions whose costs exceed their benefits should not be undertaken without special justification. That's pretty logical and hard to argue with. Naturally, assessing the future costs and benefits of any action is subject to uncertainties—perhaps very large uncertainties. But this is no reason not to do the analysis—indeed, forthrightly to confront the uncertainties is essential.

The CHOICE Act also requires an analysis after five years of how regulations actually turned out in terms of costs and benefits. This would reasonably lead-- I hope it will--to scrapping the ones that didn't work.

To enhance and provide an overview of the regulatory agencies' cost-benefit analyses, the CHOICE Act requires the formation of a Chief Economists Council comprising the chief economist of each agency. This appeals to me, because it might help the views of the economists, who tend to care a lot about benefits vs. costs, balance those of their lawyer colleagues, who may not.

Further Congressional governance of regulatory agencies is provided by the requirement that Congress approve major regulatory rules—those having an economic effect of $100 million or more. Congress would further have the authority to disapprove minor rules if it chooses by joint resolution. This strikes me as a very effective way of reminding everybody involved, including the Congress itself, who actually is the boss and who has the final responsibility.

Taken together, these provisions are major increases in the accountability of regulatory agencies to the Congress and ultimately to the People. They are very significant steps forward in the governance of the Administrative State and bringing it under better constitutional control.

Accountability of the Federal Reserve

A word more on the Federal Reserve in particular, since the CHOICE Act devotes a title to "Fed Oversight Reform and Modernization" (FORM), which includes improving its governance by Congress. In a 1964 report, "The Federal Reserve After Fifty Years," the Domestic Finance Subcommittee of the ancestor of this Committee, then called the House Committee on Banking and Currency, disapprovingly reviewed the idea that the Federal Reserve should be "independent." This was in a House and committee controlled by the Democratic Party. The report has this to say:

-"An independent central bank is essentially undemocratic."

-"Americans have been against ideas and institutions which smack of government by philosopher kings."

-"To the extent that the [Federal Reserve] Board operates autonomously, it would seem to run counter to another principle of our constitutional order—that of the accountability of power."

In my view, all these points are correct.

The President of the New York Federal Reserve Bank testified to the 1964 committee, "Obviously, the Congress which set us up has the authority and should review our actions at any time they want to, and in any way they want to." That is entirely correct, too.

Under the CHOICE Act, such reviews would happen at least quarterly. I would like to suggest an additional requirement for these reviews. I believe that the Federal Reserve should be required to produce a Savers Impact Statement, quantifying and discussing the effects of its monetary policies on savings and savers.

The CHOICE Act requires of new regulatory rules that they provide "an assessment of how the burden imposed...will be distributed among market participants." This good idea should by analogy be applied to burdens imposed on savers by monetary actions. By my estimate, the Federal Reserve has taken since 2008 over $2 trillion from savers and given it to borrowers. The Federal Reserve may defend its sacrifice of the savers as a necessary evil—but it ought to openly and clearly quantify the effects and discuss the economic and social implications with the Congress.

<u>Accountability of Banks</u>

Let me turn to accountability in banking, under two themes: providing sufficient equity to capitalize your own risks; and bearing the risk you create—otherwise known as "skin in the game."

The best known provision of the CHOICE Act is to allow banks the very sensible choice of having substantial equity capital—to be specific, a 10% or more tangible leverage capital ratio—in exchange for reduction in onerous and intrusive regulation. Such regulation becomes less and less justifiable as the capital rises. As I testified last July, this is a rational and fundamental trade-off: More capital, less intrusive regulation. Want to run with less capital and thus push more of your risk onto the government? You get more regulation.

It is impossible to argue against the principle that there is *some* level of equity capital at which this trade-off makes sense for everybody—some level of capital at which everyone, even habitual lovers of bureaucracy, would agree that the Dodd-Frank burdens are superfluous, with costs higher than their benefits.

But exactly what that level is, can be, and is, disputed. Because banking markets are so shot through with government guarantees and distortions, there is no clear market test. All answers are to some degree theoretical, and the estimates vary—some think the number is less than 10% leverage capital--for example, economist William Cline finds that optimal bank leverage capital is 7%-- or 8% to be conservative. Some think it is more—15% has been suggested more than once. The IMF came up with a desired risk-based capital range which they concluded was "consistent with 9.5%" leverage capital—that's pretty close to 10%. Distinguished banking scholar Charles Calomiris suggested "roughly 10%." My opinion is that the fact that no one knows the exactly right answer should not stop us from moving in the right direction.

All in all, it seems to me that the 10% tangible leverage capital ratio, conservatively calculated, as proposed in the CHOICE Act is a fair and workable level to attain "qualifying banking organization" status, in other words, the more capital-less onerous regulation trade-off. The ratio must be maintained over time, with a one-year remediation period if a bank falls short, and with immediate termination of the qualifying status if its leverage capital ratio ever falls below 6%--a ratio sometimes considered very good. All this seems quite reasonable to me.

The CHOICE Act mandates a study of the possible regulatory use of the "non-performing asset coverage ratio," which is similar to the "Texas ratio" from the 1980s. The point is to compare the level of delinquent and nonaccrual assets to the available loan loss reserves and capital, as a way of estimating how real the book equity is. This study is a good idea.

To be fully accountable for the credit risk of your loans, you can keep them on your own balance sheet. This is 100% skin in the game. One of the true (not new, but true) lessons of the housing bubble was that loans made with zero percent skin in the game are much more likely to cause trouble. So Dodd-Frank made up a bunch of rules to control the origination of mortgages which feed into a zero skin in the game system. These rules are irrelevant to banks which keep their own loans.

The CHOICE Act therefore gives relief to banks holding mortgage loans in portfolio from regulations which arose from problems of subprime securitization, problems alien to the risk structure and incentives of the portfolio lender.

Accountability for Deals with Foreign Regulators

A challenging issue in the governance of the Administrative State are deals that the Treasury and the Federal Reserve are alleged to have made with foreign regulators and central bankers, is in the context of their participation in the international Financial Stability Board (FSB). These deals have been made, the suggestion is, outside of the American legal process, and then imported to the United States.

Were there any such deals, or were there merely discussions?

We know that the FSB has publicly stated that it will review countries for "the implementation and effectiveness of regulatory, supervisory or other financial sector standard and policies *as agreed by the FSB.*" As agreed by the FSB? Does that mean a country, specifically the United States, is supposed to be bound by deals made in this committee? Did the American participants in these meetings feel personally committed to implement some agreements?

We also know that there is a letter which would shine light on this question: a September, 2014 letter from Mark Carney, the governor of the Bank of England and Chairman of the FSB, to then-Treasury Secretary Lew. This letter allegedly reveals the international discussions about American companies, including it is said, whether Berkshire Hathaway should be designated a systemically important insurer (an idea not politically popular with the Obama administration). A Freedom of Information Act request for the letter has previously been denied by the Treasury, which admits however that it exists.

I believe that Congress should immediately request a copy of this letter as part of its consideration of the "International Processes" subtitle of the CHOICE Act. While at it, Congress should request any other correspondence regarding possible agreements within the FSB.

The international subtitle rightly requires regulatory agencies and the Treasury to tell the Congress what subjects they are addressing in such meetings and whether any agreements have been made.

Accountability for Emerging Financial System Risks

The CHOICE Act makes a number of positive changes to the structure and functions of the Financial Stability Oversight Council (FSOC). Here I would like to suggest a possible addition.

I believe the responsibility for reporting to Congress on identified emerging financial system risks should be clearly assigned to the Secretary of the Treasury. As the Chairman of FSOC, the Secretary is in charge of whatever discussions are required with regulatory agencies, the Federal Reserve or foreign governments.

Forecasts of the unknowable financial future are hard to get right, needless to say, but I believe a unified, single assignment of responsibility for communications with Congress of the best available risk assessments would be a good idea.

Thank you again for the chance to share these views.

AMERICAN
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**Statement before the House Committee on Financial Services**

**on**

# The CHOICE Act

**Peter J. Wallison**
Arthur F. Burns Fellow in Financial Policy Studies

April 26, 2017

Testimony on the CHOICE Act
House Financial Services Committee

April 26, 2017

Peter J. Wallison

Chairman Hensarling, Ranking member Waters, and members of the Committee. I very much appreciate the opportunity to testify today on the CHOICE Act.

One way to understand the act and the need for the comprehensive reform that the CHOICE Act provides, is to recognize that the Dodd-Frank Act was completely unnecessary. It was based on a false diagnosis of the 2008 financial crisis by an administration and a Congress that didn't even try to understand why the crisis occurred. They simply assumed—or wanted to believe—that the crisis was caused by insufficient regulation of the financial system and greed on Wall Street.

Barney Frank, the chair of this committee during the period that the act was being considered, told the media, before any hearings were held, that the 2009 Congress would enact a "New New Deal." He was as good as his word. And as it often turns out when ill-considered ideas are rushed into law, the American people are the ones who suffer.

So the country has struggled through almost eight years of slow growth that has been particularly painful in our industrial heartland.

It is not an exaggeration to say that the 2008 crisis was a dangerous moment for the global financial system. For this reason, the causes of this near disaster should have been carefully studied by Congress and the administration before they acted. But that is not what happened. Shortly after the Obama administration took office, the rudiments of what became the Dodd-Frank Act were sent to Congress, and after that we were off to the races. By July of 2010, the Dodd-Frank Act was signed by President Obama.

The Financial Crisis Inquiry Commission didn't do any better. It considered only one possibility—that there was insufficient regulation of the financial system—and concluded its report six months *after* the president had signed Dodd-Frank into law. Obviously, Congress didn't expect the FCIC to draw any different conclusions, and it didn't.

Although I was a member of FCIC, I was not given access to all the information the FCIC collected in the course of its study. After the FCIC finished its work, I was able to find in the files that the commission made public a lot of materials that contradicted the FCIC's report and were never mentioned in the report.[1] These went into my book, *Hidden in Plain Sight: What Really Caused the World's Worst Financial Crisis and Why it Could Happen Again*.

[1] Peter J. Wallison, "New Questions About the Financial Crisis Commission," June 14, 2016. http://www.aei.org/?s=financial+crisis+inquiry+commission.

Those who still back Dodd-Frank will of course argue that it is necessary to prevent another financial crisis, but this is based on the false idea that the 2008 crisis was the result of insufficient regulation of the financial system. They have no explanation for why we had a nationwide decline in underwriting standards, an unprecedented housing price bubble, and a financial crisis when the bubble collapsed in 2008. None of these things had ever happened in the 75 years since the Great Depression, which is the only comparable event in American history. During all these years we had the same financial regulatory system, and if anything financial regulation was tightened during this period.

In reality, the causes of the crisis had nothing to do with a lack of regulation, or even greed on Wall Street. That is why the major provisions of this destructive law should be repealed.

The crisis was caused by the government's housing policies, beginning with the enactment in 1992 of what are called the Affordable Housing Goals. The goals required Fannie Mae and Freddie Mac, when they bought mortgages from banks or other originators, to meet annual quotas of loans to low and moderate income borrowers. Initially, the quotas were 30%--in any year, at least 30% of all mortgages they acquired had to be made to low and moderate income borrowers—but through the Clinton and Bush administrations the goals were raised aggressively by HUD, so that, in 2008, 56% of all mortgages they acquired had to be made to borrowers who were at or below median income where they lived.

Before the goals were adopted, Fannie and Freddie were well-known for buying only prime mortgages, and in fact it was that policy that Congress wanted to change in 1992. The thought at the time was that it would be easier for low and moderate income borrowers to buy homes if Fannie and Freddie could be compelled by the quotas to lower their underwriting standards.

This certainly worked. By the mid-1990s, Fannie and Freddie had abandoned their policy of accepting only mortgages with 10% downpayments. They had to; they couldn't find enough borrowers among those below median income who could make a 10 % downpayment. This was followed by reductions in FICO credit scores and increases in debt-to-income ratios as Fannie and Freddie struggled to meet the increasing goals between 1992 and 2008.

The great error in this policy was the failure to understand that Fannie and Freddie—as the dominant players in the housing finance markets—set the underwriting standards for the market as a whole. Mortgage lending is a competitive business, and as Fannie and Freddie lowered their underwriting standards lenders found that the GSEs would accept mortgages that they had never accepted before. If their competitors would make these mortgages, and if the GSEs would buy them, these underwriting standards would become the minimum standards for the market as a whole. Pretty soon, and we all remember this, people who formerly had insufficient funds to buy a home were able to buy one by borrowing almost the entire cost from a bank.

The decline in underwriting standards caused housing prices to rise. If a potential buyer has $10,000 and the underwriting standard requires a 10% downpayment, the buyer can acquire a $100,000 home. But if the required downpayment becomes 5%, the buyer can get a $200,000 home. Instead of borrowing $90,000, he now borrows $190,000. This additional borrowing, which people in the field call leverage, bids up housing prices. As a result, between 1997 and 2007, an unprecedented housing price bubble grew in the United States, with home prices rising almost 10% per year.

Why would a bank make a loan with only a 3% or even zero downpayment? Two reasons: home prices were rising so fast in the late 1990s and early 2000s that a year later the home would be worth 10% more, and thus could be sold to recover the mortgage loan if the buyer defaulted. Alternatively, the bank figured it could sell that loan to Fannie or Freddie, and both of them needed loans to borrowers below median income—no matter how risky—so they could meet the Affordable Housing Goals.

By 2008, just before the financial crisis, more than a majority of all mortgages in the US financial system were subprime, required low or no downpayment, or were otherwise weak. Of those loans, 76% were on the books of government agencies, principally Fannie and Freddie. This shows, beyond question, that it was the government that created the *demand* for these mortgages.

Finally, in 2007 and 2008, when home prices had gotten so high that no amount of concessionary lending could get borrowers to take on the loans, the bubble's growth flattened and began to decline. Then, as Warren Buffett famously said, "when the tide goes out you can see who's swimming naked." A deluge of defaulted mortgages hit the financial system, buyers of mortgage backed securities that were not guaranteed by the government disappeared, and financial firms that had bought the mortgages or the mortgage-backed securities were left holding the bag. The outcome was a financial crisis in 2008 and a deep recession that ended in June 2009.[2]

This isn't to say that the banks were blameless; they were profiting from the sale of deficient mortgages, but the reason they could sell them was because Fannie and Freddie and other government agencies were buying them to meet government quotas.

To address this problem, the financial regulators did not need any more authority. They had plenty of authority and plenty of visibility into the banks to know what the banks were doing. They didn't stop the fun or take away the punchbowl because they knew Congress liked what was happening. More people were buying homes and housing prices were rising, making everyone feel richer.

But after the carnival came to an end, the only thing the Obama administration and the congressional majority could think of was to pile more regulation on the financial system. No one, either among the regulators or in Congress, wanted to take the blame, or even find out the truth, so the banks became the scapegoat and Dodd-Frank was fastened onto the American economy.

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[2] The causes of the 2008 financial crisis, from beginning to end, are detailed in my book, *Hidden in Plain Sight: What Caused the World's Worst Financial Crisis and Why it Could Happen Again*, Encounter Books, 2015

George W. Bush was the only person in authority during this period who has made an honest assessment of what happened. He said in his memoirs, "I was pleased to see the ownership society grow. But the exuberance of the moment masked the underlying risk."[3]

The winners write the history, and the incoming administration of Barack Obama and the Democratic supermajority in Congress blamed the crisis on insufficient regulation of the private financial sector. This narrative, although factually unsupported, gave rise to the Dodd-Frank Act, which imposed significant new regulation on the US financial system but did virtually nothing to reform the government policies that gave rise to the financial crisis.

Today, as a result, housing prices are rising on the same trajectory that they were on in the mid-1990s. If we don't change our housing policies, we are headed to another financial crisis.

**Important Reforms in the CHOICE Act**

The balance of this prepared testimony will focus on five elements of the Dodd-Frank Act that have, or I believe will have, severe adverse consequences for the US economy—(i) the compliance costs imposed on community banks that have stifled US economic growth; (ii) the authority provided to the Financial Stability Oversight Council; (iii) the Orderly Liquidation Authority; (iv) the danger inherent mandatory clearing of derivatives; and (v) the Volcker Rule.

The CHOICE Act addresses all of these important issues, as summarized below, and I urge its approval by this committee:

**First**, the Dodd-Frank Act has had a highly adverse effect on economic growth in the United States, primarily—although not entirely—through imposing substantial costs on small and community banks. The CHOICE Act attacks this problem in a comprehensive way—providing these banks, and potentially others, with an "off-ramp" that would allow them to avoid many of the most costly regulations if they adopt a capital position based on a 10% leverage ratio instead of the Basel risk-based capital standards. Larger banks could also take advantage of this exemption. This is an imaginative way comprehensively to address the problem of excessively costly regulations for small and community banks and restore the growth in the small bank sector that has been missing since the enactment of Dodd-Frank. A return of small and community banks, over time, will restore the growth among small business and startups that will get our economy moving where it needs the most help—at the local level.

**Second**, the CHOICE Act would rescind the authority of the FSOC to designate systemically important financial institutions, or SIFIs. This is certainly a much-needed reform. A federal district court in the District of Columbia, has already determined, in the MetLife case, that the FSOC's actions in designating MetLife as a SIFI were arbitrary and capricious. But it could hardly be otherwise. It is impossible for any agency, or council of agencies, to know that at some point in the future—in completely unknown market conditions—the failure of a particular firm will cause instability in the US financial system. The FSOC, already of doubtful constitutionality, also has the authority under Dodd-Frank to prohibit other firms from engaging in lawful activities that the FSOC deems to be risky for the economy. This was too much

[3] George W. Bush, "Decision Points," (Crown Publishers, 2010), p449

discretionary power to be given to any government agency, and the CHOICE Act would also eliminate that authority.

**Third**, the CHOICE Act would repeal Title II of Dodd-Frank, the Orderly Liquidation Authority, which would permit the secretary of the Treasury to take control of and liquidate a failing non-bank financial firm that, in the secretary's judgment, would cause instability in the US financial system if it were allowed to file for bankruptcy. The secretary is then directed to turn the company over to the FDIC for liquidation. This provision will create substantial confusion among creditors, who will not know which rule would apply—the Bankruptcy Code or the secretary's opinion—and will probably increase credit costs for all large financial firms. As important is the fact that this is a totally unnecessary provision, because there is no indication—after Lehman—that a nonbank firm can cause a financial crisis. The Choice Act, correctly, would substitute a new provision of the Bankruptcy Code as the mechanism for winding down failed nonbank financial firms.

Finally, the repeal of Title II of Dodd-Frank will prevent supporters of the act from contending, falsely, that Dodd-Frank ended too-big-to-fail. It did not. There are certain TBTF firms in our economy, but they are not bank holding companies or other large financial firms that may be covered by Title II; they are the largest commercial banks, and Title II does not apply to them. This means that the US at this point does not have any way to deal with the enormous problems that would be created by the failure of one of our largest banks. The only workable solution is to make sure that none of these banks fails, and the only way to do that is to assure that these banks have enough capital to withstand every possible adversity. The leverage ratio in the CHOICE Act may be the best solution here, as it is for small banks.

**Fourth**, the CHOICE Act would repeal the authority of the FSOC to allow clearinghouses to have access to the Fed's discount window. This will set up the same kind of moral hazard problem that always develops when a profit-making firm has access to government support. The availability of Fed backing will inevitably mean that the clearinghouses, which compete for clearing business, will gradually allow their financial strength to weaken in order to attract business. This will not worry their customers, because the customers will know that the clearinghouses will have access to the Fed's support if they ever get into trouble. The result, unfortunately, is likely to be a future event in which one or more clearinghouses are unable to meet their payment obligations. The Fed will have to step in, but we can only hope that a real financial crisis does not occur.

**Fifth**, the CHOICE Act would repeal the Volcker Rule, which has driven many bank-related financial firms out of the business of making markets in debt securities. This has resulted in a serious lack of liquidity in the debt markets, and could result in many bankruptcies—and even a financial crisis—in a stress environment where many investors want to sell debt securities to get needed liquidity.

**Dodd-Frank's Harm to the Economy**

The Dodd-Frank Act is the only plausible reason for the slow recovery of the US economy from the 2008 financial crisis. The US economy is a giant multifaceted organism that cannot be easily suppressed. Anything capable of doing so would have to be a very large and comprehensive shock—something only the US government could produce. During the last eight years, there have only been three major policies that could qualify for this role—the Affordable Care Act, the Fed's Quantitative Easing program, and the Dodd-Frank Act. The first two would most likely be stimulative, because they both either pumped more money into the financial system or lowered interest rates. Accordingly, the third, the strict new financial regulations in Dodd-Frank, are the likely sources of suppressed growth. The chart below shows the degree to which the period from the end of the last recession in June 2009, through 2013, was an outlier among US recoveries since 1960.

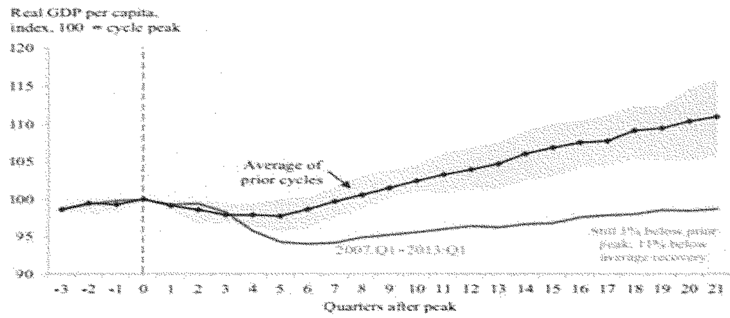
Still, exactly how Dodd-Frank has adversely affected the growth of the US economy is a legitimate question. In general, the need for many firms to adjust their business plans and strategies could certainly be one of the causes of slower growth. This is especially true when almost everything Dodd-Frank commanded had to be embodied in regulations, sometimes by several agencies acting jointly. Even seven years after the enactment of the law all the required regulations—which once numbered almost 400—have not been issued. It would have been reasonable for financial or other businesses to have waited for all relevant regulations to be adopted before making new investments.

Then there is the question of risk-taking; the whole purpose of the law was to place controls on risk-taking, so many financial firms have hung back from financing new ventures. In the consumer economy, the CFPB's refusal to define the term "abusive" left many firms fearful of making offers to customers that the CFPB might later punish. All these, and many more, are plausible reasons for the economy to slow after Dodd-Frank. However, in this testimony, I will argue that the principal mechanism for slowing the economy has been the act's effect on small and community banks.

Dodd-Frank became a law on July 21, 2010. It is important to keep this date in mind, because it is the after-effects of the law that are of interest. The chart below was prepared by the Federal Reserve Bank of Dallas[4] and shows the quarter-by-quarter growth of the US economy from before the crisis to the second quarter of 2013. The gray area is the range, and the black line is the average, of prior cycles. The chart shows that the current recovery—the line below the shaded area—is far weaker than the range and average of prior periods.

[4] Adapted from Tyler Atkinson, David Luttrell, and Harvey Rosenblum, "How Bad Was It? The Costs and Consequences of the 2007-2009 Financial Crisis," *Staff Papers* no. 20, July 2013.

**Dodd-Frank's Legacy: The recovery from the 2008 crisis and recession compared to previous recoveries.**




NOTE: The gray area indicates the range of major recessions since 1960, excluding the short 1980 recession. [3]
SOURCES: Bureau of Economic Analysis; Census Bureau; authors' calculations.

Demonstrating the connection between regulation and suppressed growth is difficult; economists generally do not try to model the effects of regulation as they do with taxes. What we can do, however, is make clear how Dodd-Frank regulation could have caused or contributed to the slow growth in the economy.

In this testimony, then, I will point to Dodd-Frank's extensive regulatory burdens on small banks—the 98.5 percent of all banks that have assets of $10 billion or less—as the most important reason for the slow recovery. I will argue that these costs and the strict one-size-fits-all lending standards that have been imposed by regulators under Dodd-Frank, have reduced the productivity, raised the operating costs, and limited the amount of credit that small banks could provide to small business borrowers—especially the small business startups that are largely responsible for increased jobs and economic growth.

It is not well-known that a large proportion of the new employment in the US market has come from local start-ups, and these are the firms that often depend on local bank financing and are hardest hit by the loss of these local financial institutions. [5]

If this analysis is correct, we should see that firms that can access the capital markets—and are not dependent on bank lending—have been growing at a pace that is consistent with most other recoveries. The data shows that this is true. We should also see that small businesses—those that rely on banks for their credit needs—are growing far more slowly than larger businesses that do not have to rely on bank credit. This is also supported by the data.

Finally, there is the question whether the crisis of 2008—because it was a financial crisis—was destined to recover more slowly than any previous crisis or recession.

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[5] John Haltiwanger, Ron S. Jarmin, and Javier Miranda, "Who Creates Jobs? Small Versus Large Versus Young," The Review of Economics and Statistics, May 2013, 95(2):347-361

Defenders of Dodd-Frank sometimes argue that a slow recovery is typical after financial crises, and accounts for the slower economic growth since 2010, but recent scholarship shows that this idea can be dismissed. Michael Bordo and Joseph Haubrich studied 27 recession-recovery cycles since 1882 and concluded: "Our analysis of the data shows that steep expansions tend to follow deep contractions, though this depends heavily on when the recovery is measured. In contrast to much conventional wisdom, the stylized fact that deep contractions breed strong recoveries is *particularly true* when there is a financial crisis."[6]

The Bordo-Haubich paper also shows that financial crises have resulted in sharp recoveries, except where government has stepped in with new regulations such as Dodd-Frank. Together, these supporting elements add weight to the argument that the Dodd-Frank Act was a major cause of US economy's slow recovery from the 2008 crisis.

**The Economic Growth Costs of Additional Regulations on Small Banks**

As chart above shows, through the first quarter of 2013, there had been some modest economic growth, but far less than in a normal recovery. Since then, as we know, the pattern has continued. In fact, an average growth rate of about 2% continued through the end of the Obama administration.

Is there a plausible connection between this slow growth and the Dodd-Frank Act?

In developing and adopting the Dodd-Frank Act, Congress and the administration did not appear to be concerned about placing additional regulatory costs on the financial system. For example, all bank holding companies with $50 billion in assets or more were treated in the act as systemically important financial institutions (SIFIs) and subjected to "stringent" regulation by the Fed. Among many other requirements, these banking organizations must prepare so-called "living wills"—detailing how they would be broken up if they fail—and participate in annual Fed-designed stress tests.

These and other requirements add substantial additional costs to whatever "stringent" new regulation by the Fed might entail. Even if only in the form of more compliance officers than loan officers, this will mean that these banks will supply less credit to the real economy. If these firms did not have to hire any additional compliance officers, all their new hires—if any—would likely be employees who produce revenue, and hence more revenue for the bank and more economic growth for the real economy.

Moreover, placing these burdens on $50 billion banks was completely gratuitous. There is no basis for the belief that a $50 billion bank—or even a $100 billion bank—is a SIFI. The failure of a bank of that size would not cause a systemic event, and even if this were a rational fear the bank could be sold to one of the many banks larger than $250 billion. It is difficult to escape the conclusion that the Congress that imposed these unnecessary costs just didn't care about the effect on the economy.

[6] Michael D. Bordo and Joseph G. Haubrich, "Deep Recession, Fast Recoveries, and Financial Crises: Evidence From the QAmerican Record," Working Paper 18194, National Bureau of Economic Research, June 2012, p2.

In a study of the effect of the "systemic" regulations imposed on regional banks with assets of more than $50 billion—not the largest banks that operate nationally and internationally— Federal Financial Analytics concluded that "the direct costs of systemic standards for a sample of U.S. bank holding companies (BHCs) may be at least $2 billion, resulting in a possible reduction of credit in the markets served by the largest of these BHCs of 5.7 to 8 percent. Over a five-year period, this reduction in lending by regional banks could total approximately $14 to $20 billion."[7]

A similar analysis applies to small banks, which have also been required to conform to many new regulations coming out of Dodd-Frank, especially in mortgage and consumer lending. A study by the Government Accountability Office (GAO) identified seven Dodd-Frank titles that have the potential to increase the costs or the competitive burdens for "community banks,"[8] which the GAO and many others define as banks with assets of $10 billion or less (unless otherwise stated, this testimony will use that definition). Similarly, studies by the Mercatus Center[9] and the American Enterprise Institute[10] have also shown that Dodd-Frank regulations have imposed substantial additional costs on community banks. As noted earlier, banks of this size or less are 98.5 percent of all US banks; as of 2015, there were only 98 banks in the US with more than $10 billion in assets,[11] and only 39 with assets of $50 billion or more.

The additional costs are substantial. Mercatus, in particular, based its study on a survey of approximately 200 small banks, noting that "our survey reveals increased hiring of compliance personnel, more noncompliance employee time spent on compliance, and increased spending on compliance, trends noticed in other surveys."[12] The study further reported, "[A]pproximately ninety percent of respondents reported an increase in compliance costs, and most (82.9%) of participating banks reported that their compliance costs had increased by more than five percent."[13] In effect, for these banks the median number of compliance personnel doubled—from one to two—after July 2010, and a quarter of respondents planned to hire additional compliance officers.[14] More compliance officers, or more noncompliance employees engaged in compliance activities, translates directly into higher employee costs and lower employee productivity—meaning in the end less credit or more costly credit for the small businesses that borrow from banks.

As a rule of thumb, whatever regulatory costs are imposed on banking organizations—whether they be $2 trillion banks like JPMorgan Chase, $50 billion banks or $50 million banks—the larger the bank the more easily it will be able to adjust to these costs. As Federal Reserve

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[7] Federal Financial Analytics, Inc., "The Consequences of Systemic Regulation for U.S. Regional Banks," August 6, 2015, p *i*

[8] U.S. Gov't Accountability Office, GAO-12-881, Community Banks and Credit Unions: Impact of the Dodd-Frank Act Depends Largely on Future Rule Makings (2012) Appendix II.

[9] Hester Peirce, Ian Robinson, and Thomas Stratman, "How are small banks faring under Dodd-Frank?" Working Paper, Mercatus Center, George Mason University, February 2014, p15

[10] Tanya D. Marsh & Joseph W. Norman, The Impact of Dodd-Frank on Community Banks (American Enterprise Institute May 7, 2013), available at http://www.aei.org/papers/economics/financial-services/banking/the-impact-of-dodd-frank-on-community-banks/.

[11] Mercatus study, supra note 7., p 11

[12] Id., p16

[13] Id., p 34

[14] Id., p 35 and 36

Governor Daniel Tarullo has observed, "Any regulatory requirement is likely to be disproportionately costly for community banks, since the fixed costs associated with compliance must be spread over a smaller base of assets."[15] William Grant, then chair of Community Bankers Council of the American Bankers Association, noted in congressional testimony in 2012, "The cost of regulatory compliance as a share of operating expenses is two-and-a-half times greater for small banks than for large banks."[16] That's most likely why, since the enactment of Dodd-Frank, the smallest banks, as we will see, have suffered the greatest losses of market share and the largest banks have continued to grow.

Ironically, then, although there has been great concern in Congress about the financial advantages of too-big-to-fail banks (TBTF), the heavy regulations in Dodd-Frank have given the largest TBTF banks even more significant competitive advantages over their smaller competitors. Indeed, Jamie Dimon, the chair of JPMorgan Chase, has referred to regulation as a "moat" that reduced competition from its smaller rivals.[17]

Consistent with these data, small banks have been losing market share to larger banks since the enactment of Dodd-Frank. In a 2015 paper, Marshall Lux and Robert Greene noted that "Community banks withstood the financial crisis of 2008-09 with sizeable but not major losses in market share—shedding 6 percent of their share of U.S. banking assets between the second quarter of 2006 and mid-2010...But since the second quarter of 2010, around the time of the Dodd-Frank Wall Street Reform and Consumer Protection Act's passage, we found community banks' share of assets has shrunk drastically—over 12 percent...Since Q2 2010, the smallest community banks' ($1 billion or less in assets) share of U.S. banking assets has fallen 19 percent."[18]

An important factor in this decline, according to Lux and Greene, is that community banks did not share in the 44% increase increase in commercial and industrial (C&I) loans outstanding since mid-2010: "Community banks share of this lending market is down 22.5 percent since Q2 2010 (from 20.6 percent to 16.0 percent). More striking, the smallest community banks' market share is down 35.6 percent (from 9.6 percent to 6.2 percent) since Q2 2010, and despite overall growth in the sector, these banks realized a net decrease in volume of 7.5 percent."[19]

Part of the reason that small banks have been losing market share is the decline in their numbers, because of acquisitions by larger banks and a complete collapse since the financial crisis in the chartering of new banks. Both can be attributed to Dodd-Frank. Many community banks are selling out to larger institutions, which can operate more cheaply in the costly

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[15] Daniel Tarullo, Remarks at the Federal Reserve Bank of Chicago Bank Structure Conference, May 8, 2014.
[16] William Grant, Statement before the House Subcommittee on Financial Institutions and Consumer Credit, May 9, 2012.
[17] John Carney, "Surprise! Dodd-Frank Helps JPMorgan Chase," CNBC NetNet, February 4, 2013. http://www.cnbc.com/id/100431660.
[18] Marshall Lux and Robert Greene, The State and Fate of Community Banking," *M-RCBG Associate Working Paper Series*, No. 37, Mossavar-Rahmani Center for Business and Government, Harvard Kennedy School, February, 2015, p3
[19] Id., pp 17-18.

regulatory environment since the enactment of Dodd-Frank. Kelly King, the chairman of BB&T, a larger bank that is aggressively seeking to acquire community banks, recently observed:

> I think a lot of banks with $5 billion to $10 billion in assets are going to recognize that it is an unsolvable problem when they look at the massive investment they have to make to comply...The cost for them to expand is enormous, and they would go through a trough of several years where their stock price would be diluted. From an economic point of view selling is almost a no-brainer.[20]

Indeed, the chartering of new banks, which at one time averaged 100 per year, has declined to less than three per year since 2010. This is almost certainly attributable to the squeeze on profits as a result of increased regulation, although low interest rates could also be a contributing factor. If existing community banks can't make a go of it in the current environment, why would anyone invest in a new one?

Another element causing difficulties for small banks is the narrative underlying the Dodd-Frank Act; in this story, the financial crisis was caused by insufficient regulation of banks and other financial firms, allowing them to take risks that resulted in the financial crisis. As discussed elsewhere, this narrative is false,[21] but blaming the failure of a large number of financial institutions on lax regulation has produced an examiner crackdowns in the past, often accompanied by a downgrading of smaller banks. Larger banks are seldom downgraded. After the recession in 1989-1991, according to a history of bank regulation, regulatory attitudes changed: "Bank examiners became too restrictive, helping to create a near credit crunch."[22]

A 2015 paper by Paul Kupiec, Yan Lee, and Clair Rosenfeld has shown that, when regulatory downgrades occur, loan growth is impaired. "[S]upervisory restrictions," they report, "have a negative impact on bank loan growth after controlling for the impact of monetary policy, bank capital and liquidity conditions and any voluntary reduction in lending triggered by weak legacy loan portfolio performance or other bank losses."[23]

**The Effect of Additional Regulatory Costs and Tighter Lending Standards on Small Business**

Because of the unique role of community banks in lending to small firms, increases in bank regulatory costs and tightening bank credit requirements are particularly bad news for small business. As Drew Breakspear, the commissioner of Florida's Office of Financial Regulation, pointed out in a 2015 article, "Community banks have traditionally supported local agricultural and small business needs by incorporating information about borrower' characters into lending

[20] Kristin Broughton, "Too Costly to Grow: Why National Penn Decided to Sell," American Banker, August 18, 2015.
[21] Wallison, *Hidden in Plain Sight*, supra note 1
[22] Alan Gart, *Regulation, Deregulation, Reregulation: the Future of the Banking, Insurance, and Securities Industries.* New York: John Wiley & Sons. 1994. p 163.
[23] Paul Kupiec, Yan Lee and Claire Rosenfeld, in "Does Bank Supervision Impact Bank Loan Growth?", draft of May 7, 2015, p1.

decisions. But Dodd-Frank has standardized lending practices, which works to the advantage of large banks and punishes community banks."[24]

Indeed, anecdotal information from small business managers and small banks indicates that since the enactment of Dodd-Frank examiners have been insisting that all borrowers with similar financial standing be treated the same way, so that credit is not necessarily available anymore to borrowers that do not meet certain revenue standards or do not have suitable collateral, guarantors, or vouching materials such as audited financial statements. Character loans, as Mr. Breakspear described them, one of the strengths of community banks that know their customers, appear to be a thing of the past.

One-size-fits-all lending standards certainly reduce one of the key advantages of the small bank lending system, but it may be more important for our purposes to understand that it also reduces the availability of credit for small business borrowers, especially start-ups, which generally have few of the supporting elements for credit that regulators want to see. As one study noted, small banks can fill a niche "stemming from their ability either to successfully lend to what have been variously described as 'informationally opaque' borrowers—borrowers without long credit histories suitable for credit scoring or other model-based lending practiced by large banks—or to engage in relation-or-reputation-based lending or lending in low-volume markets."[25] In other words, small banks can be unique sources of credit both for start-ups or more mature small businesses that do not otherwise have the credentials that regulators require for larger institutions.

At this point, it is necessary to make a key distinction about the contribution of small firms to economic growth and jobs. It is generally understood by economists that small firms are the principal drivers of new growth and jobs in the economy, but most of the discussion about small firms has focused on these firms as a single category. Within this category, however, are small firms that are trying to expand, and those that are not, and start-ups that contribute to growth in employment far beyond their numbers.

The most recent Small Business Credit Survey by the 12 Federal Reserve Banks, published this month, shows that 61% of small firms experienced credit challenges of various kinds during the last 12 months, with 44% all small firms reporting credit "unavailability" or difficulty finding credit for "expansion."[26] Growing firms—firms that are succeeding in satisfying their customers—are exactly those that should be able to get credit, yet only a little over half of these firms were able to meet their credit needs. These were clearly small firms that are applying to small and community banks, because the most sought after credit amount for firms with less than $1 million in revenue was only $100,000.[27]

Of the 10,000 firms that responded to the Fed survey, 33% were between 0 and 5 years old, the usual definition of start-ups. These young firms are particularly important because they

[24] Drew Breakspear, "Too Small to Comply: Florida Regulator on Dodd-Frank's Defects," Bank Think, August 9, 2015

[25] Tim Critchfield et al., The Future of Banking in America: Community Banks: Their Recent Past, Current Performance, and Future Prospects, FDIC BANKING REV. (2004), at 4

[26] 12 Federal Reserve Banks, "Small Business Credit Survey: Report on Employer Firms," April 2017, p6

[27] Id., p9

are the major drivers of growth and jobs in the US economy. In an important paper on this subject, three researchers observed: "The share of jobs created and destroyed by different groups is roughly their share of total employment. An important exception in this context is the contribution of firm start-ups: they account for only 3% of employment but almost 20% of gross job creation."[28] As the authors explain, using 2005 as an example: "About 2.5 million net new jobs were created in the U.S. private sector in 2005. Strikingly, firm start-ups (firms with age 0) created about 3.5 million net new jobs. In contrast, every other firm age class except for the oldest firms exhibited net declines in employment in 2005."[29]

For this reason, data showing that small firms in general are not having difficulty finding credit, or don't need new credit,[30] should be understood as the result of sampling older established small firms or firms that are not looking to expand, and not the growing and start-up category, which is where the economic and job growth in the U.S. economy is apparently concentrated. It is the start-up category that would be having the most difficulty getting bank credit as a result of the tightening lending standards and greater small bank regulatory costs induced by Dodd-Frank. Banks, especially small banks, are not venture capitalists; to the extent that they are willing to take venture-type risks, it's with the "informationally opaque" firms that now draw criticism from examiners.

Lux and Greene report that "[C]ommunity banks provide 51 percent of small business loans. In the decade before the crisis (Q2 1998 to Q2 2008), community banks' lending to small business doubled in volume [citing FDIC data]. Small businesses create the majority of new jobs and account or the vast majority of employers...Alarmingly, however, community banks' overall volume of small business lending has declined significantly since Q2 2010—down 11 percent."[31] While this could also be the result of lower small business loan demand, the authors also point out that the volume of small business lending by the largest banks has declined only 3 percent.

Most significantly, in the same study, the results for community banks since the enactment of Dodd-Drank are even worse in the commercial and industrial (C&I) loan market—loans made to businesses that are not agricultural loans or commercial and residential real estate loans. There, "community banks' share of this lending market is down 22.5 percent since Q2 2010 (from 20.6 percent to 16.0 percent). More striking, the smallest community banks' market share is down 35.6 percent (from 9.6 percent to 6.2 percent) since Q2 2010, and despite overall lending growth in the sector, these banks realized a net decrease in volume of 7.5 percent."[32]

These observations are supported by other data. In 2014, two researchers at the Federal Reserve used data in bank call reports to assess whether there is a difference between large banks and community banks in business lending. "Following the financial crisis," they wrote, "total outstanding loans to businesses by commercial banks dropped off substantially. Large loans outstanding began to rebound by the third quarter of 2010 and essentially returned to their

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[28] Haltiwanger, et al, "Who Creates Jobs? Small Versus Large Versus Young," supra, note 3, p 360.
[29] Id., p350
[30] See, e.g., data of the National Federation of Independent Business (NFIB) for 2015, showing that members are having no difficulty obtaining credit. NFIB Research Foundation, "Opinions of Small Employers," p.8. http://www.nfib.comsmallbizsurvey2015.
[31] Lux and Greene, op. cit., p11.
[32] Id., p18

previous growth trajectory while small loans outstanding continued to decline (Chart 1). Furthermore, much of the drop in small business loans outstanding was evident at community banks (Chart 2)."

**Chart 1. Amount Outstanding on Loans to Businesses[33]**

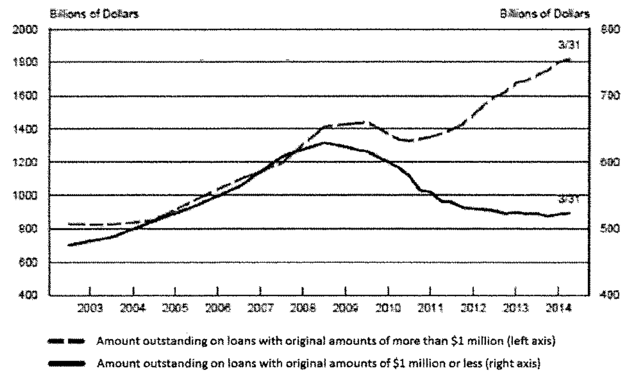
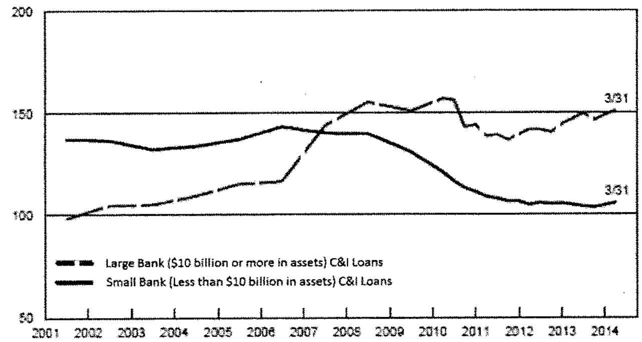



**Chart 2. Small C&I Loans Outstanding by Banking Organization Size**

[33] These charts appear in Dean Amel and Traci Mach, "The Impact of the Small Business Lending Fund on Community Bank Lending to Small Business," Finance and Economics Discussion Series, Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board, No. 2014-111, December 2014, p17

Total Amount Outstanding on C&I loans with initial amounts of $1 million or less




Source: According to the authors, these data are constructed from special tabulations of the June 30, 2002 to March 31, 2014 Call Reports.

Bank Call Reports do not provide information on the size of the business that received the loan, but as the authors of the paper note, loans up to $1 million are frequently seen as a proxy for a small business loan. So what these charts show is that small business lending by small banks, and small business borrowing by small firms, has not recovered from the post-crisis recession and has declined even more sharply after the enactment of the Dodd-Frank Act in 2010. Even banks over $10 billion have not been expanding their lending to small business. The likely reasons, as outlined above, are that higher regulatory costs and one-size-fits-all lending standards imposed after Dodd-Frank have stymied lending, particularly to start-ups which account for most of the economy's new jobs and growth.

Finally, the new and more costly regulation imposed by Dodd-Frank appears to have stalled the formation of new banks, which in turn has also affected the availability of credit for the small and medium-sized businesses that are dependent on bank lending. A Federal Reserve Bank of Richmond report in March 2015 notes that "The rate of new-bank formation has fallen from an average of about 100 per year since 1990 to an average of about three per year since 2010." Trying to assess the reasons for this sharp decline, the report continued, "Banking scholars ...have found that new entries are more likely when there are fewer regulatory restrictions. After the financial crisis, the number of new banking regulations increased with the passage of legislation such as the Dodd-Frank Act. Such regulations may be particularly burdensome for small banks that are just getting started."[34]

[34] Roisin McCord, Edward Simpson Prescott, and Tim Sablik, "Explaining the Decline in the Number of Banks since the Great Recession," Economic Brief, Federal Reserve Bank of Richmond, March 2015.

The authors suggest other possible causes, but the fact that the decline became so severe in 2010, the year of the enactment of Dodd-Frank, is strong evidence that the new requirements in the act—which have been cited again and again by small banks since 2010—are responsible. In any event, the decline in the formation of new banks caused an overall decline of 800 in the total number of small independent banks between 2007 and 2013. All these factors—increased regulatory costs, tougher lending standards, and a decline in the absolute numbers of small banks because of regulatory costs—have had an adverse effect on the small businesses, and particularly the small business start-ups, that depend on small banks for credit.

**Small Business and the Bifurcated Credit Market**

It is not generally understood that the US has a sharply bifurcated credit market. According to the Small Business Administration, in 2010 there were 28 million small businesses in the US, defined as firms with fewer than 500 employees. Of these, about 5.5 million were employers; the rest were small proprietorships (mom and pops) with no formal employees. At the same time, there were 18,500 larger businesses (less than 1 percent of all employers) with 500 employees or more.[35]

These two classes of businesses have very different sources of credit. Most of the 18,500 larger businesses are in a position to borrow from banks or to finance in the credit markets. In 2014, there were approximately 10,000 firms registered with the SEC and thus in a position to issue securities in the capital markets. However, (leaving aside the growing but limited crowdfunding market) the 28 million small businesses, including the 5.5 million that were employers, are likely to be completely dependent on banks for their credit needs. For these firms, increases in the cost, or reductions in the availability of bank lending—particularly by small banks—would have a substantial impact on their prospects for growth.

The chart below shows that since the mid-1980s the capital markets have far outpaced the banking industry as a source of credit for business firms.[36] This alternative means of financing, however, is not available to small or medium sized businesses, because they are not generally owned by public shareholders and do not report their financial results to the SEC. In addition, the considerable costs of maintaining a securities registration make registration unaffordable for smaller businesses. For these smaller firms, then, greater and more costly regulation of banks would inevitably cause either an increase in the cost of bank credit, a reduction in its availability, or both.

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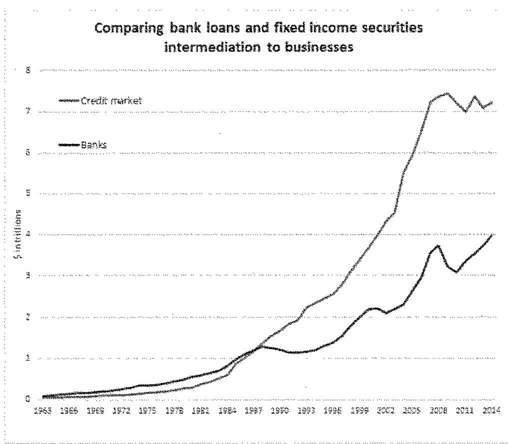
[35] Small Business Administration, "Frequently Asked Questions About Small Business," September 2012, p1.

[36] There are several reasons for this. Agency intermediation is more efficient than the principal intermediation of banks; banks are more heavily regulated than broker-dealers, mutual funds and other participants in the capital markets and thus have higher costs; and technological advances in information distribution have made it easy for firms to communicate their financial position directly to analysts and investors, so banks have lost their special position as the repositories of the best financial information about companies. The trend toward capital markets financing has caused a backlash from bank regulators, who now want to use the Dodd-Frank Act to regulate the capital markets—what they call the "shadow banking system."




Source: Fed Flow of Funds

There is another explanation for the difficulty of small business, particularly start-ups, in getting credit for growth. In a Goldman Sachs report published in April 2015, and titled "The Two-Speed Economy," the authors posit that new banking regulations have made bank credit both more expensive and less available. "This affects small firms disproportionately because they largely lack alternative sources of finance, whereas large firms have been able to shift to less-expensive public market financing."[37]

Using IRS data, the Goldman study finds that large firms—those with $50 million or more in revenue annually, have been growing revenue at a compounded annual rate of 8 percent, while firms with less than $50 million in revenue have been growing revenue at an average of only 2 percent compounded annually. Even more significant, using Census data, the Goldman authors found that "firms with more than 500 employees grew by roughly 42,000 per month between 2010 and 2012, exceeding the best historical performance over the prior four recoveries. In contrast, jobs at firms with fewer than 500 employees declined by nearly 700 per month over the same timeframe, although these small firms had grown by roughly 54,000 per month on average over the prior four recoveries."[38]

This accounts for the dearth of new business formations. Small firms are simply unable to get the credit that used to be available to small business start-ups, and the credit that they can get is more expensive. This would also have a disproportionate effect on employment in the recovery, because small business start-ups, as noted earlier, are the principal source of new employment growth in the US economy.

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[37] Goldman Sachs, "The two-speed economy," April 2015.p3 http://www.goldmansachs.com/our-thinking/public-policy/regulatory-reform/2-speed-economy-report.pdf.
[38] Id., p8

Finally, the Goldman paper expresses concern that this is not necessarily a temporary phenomenon: "Taken together, the reduced competitiveness of small firms…are reshaping the competitive structure of the US economy in ways that are likely to reverberate well into the future, and in ways that any future evaluation of the aggregate effects of post-crisis regulations should consider."[39]

It would be hard to find a better way to express the dangers of leaving the Dodd-Frank Act in place without serious reforms.

**Other Specific Provisions of Dodd-Frank that Will Harm the US Economy**

Apart from its damage to the economy through its harmful effects on small banks and small business, there are other serious problems with Dodd-Frank that will be corrected through the CHOICE Act. These include the authorities provided to the Financial Stability Oversight Council under Title I of the act, the Orderly Liquidation Authority under Title II, the Fed's authority to open the discount window to clearinghouses, and the Volcker Rule. The CHOICE Act is important and necessary legislation because it would eliminate all of these Dodd-Frank provisions that are harmful to the economy in themselves and in some cases could be responsible for financial crises in the future.

**The Financial Stability Oversight Council**

**Summary of this section:**

1. **FSOC's authority under Section 113 to designate nonbank financial firms as SIFIs should be repealed, including the language in Section 113 that permits the FSOC to designate SIFIs because of their "nature, scope, size, scale, concentration, interconnectedness, or mix of activities."**
2. **FSOC's authority under Section 120 to recommend "stringent" regulation of any "activity," and its authority under Section 121 to terminate certain activities by any financial company, should be repealed**
3. **The provisions of Section 165 that impose requirements for stringent regulation, stress tests and living wills should apply only to the largest insured banks.**
4. **The FSOC could be retained solely as an information-sharing resource for financial regulators, like the President's Working Group in the prior administrations.**

As noted in the earlier discussion of the causes of the crisis, the Dodd-Frank Act as a whole is founded on a false narrative—that the 2008 financial crisis was caused by insufficient regulation of the private financial sector. However, Titles I and II of the act are based on a different and narrower misconception: that the immediate cause of the crash in 2008 was the bankruptcy of Lehman Brothers, a large nonbank financial firm. As a result, Title I of the act is focused on identifying and preventing the failure of large financial firms, while Title II attempts

[39] Ibid.

to provide an alternative to bankruptcy, which the act's sponsors believed is an inherently disorderly process.

Reflecting the view that the failure or "material financial distress" of a nonbank financial firm could cause another financial crisis, Title I establishes a council of financial regulators—the Financial Stability Oversight Council (FSOC or Council)—to identify these firms. When identified, a firm (commonly called a "systemically important financial institution" or SIFI) is then turned over to the Federal Reserve for special regulation that the act specifies must be both "prudential" and "more stringent" than the regulation to which similar firms are normally subject.

As shown earlier, however, the financial crisis was caused by the collapse of an entire asset class—home values and mortgages—brought about by the government's own housing policies. Neither special stringent regulation of large firms nor a special non-bankruptcy resolution system will prevent another crisis in the future if the government continues the same policies that it pursued before 2008.

Indeed, the policies introduced in Titles I and II will have harmful potential effects themselves. Among other things, they will create moral hazard and spread to other financial sectors the too-big-to-fail problem which has previously been limited to the banking industry. Since these policies will do considerable harm to the US economy, and they do no discernible good, they should be eliminated through repeal of the FSOC's authority to designate nonbank financial firms as SIFIs. In addition, the firms that have already been designated should be released from the Fed's control.

The following discussion is organized around the sections of Title I that establish the FSOC or provide it with authority to designate nonbank financial firms as SIFIs.

**Section 111**

Section 111 of the act establishes the FSOC, and specifies that the voting members will be the Secretary of the Treasury, as the chair, and the chairs or heads of all the other federal financial regulators. In addition, the president is given the power to appoint an independent voting member with insurance expertise. This amounts to 10 voting members, all of whom are appointees of the president then in office, and three of whom are bank regulators.[40] Routine decisions are to be made by a majority, but decisions on SIFI designations must be made by 2/3rds vote and have the affirmative vote of the secretary of the Treasury.

This structure—which constitutes the council as a group appointed by the administration then in office and probably from the president's political party—makes the council a political body. This is a substantial break from the past, where important financial regulatory decisions

[40] In addition to the secretary of the Treasury, the voting members of the FSOC include the chairs of the Federal Reserve, the Securities and Exchange Commission, the Federal Deposit Insurance Corporation, the Commodity Futures Trading Commission, and the National Credit Union Administration Board; the Comptroller of the Currency; the directors of the Consumer Financial Protection Bureau and the Federal Housing Finance Agency; and an independent member appointed by the president with the advice and consent of the Senate, having insurance expertise.

were made by bipartisan commissions made up of individuals who were deemed to be experts in a specific area of financial activity. Thus, the makeup of the FSOC raises questions that go beyond whether a bank regulator should be voting on a securities issue; it imports political and partisan considerations into what have traditionally been decisions that were made on the merits, in a bipartisan regulatory process. Although the heads of the financial regulatory agencies may be experts in regulation within their respective areas of specialty, their appointment by the president then in office—and the president's ability to remove them as chairs or agency heads—makes them unusually responsive to the president's political direction.

This problem is made considerably worse by the appointment of the secretary of the Treasury as the chair of the FSOC, which places one of the principal political officers of the administration, usually a confidant of the president, at the head of the table in FSOC meetings. It would be natural, then, for the other appointees of the president's political party to look for guidance on major decisions from the secretary of the Treasury instead of using their independent judgment. While political accountability is generally good, in financial regulation Congress has determined that it is best achieved through the bipartisan balance that is inherent in the bipartisan commission structure—a structure that is upended in the FSOC.

All these elements argue for the FSOC's transformation into a purely consultative body, similar to the President's Working Group (PWG), which was established by an executive order in the Reagan administration and continued to operate in subsequent administrations.[41] In that case, the council could retain its current structure, with the Treasury secretary as its chair.

**Section 113**

Section 113 authorizes the FSOC to designate particular nonbank financial firms as systemically important financial institutions (SIFIs), if the Council "determines that material financial distress at the US nonbank financial company, or the nature, scope, size , scale, concentration, interconnectedness, or mix of activities" of the firm "could pose a threat to the financial stability of the United States." After designation, the firm is turned over to the Fed for what the act calls "stringent" new regulation.

This is the FSOC's most distinctive power, and flows directly from the mistaken idea that the failure of a nonbank financial firm, like Lehman, can cause another financial crisis. The sponsors of the act thought that turning these firms over to the Fed for regulation would prevent their failure and thus—to that extent—prevent another financial crisis.

This idea is wrong; as will be shown, the failure of Lehman did not cause the 2008 financial crisis, and preventing such failures will not prevent another financial crisis. Moreover, there is no support in banking history for the proposition that Fed regulation can prevent bank failure. Finally, there are reasons to believe that the FSOC is not pursuing a fair or objective investigative or decision making process when it designates SIFIs. All of these are reasons for eliminating this authority.

[41] Executive Order 12631 of March 18, 1988, http://www.archives.gov/federal-register/codification/executive-order/12631.html.

**The FSOC's implementation of its Section 113 designation authority: the MetLife Case**

As noted above, the FSOC's designation authority is based on the notion, adopted by the sponsors of the Dodd-Frank Act, that large financial firms are "interconnected," If one of them fails, according to this theory, its "interconnections" with other firms will drag them down, causing instability in the US financial system. This led to the conclusion that additional regulation was necessary to assure that these large nonbank financial firms did not fail. Hence, the FSOC was given the extraordinary authority to designate certain firms as SIFIs.

When MetLife challenged its designation as a SIFI in 2014, FSOC argued in both the trial court and on appeal that, as an expert group, it can predict whether the financial distress of a firm like MetLife will be likely to cause instability in the US financial system in the future. This can be done, apparently, without knowing the conditions of the market in the future or MetLife's position within it. FSOC established no standards and referred to no historical precedents for making this decision, just as it had not for previous designations of AIG, GE Capital and Prudential Insurance. Its essential position, then, was that while it couldn't define what degree of interconnection with others would make a company a candidate for designation, MetLife's evidence was insufficient to show that its financial distress or failure would *not* cause instability in the US financial system—a position that MetLife's brief called *ipse dixit* (colloquially: "because I said so"). On this basis, the council claimed that its position was entitled to deference from the courts against MetLife's argument that the council's conclusions were arbitrary and capricious.

The MetLife brief raises serious questions about what standards the FSOC has been using to make its designations. MetLife is the first case in which the FSOC's standards have been publicly revealed. Apparently, the agency was prepared to designate MetLife as a SIFI without articulating any standards by which such a judgment would be made. Without standards, almost every prediction about whether the failure or material distress of a firm will cause financial instability in the future becomes completely discretionary—nothing more than a guess—and thus arbitrary and capricious. Indeed, the trial court found that FSOC had acted arbitrarily and capriciously in designating MetLife as a SIFI.

In a sense, FSOC should not be blamed for its inability to establish standards. The problem is that the agency was empowered by Congress to make a decision that is inherently one without standards. How can any person or group decide what is likely to happen in a completely unknown future time, when the relationships between a company under consideration for designation and the many other companies its failure might injure are completely unknown and unknowable? For this reason alone, FSOC should not have the power it is granted by Section 113. It is a power to use discretion without any limit. Perhaps the courts might not strike it down, but Congress certainly should.

There are substantial negative policy consequences of designating a firm as a SIFI. Principal among these is the danger that the firm has in effect been labeled by the government as "too big to fail" (TBTF) After all, a SIFI designation is a statement by the government that allowing the firm to fail would be dangerous to the stability of the US financial system. Under these circumstances, firms that are designated as SIFIs may have financial advantages over competitors because—other things being equal—it is less risky to lend to them than to lend to firms that have an equal risk of failure but, if they fail, will not be rescued by the government.

Another important question is the effect of a designation on competition within a market. Insurance is a good example. It is not difficult to imagine that each of the three insurance firms that have been designated by the FSOC will be able to tell potential insurance customers that they are safer sources of insurance—whether life or property and casualty—than their competitors because they have been designated as SIFIs and are likely to be protected or rescued by the government. As happened with Fannie and Freddie, these companies will be able to outcompete others in the same industry because their apparent government backing made their guarantees seem safer than those of their competitors.

Over time, SIFI designations could produce powerful and unassailable firms that can dominate a market such as insurance that never had a TBTF problem in the past. If designations continue, involving other kinds of firms—and the FSOC is arguing in the MetLife case that it has an unlimited license to designate *any* firm—this will produce unnecessary concentration in financial fields other than banking and insurance, as the firms designated as SIFIs come to dominate their markets. It may also lead to firms requesting designation so they can reap the crony capitalism advantages of their relationship with the Fed.

Finally, designation authority can have a negative effect on the economy as whole. A good example of this is what happened to GE Capital in the wake of its designation as a SIFI. GE Capital was highly successful finance company in many areas—which means that it provided financing for firms that were ultimately successful and contributed importantly to economic growth. One of the areas where GE Capital specialized was in lending to small companies with large risks but strong growth prospects. It was willing to take risks and its astute investments over the years had enabled it to grow larger than GE, its parent company.

We do not know what stringent regulations the Fed proposed to put on GE Capital, but whatever they were they so impaired its earning power that in April 2015 GE decided—in the hope of getting GE Capital "de-designated"—to shrink it down into a financing source primarily for GE's customers. In other words, the government, through the powers granted to the FSOC, removed from the economy a significant source of risk-taking finance for smaller companies with good growth prospects. And this was done ostensibly because the regulators at the FSOC thought that if GE Capital encountered "material financial distress" at some point in the future it could cause a financial crisis.

This is a powerful example of how a set of regulatory blinders can impair the growth of the US economy. Even assuming that the FSOC was able to predict what would happen at some time in the future if GE Capital were to fail, it is not a matter of speculation what FSOC did to the US economy by essentially putting GE Capital out of business. No government organization should have this discretionary power.

**Is the FSOC or SIFI designation necessary to protect the financial system?**

Against all these disadvantages and costs to the financial system, what evidence is there that designation is necessary to protect the financial system? The short answer is: none. First, of course, if we look at what happened in the financial crisis, it does not appear that prudential bank-like regulation was superior to non-regulation or market discipline in protecting financial firms from failure in the financial crisis. Three large nonbank financial firms failed in the crisis—Bear Stearns, Lehman Brothers and AIG; and three large heavily regulated banks—IndyMac, Washington Mutual and Wachovia (in addition to hundreds of smaller banks)—also failed during the crisis period. One large heavily regulated banking organization, Citigroup, might have been saved from failure by government assistance, but that is disputed by its management. On this evidence, there is nothing to make anyone confident that the regulation of banks produces firms that are safer for the system than firms regulated primarily by market discipline.

But it is the failure of the "interconnections" idea—the notion that if a large nonbank financial firm fails it will drag down others—that ultimately destroys the rationale underlying the Dodd-Frank Act and the FSOC's designation power. The idea grew out of the chaos that followed the bankruptcy of Lehman Brothers, but if we take only a cursory look at that chaotic period we can see that the failure of Lehman—one of the largest financial firms in the US at the time—had no significant direct or indirect effect on other large financial firms. Despite the market's anxious state before Lehman filed for bankruptcy, no other large firm failed because it was exposed to Lehman. This is true even though Lehman was a major player in the credit default swaps market, which has been wrongly charged with "bringing the financial system to its knees," and there were many such swaps written by others on Lehman itself.

Seldom in social science studies can one demonstrate the fallacy of a major assumption on which legislation has been based, but this is one example. The Lehman case shows that—even under the adverse conditions in which it occurred—the failure of a large nonbank financial firm will not drag down other large firms. The same would have been true if Bear Stearns and AIG had been allowed to fail.

This is understandable when it is given any thought; large firms are generally highly diversified, and the failure of one counterparty is unlikely to cause a diversified firm to fail. In order to challenge the idea that large firms are dangerous in this way, MetLife commissioned a study that showed its complete collapse would not have had a significant effect on the largest banks, which are likely to be highly diversified and hold the debt securities of many different issuers.

To be sure, a money market mutual fund—the Reserve Primary Fund—"broke the buck" because of its losses on Lehman, but that is far from an insolvency or failure of a company. It is roughly equivalent to a corporation suffering a loss in a year, with a resulting decline in the value of its shares. Ultimately, the shareholders of the fund received 99 cents on the dollar,[42] so their losses in any case were small and the fund could have continued in business. The Reserve Primary Fund was not covered by the insurance system that the Treasury put in place after it

[42] Press Release, the Reserve, Reserve Primary Fund to Distribute $215 Million (Jul. 15, 2010), available athttp://www.primary-yieldplus-inliquidation.com/pdf/PrimaryDistribution_71510.pdf.

broke the buck, so the Treasury's action does not account for the small losses that the fund ultimately suffered.

If we look for the causes of the panic that occurred when Lehman failed, we can easily find them in the rescue of Bear Stearns in March 2008. That was the original sin. Once Bear was rescued, market participants assumed that the government would rescue all other large financial firms. There was no logical reason that the government would rescue Bear's creditors and not the creditors of others. This created a form of moral hazard; thereafter, the managers and creditors of large financial firms assumed that if a large nonbank firm failed its creditors would be rescued just as Bear's were rescued.

Accordingly, managers of large firms did not believe that they had to raise as much additional equity as they normally would do to reassure their creditors. Rather than further dilute their shareholders in bad market conditions, it was sensible to wait out the weakness in the market. Creditors had the same reaction; instead of selling their holdings in a weak firm—and taking a loss—it made sense to stay where they were, since they would be made whole if the firm ultimately failed. That was probably the reasoning of the Reserve Fund's management.[43] Then, when the government failed to rescue Lehman—a firm that was 50 percent larger than Bear—all these assumptions were upended and a genuine financial panic ensued.

What actually happened in the financial crisis was not that Lehman dragged down other firms; it was the collapse of an entire asset class —mortgages and private MBS backed by non-traditional mortgages (NTMs)—that were held by many financial institutions. Bear, Lehman and AIG, for example, all suffered severe losses and liquidity problems because of private MBS; Bear and Lehman had heavily invested in them. AIG, on the other hand, had guaranteed credit default swaps (CDS) issued by a subsidiary that covered others' losses on private MBS. To compound its error, AIG then used cash collateral it had received as a CDS issuer to invest in additional MBS. Because these MBS became unmarketable when the private MBS market collapsed in 2007, AIG was then unable to meet its obligations to return the cash collateral when its counterparties demanded it.

In any event, for the same reason that Lehman's bankruptcy did not cause others to fail, it is doubtful that if AIG had been allowed to fail there would have been the catastrophic collapse of the market that government officials described in justifying their actions. Even if AIG had defaulted on its CDS coverage of private MBS, the counterparties affected by AIG's inability to meet its obligations would likely have purchased additional coverage in the CDS market, which continued to function all through the financial crisis. Indeed, Goldman Sachs, the largest counterparty of AIG's CDS protection, told the Financial Crisis Inquiry Commission that it was fully covered by other CDS if AIG had failed.

It is important to keep in mind, then, that the failures of both Lehman and AIG were the result of government policies. First, the government's housing policies, which reduced underwriting standards and built an unprecedented housing price bubble. Second, capital rules—

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[43] This is corroborated in a Wall Street Journal article in December 2008, in which Bruce Bent, the chairman of the Reserve Primary Fund said, before Lehman's bankruptcy, that the firm should be saved by the government because of its importance. Steve Stecklow and Diya Gullapalli, "A Money Manager's Fateful Shift," Wall Street Journal, December 8, 2008.

which lowered the capital required to hold private mortgage-backed securities—herded banks and other financial firms subject to the Basel rules into private MBS. Third, accounting rules implemented and kept in effect by the SEC during the crisis, required all financial firms to carry their securities assets at market value. This required them to write down their assets when the market for MBS collapsed in 2007, creating the widespread impression that they were financially weak. And finally, the government's inexplicable reversal of policy on rescuing large financial firms threw the market into turmoil when Lehman failed.

Under these circumstances, it seems clear that there are few if any advantages to the financial system that arise out of SIFI designations, but many significant disadvantages. It would make sense, then, to repeal the FSOC's authority—as the CHOICE Act does—to designate SIFIs.

**Other authorities under Section 113**

In addition to the designation of SIFIs because of the supposed effects of their material distress, Section 113 also authorizes the FSOC to designate nonbank financial firms as SIFIs because the "*nature, scope, size, scale, concentration, interconnectedness, or mix of activities* of the U.S. nonbank financial company could pose a threat to the financial stability of the United States." [emphasis added] This is an extraordinary grant of power, even for the Dodd-Frank Act. And it is a grant of power without any inherent standards or limitations. Did Congress really intend to give the FSOC the power to designate a nonbank firm as a SIFI—and thus subject it to stringent regulation by the Fed—because of its "nature?" At least in the case of large firms, it is possible to suppose that their failure could jeopardize others—so that would be an inherent limitation—but in this list of unrelated items Congress has granted what is essentially a license to designate *any* firm as a SIFI, and subject it to stringent new regulation by the Fed, for virtually any reason at all.

Although the legal principle of an unconstitutional delegation power has fallen into disuse in recent years, this is a case where it is applicable. Unless its supporters can place some kind of standards around its exercise—some kind of limiting principle that explains what Congress had in mind—this provision should be repealed.

Ironically, many financial firms—especially in the asset management business—believe that the FSOC's focus on "activities" would relieve them of the danger of designation as SIFIs. This might be true if the only standard for designation is size. Size is not relevant when the standard is activities. However, "activities" can capture many more firms, including the small as well as the large. Section 113, as noted above, contains language that permits the FSOC to designate firms as SIFIs because of many factors.

Thus, there is a plausible argument based on the language in Section 113, that the FSOC could designate as SIFIs all firms that engage in certain defined transactions—say, buying the commercial paper of asset-backed trusts—or participating in those transactions to an extent that exceeds some dollar amount. The danger of being designated for these suspect transactions would be enough to give the Fed the ability to approve or disapprove transactions of that kind on a case-by-case basis—a plausible substitute for direct prudential regulation of firms like asset managers now active in the capital markets.

By using the "activities" language in Section 113, the FSOC and the Fed could be successful in imposing prudential regulation on asset managers, securities firms, investment funds, finance companies and hedge funds, among others, which they characterize as "shadow banking." If so, they will stifle the continued development of the securities and capital markets in the United States, with dire consequences for economic growth.

We don't know, of course, how the courts will respond to interpretations like these. Even when it is a distortion of the statutory language, courts often accord deference to agencies' interpretation of the scope of their statutory authority, especially if the court believes that the agency is attempting to address a serious problem that is within the "spirit" of the legislation.

Supreme Court decisions like the 1984 decision *Chevron v. Natural Resources Defense Council,*[44] remain binding on the lower courts and authorize substantial deference to administrative agencies' interpretations of their statutory authority. Fortunately, in the one case questioning the FSOC's designation power that has reached the courts—the designation of MetLife as a SIFI—has found a Federal District Court willing to question the FSOC's authority. The case is now on appeal to the Circuit Court of Appeals for the DC Circuit, and should be watched carefully.

With the election of Donald Trump as president in 2016, these possibilities seem remote, but once laws like this are on the books and remain there a future administration might be inclined to use them. They, and many like them, should be repealed as soon as the opportunity presents itself, and that is the CHOICE Act.

In any event, the likely decisions of the courts are not relevant at this point. It is Congress that should act to prevent the excessive accretion of discretionary power by financial regulators. Power of this kind enables regulators to obtain compliance from individual firms by threatening to invoke this unbridled discretion.

**Sections 120 and 121**

These sections are additional examples of the extremely broad delegation of authority to the FSOC. In Section 120, it can make recommendations to the primary regulator of particular industries, requiring regulations that restrict various activities, even though they were previously permitted. The primary regulator must implement the standards recommended by the FSOC or explain why it has not, both to the FSOC and Congress. Given that the head of the primary agency has been appointed by the same president who has appointed the secretary of the Treasury and the other members of the FSOC, this would be a difficult directive to ignore.

Section 121 not as far-reaching as the authority to regulate undefined "activities" under Section 113, and applies only to individual firms and not entire industries as is the case under Section 120, but Section 121 still provides more discretionary and unrestricted power to an administration than Congress should delegate. Among other things, it authorizes the FSOC to "restrict the ability of [a] company to offer a financial product or service." In other words, the Council on its own motion, with no apparent standards of any kind, can put a firm out of business. Again, even if unused, this authority would enable any administration to control any

[44] Chevron v. Natural Resources Defense Council, 104 S.Ct. 2778 (1984).

financial company by threatening to invoke this power. For this reason, the authority, too, should be terminated.

**Section 165**

Section 165 is as important in many respects as Section 113. It requires the Fed to create more stringent regulatory standards not only for nonbank firms that have been designated as SIFIs but also for all bank holding companies (BHCs) with consolidated assets greater than $50 billion. In effect, then, Section 165 designates as SIFIs all BHCs with consolidated assets of more than $50 billion (BHC SIFIs). In addition to more stringent regulation, Section 165(d) also authorizes the Fed to require nonbank SIFIs and BHC SIFIs to prepare and submit to the Fed so-called "living wills," which outline in detail how they would be wound down in the event of their financial distress. Both requirements are based on the three fallacies discussed earlier: that (i) that the failure of a large nonbank financial firm will drag down others through "interconnections," (ii) the precipitating cause of the financial crisis was the disorderly bankruptcy of Lehman Brothers, and (iii) bankruptcy is inherently a disorderly and disruptive process.

Moreover, imposing the stress test and living will requirements on all BHCs with $50 billion or more in consolidated assets is unreasonable. The total assets of the US banking system, according to the Fed's Flow of Funds accounts, is $17 trillion. A bank with $50 billion in assets has only .3 percent of the total assets of all banks and an even smaller percentage of the $85 trillion of all US financial assets. The idea that the failure of a $50 billion bank will cause instability in the US financial system is fanciful at best.

The same is true of BHCs with $200 billion (1.2% of all bank assets) and even BHCs with $500 billion (3% of total bank assets). As outlined in the earlier discussion of the costs imposed by Dodd-Frank, imposing costs for developing living wills or complying with stress tests, will only further reduce the amount of credit available to the small business firms in the US or make that credit more expensive.[45] Even as to the largest BHCs, the living will requirement provides the Fed with extraordinary authority to force divestiture if the BHC does not organize itself as the Fed desires, and this provides leverage for the Fed to bend regulated firms to its will.

As noted earlier, in the discussion about the effect of Lehman's bankruptcy on other firms, there are good reasons to believe that the failure or financial distress of banks or nonbank firms up to $500 billion in assets will not have any significant effect on other firms or create instability in the US financial system. Lehman itself was a firm larger than $600 billion and declared bankruptcy in the midst of a market on the brink of wholesale panic. If Lehman did not cause other firms to fail, and it did not, then Congress should revisit the whole question of whether smaller firms—like BHCs with assets up to $500 billion and other nonbank firms—should be subjected to the extensive costs that living wills and stress test requirements impose.

In a March 2017 paper, my AEI colleague, Paul Kupiec, set up various alternative stress test models, including some that were close to the models used by the Fed, and analyzed their success in predicting the effect of the 2008 financial crisis on banking organizations. His

[45] Federal Financial Analytics, Inc., "The Consequences of Systemic Regulation for U.S. Regional Banks," August 6, 2015.

conclusion was that "Results show large inaccuracies in stress test model forecasts, even for models that fit the data exceptionally well."[46] Thus, these tests are not worth the added costs they impose.

**The Orderly Liquidation Authority Does Not Solve the Too-Big-To-Fail Problem**

**Summary of this Section:**

- **As discussed in connection with the reform of Title I, the bankruptcy of Lehman Brothers demonstrated that large nonbank financial firms can fail without dragging down others.**
- **Accordingly, there is no need for a government managed system such as the Orderly Liquidation Authority (OLA) in Title II to resolve large nonbank financial institutions that are headed for failure.**
- **The current bankruptcy system is sufficient to resolve failing nonbank financial firms, although it could benefit from some reforms recently proposed by the House Judiciary Committee.**
- **Therefore, Title II of Dodd-Frank should be repealed insofar as it is directed at substituting a government-run resolution system for the current bankruptcy system.**
- **Although the largest banks may pose a systemic threat if they fail, Title II is not applicable to these banks. Even if it were, Title II does not provide a workable mechanism for resolving the largest systemically important banks.**
- **Thus, despite the claims of supporters of Dodd-Frank, the too-big-to-fail (TBTF) problem has *not* been solved.**
- **The best policy for addressing the TBTF problem for systemic banks is replace Title II with a plan for substantially increasing the capitalization of systemically important banks.**
- **The CHOICE Act's proposal for a a leverage ratio may be the best solution if of sufficient size and applied to the largest banks.**

Title II of Dodd-Frank, entitled the Orderly Liquidation Authority (OLA), was enacted as a reaction to the chaos that occurred after the bankruptcy of Lehman Brothers in September 2008. The sponsors of the act, and many others at the time, believed that it was the Lehman bankruptcy filing that caused the enormous panic that we now know as the financial crisis. In a sense, then, the OLA is really the heart of the Dodd-Frank Act, because it was designed to avoid another financial crisis by preventing the disruptive and disorderly failure of large financial firms. That feature also allowed the act's sponsors to claim that it had solved the problem of financial firms that were too-big-to-fail (TBTF) because the government—in fear of allowing them to fail—would inevitably save them. With the OLA, said the act's proponents, the government had a way to liquidate or resolve these firms without disrupting the financial system.

Later analysis, however, has shown that it was incorrect to believe that Lehman's bankruptcy—and thus any large financial firm bankruptcy—would be inherently disorderly. Lehman's bankruptcy counsel told the Financial Crisis Inquiry Commission (FCIC) that the

[46] Paul Kupiec, "Inside the Black Box: The Accuracy of Alternative Stress Test Models"

firm's bankruptcy was disorderly because he was not asked to draw up bankruptcy papers until the Sunday afternoon before the Monday filing. Thus, a more orderly and prepared filing—even a debtor in possession filing under Chapter 11—was impossible in the Lehman case. And of course, Lehman's bankruptcy seemed disorderly because it came as an almost complete surprise and reflected an inexplicable and illogical reversal of what the market thought was a government policy.

Far more important, however, is the fact that, while the Lehman's failure caused huge disruption throughout the financial system, no other large financial institution failed as a result of Lehman's sudden and unexpected bankruptcy. To be sure, one money market firm broke the buck, but in the end its investors received 99 cents on the dollar. That no other large financial firm failed because of Lehman demonstrates something important: that even when the market is in a weakened and fragile condition, the failure of a large nonbank financial firm will not drag down others. In other words, as discussed earlier, nonbank financial firms are not so "interconnected" that the failure of one will cause a financial crisis—or, in the words of the Dodd-Frank's Title I, create "instability in the US financial system."

This is a serious problem for the underlying purpose of the OLA, which is to substitute a government-run resolution system for the private bankruptcy system in the case of large financial institutions. Title II contemplates that when a large financial firm is in "material distress" the secretary of the Treasury can decide, with the approval of the Financial Stability Oversight Council (FSOC), to turn it over to the FDIC for resolution.[47] The FDIC then has roughly the same powers it has under the Federal Deposit Insurance Act to liquidate the failing firm. It is questionable whether the FDIC's liquidation will be less disruptive than a liquidation in bankruptcy but, even if it is, it is unnecessary. The aftermath of the Lehman bankruptcy—where no additional large firms failed as a result of Lehman's failure—shows that there is no reason for the government to intercede in the failure of a large nonbank financial firm.

Nevertheless, the very existence of the secretary's power to direct a different form of resolution for large financial firms than for others has serious consequences, even if it is never exercised. First, the firms that might be subject to it are not known—Title II applies to all financial firms, not just those that have been designated as SIFIs. This means that creditors of any large financial firm cannot be sure of the outcome if the firm is ever in material financial distress. Will the firm go through bankruptcy, which is a known process with disclosed rules that are followed by courts, or will it be pulled into the FDIC's process, in which the agency has wide discretion and the power to prefer some classes of creditors over others?

This in itself will raise the costs of financing for the firms that are potentially within this charmed circle, and will be especially harmful when a weakening firm actually needs new financial support from the market. In that case, creditors will be reluctant to provide that support because there is no way of knowing what law will be applied if the firm ultimately fails. So, many firms are likely to fail because of this creditor uncertainty than would be the case if the path to resolution were clear.

[47] See Sections 203 and 204(b)

Thus, in order to avoid adding yet more uncertainty and risk to the credit markets, Title II should be repealed and the bankruptcy system restored as the only method for resolving nonbank financial firms. The CHOICE Act does this, and proposes to substitute a number of reforms to the bankruptcy laws, proposed by experts in the field and adopted by the House Judiciary Committee, that would tailor these bankruptcy procedures more effectively for financial firms.[48] These are beyond the scope of this testimony but are a major step forward if they eliminate the uncertainty that creditors of large financial firms will face when the firm is in danger of failure.

**The Single Point of Entry (SPOE) Strategy and TBTF Banks**

In 2013, the FDIC proposed a strategy for recapitalizing a large bank (not a BHC, but an insured bank) without disrupting its operations, thus saving the market from instability when a large bank fails. The FDIC plan, known as the single point of entry (or SPOE) would use the powers in Title II to take over the holding company of a failing bank, create a new bridge holding company, and leave the former BHC shareholders and all the BHC's non-secured liabilities behind. It would then use the assets of the old holding company (now in the new bridge company) to recapitalize the underlying bank. There are many legal problems with this idea, not the least of which is the fact that Title II was clearly intended to be used for *liquidating* a nonbank not *recapitalizing* a failing bank. Also, Title II is explicit that it was not supposed to apply to banks, only non-bank financial firms.

But leaving these issues aside, the plan doesn't work, anyway, for the largest banks, which are the ones that pose the greatest risk to the stability of the financial system. This is because the holding company of a failing bank cannot be taken over by the secretary of the Treasury and the FDIC unless the holding company is also insolvent. In a 2015 paper, my AEI colleague, Paul Kupiec, and I showed that the 14 largest US bank holding companies would not be insolvent—and thus ineligible for takeover under Title II—if their investment in their largest subsidiary banks were to be written down to zero. All of them had other subsidiaries that were profitable enough to keep the parent afloat even if its largest subsidiary banks were to fail.[49] Accordingly, even if SPOE were a legal strategy, which it appears it isn't, it would not work for the 14 largest bank holding companies in the US.

In other words, in the one area where it is most important—protecting the taxpayers and the economy against the failure of the largest banks—the Dodd-Frank Act has failed. There is still no way for the taxpayers to be sure that if one of the largest banks fails the government will be able to prevent another financial crisis. The likelihood is that the taxpayers will have to assume that burden. This also means that the Dodd-Frank Act has not solved the TBTF problem, as the act's proponents claim, because everyone will know that the government must step in with taxpayer funds to prevent these banks from failing.

**Curing the TBTF problem**

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[48] See, for example, Kenneth E. Scott, Thomas H. Jackson and John B. Taylor, eds. *Making Failure Feasible: How Bankruptcy Reform Can End "Too Big to Fail,"* Hoover Institution Press, 2015

[49] Paul Kupiec and Peter Wallison, "Can the 'Single Point of Entry' strategy be used to recapitalize a systemically important failing bank?" Journal of Financial Stability, October 2015.

Thus, the OLA in Title II has not cured the TBTF problem for the largest systemic banks, which means—despite the claims of its proponents—that it has not solved the TBTF problem. There is still no way at this point to assure that if such a bank fails it will not cause instability in the US financial system, requiring the government to step in with taxpayer funds. If it is still the objective of Congress to address the TBTF problem, it will be necessary to replace Title II with a resolution system that is adequate for resolving the largest banks.

How would this resolution system be structured? The FDIC's SPOE strategy is based on one important insight—that if an operating bank can be kept operating through recapitalization there would be no danger of a financial crisis. The FDIC attempted to implement this strategy in a way that did not fit within the language of the OLA, but making sure that the largest banks are always adequately capitalized may be the key to solving the TBTF problem.

This strategy would require the largest banks to have considerably more capital than they hold today, and it would require an adjustment in the prompt corrective action rules so that these banks would never fall below this high level of capitalization. Prompt corrective action, which was instituted in FDICIA in 1991, has not been effective, probably because the capital positions of thousands of small banks could deteriorate too quickly for examiners to stop the risky practices that are causing the losses. In addition, the moral hazard implicit in insured deposits, and the FDIC's history of saving all depositors and creditors when banks are sold or merged, has eroded the usual effectiveness of market discipline. This has allowed banks that are losing money to "gamble for resurrection," suffering losses from risky loans that impair their capital positions before that information comes to the attention of their regulators.

But if large systemic banks were required to maintain, say, 16 to 20 percent risk-based capital, and prompt corrective actions were to take effect when their capital had declined to 8 to 10% , taxpayers could have greater confidence that these banks are highly unlikely to fail. For the small number of banks to which these requirements would apply, it would be possible for regulators to keep accurate and current tabs on their capital positions. The CHOICE Act requires a 10% leverage ratio instead of the Basel risk-based system, and that also provides a foundation for a better and safer capital system.

In other words, rather than rely on parent holding companies to serve as sources of strength for their bank subsidiaries, the capital positions of the largest banks should be strengthened directly by infusions of capital from their holding companies, which would borrow the necessary sums. The funds invested in the equity of subsidiary banks would still appear as equity on the consolidated balance sheets of the BHCs. This would also provide a basis for eliminating the Fed's capital and other regulation of BHCs, which is another source of the widely held view—supplementing TBTF—that the Fed is willing to assist the BHCs it regulates in order to prevent them and their subsidiaries from failing.

If Congress is really interested in eliminating TBTF, there appears to be only one way to do it for the largest banks—ensuring that their capital positions never erode to a point where they are in default or in danger of default. The simplest and most effective way to do this is to require a level of capitalization that can be watched continuously by regulators, with the regulators having authority to apply prompt corrective action when the banks' losses or potential losses reach a point where they have lost, say, half their required capital. This would not put a large bank in danger of default, but it would allow regulators and bank managements to take corrective steps that would eventually restore the bank to its required capitalization level. In this way, the taxpayers could be assured that they will never be called upon to rescue the largest banks.

The leverage ratio system of capitalization proposed in the CHOICE Act—which would replace the Basel risk-based system--could be the best start toward this result. The CHOICE Act's leverage ratio was proposed as an "off-ramp" to reduce regulations on qualifying small banks, but it is also applicable to large banks that choose to adopt it. For the largest banks, the leverage ratio should perhaps be higher, but a leverage ratio—which is much simpler than the complex Basel rules and less easily gamed by the largest banks—is easier for regulators to enforce through prompt corrective action.

**Mandatory clearing of swaps**

The most important thing to understand about the clearing system for swaps—which was largely bilateral and distributed widely before the crisis—is that it functioned flawlessly throughout the crisis and right up until the time that the Dodd-Frank Act adopted new clearing standards. The fact that the system could work without difficulties in the midst of the most serious financial crisis since the Great Depression, raises questions about why it should have been modified by Dodd-Frank.

Nevertheless, Sections 723, 724 and 725 of Dodd-Frank contain the basic rules for the mandatory centralized clearing of most swaps through a system of clearinghouses known as central clearing parties (CCPs).

The success of the old system is not of course a sufficient reason to repeal the new mandatory system, but I believe the new system creates serious risks for the future that must be corrected. Most derivatives and swaps are within the jurisdiction of the Agriculture Committee, so it is not something that this committee can do on its own. However, there is at least one issue that is within the committee's jurisdiction, and its presence in the act multiplies the risks of mandatory clearing.

In addition to requiring mandatory centralized clearing of almost all swaps, Dodd-Frank authorized the FSOC to provide access by CCPs to the Fed's discount window. The FSOC authorized this shortly after it was established. Dodd-Frank's sponsors probably wanted the Fed's backing for CCPs because they feared that the loss of liquidity by a clearinghouse could have a systemic effect. Ironically, the systemic effect they were concerned about was the result of interconnections—the very danger that the act's sponsors wrongly believed would bring down the financial system if a large nonbank financial firm were to fail.

Although interconnections are not a significant factor in the case of nonbank financial firms, they are a serious problem with CCPs because interconnections are the whole purpose of clearinghouses. When two parties agree to have their swap cleared through a CCP, they are agreeing to trust the clearinghouse to have the funds necessary to make all required payments, even if one of the counterparties defaults on its payments to the CCP. However, if the clearinghouse itself fails to make one or more payments, the party that does not receive an expected payment may not be able to meet its own obligations, and this failure could have knock-on effects throughout the economy as firms further down the line are unable to meet their own obligations. The problem is compounded if the CCP fails entirely and is not able to make a large number of payments. This could lead to a financial crisis.

This is a danger in general for clearinghouses when clearing is mandatory, but giving the clearinghouses access to the Fed's discount window does not cure the problem—it makes the problem much worse. Access to the Fed's discount window sets up a system that once again creates moral hazard, with private profit-making institutions (in this case the eight clearinghouses) competing with one another while the government is at risk for their losses.

Before the financial crisis, clearinghouses competed for business with banks and others by assuring their customers that they were safe and sound. They not only had capital, but the amount of collateral (called "margin") they required from clearing parties was sufficient to protect those who expected to receive payments from the clearinghouse even if a counterparty should default in a payment to the clearinghouse.

The same system also worked for swaps that were cleared through banks; the banks were deemed to be sufficiently well-capitalized, and insisted on sufficient collateral from counterparties, so that a default by a counterparty in, say, a CDS transaction, would not mean the other side of the transaction would not receive its expected payment. The banks would liquidate the collateral and pay the counterparty, or make the payment and then liquidate the collateral. Of course, the bank in this system (as well as the clearinghouse) would not accept as a counterparty any person or organization that was not itself sufficiently strong financially to reduce the clearing party's risks. This is the system that worked right through the financial crisis and was working up to the point that Dodd-Frank's mandatory clearing requirement took effect.

But the system was fundamentally changed by the introduction of the Fed as a guarantor of clearinghouse liquidity. Now, without saying so, neither CCPs nor their customer-counterparties have to worry about their own financial soundness in competing for business. They can reduce the margin they are requiring from members and counterparties and can accept counterparties that are not financially sound. This is because those who are choosing them for clearing no longer have to worry about the financial soundness of the clearinghouse itself. They know that if a CCP defaults the Fed will supply the necessary funds so that all counterparties can be paid. And of course, because of mandatory clearing, clearinghouses will be much larger and have much more business than under the old bilateral system.

Although the CHOICE Act does not repeal the mandatory clearing rules—those are within the jurisdiction of the Agriculture Committee—it does repeal the provisions in in Dodd-Frank that authorize the Fed to provide assistance to CCPs. That will be a major step forward in preventing financial crises in the future.

### The Volcker Rule

At the heart of the Volcker Rule is a simple contradiction. The rule *prohibits* proprietary trading by banks or firms affiliated with banks, but it also *permits* these same entities and affiliated banks to continue the vital functions of market-making and hedging their risks. Market-making and hedging — principally done through buying and selling debt securities — look a lot like proprietary trading. Drafting a rule that prohibits proprietary trading but permits market-making and hedging was devilishly difficult, and probably not possible without impairing one or the other.

The Volcker rule is highly complex, and the issues that it raises were never fully explored in public, let alone debated, while it was under consideration in Congress or among the responsible regulatory agencies. The easiest way to explain the rule's underlying concepts and effects is in a question and answer format:

**What is proprietary trading?**

The rule prohibits what is called "proprietary trading" — that is, a bank or bank-related entity (like a bank holding company or a subsidiary of the holding company) buying or selling securities as principal for its own account and not for the account of customers. In other words, the financial institution involved has made a business that earns profits by buying or selling securities when it sees favorable circumstances in the market.

**What institutions are covered by the rule?**

The rule was explained to the public as a way to prevent banks from using insured deposits to engage in "risky trading" for their own accounts. For example, after the approval of the rule, Treasury Secretary Jack Lew noted that President Obama proposed the rule "to put an end to banks' ability to engage in high-risk activities solely for their own benefit, while enjoying the advantages conveyed by deposit insurance and other government protections."

This statement might be charitably characterized as a half-truth. Because the Volcker rule was written to apply to "bank-related entities," it encompasses far more than insured banks, and covers many entities that have no access to insured deposits. Moreover, referring to proprietary trading as a high-risk activity is misleading; as outlined below, proprietary trading is less risky than lending—the activity we expect from banks that take insured deposits.

Bank-related entities such as bank holding companies (BHCs) and the BHCs' non-bank subsidiaries are all ordinary corporations that raise their funds in the capital markets. They have no access to insured deposits or the Fed's discount window. What's more, there are strong "firewalls" between banks and their BHCs and non-bank affiliates, so that these firms cannot use the bank or its insured deposits for their own purposes. Accordingly, while the public was told that the Volcker rule was intended to protect their insured deposits, it actually severely restricts the legitimate and valuable activities of non-bank affiliates of banks that pose no threat to a bank's insured deposits. These restrictions will be very harmful to the financial system and the U.S. economy.

**Is proprietary trading especially risky? Was it one of the causes of the financial crisis?**

The answer to both these questions is no. It's hard to see how trading debt securities is riskier than lending. When it lends, a bank commits cash to the control of another party for an extended period of time. The bank seldom has effective control over the way the borrower uses the funds — leading to the possibility of loss — and by lending the funds it has reduced the amount of cash it has on hand in case large numbers of depositors or other creditors want their money back. Trading securities, on the other hand, is simply buying and selling from an inventory. There is of course always the danger that a bank's inventory of securities will decline in value, but at least the banking entity has control over it at all times and can sell it quickly if it foresees adverse events in the future. Lenders can seldom recall a loan when they foresee problems for the borrower or for themselves.

There has never been any evidence that the proprietary trading of securities had anything to do with the financial crisis. Indeed, it was not *trading* of securities, but *investing* in securities — particularly securities backed by subprime and other low quality mortgages — that caused the losses to the banks and other financial institutions in the 2008 crisis.

**Why is the prohibition on proprietary trading so controversial?**

Proprietary trading was profitable for the banks and their nonbanking affiliates. Profits make banking entities healthier and provide them with the funds and the confidence to make loans and expand their activities. If banks are expected to use insured deposits to make loans—and we certainly expect that they will do that—buying and selling fixed income securities like bonds and notes should not be considered excessively risky. Bonds and notes, after all, represent loans that others have made, and banks—as professional lenders—are uniquely qualified to evaluate the quality of these instruments when they are buying or selling for their own account.

Nevertheless, even if proprietary trading is looked upon as too risky for banks because they are funded in part by insured deposits, that is not true of their holding companies and other affiliates that have no access to insured deposits.

In fact, it may be riskier to deny bank-related entities like BHCs the opportunity to engage in proprietary trading than to permit them to continue doing it. We all recognize that the economy is constantly changing and that businesses must change in order to remain viable. Bank-related entities face the same problem of adaptation to change. They were once the major source of financing in the economy; now they are dwarfed by the securities markets. Virtually all large companies in our economy now fund themselves by issuing securities — bonds, notes, and commercial paper — not by borrowing from banks. Companies have found that issuing debt securities is more efficient than borrowing from a bank. If regulation confines banking entities to the businesses they have always been in, rather than the businesses that are likely to be growing in the future, the banks will inevitably fail.

**Why did it take so long for the Volcker rule to be approved?**

As noted earlier, while the Volcker rule prohibited banking entities from proprietary trading, it permitted them to continue to engage in two other vital activities: market-making and hedging transactions. Both are made far more difficult by the Volcker rule, and I suspect that the reason was the reluctance of the bank regulators to impair either of these vital activities.

Market-making is just what it sounds like: creating a place where buying and selling can occur. The stock market is an example of a market where trading occurs, but the stock market has vast numbers of buyers and sellers; when a seller appears, there are almost always buyers. However, the market for debt securities is thin. Although the debt market is much larger in dollar size than the equity markets, its trading is much thinner.

There are several reasons for this, but important among them is the fact that major investors like insurance companies and pension funds buy debt securities to hold them to maturity for the interest they receive, not to trade them. So when an offering of debt securities comes into the market, much of it disappears into investors' portfolios and is never seen again. The number of bonds or notes available for trading can be small.

Accordingly, if a pension fund decides that it wants to sell a debt security to meet a pension liability, there may not be buyers around ready to bid. Unless a market-maker is there to buy the security, there can be a very long delay before the fund receives the cash it needs to make pension or other payments. In a thin market, the fund may have to take a sharp cut in the value it expected to realize on the sale if it has to cut its price to effectuate a quicker transaction.

In acting as market-makers, banks and bank-related entities serve as important intermediaries; they buy bonds from sellers and sell bonds to buyers. In other words, banks and bank-related entities are the lubricants of the debt markets; they make it work by acting as principal intermediaries between buyers and sellers. Without them, the search costs for buyers and sellers would be very large. The "spread" between the bid and ask prices for the bond would be much wider, and that means it would cost firms more to buy a bond and they'd get a lower price when they sell it. If this becomes the regular pattern in the market for debt securities, it will be harder for companies to meet their cash needs by issuing these securities.

If we recall now that the Volcker rule prohibits banks from trading securities for their own account, we can begin to see the problem. Market-making sounds a lot like proprietary trading; the bank has a portfolio of bonds, which it is offering to buy or sell for its own account. How does one tell the difference between proprietary trading, which is forbidden, and market-making, which is vital to the markets and permitted by the rule?

The difficulty of drawing that line in a regulation was what probably stopped the regulators who were charged with drafting the rule. They realized that they could seriously impair the debt markets if they drafted a rule that impinged excessively on market-making, and were reluctant to do so. But, eventually, under criticism from the Left that a major provision of the Dodd-Frank Act was stalled, and statements in the media that the banks were weakening and delaying the Volcker rule, the White House and Treasury forced a decision in favor of a "tough" rule — one that favored prohibiting proprietary trading over permitting market-making. This should not be surprising; the Obama administration would not want a headline that said they had weakened the Volcker rule to please the banks.

The danger to the markets now comes from the chilling effect that the rule will have on market-making by bank-related entities. Imagine traders functioning as market-makers for a banking entity. Could they be certain that market-making trades would not be re-characterized by the regulator as proprietary trades? If that happens, it's likely their employer will have to pay a hefty fine and suffer bad publicity as a rule-breaker.

It's not that the banking entity or its personnel can't follow the rules; it's that the rules are inevitably ambiguous — the explanatory material that goes with the Volcker rule is almost 1,000 pages — and subject to varying interpretations. The chilling effect on banking entities and their employees will mean that the markets will move more slowly, the bid-ask spreads will be wider, and everyone who buys a security will have to pay more when it's bought and take less when it's sold than would have been the case before the rule went into effect. This will inevitably raise costs for all companies that issue securities to finance their activities, as well as firms that buy these securities for investment.

In the worst case, so many participants will exit the market that it will be difficult for firms to raise funds by selling bonds when they need to. This would be known as a shortage of liquidity, and it could be a serious problem if some future event induces large numbers of investors to try to sell their bonds or notes at the same time. In that case, there might be no market, and many companies or funds could default on their obligations. This is how the Volcker Rule could be responsible for another financial crisis.

In this connection, in September 2016, three Fed economists published a paper that concluded: "Since Volcker-affected dealers [banks and their affiliates] have been the main liquidity providers, the net effect is that bonds are less liquid during times of stress due to the Volcker Rule." It is during times of stress, of course, that market liquidity will be most needed.

**How does the Volcker rule affect hedging?**

Hedging transactions are vital for banking entities and others. When a company uses a hedge it is attempting to reduce the risk of a transaction or a purchase. For example, if a banking entity buys a bond that pays a market-rate of interest, it may simultaneously enter an interest rate swap with another financial institution to protect itself against a decline in interest rates. Is the swap a hedge against the risk on the bond or is it an independent and prohibited proprietary trade? The fact that they were done simultaneously may be some evidence that one was intended to hedge the other, but what if the transactions are separated by a week?

Like the market-making example, whether what was done was a permissible transaction or an impermissible proprietary trade will often be a matter of interpretation. The rule requires that hedges "demonstrably" reduce the risk of a specific trade or transaction. That does not mean banks and bank-related entities will stop hedging; they can't, it would be too risky not to hedge. What will happen is that some transactions may not be done at all because there is no hedge that can without question be shown to demonstrably reduce the risk involved.

The entire set of "London Whale" transactions, where JPMorgan Chase lost over $6 billion, was said by the bank to be a hedge against possible losses on a large portfolio of EU securities. Others claimed that the hedge was a fake, a cover for a lot of proprietary trades that went awry. That points to the fact that hedges themselves can be subject to differing interpretations.

How many banking entities, and how many of their employees, will engage in transactions where they cannot be sure that the hedge they intend to use will demonstrably reduce the risk? The fewer transactions, the less economic activity stimulated by banks and the slower our economy will grow.

Thus, although presented as a rule that will prevent risky bets by insured banks engaged in proprietary trading, the Volcker rule will actually prevent a wide range of bank-related entities from engaging in activities that are no more risky than ordinary lending while chilling the provision of vital services to the financial markets.

The CHOICE Act would repeal the Volcker Rule. That appears to be a necessary and prudent step to restore liquidity in the bond markets.

**Coalition to Congress: Support the Financial CHOICE Act**

April 26, 2017

Dear Members of the House of Representatives:

On behalf of our organizations and the millions of Americans we represent, we write to express our strong support for many provisions of the Creating Hope and Opportunity for Investors, Consumers and Entrepreneurs, or Financial CHOICE Act of 2017. This bill will promote economic growth while eliminating harmful regulations and provide better oversight for financial institutions and regulators by repealing some of the worst provisions contained in the misnamed 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act.

In response to the recent recession, Congress recklessly passed Dodd-Frank and imposed 3,500-plus pages of new rules and regulations on the financial industry and various parts of the economy. Dodd-Frank codifies "too big to fail" policy, runs local community banks out of business, restricts access to credit for investors and homebuyers, raises lending costs, reduces access to capital for small businesses, and created one of the most powerful and unaccountable federal agencies -- the Consumer Financial Protection Bureau (CFPB).

House Financial Services Committee Chairman Jeb Hensarling's CHOICE Act will begin the process of eliminating Dodd-Frank and the burdensome regulations that have restricted business creation, innovation, and entrepreneurship. By reducing red tape and empowering job creators and consumers over Washington bureaucrats, the CHOICE Act will help get our economy out of its historically slow economic recovery and create a financial system that benefits all Americans.

The CHOICE Act will also upend the unaccountable CFPB. This bill would restructure the bureau into strictly an enforcement agency with no supervisory authority, subject it to Congressional oversight and the appropriations process, and empower the President to fire the Director at will. These changes will protect consumers by preserving their right to make informed financial choices instead of Washington's typical one-size-fits-all approach. In contrast to the CFPB's current practice of regulating through enforcement, the agency will be accountable for administrating rules already on the books.

Republicans have repeatedly promised to repeal Dodd-Frank and restore economic opportunity for all. The Financial CHOICE Act is a significant first step toward fulfilling this promise. We, the undersigned organizations, urge all members of the House of Representatives to support the Financial CHOICE Act's many provisions to provide consumers with real economic freedom.

Sincerely,

Christine Harbin, Vice President of External Affairs
Americans for Prosperity

Michael Needham, CEO
Heritage Action for America

Grover G. Norquist, President
Americans for Tax Reform

David McIntosh, President
Club for Growth

Adam Brandon, President and CEO
FreedomWorks

Pete Sepp, President
National Taxpayers Union

David Williams, President
Taxpayers Protection Alliance

Daniel Garza, Executive Director
The LIBRE Initiative

Mark Lucas, Executive Director
Concerned Veterans for America

Andrew Clark, President
Generation Opportunity

Mark Holden, Chairman
Freedom Partners Chamber of Commerce

Judson Phillips, Founder
Tea Party Nation

John Berlau, Senior Fellow
Competitive Enterprise Institute

Michael J. Bowen, CEO
Stephani Scruggs Bowen, COO
Coalition for a Strong America

Peter J. Thomas, Chairman
Americans for Constitutional Liberty

Sabrina Schaeffer, Executive Director
Independent Women's Forum

Heather R. Higgins, President and CEO
Independent Women's Voice

Rick Manning, President
Americans for Limited Government

Jeffrey Mazzella, President
Center for Individual Freedom

Steve Pociask, President
American Consumer Institute, Center for Citizen Research

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April 25, 2017

The Honorable Jeb Hensarling
Chairman
Committee on Financial Services
United States House of Representatives
Washington, DC 20515

The Honorable Maxine Waters
Ranking Member
Committee on Financial Services
United States House of Representatives
Washington, DC 20515

Dear Chairman Hensarling and Ranking Member Waters:

On behalf of America's credit unions, I am writing regarding the hearing entitled, "A Legislative Proposal to Create Hope and Opportunity for Investors, Consumers and Entrepreneurs." CUNA represents America's credit unions and their 110 million members. We respectfully ask that this letter be included in the record of the hearing.

We appreciate that the Committee is taking the initial steps in a legislative process that we hope will result in a reduction of regulatory burden for credit unions while still maintaining important consumer protections. We thank Chairman Hensarling for his leadership in this effort. While we have significant concerns regarding some provisions of the legislation and we believe the legislation could be improved through the inclusion of provisions that are not presently in the bill, we endorse the process and encourage the Committee to proceed expeditiously.

Credit unions are unique in the financial services space because they are not-for-profit financial cooperatives with a statutory mission to promote thrift and provide access to credit for provident purposes. This means "why" and "how" credit unions do what they do for their members is fundamentally different than what for-profit banks do to their customers. Credit unions are owned by the same people and small businesses they serve, and they were created to ensure that consumers and small businesses have access to safe and affordable financial services. Therefore, credit unions have a significant interest in ensuring their members—and consumers in general—are well protected in the financial services space, and they work hard to support these virtues through service to their members. We are quite proud—although not surprised—that *Consumer Reports* acknowledged credit unions as one of the highest rated services they had ever measured.[1]

Unfortunately, credit unions' ability to provide safe and affordable financial services has been significantly impeded in the last several years by a regulatory scheme rigged to favor the large banks and nonbank financial providers that can better afford to comply with the regulations coming out of Washington. This imprudent policymaking is hurting consumers, costing them time and money, and limiting their access to safe and affordable financial services from credit unions. Since 2008, credit unions have been subjected to more than 200 regulatory changes from more than a dozen federal agencies, totaling more than 7,000 pages in the *Federal Register*. In 2014, we estimated this burden cost

[1] Jeff Blyskal, *Choose the Best Bank for You*, Consumer Reports, *available at* http://www.consumerreports.org/banks-credit-unions/choose-the-best-bank-for-you/ (Dec. 4, 2015).

credit union members $7.2 billion, an increase of more than 40% from 2010. Many more new regulations have been finalized, implemented, or are in the process of being implemented since we studied the cost to credit union members. Accordingly, it is reasonable to assume these costs have continued to rise. The unfortunate reality is that every dollar a credit union spends to comply with a regulation established to govern abuses perpetrated by other actors is a dollar not used to the benefit of its member and community. Given all the lawmakers in Washington working on these issues, there must be a better approach to consumer financial protection than making it difficult for credit unions – consumer financial protection heroes – to serve their members.

## Summary of Credit Unions' Views Regarding the CHOICE Act

Chairman Hensarling has proposed the Creating Hope and Opportunity for Investors, Consumers and Entrepreneurs (CHOICE) Act. We believe this legislation represents a bold first step in a legislative process we hope will produce meaningful regulatory relief for credit unions and their members. While imperfect, we think this bill is an important vehicle for beginning the conversation and moving the process along.

As described in greater detail below, we support several CHOICE Act provisions, including the provisions that: provide regulatory relief to very well capitalized credit unions; change the structure, authorities, and some practices of the Consumer Financial Protection Bureau (CFPB); add additional checks and balances to require that CFPB rulemakings are providing benefits that outweigh costs to consumers; provide protections for credit union employees reporting elder abuse; prohibit regulators from forcing credit unions to close certain accounts for certain industries; provide additional rights for the conduct and appeal of examinations; require notice and opportunity to comment on the National Credit Union Administration (NCUA) budget; require detailed information on NCUA's Overhead Transfer Rate; and direct regulators to adjust risk-based capital standards appropriate to risks posed by current activities and businesses on a forward-looking basis.

However, we have significant concerns regarding the provisions that: provide savings and loans with national bank powers—including unlimited statutory business lending authority—in the absence of similar accommodations for credit unions; bring NCUA under the appropriations process; eliminate the CFPB's supervisory authority for nonbank financial service providers; remove the CFPB's authority to regulate small dollar, payday and title loans; and make it easier for the largest banks to grow even larger through the removal of the 10% domestic deposit cap.

Furthermore, we believe there are several additional provisions that, if included, would improve this legislation such as language to: strengthen the CFPB's authority to exempt credit unions and small banks from its rulemaking; replace the CFPB director with a five-person commission; and provide credit unions parity with banks in the treatment of 1-4 family non-owner occupied residential loans.

## CHOICE Act Provisions America's Credit Unions Support

### Regulatory Relief for Strongly Capitalized, Well-Managed Financial Institutions

Title VI would create a path for qualifying credit unions and other banking organizations to operate with a reduced regulatory burden. Under Section 601, qualifying credit unions would need to maintain an average leverage ratio (net worth) of at least 10 percent. If a credit union meets this requirement and elects to operate under the provisions of Section 602 of the legislation, it would be exempt from certain provisions of the Federal Credit Union Act (FCUA), and rules and regulations promulgated by the NCUA that address capital or liquidity requirements or standards. The legislation includes processes for credit unions and the NCUA to follow if a credit union's average net worth ratio falls below 10 percent; this process envisions the submission of a net worth restoration plan and provides for the immediate loss of election and corresponding regulatory relief benefits in the event the credit union's net worth ratio falls below 6 percent.

Section 603 directs the Federal Reserve, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency each to study how to design a requirement that banking organizations issue contingent capital with a market-based conversion trigger.

Section 604 directs the Governmental Accountability Office to study the benefits and feasibility of altering the current prompt corrective action rules and replacing the Basel-based capital ratios with the nonperforming asset coverage ratio as the trigger for specific required supervisory interventions.

Under the FCUA, credit unions are subject to statutory capital requirements. To be considered well-capitalized for the purposes of prompt corrective action, a credit union must maintain a leverage ratio of seven percent. This is two percentage points higher than the requirement for banks. Unlike banks, most credit unions' only source of capital is retained earnings. With limited ability to raise capital and given the relatively conservative incentive strategy inherent in credit unions' cooperative structure, many credit unions operate with a leverage ratio of more than 10 percent. To illustrate the portion of the credit union sector affected by this legislation, today 3,923 out of 5,906 insured credit unions have net worth ratios greater than 10 percent. This represents approximately 65 percent of credit unions that hold 62 percent of credit union assets and serve nearly 60 percent of credit union members. We believe many of these credit unions would take advantage of the regulatory relief provided under Section 602 which would include relief from, among other things, NCUA's regulations on interest rate risk, liquidity requirements, and the recently finalized risk-based capital requirements.

We appreciate that this legislation structures the higher capital threshold as an option and not a requirement. We would resist efforts by Congress or the NCUA to require credit unions to hold additional capital because it would take operational decisions out of the hands of credit unions and reduce the ability to lend to credit union members. Further, such a requirement would be inappropriate and unnecessary for credit unions because they do not have a history of capital inadequacy. Nevertheless, while we strongly believe all credit unions should receive regulatory relief, providing relief to credit unions with a demonstrated history of operating at higher capital levels and a process for remediation if capital levels fall below 10 percent strikes an appropriate balance. It would both ensure the continued safety and soundness of credit unions and remove barriers that keep credit unions from doing even more for their members.

This legislation recognizes the safe and sound practices that credit unions already undertake and provides incentives for all credit unions to consider maintaining a higher leverage ratio. This would provide an increased buffer against the National Credit Union Share Insurance Fund (NCUSIF) in exchange for reduced regulatory burden. Given the history and performance of America's credit unions, this option makes a lot of sense.

With respect to Section 602, we note that several of the provisions would apply only to banks and we believe it is necessary and appropriate to extend additional relief to very well capitalized credit unions. We encourage the Committee to include additional exemptions from other statutory requirements including, but not limited to, loan maturity limits (Section 1757(5) of the FCUA) and credit union service organization investment limits (Section 1757(5)(D) of the FCUA). We also encourage it to consider how similar relief for an extended exam cycle can be provided to larger credit unions, who are still much smaller than the largest banks. We also ask the Committee to provide qualifying credit unions relief such as NCUA's Regulatory Flexibility Program, which was discontinued by former NCUA Chairman Debbie Matz. These are items that NCUA has historically deemed to not pose a significant safety and soundness issue for well capitalized credit unions.

Further to Section 602, we have concerns related to Section 602(a)(9) which we will discuss later in this letter.

Changes to the Structure and Authority of the Consumer Financial Protection Bureau

Title VII includes significant change to the structure and authority of the CFPB's successor, the Consumer Law Enforcement Agency (CLEA). As described below, we support many of these changes.

Bringing the Consumer Law Enforcement Agency Under the Appropriations Process

Section 713 would bring the newly named CLEA under the appropriations process. This is a critical step because the CFPB's current funding scheme does not incentivize the CFPB to prioritize resources and fails to ensure appropriate oversight. Instead of engaging in cost-benefit analysis to determine how to narrowly focus its rules on abuses harming consumers, the CFPB has haphazardly strewn-together broad sweeping rules that cast such a wide net in the financial services marketplace that they have negatively impacted local credit unions and small banks that never engaged in the abuses the rules are meant to curtail. Funding the CLEA through appropriations would mean that the agency itself would be forced to focus on the biggest problems. Credit union members will benefit from an agency that is going after the bad guys and not using access to unbridled resources to impede the delivery of safe and affordable financial services.

Consumer Law Enforcement Agency Inspector General Reform

Section 714 would establish an independent Inspector General at the CLEA, nominated by the President and confirmed by the Senate, to oversee the work of the Agency's director. If Congress keeps the single director model at the CLEA, the Office of Inspector General will become a more important oversight lever. We support this provision.

Civil Investigative Demands to be Appealed in Courts

Section 716 would require more specific notice of the reason a company is a recipient of a civil investigative demand (CID), require a meeting with CLEA investigators within 30 days of receiving the demand to discuss and attempt to resolve all issues involving compliance with the demand, and allow additional time for seeking to modify or set aside a CID. We support these provisions because they will provide more transparency and fairness to the CID process, which in turn will result in more efficient and equitable resolution of any concerns. This ultimately could allow any consumer protection concerns to be addressed more quickly and without wasting resources of financial institutions and the consumers they are serving.

Economic Analysis and Review of Rules

Section 717 would establish an office of economic analysis, which among other things will require the agency to assess the impact of the agency's rules and regulations on consumer choice, price, and access to credit products. We support this provision because additional analysis is necessary to ensure that one-size-fits-all rules do not harm consumers of smaller and less complex financial institutions such as credit unions. The CFPB should be working to ensure that consumers have more options for safe and affordable products and services from credit unions instead of arbitrarily limiting safe options such as credit union small dollar loans and other access to credit. In general, we support several provisions in Title III of the legislation which provides more checks and balances on the rulemaking process and requires that the CFPB provide greater consideration to the cost versus the benefits of its rules before and after promulgating them. Specifically, we believe that a five-year review of rulemakings as outlined in Section 315 and 316 is appropriate and necessary to put measures in place to determine whether consumers are benefiting from rules, rather than paying the price for unnecessary or duplicative regulatory burdens.

Advisory Opinions

Section 721 would require the Director to establish a procedure and, as necessary, promulgate rules to provide written opinions in response to inquiries concerning the conformance of specific conduct with federal consumer financial law. We support this provision because there has often been ambiguity about whether the CFPB finds activities to be appropriate, particularly in areas where it has proposed rules or engaged in enforcement actions that conflict with guidance from prudential regulators. Advisory opinions would help provide transparency and due process for credit unions and others in the financial services marketplace, and would confirm their actions follow the CLEA's interpretations of laws and regulations.

Removal of Agency UDAAP Authority and Preservation of UDAP Authority for Banking Regulators

We support Section 736 and 737, which would repeal the CLEA's Unfair, Deceptive, and Abusive Acts and Practices (UDAAP) authority and preserve banking regulators Unfair Deceptive Acts and Practices (UDAP) authority.

Basic tenets of the rule of law suggest regulations should be clear, publicized, stable, and just. Nevertheless, the current CFPB has failed consumers by ignoring these principles. The CFPB has used its UDAAP authority as a broad tool to sweep credit unions into proposed regulations consistent with its ideological goals, despite no evidence of harm to consumers. For example, the CFPB attempted to circumvent the data collection and research requirement necessary to issue rules by applying UDAAP as a "catch-all," as illustrated with its payday lending proposal. In its supervisory role, the CFPB has used this authority to admonish and penalize a credit union for engaging in practices consistent with longstanding statutory directives and guidance from its prudential regulator. Through these actions, the CFPB harms consumers by creating an uncertain operating environment for credit unions and their members. The CFPB unfortunately has proven that many abuses can stem from such unrestrained authority to make UDAAP findings. Accordingly, Congress should repeal the CFPB's UDAAP authority.

Repeal of Authority to Restrict Arbitration

We support Section 738. As consumer-owned cooperatives, credit unions have a tradition of protecting their members' interests, and in most instances, can amicably resolve any disputes that arise. The CFPB's current arbitration proposal is a de facto ban on the effectiveness of the arbitration process. This is troublesome for credit unions for at least two reasons. First, it is difficult to imagine a case in which class action litigation against a credit union would be a reasonable course of action for credit union members since it would put them in a position of essentially suing themselves, as they are member-owners of the credit union. Second, in the rare situation that a group of credit union members believes a credit union is in the wrong, the group, as member-owners, already have direct recourse to remove the credit union's Board of Directors and management using their one-member, one-vote membership powers. Eliminating class action waivers, while providing no alternative solutions other than to steer consumers into the arms of fee-driven lawyers is no solution at all. The CFPB's own research showed that there are consumer benefits to arbitration, and its proposed rule did not propose meaningful solutions to improve the arbitration process. Accordingly, we support the Committee continuing to examine this issue.

Improving Mortgage Lending Laws and Regulations

The CHOICE Act includes several provisions to improve mortgage lending laws and regulations, allowing credit unions to continue to provide their members with access to safe and affordable mortgage products.

Home Mortgage Disclosure Adjustment

CUNA supports the relief from the Home Mortgage Disclosure Act (HMDA) provided by Section 576 which would increase the thresholds for HMDA reporting requirements for small depository institutions. The CFPB is now requiring credit unions that have originated 25 or more closed-end mortgage loans in the prior year to report dozens of data points in addition to what is required under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). Further, the CFPB has extended these reporting requirements to home equity lines of credit.

These requirements impose significant burdens on credit unions beyond what Congress envisioned when enacting the Dodd-Frank Act. Credit unions are undertaking significant expense to bring their systems into compliance with a rule that does very little, if anything, to provide credit union members with additional protection. This new rule adds to the compliance costs credit unions must pay and will lead to mortgage credit and other credit union services being that much more expensive and possibly less available. This legislation would raise the threshold that triggers HMDA reporting requirements to 100 closed-end and 200 open-end mortgages. While we welcome this limited expansion, and appreciate your including the text in the CHOICE Act, we would argue the Committee could go even further, and exempt lenders who perform fewer than 500 closed-end and 1000 open-end mortgages.

Homeowner Information Privacy Protection

CUNA also supports Section 571 which would require the Government Accountability Office (GAO) to examine whether additional HMDA data required to be collected and reported by CFPB could cause consumers harm. The CFPB has finalized a rule requiring credit unions that have originated 25 or more closed-end mortgage loans or 100 or more open-end loans in the prior year to report dozens of data points in addition to what is required under the Dodd-Frank Act. Congress outlined only 17 additional data points for the CFPB to collect as part of its HMDA information. While Congress authorized the collection of "such other information as the Bureau may require," it is highly unlikely its intent was to allow the CFPB to more than double the amount of express data points collected.

Studying the impact of reporting more data points will ensure that consumer data remain secure and not unnecessarily disclosed. This study should be completed before the CFPB rule is implemented to identify and reduce the risk of fraud or identity theft. Furthermore, assessing the impact of increased data reporting will ensure that credit unions, which did not cause the financial crisis, are not unduly burdened. This provision will result in reduced burden on credit unions and enhanced protection of credit union members' personal identifying information.

Mortgage Choice

CUNA also supports adjusting the definition of points and fees to ensure greater consumer choice in mortgage and settlement services under the Ability to Repay/Qualified Mortgage (QM) Rule. The QM rule sets the standard for consumer mortgages by providing significant compliance certainty to loans that do not have risky features and meet strict federal requirements. Credit unions are likely to provide these loans given this compliance certainty. A key requirement is that points and fees for a QM may not exceed 3 percent of the loan amount. However, under current regulations, what constitutes a fee or a point for purposes of the points and fees cap varies greatly depending upon who is making the loan and what arrangements are made by consumers to obtain title insurance. If the consumer chooses a title insurance provider that is affiliated with the lender, the title insurance charges count towards the cap, but if the insurance is purchased from an unaffiliated title agency, the title charges do not count. In addition, escrowed homeowners' insurance premiums may count as "points and fees" due to ambiguous language in Dodd-Frank. The inclusion of either title insurance or escrowed homeowners' premiums can cause many loans, especially those for low- and moderate-income consumers, to fail the QM test. Thus, many otherwise qualified borrowers are not able to access safe and affordable mortgage credit.

This provision endeavors to restore a full and open competitive market by clarifying the definition of fees and points. In doing so, the legislation will ensure consumers have greater access to mortgage credit and more choices in credit providers.

Portfolio Lending and Mortgage Access

Section 516 Portfolio Lending and Mortgage Access Act's inclusion in the CHOICE Act would benefit credit union members by classifying mortgages held in portfolio as QM loans for purposes of the CFPB's mortgage lending rules. Classifying loans that financial institutions hold on their balance sheets as QM loans is reasonable because the lender retains all the risk involved with these mortgages and is subject to significant safety and soundness supervision from its prudential regulator. Nearly three quarters of mortgage originating credit unions retain some or most of their mortgages in portfolio, and credit unions retain approximately 60 percent of all first mortgage originations. This legislation represents meaningful regulatory relief for credit unions, and will allow them to more fully serve their members. We appreciate its inclusion in the CHOICE Act.

Community Institution Mortgage Relief

CUNA also supports Section 531, the provision exempting mortgages made by institutions under $10 billion in assets and held in portfolio for three years from the Truth in Lending Act (TILA) escrow requirements, as well as exempting mortgage servicers servicing fewer than 20,000 mortgages annually from Real Estate Settlement Procedures Act (RESPA) Section 6 requirements.

Prior to the enactment of the Dodd-Frank Act, credit unions were required to open escrow accounts for one year on higher priced, first-lien mortgages secured by the borrower's principal dwelling. However, because of new rules promulgated by the CFPB based on requirements from the Dodd-Frank Act, credit unions are required to hold an escrow account open for five years. Thus, some credit unions have limited or stopped offering higher-priced mortgages, which may only be as little as 1.5 percentage points over the Average Prime Offer Rate, because of the expertise that is required to establish and maintain escrow accounts under the requirements of Reg Z.

This legislation makes two important changes to the TILA-RESPA framework to reduce the burden on small financial institutions. The legislation would exempt mortgage loans made by financial institutions under $10 billion in assets and held in portfolio for three years from TILA's escrow requirements; the legislation would also exempt mortgage servicers that service fewer than 20,000 mortgages annually from the requirements of Section 6 of RESPA. We believe the CFPB currently has the authority to make these exemptions per the directive of Congress to keep the regulatory burden on community financial institutions limited while directing rulemaking to large banks and the abusers of consumers. Unfortunately, the Bureau has not exercised this authority fully, making this legislation necessary to ensure these rules are appropriately focused. The two changes made by this legislation will provide important regulatory relief to credit unions and help them to continue efficiently serving their members. We strongly support this provision in the CHOICE Act.

National Credit Union Administration Budget Transparency and Overhead Transfer Rate Transparency

We support Section 541 and commend your efforts to make the NCUA budget process more open and transparent. Members of the credit union community should be able to examine and comment on the agency's budget before its adoption. Further, we support Section 586, which would require greater transparency with respect to the overhead transfer rate, the means through which the NCUA allocates resources annually from the NCUSIF to cover insurance-related expenses. These provisions would codify steps that NCUA is presently taking.

Examination Fairness

CUNA also supports Section 536 reform of the financial institution examinations process to create an independent ombudsman and independent examination appeals procedures. CUNA strongly supports this provision and views it as a vital step toward ensuring that federal financial institution regulators conduct fair examinations for those they supervise, consistent with the law and regulation, and their duty to maintain safety and soundness.

This provision would also make available to financial institutions the information used by their regulator to make decisions in their examination; codify certain examination policy guidance; establish an Independent Examination Review Office at the Federal Financial Institution Examination Council

(FFIEC), to which financial institutions could raise concerns with respect to their examination; and establish an appeals process for institutions aggrieved by an examination decision before an independent administrative law judge.

Credit unions support a strong and effective regulatory system. After all, credit unions' own net worth and combined NCUSIF deposits are the funding source to resolve credit union losses. This provision will increase the consistency and fairness of the system, leading to enhanced safety and soundness. Furthermore, this part of the bill will facilitate transparency and improve consistency in the examination process, provide a necessary resource for financial institutions to express concern about their examination experience, and establish an independent adjudicatory process for the appeal of material adverse supervisory determinations which would lead to more fairness and accountability in the examination process. We strongly support this provision and appreciate its inclusion in the CHOICE Act.

Safe Harbor for Reporting Elder Financial Abuse

CUNA also supports the inclusion of the Senior$afe Act (Title IV, Subtitle R). These provisions would protect credit unions employees who in good faith report suspected financial elder abuse to law enforcement from any liability resulting from such reporting. Financial exploitation is one of the most common forms of elder abuse. CUNA strongly supports the goal of this legislation to help seniors avoid financial exploitation and to encourage responsible decisions regarding financial management.

Ending Regulator-Induced Account Terminations

CUNA also appreciates Section 511, the language that would limit Operation Choke Point. This provision would prevent the federal government from terminating credit unions' relationships with certain customers without just cause; the reason for termination cannot be solely the reputation risk of the credit union member. Credit unions are committed to maintaining the ability to serve their members while also strictly following the laws and regulations that govern them.

Taking Account of Institutions with Low Operation Risk

CUNA also supports Section 546, the Taking Account of Institutions with Low Operation Risk (TAILOR) Act. The TAILOR Act would instruct the CFPB, the NCUA, and other regulators to account for an entity's size and risk in promulgating regulations. Credit unions are precisely the institutions this legislation is designed to help because they overwhelmingly tend to be well-capitalized with a low risk profile and a long history of meeting their members' credit needs.

Although we regularly hear policymakers accurately stating that credit unions did not contribute to the financial crisis, the public policy response to the crisis so far has failed to recognize this fact. Overregulation is one of the primary reasons that small financial institutions are disappearing at an alarming rate. Constant regulatory changes present a challenge for small depository institutions because the fixed costs of compliance are proportionately higher for smaller-sized credit unions and banks than for large institutions. Over the last 20 years, the number of credit unions has been cut in half, from more than 12,500 in 1995 to just more than 6,000 today. For the last several years, the rate of regulatory and compliance-driven credit union consolidation has increased despite an improving economy. We now lose one credit union per day on average.

When there are fewer credit unions for Americans to access for safe and affordable financial services, consumers are increasingly forced to turn to other providers who are too influenced by their bottom line. This outcome is the opposite result of what lawmakers intended with their post-financial crisis legislation. Inclusion of the TAILOR Act in the CHOICE Act would help fix this problem, and would enable credit unions to more fully serve their members.

### Prohibition on Government Price Controls for Payment Card Transactions

America's credit unions strongly support Section 735 the CHOICE Act's repeal of the Durbin Amendment. The Durbin amendment introduced price-fixing for debit transactions that use PIN for authentication to a functional and competitive card marketplace. Dubious promises were made that this price-fixing scheme would reduce costs to merchants who would then pass savings along to consumers. Unfortunately for consumers, they have not seen any reduction in prices charged by merchants. Today, consumers are paying the price of this misguided policy, and the industries that pressed Congress to enact it enjoy a windfall. Since implementation, members of America's credit unions and customers of other financial services providers have been forced to transfer more than $36 billion to the big box retailers with no public benefit. Repealing the Durbin amendment would restore balance and market functionality by ending main street financial institutions' subsidy to the largest retailers.

## CHOICE Act Provisions that Concern America's Credit Unions

### Federal Savings Association Charter Flexibility

While we view most of the CHOICE Act provisions affecting and related to credit unions positively, we must reiterate our strong opposition to provisions that would allow federal savings associations (S&Ls) to operate with the duties and responsibilities of national banks unless similar legislation enhancing the flexibility of the credit union charter is added to the CHOICE Act (Section 551). Our opposition is a matter of fairness and frankly, in the interest of good and consistent public policy. Among other things, Section 551 essentially eliminates the S&Ls' statutory cap on commercial lending. It makes little sense to include this provision without also eliminating credit unions' commercial lending restrictions.

Continuing to subject credit unions to the member business lending cap ignores credit unions' history of serving this market and insults small businesses seeking access to credit from credit unions otherwise willing and able to lend to them. While S&Ls were chartered for the specific purpose of mortgage lending, credit unions have been offering business purpose loans to their members for over 100 years. Since the beginning of the financial crisis, business loans have been the fastest growing loan type at credit unions; during this same period, commercial lending by S&Ls has decreased more than 17 percent.

Why either cap on business lending would exist in the first place is dumbfounding. Yet why Congress would consider eliminating a commercial lending cap on an S&L sector that is either disinterested or unable to lend to this market is even more inexplicable. There are few more provident uses of credit than to start, maintain, or expand a business, and America's small businesses need more options. Credit unions have a long and rich history of serving their small business members well, but many of the credit unions that serve these members are staring the business lending cap straight in the face.

Critics of proposals to increase the credit union member business lending periodically cite credit unions' tax treatment as a reason for the restriction; however, credit unions' tax status has nothing to do with the statutory restrictions on credit union business lending. The tax status of credit unions is based on their structure and mission as not-for-profit cooperatives to promote thrift and provide access to credit for provident purposes. The member business lending cap was enacted twenty years ago at the behest of the banking industry and serves no safety and soundness function whatsoever. Congress should not use the tax status as an incongruous excuse not to address the member business lending cap.

Accordingly, we urge you to take advantage of the opportunity that this broad regulatory relief legislation presents by including provisions to completely and unconditionally eliminate the credit union member business lending cap.

Bringing the National Credit Union Administration under the Appropriations Process

We do not support Section 363, bringing NCUA into the appropriations process. The money that funds the NCUA comes from credit unions and their members, not the taxpayers in general. Maintaining a separate, independent federal regulator and insurer is critically important to the credit union system, and the structural and mission-driven differences between credit unions and banks necessitate such a regulatory scheme. We are concerned that subjecting NCUA to the appropriations process could blur the independence of NCUA and the credit union system. Credit unions and their members remain willing to pay for their own regulator provided there is sufficient transparency with respect to the agency's budget and the overhead transfer rate.

We appreciate the modifications that have been made to this language from the original version of this legislation. The new bill provides that NCUA would collect from credit unions fees equal to the amount appropriated by Congress. While this is a step in the right direction toward addressing our concern that the government might collect more from credit unions than Congress appropriates, bringing credit union resources into the appropriations process is a solution in search of a problem.

We encourage the Committee to remove this provision from the bill.

Elimination of Consumer Law Enforcement Agency's Supervisory Authority

We have long supported legislation to increase the supervisory threshold for credit unions from $10 billion to a significantly higher number. However, we have concerns with Section 727 because it would eliminate the CLEA's supervisory authority for not just large credit unions but for large banks and nonbank providers. Even the largest credit unions are less complex financial institutions and pose significantly less risk than the largest banks or nonbank lenders.

In the case of credit unions and banks, it appears that supervision would be conducted by these institutions' prudential regulators; this is an appropriate transfer. However, nonbank financial providers ought to be subject to some form of federal supervision, particularly to the extent they are engaged in similar consumer financial activity, which not only puts consumers at risk but provides for an unfair market. We believe an alternative approach would be to mandate that credit unions and banks are supervised by their prudential regulator and nonbank providers are supervised by the CLEA.

Removal of Authority to Regulate Small Dollar Loans

We do not support Section 733, which would remove the CLEA's authority to promulgate rules and regulate payday loans, vehicle title loans, or other similar loans. While we have significant concerns with the CFPB's proposed rule on small dollar loans, consumers could benefit from a regulatory approach that balances the need for access to credit with addressing consumer harms and predatory behavior. Our concern with the CFPB's small dollar rulemaking is that it would impede and discourage credit unions from offering small dollar credit to consumers, depriving them of access to a safe and affordable alternative to entities with well-established histories of abuse. We encourage the Committee to take a more measured approach to this issue that provides more protection to consumers, without unnecessarily limiting safe and affordable options in this market.

Allowing Big Banks to Circumvent the 10 Percent Domestic Deposit Cap

Section 602(a)(9) would give banks with a leverage ratio more than 10 percent an exemption from "any federal law, rule or regulation providing limitations on mergers, consolidations, or acquisitions of assets or control, to the extent such limitations relate to capital or liquidity standards or concentration of deposits or assets, so long as the banking organization, after such proposed merger, consolidation, or acquisition, would maintain a quarterly leverage ratio of at least 10 percent."

This language appears to provide very well capitalized banks an exemption from the 10 percent domestic deposit cap. We urge the Committee to consider the systemic risk this type of exemption would present, even if applied only to very well capitalized banks. It appears this provision could easily enable the very large banks to get substantially larger, increasing risk to the banking system and reducing consumer choice in the banking sector.

Judicial Review of Financial Regulations

CUNA has concern with Section 341 which would repeal the Chevron deference doctrine of administrative law that gives federal agencies deference on their interpretations of statutes; we believe the implications of this provision, particularly its applicability only to financial regulators, ought to be given further consideration before changes are enacted. CUNA continues to support the incorporation of the REINS Act into the CHOICE Act to provide Congressional oversight of regulations with a large economic impact.

## Additional Proposals that America's Credit Unions Ask Be Included in this Legislation

Strengthening the CFPB's Exemption Authority

Section 1022 of the Dodd-Frank Act provides the CFPB with authority to exempt 'any class of covered entity' from its rulemaking. Last year, 399 Members of Congress—bipartisan majorities in both chambers—called on the CFPB to exercise this authority to shield credit unions and small banks from rules designed to reign in large banks and other abusers of consumers. However, the CFPB has failed to exercise this authority fully and this failure has harmed consumers seeking safe financial services, including remittances and mortgages, from credit unions. Congress should enact legislation to clarify that credit unions are exempt from CFPB rules unless the Bureau demonstrates credit unions are causing consumer harm.

Representative Roger Williams (R-TX) has introduced H.R. 1264, the Community Financial Institution Exemption Act, which would provide credit unions and small banks an exemption from CFPB rules unless the Bureau demonstrates a pattern of abuse by these institutions that needs to be addressed and receives affirmative consent from credit unions' and banks' prudential regulators. The bill would allow the CFPB to write new rules for credit unions and small banks to reduce their burden under existing regulations. We believe H.R. 1264 is a workable approach to ensuring the burdens facing credit unions and small banks do not increase unless there is a tangible problem to address.

We encourage the Committee to include H.R. 1264 in the CHOICE Act. If the Committee is unable to do so, we call on the Committee to hold a hearing on this legislation with the intention of reporting it to the House as stand-alone measure.

### Installing a Five Member Commission at the CFPB

We are disappointed that the new version of the CHOICE Act does not include provisions from the original version to install a five-member commission at the CFPB. As presently structured, the CFPB is an anomaly in the federal government. The CFPB's extraordinary authority is vested in a single person, absent appropriate levels of Congressional oversight. While we appreciate the steps the new CHOICE Act takes to repair the agency, we strongly believe that modernizing it to include a multi-member Commission would enhance rulemaking by ensuring diverse perspectives are included in final rules and prevent disruptions caused by personnel changes. Credit union members will benefit from policymaking that includes more voices and different expertise.

The CHOICE Act takes many steps to address the supervisory concerns facing large institutions and nonbank providers; but, aside from the removal of UDAAP authority, it does very little to address the concerns that credit unions and small banks have regarding the rulemaking process. A single director structure leaves consumers vulnerable to market uncertainty and drastic swings in policy because of presidential election outcomes. For credit unions, which have fewer resources than the largest banks, this uncertainty and the frequent changes in rules and policy can be extremely problematic, forcing membership resources to be diverted to whatever the most recent perspective the CFPB director has.

Consumer protection should not be about politics; it should be about creating the best environment to enable financial health and safety—a mission that the credit union movement has adhered to for many decades with bipartisan support. The best way to remove politics from this equation is through a multi-member commission. One of the clearest indications that the present structure—which would continue in large part under the CHOICE Act—is politically driven is the fact that the current director remains in office notwithstanding the outcome of the election, despite conflicting precedent for this at several other agencies.

We find folly in the argument that a commission would not be a better structure because the Senate has shown itself unable to fill other boards and commissions. Americans expect their legislative leaders to work through disagreements in the interest of all consumers, not in the interest of political posturing. Americans should not have to pay the price of bad policy making because Senators are unable or unwilling to exercise a basic function of Article II of the Constitution.

We encourage Congress to continue to consider the virtues of a multi-member Commission to bring fairness and certainty to the rulemaking process for America's credit unions and small banks.

Parity in the Treatment of 1-4 Family Non-Owner Occupied Residential Loans

The CHOICE Act includes an entire Title (Title IV) that aims to "unleash opportunities for small businesses, innovators, and job creators by facilitating capital formation." Many of the provisions of this title are very well intentioned; however, inexplicably, the legislation overlooks the potential credit unions can provide in this area.

Credit unions have been lending to small businesses for more than 100 years. It is well established that during the financial crisis, credit unions continued to lend to small businesses when large and small banks withdrew access to credit. NCUA has recently taken steps, which the courts have affirmed, to make it easier for credit unions to lend to their members; nevertheless, the Federal Credit Union Act continues to restrict credit unions' full potential.

Representatives Ed Royce (R-CA) and Jared Huffman (D-CA) have introduced H.R. 389, the Credit Union Residential Loan Parity Act, which would clarify that credit union loans on 1-4 family non-owner occupied residential properties do not count as business loans for the credit union member business lending cap. This legislation would provide parity in the treatment of these loans with the way they are treated if made by a bank. There is no economic or safety and soundness reason that these loans should be considered business loans, particularly when they are classified as residential loans when made by banks. Providing parity would give credit unions flexibility to provide more access to credit for their small business members.

We encourage the Committee to include H.R. 389 in the CHOICE Act. If the Committee is unable to do so, we call on it to hold a hearing on H.R. 389 with the intention of reporting it to the House as a stand-alone measure.

Treatment of the Business of Insurance

We encourage the Committee to also include clarification in the CHOICE Act that Title X of the Dodd-Frank Act exempted the business of insurance from CFPB authority, and reiterate that the regulation of insurance has been delegated to the states. In its recent proposal for small dollar and payday loans, the CFPB proposed that voluntary insurance products, such as credit insurance, be included in the loan calculation of the annual percentage rate (APR). They proposed this requirement even though insurance is not a loan, is not under the jurisdiction of the CFPB, and is regulated at the state level. The CFPB has further waded into the area of insurance by publishing a Request for Information which includes questions about the sale of credit insurance. Furthermore, the CFPB has engaged in enforcement actions in this area.

Consumers, particularly those without access to insurance products through work or elsewhere, may rely on their credit union for these products. And, the Dodd-Frank Act did not provide the CFPB authority to regulate insurance products. Thus, the CFPB's actions in this area have created uncertainty and present serious due process concerns for credit unions, and their members who may look to them for insurance products. Accordingly, we urge the Committee to clarify the CFPB's lack of authority with respect to persons regulated by a state insurance regulator.

## Conclusion

No bill of this size and scope is perfect. The CHOICE Act is no different. The legislation includes several provisions that would make it easier for not-for-profit credit unions to more fully serve their members by reducing regulatory burden and balancing a regulatory scheme that today is rigged for large banks and nonbank financial service providers. However, it also includes several provisions that perpetuate the rigged aspect of this system, including provisions that exempt nonbank providers from federal supervision and allow large banks to circumvent well established caps on market share.

We understand the process for producing regulatory reform legislation is long and the Committee's consideration of this legislation represents the first step, not the last. We support the process in which the Committee is engaged. As this and other legislation moves through the process, we will work with the House and the Senate to ensure the legislation ultimately enacted into law meaningfully reduces credit unions' regulatory burden and maintains important consumer protections. We look forward to working with you throughout the process.

On behalf of America's credit unions and their 110 million members, thank you for your consideration.

Sincerely,

Jim Nussle
President & CEO

NAIC National Association of Insurance Commissioners & The CENTER for INSURANCE POLICY and RESEARCH

**Statement for the Record**
**From the National Association of Insurance Commissioners**
**For the House Financial Services Committee**
**Hearing on "A Legislative Proposal to Create Hope and Opportunity for Investors, Consumers and Entrepreneurs"**
**April 26, 2017**

Chairman Hensarling, Ranking Member Waters, and members of the House Financial Services Committee, the National Association of Insurance Commissioners (NAIC)[1] appreciates the opportunity to submit this written statement for the April 26, 2017 hearing on "A Legislative Proposal to Create Hope and Opportunity for Investors, Consumers, and Entrepreneurs." As regulators of the largest and most diverse insurance market in the world, our focus is on the dual objectives of protecting insurance consumers and ensuring vibrant, competitive insurance markets in our states. To that end, we share the goal of providing a balanced, measured, and appropriately sized regulatory environment that allows for innovation and opportunity, while not sacrificing consumer protections. The Financial CHOICE Act has some promise in this regard, but improvements need to be made to ensure that it works for the insurance sector and its regulation. We have serious concerns with certain aspects of it, most notably the inclusion of the office of the Independent Insurance Advocate.

For more than 150 years, states have successfully regulated the insurance sector in this country. Through our approach to regulation, our sector has weathered several economic downturns and crises, including the most recent financial crisis. Insurers remained solvent and claims were paid to insurance policyholders. While several hundred banks failed, only a few insurers did. Today, much of the insurance sector is as strong as ever. Notwithstanding our track record, throughout the past six years, we have witnessed significant levels of federal overreach in the insurance sector we regulate. Such intrusion is not only unnecessary and inefficient, but it has proven to be ineffective, has distorted the competitive landscape and threatened to undermine policyholder protection. From the Collins Amendment fix that provided the Federal Reserve flexibility to create capital standards for certain insurance holding companies, to the Policyholder Protection Act that ensured that insurance company assets remained available to pay insurance consumer claims, the NAIC and state insurance regulators have expended time and resources working with Congress to fix problems created initially by federal solutions. Even then, issues still remain including unsupported and substantively flawed designations of insurance companies by the Financial Stability Oversight Council (FSOC), an ambiguous Covered Agreement negotiated with little input from regulators that potentially preempts insurance consumer protections,

[1] Founded in 1871, the NAIC is the U.S. standard-setting and regulatory support organization created and governed by the chief insurance regulators from the 50 states, the District of Columbia and the five U.S. territories. Through the NAIC, state insurance regulators establish standards and best practices, conduct peer review, and coordinate their regulatory oversight. NAIC members, together with the central resources of the NAIC, form the national system of state-based insurance regulation in the U.S.

and an opaque international standard-setting process creating standards that, in some cases, would not work for the U.S. insurance sector and consumers.

We urge the committee not to let history repeat itself. With respect to insurance and consistent with the Trump Administration's stated policy objectives, Congress should focus on proposals that reduce the federal government's intrusion in the regulation of the sector not expand it. While the CHOICE Act shows some promise in this regard, it also continues to make the mistakes of the past. Specifically, state insurance regulators have serious concerns with the creation of the Independent Insurance Advocate, oppose its inclusion in the CHOICE Act, and instead urge elimination of the Federal Insurance Office as both are unnecessary. While at first blush a proposal to combine the Federal Insurance Office with the Office of FSOC's independent member would appear to merely concentrate the federal footprint in insurance policy, a policy office with this size, scope, independence, and rulemaking authority within the Treasury Department would be unprecedented and would create an entity with the trappings of a regulator. The new office assumes, with some minor modifications, FIO's authorities. However, a standalone office is not needed to carry out those authorities. The roles for which FIO or the Independent Insurance Advocate could provide some value (e.g., housing federal insurance expertise, overseeing the Terrorism Risk Insurance Program, coordinating federal agencies as it relates to insurance), can be filled by the Treasury Department without a stand-alone office or agency – indeed, many of these functions were being addressed by Treasury before FIO's creation. While insurance regulators agree that the federal government should have access to insurance expertise, there is simply no need for a standalone office in any form to conduct these functions under the imprimatur of its own authorizing statute.

Under the current Choice Act proposal, the Independent Insurance Advocate would also continue to play FIO's international role, a role that, to date, has complicated and confused U.S. engagement on insurance regulatory standard setting. Prior to the establishment of FIO, certain insurance sector participants created a mythology that Treasury's involvement in insurance regulatory standard-setting was necessary for the U.S. to "speak with one voice" and to achieve better outcomes for U.S. insurers in those processes. Despite the FIO's substantial involvement at the International Association of Insurance Supervisors (IAIS) over the past five years, the Treasury's policymaking process has never been clear and, in some cases, has made it more difficult for U.S. regulators to defend the state-based system and influence the standard-setting process. The standards developed by the IAIS continue to reflect a largely European approach to supervision and in certain fundamental aspects would not be compatible with the U.S. system. In fact, several pieces of legislation have been proposed by members of Congress including three members of the House Financial Services Committee to address concerns that were created by virtue of FIO's involvement in international standard setting. Furthermore, the Independent Insurance Advocate would not be a regulator, so its involvement in regulatory standard-setting undermines state regulator independence and authority. It has been argued that only the federal government can bind the U.S., which is true, but this fails to recognize that activities of international standard-setting bodies like the IAIS are binding on no one – not the U.S. and not even the states who participate. The idea that the U.S. is at some disadvantage by virtue of its state regulatory system is simply false. To be clear, there are venues and dialogues occurring at the international level where Treasury does engage and provide coordination of U.S. state and federal regulators, and those should continue. But Treasury has no business taking an exclusive leading role on insurance regulatory policy at the IAIS where all the standards must ultimately be considered at the state level. To the extent Treasury needs to engage internationally with foreign governments and entities on insurance matters, Treasury has an entire Office of International Affairs that is equipped to do so.

Like the independent member does today, the Independent Insurance Advocate would serve in a voting capacity on FSOC, albeit an FSOC with vastly curtailed authority. We wholeheartedly agree that FSOC is in dire need of serious reform. While well-intentioned, its design and implementation is seriously flawed. We agree that the non-banks designation process is in need of significant reform and we were pleased to see that the CHOICE Act seeks to address very serious concerns insurance regulators and others have had with an arbitrary process that has yielded procedurally and substantively flawed designations of insurance firms. We strongly support formal vehicles for regulators to convene, coordinate, and share information regarding risks to our financial system, and the CHOICE Act proposes to have the FSOC continue to serve that function. Because the Independent Insurance Advocate is not a regulator, its role on the Council under the CHOICE Act construct is at best, superfluous.[2] Instead, a state insurance regulator should be given a voting seat. State insurance regulators are the primary financial regulators for the largest insurance sector in the world, yet, under the Dodd-Frank Act, have been singled out as the only primary financial regulator without a voting seat on FSOC. To ensure that the insurance perspective is adequately represented in FSOC discussions, state insurance regulators should be given a vote on the council.[3]

In addition to our concerns with the creation of the Independent Insurance Advocate, we also share the concerns of our fellow state regulators with the text of Section 391. We very much agree with the spirit of this section to encourage coordination among regulators. For our part, we strive to coordinate as much as possible with our federal counterparts, particularly the Federal Reserve, and share any relevant or requested information with federal agencies to reduce burden on our regulated companies. Historically, our concerns with coordination have stemmed from our federal counterpart's failure to rely on our work or to share their information with us. We have concerns that the text of Section 391 allows federal agencies to continue this practice by enabling them to develop policies that dictate the terms of engagement with state insurance regulators. As the primary regulators of the insurance sector, our federal counterparts should be required to defer to us, not the opposite.

In conclusion, we believe that the Financial CHOICE Act has promise to provide needed reforms to the federal financial regulatory framework, promote competitive markets, and protect consumers. However, history has proven that insurance regulation at the state level has served this country and its citizens well throughout the past 150 years. We urge the committee to rethink those areas of the Financial CHOICE Act that expand and concentrate a duplicative federal presence in our work, are inconsistent with our state insurance regulatory system, and undermine our ability to promote vibrant, competitive insurance markets and protect insurance consumers. We appreciate your consideration of our proposals and look forward to working with you to address these issues. Thank you for the opportunity to submit this written statement for the record.

[2] Should the FSOC continue to exist in its present form, we would support legislation to allow Roy Woodall to continue on as the voting independent member with insurance expertise until any successor is appointed by the President and confirmed by the Senate. It is critical that the Council have a voting member with substantial insurance expertise.

[3] Any constitutional concerns could be addressed by meeting the requirements of the Appointments clause and having the President appoint the state insurance regulator member.

NAMIC®
NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

Statement

of the

National Association of Mutual Insurance Companies

to the

United States

House Financial Services Committee

Hearing on

**A Legislative Proposal to Create Hope and Opportunity for Investors, Consumers, and Entrepreneurs**

April 26, 2017

The National Association of Mutual Insurance Companies (NAMIC) is pleased to provide comments to the House Financial Services Committee on the discussion draft of the Creating Hope and Opportunity for Investors, Consumers, and Entrepreneurs Act (CHOICE Act). We appreciate the hard work that has gone into producing the draft because it is essential that financial regulation work for everyone from Wall Street to Main Street. The committee's leadership on reforming financial services regulation in this country is essential – the Dodd-Frank Wall Street Reform and Consumer Protection Act was not – and is not – perfect, and change is needed.

NAMIC is the largest property/casualty insurance trade association in the country, with more than 1,400 member companies representing 39 percent of the total market. NAMIC supports regional and local mutual insurance companies on main streets across America and many of the country's largest national insurers. NAMIC member companies serve more than 170 million policyholders and write more than $230 billion in annual premiums. Our members account for 54 percent of homeowners, 43 percent of automobile, and 32 percent of the business insurance markets.

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## The CHOICE Act

The discussion draft of the CHOICE Act is a wide-reaching proposal to reform the financial services regulatory system by repealing, revising, and/or replacing significant sections of the Dodd-Frank Act. Much of the draft legislation would not directly impact the property/casualty insurance industry, and so we will limit our comments to the provisions of particular importance to our industry. Chief among those is the elimination of the Federal Insurance Office (FIO) and its replacement with the Office of the Independent Insurance Advocate (OIIA) which we will discuss in greater detail below.

In general, NAMIC is supportive of the following concepts:

**Reigning-in the Consumer Financial Protection Bureau** – Though the business of insurance was ultimately removed from the jurisdiction of the CFPB in Dodd-Frank, we remain wary of efforts to expand its authority. Its targeting of industries outside its original purview (such as auto dealers through indirect lending), use of disparate impact discrimination standards, and attack on arbitration clauses in financial contracts are all reasons for NAMIC members to be concerned about the future of the bureau. Limiting the concentration of power at the CFPB and ensuring its resources are subject to the budgetary process should be just the first of many reforms.

**Eliminating the Office of Financial Research** – The jurisdiction and mission of the OFR remain vague, and yet the office was given essentially limitless subpoena authority over all financial companies – including insurers. That sort of authority over the insurance industry is unnecessary at the federal level given the robust regulation of insurance conducted by the states.

**Eliminating SIFI Designations** – NAMIC has long argued that the property/casualty insurance industry does not, and cannot, pose a systemic risk. Removing the danger that the FSOC might unfairly designate an insurance company – as they clearly did in the case of MetLife – can do nothing but bring more certainty to the marketplace and remove any potential competitive advantage of perceived government backing for being named "too-big-to-fail."

**Passing the REINS Act** – NAMIC is concerned that the true costs of regulatory compliance are not appreciated by many regulators. Requiring major and costly regulatory rules to come back to the legislative branch for congressional approval will rebalance power between the branches and bring more accountability to regulatory agencies.

**Altering Chevron Deference** – The pace, scope, cost, and interpretive leeway of federal regulations over recent years has been nothing short of incredible. NAMIC, whose warnings against regulatory overreach were ignored throughout the regulatory rulemaking process, was forced to sue the Department of Housing and Urban Development over its unlawful promulgation of a rule applying to our industry. This is no way to govern. Rules and regulations have now granted bureaucrats inordinate authority and the courts cannot simply have blind faith in the interpretation of laws put forward by executive branch agencies. Even though Chevron deference was originally envisioned to be a bulwark against activist judges, it has become an excuse for judges to simply abdicate their responsibility to examine the merits of a legal interpretation by what is often an interested and affected party. This action will also bring a needed rebalance of power between branches of the federal government and increase agency accountability.

## Title XI – Independent Insurance Advocate

The purported purpose of Title XI of the discussion draft is to streamline federal resources by combining the existing FIO and the FSOC Independent Member with Insurance Expertise to create one independent office that is both more accountable and more capable of effectively defending U.S. interests in international insurance negotiations. To that end, the CHOICE Act stands up the OIIA and gives it many of the same roles and authorities that were previously assigned to the FIO.

As a supporter of the state-based system of insurance regulation, NAMIC believes that if a federal office dealing with the insurance industry is needed, then that office must be very carefully crafted, its purpose made clear, and its authority limited to that purpose. From that perspective, the CHOICE Act makes some positive changes to the authorities granted to the new office as compared with the FIO. Examples of those positive changes include:

- Removes the mandate to monitor insurance access and affordability in "traditionally underserved communities," an undefined concept and a project which is an exercise in attempting to quantify the subjective
- Removes the office's authority to subpoena information directly from insurance companies
- Prevents the office from becoming a voting-member of the International Association of Insurance Supervisors

- Prevents the participation of the office in any supervisory colleges
- Removes the authority to recommend the designation of insurance companies to the FSOC for designation as a SIFI
- Includes a notice and comment period for the final text of any covered agreements the office negotiates

However, we no longer believe the FIO is even necessary and we support eliminating the office without replacing it. There are, in the abstract, good arguments to be made in favor of the idea of an office with insurance expertise existing at the federal level. However, the country now has had seven years of experience with the FIO. Based on this experience, NAMIC has concluded the office adds little value to the U.S. insurance system, policyholders, or taxpayers. The experiment has been a failure, and the time has come to simply eliminate the office.

At the end of the day, the FIO is not necessary and, in many cases, is actually creating duplicative burdens and causing harm:

**The FIO Has Not Lived Up to the Promise of Being a Strong International Voice For the U.S. Insurance Industry.** Originally touted as necessary for proper representation of the U.S. internationally (e.g., by supporting U.S. interests before the Financial Stability Board and the International Association of Insurance Supervisors), the FIO has not improved these discussions. The FIO has not improved the results for the U.S. in the group capital debates, has voted against transparency at the IAIS by blocking due process, has not improved the Treasury representation of insurance at the FSB, and has advocated for compromise instead of flexibility in global standards. The U.S. is already represented internationally by the Treasury Department, Federal Reserve, USTR, and the functional state insurance regulators engaged in these discussions. It is unclear what the FIO adds that cannot be accomplished by the other U.S. participants.

**The FIO Rushed to Finalize a Bad Deal in the Covered Agreement With the EU.** The U.S. and EU recently concluded a covered agreement, which was negotiated behind closed doors. The agreement is an invented solution to a problem invented by the EU – the question of whether European regulators will deem the U.S. regulatory system "equivalent" to the EU's system. The agreement does more harm than good, and sets up an open channel for Europe to continue to impose its regulatory standards on U.S. state-regulated insurance markets. Its performance in negotiating the covered agreement amply demonstrates that the FIO should not have been given the authority to enter into any agreement that can lead to the preemption of state insurance laws.

**The FIO Is Attempting to Define the Undefinable With Its Affordability Studies.** State insurance commissioners across the country are committed daily to enforcing state laws that protect consumers against insurance prices that are excessive, inadequate, or unfairly discriminatory. That is the role of a regulator. The FIO, on the other hand, has engaged in a variety of quixotic crusades to objectively define the concept of "affordability," which will inevitably lead to misguided conclusions about the state of insurance markets without consideration of the actual costs of providing insurance products. Further, even conducting these studies has the negative effect of adding costs by now requiring insurers to participate in an annual data call.

**The FIO Has Repeatedly Abused Its Role as "Monitor" of Insurance Regulation in the U.S. to Call for More Authority.** Instead of providing objective assessments of regulations in the U.S., the FIO has used every opportunity it gets to call for more power and authority. In a report, ostensibly about "modernizing" the regulatory structure in the U.S., the FIO called for federal regulation of mortgage insurance and for the FIO to be included in supervisory colleges with state regulators to help oversee large insurance groups.

**The FIO Unilaterally Expanded Its Mandate With Its Self-Serving Report on Consumer Protections.** Absent any congressional request or statutory mandate, the FIO spent its time and resources producing reports like the recent one on consumer protections. That report was a grab bag of controversial political opinions, contributed nothing to anyone's understanding of insurance in the U.S., and was arguably outside the mandate of the FIO in the first place. We do not need a federal office for this.

**The FIO Is Not Needed to Manage Any Particular Program**. The FIO is currently tasked with overseeing the TRIA program, but this is not a task requiring a stand-alone federal entity. TRIA was ably handled by the Treasury Department for a decade prior to the FIO's creation. If the office were eliminated, Treasury could simply revert to that system.

**The FIO Has Pursued Duplicative And Unnecessary Data Calls.** Insurance companies are required to produce a vast amount of data as a part of their day-to-day regulation by state insurance commissioners. The FIO is statutorily required to work with those regulators and other public sources before seeking information directly from insurers. However, despite the fact that the states are now collecting the type of information it needs, the FIO is requiring insurance companies participating in the TRIA program to submit data again. We do not need a federal entity launching duplicative data calls with very little in the way of real justification.

**The FIO Concurred in Poorly Conceived SIFI Designations For Insurers.** Serving as a non-voting member of the Financial Stability Oversight Council, the FIO director went against both the FSOC's Independent Member with Insurance Expertise and the non-voting representative for state regulators in considering insurers for SIFI designation. Clearly, the FIO has not been adding value to these discussions, and its role should be ended.

## Conclusion

Again, NAMIC appreciates the hard work that went into crafting the discussion draft of the CHOICE Act. We respectfully urge the committee to continue to pursue the elimination of the Federal Insurance Office, but without replacing it. Doing so would fit perfectly with the current administration's aspiration to eliminate programs and offices that are duplicative and non-essential, with roles already carried out in some form by state and local government. We look forward to working with you on this important project.

NATIONAL ASSOCIATION OF PROFESSIONAL INSURANCE AGENTS

Local Agents Serving Main Street America℠

STATEMENT BEFORE THE U.S. HOUSE COMMITTEE ON FINANCIAL SERVICES REGARDING "A LEGISLATIVE PROPOSAL TO CREATE HOPE AND OPPORTUNITY FOR INVESTORS, CONSUMERS, AND ENTREPRENEURS"
April 26, 2017

Founded in 1931, the National Association of Professional Insurance Agents (PIA National) is a national trade association that represents independent insurance agencies and their employees who sell and service all kinds of insurance, but specialize in coverage of automobiles, homes, and businesses. PIA National represents independent insurance agents in all 50 states, Puerto Rico, and the District of Columbia. They operate cutting-edge agencies and treat their customers like neighbors, providing personal support and service. PIA members are Local Agents Serving Main Street America℠.

**Introduction**

In 2010, advocates of federal insurance regulation succeeded in getting the Federal Insurance Office (FIO) established as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). PIA National opposed the creation of the FIO from the outset. We were somewhat pleased that its enabling legislation did not give the office broad authority to regulate or supervise insurance, and its director was not a politically appointed position, which would have unnecessarily elevated its profile. That said, our concerns with the very existence of the office have continued as federal offices tend to gain rather than lose power over time. In late 2016, the FIO issued a report recommending that Congress consider prescribing a uniform national standard for state guaranty association coverage limits. This report validates our concerns that the FIO's ultimate aim is to federalize, or itself become a federal regulator of, insurance.

Many of the duties of the FIO are examples of federal overreach in the context of our current system of state insurance regulation. For over 150 years, the state-based system of insurance regulation has worked, successfully protecting consumers and creating a competitive and diverse U.S. insurance market. PIA National does not believe the federal government should act to undermine the state-based system of insurance regulation. If the goal is to eliminate unnecessary federal regulation, fully repealing the FIO would reaffirm that the regulation of insurance should continue to be the responsibility of the states.

**Concerns with the Financial CHOICE Act of 2017**

PIA National has strong concerns about the provision of this bill that would amend Title V of Dodd-Frank to create a new federal office called the Office of the Independent Insurance Advocate within the U.S. Treasury Department. PIA National sent this committee letters highlighting our concerns on January 3rd and April 17th of this year. We appreciate the goal of ensuring a unified voice when it comes to international insurance negotiations; however, we fear the potential for federal overreach if this office is to become law. While PIA National is pleased with the inclusion of language stating that the proposed office would not have the power to supervise or regulate the business of insurance, we are not convinced of the need to create a new permanent insurance office in the federal bureaucracy.

Below are the elements of the Independent Insurance Advocate provision that we view as most problematic:

- **Senate-confirmed term.** This elevates the office focusing on insurance to an inappropriately high degree in the context of our already strong system of state insurance regulation.

- **Separate office budget.** The latest discussion draft provides the Advocate's office with its own budget in the president's budget request. The bill also includes language allowing the Secretary of Treasury to provide the Advocate with such services, funds, facilities, and other support services as the Advocate requests and the Secretary approves, so a separate budget isn't necessary.

- **Permission for Advocate to hire employees** such as "attorneys, analysts, economists, and other employees as may be deemed necessary ..." This provision plants the seeds for the bureaucratic overgrowth of an unnecessary, and large, federal office.

- **Prohibition on Secretary of the Treasury taking action** to "delay or prevent the issuance of any rule or the promulgation of any regulation by the Independent Insurance Advocate," and prohibiting the Treasury Secretary from intervening "in any matter or proceeding before the Independent Insurance Advocate, unless otherwise specifically provided by law." We are struck by how powerful this position will be. We also question what regulations, rules, or proceedings the Advocate's office will issue or supervise if this provision is not intended to create an office meant to grow into a regulatory bureaucracy.

- **Authority to observe all aspects of insurance industry** and identify issues or gaps in the regulation of insurers; this authority has historically been delegated to states in accordance with the existing framework of state insurance regulation.

- **Scope of office.** The latest discussion draft states that its scope of authority will include all insurance lines *except* for health insurance, long-term care insurance, and crop insurance. The National Flood Insurance Program (NFIP) is conspicuously absent from that list. This list of exceptions may open the door to allow the Advocate's office to administer the NFIP, a change that PIA National would oppose.

- **Administration of Terrorism Risk Insurance Act (TRIA) program.** The TRIA program was restructured to be overseen by the FIO in Dodd-Frank. The TRIA program functioned well from 2002-2010 without the FIO's involvement and could function again without the involvement of this new office.

- **Administration and implementation of the National Association of Registered Agents and Brokers (NARAB).** FIO already seems to have taken the authority for administering the implementation of the NARAB, a power with which it was never provided. In fact, we would support new language specifically stating that the Advocate's office will not administer NARAB. If the goal is to avoid a Washington-centric approach, addressing these issues would slow the momentum of the FIO/Advocate's office in the regulation of insurance.

**Conclusion**

PIA National supports state insurance regulators as the primary source of oversight of insurance. State regulation has served the insurance industry and consumers well for over one hundred years. Any attempt to increase federal regulation of insurance is inappropriate, and the intervention of federal bureaucrats with little knowledge of their needs would negatively impact policyholders.

PIA National agrees with the notion that a unified voice in international negotiations is good for U.S. policyholders and the insurance market. Given the existence of the U.S. Trade Representative office, which is capable of negotiating international agreements, combined with the existing robust state insurance regulatory framework, neither an Advocate's office focusing on the insurance industry nor the existing FIO is necessary. However, if Congress decides to create an Advocate's office, we respectfully ask that our concerns, highlighted above, be taken into consideration to avoid the unintended consequences of creating a large, powerful federal insurance office.

*The Commonwealth of Massachusetts*
*Secretary of the Commonwealth*
*State House, Boston, Massachusetts 02133*

*William Francis Galvin*
*Secretary of the Commonwealth*

April 25, 2017

Via Email

The Honorable Michael E. Capuano
Financial Services Committee
1414 Longworth House Office Building
Washington, DC 20515

**Re: Comments in Opposition to the Financial CHOICE Act**

Dear Congressman Capuano:

I am writing in my capacity as chief securities regulator for Massachusetts to strongly oppose the Financial CHOICE Act ("Act").

While the preamble to the Act uses the language of hope, choice, and stability, the substance of the bill shows that such claims are entirely disingenuous. Numerous provisions of the Act will reduce transparency, expose retail investors to unjustified risks, and promote conflicts of interest that will harm retail investors.

It is apparent the Act is intended to be a gift to the investment industry and Wall Street special interests. A headline in the April 20, 2017 Washington Post noted that the Act is even more generous than the banks asked for. This is exactly the wrong path. We are still in the aftermath of the financial crisis; we must not forget the lessons that recent experience has taught us about financial abuse, conflicts of interests, and fraud. In a time of sweeping technological change and sophisticated financial scams, we must preserve and update our tools to fight financial fraud.

I understand that this bill will go through many iterations as it moves through Congress, and my office expects to provide more detailed comments during that process. This letter addresses three main points: (1) the need to protect the states' police powers relating to securities; (2) opposition to provisions that preempt state regulatory authority; and (3) opposition to language that would revoke the U.S. Department of Labor's Fiduciary Rule.

**Protect State Police Powers To Act Against Financial Fraud**

The Act is a direct threat to important police powers that allow the states to protect their citizens against fraud and financial abuse and that enable the states to avoid becoming havens for fraud.

State securities regulators would be severely hamstrung were Section 391 to go into effect. I strongly object to any language that dictates mandatory federal and state enforcement coordination, and the designation of a "lead investigative agency" that will head coordinated federal and state investigations. Maintaining the independent authority of the states is especially important in light of language in the Act that has the effect of reducing the SEC's enforcement powers. Provisions that mandate state and federal enforcement coordination are just thinly-veiled attempts to similarly tie the hands of the states. Therefore, I urge that all references to state authorities be removed from Section 391 of the Act.

There is abundant evidence that the states have been uniquely effective early responders against securities fraud. The states have given consistent priority to the protection of mom-and-pop investors. The states are in close contact with their investors and with members of local business communities, and they have acted quickly to address investor complaints and initiate investigations. Having the states take a back seat during investigations that involve more than one agency would put more investors in harm's way for longer periods of time and thwart investor protection.

State securities laws enable the states to quickly stop frauds that are offered to investors within their borders and they permit the states to crack down on frauds that may originate from their jurisdictions, permitting the states to avoid becoming havens for fraud.

The healthy diversity of regulators at the state and federal levels reflects the federalism in our Constitution. Any attempt to yoke the states to the federal securities regulators would remove the great benefits now provided by the current system of parallel federal and state authority.

As my office stated in a White Paper[1] issued shortly after the 2008 financial crisis:

> "Such increased cooperation, information sharing, and coordination among federal agencies and state agencies would likely increase the consistency of investor protection efforts and lessen the likelihood of certain products and business conduct practices falling through the regulatory cracks. However, in order to protect the states' demonstrated and valuable role as the 'fail safe' protector of savers and investors, and to protect our nation's history of regulatory competition which has increased regulatory vigilance, **such cooperation must be promoted in a manner that does not compromise the independence and authority of state securities regulators**." (Emphasis added.)

I urge you to be vigilant to protect the reserved powers of the states to police securities fraud and securities law violators. Do not remove or blunt the tools that have allowed the states to effectively protect investors.

**Examples of Successful Coordination Between State and Federal Enforcement Agencies**

I acknowledge that cooperation and coordination between states and their federal counterparts is important. In the past few years, there have been many successful enforcement actions that were the result of cooperation and coordination between my office and federal agencies, and were not the result of mandatory coordination. The following examples show how states and federal agencies have worked together to help combat investor harm:

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[1] *States' Demonstrated Record of Effectiveness in Their Investor Protection Efforts Underscores the Need to Avoid Further Preemption of State Enforcement Authority*, White Paper, Office of the Secretary of the Commonwealth William F. Galvin (Dec. 10, 2008).

***Multi-Level Marketing Case: Telexfree***

In 2014, my office filed an enforcement action against Telexfree, a Massachusetts-based entity engaged in a multi-billion dollar pyramid and Ponzi scheme said to be the largest fraud of all time in terms of the number of people affected. The Telexfree scheme targeted primarily the Brazilian immigrant community. The Securities Division was at the forefront of a complex investigation that also included coordination with the SEC and the U.S. Department of Justice. Acting swiftly, my Securities Division was able to gather and preserve critical pieces of evidence, culminating in the first legal action against Telexfree. The quick action by the Securities Division exposed the scheme and alerted the public to the fraud, preventing further investor harm. The evidence gathered by my office was shared with federal regulators and proved crucial in the filing of federal criminal and civil charges. To date, federal and state authorities have identified over 950,000 victims from this notorious scheme in the U.S. and around the world, with combined losses totaling approximately $1.8 billion.

***Ponzi Scheme: Stephen Eubanks and Eubiquity Capital***

Last year, my office received a referral concerning a Massachusetts resident operating an unregistered hedge fund. The Securities Division immediately began collecting financial records and speaking with numerous investors. The Securities Division uncovered that the hedge fund operated as a Ponzi scheme, taking in over $500,000 from at least 30 investors, from Massachusetts and other states, resulting in investor losses of over $435,000. After filing a civil complaint to quickly halt the fraud, the Securities Division referred the matter to federal authorities, who recently secured a guilty plea to wire fraud from the principal.

***Auction Rate Securities Market Failure***

States led the charge in auction rate securities enforcement actions, which resulted in refunds of over $50 billion to mom-and-pop retail investors. Massachusetts, in particular, was out in front in this area. My office exposed conflicts of interest between financial institutions and investors and showed how those conflicts had a detrimental impact on the investors. For years, financial firms had propped up the auction rate market and marketed auction rate market securities to retail investors as "cash equivalent" and safe investments. Eventually, the same financial firms that had supported the auction rate market ceased to do so and the auction rate market froze. Investors were left holding these illiquid securities, which were anything but "cash equivalents." State securities regulators and the SEC cooperated to negotiate investor refunds resulting in billions of dollars returned to retail investors.

**Remove Language That Preempts State Authority**

I urge that the following language, which preempts state regulatory authority, be deleted from the Act.

- Section 478(b)(1) of the Act should be amended to delete or relocate the words, "except that a State may not impose any fees under such authority." This wording appears after language that explicitly preserves state enforcement authority. I am concerned that some may argue that the "no fee" language may be read to mean that states cannot impose fines for violations of law in connection with offerings that purport to be crowdfunding offerings. Because we believe that is not the intention of the drafters, we ask that the language be changed to remove that potential confusion.

- Remove state preemption language, "Exemption under State Regulation," from the Section 461 exemption for micro offerings. This exemption could potentially be used to sell frauds of up to $500,000 without registration or even the filing of a notice with any regulator. It is important to preserve the ability of the states to have notice of these offerings and be able to police potentially abusive offerings.
- Remove from Section 476, Relating to Venture Exchanges, language in Section 476(b) that preempts state authority with respect to securities listed on such exchanges. Many of the securities on these exchanges will be high-risk penny stocks. This is an investment category where numerous retail investors have been harmed by fraud and manipulation, so it is important to retain state powers in this area.
- Remove Section 496, "National Securities Exchange Regulatory Parity." As it is now drafted, this provision allows the SEC to designate any market or exchange as a "covered exchange" (state authority over the securities listed on such an exchange is preempted) without regard to the standards or quality of that exchange.

**Objection to Revocation of the DOL Fiduciary Rule**

I urge that provisions of the Act that revoke the U.S. Department of Labor's Fiduciary Rule be deleted from the Act. My office has conducted numerous enforcement actions relating to fraud and abuse in the sale of investments to retirement investors. Very often, investors are unable to recover from the grievous financial harm they suffer from such frauds. The Department of Labor's Fiduciary Rule addresses a longstanding problem by requiring that any person providing retirement financial advice must act in the customer's best interest. The adoption of the Rule represents a victory for retirement investors; I urge that the Rule be maintained and conscientiously administered.

**Investor Protection Must Be Our Highest Priority**

The Act purports to benefit Main Street and Mom and Pop. Instead, it is a generous gift to Wall Street and a grave threat to the interests of retail investors. Various provisions of the Act will have the effect of reducing the SEC's rule making and enforcement powers; diminish or eliminate required disclosures; expose retail investors to high-risk segments of the securities markets, where they have often been hurt; reduce market transparency; and remove protections against severe financial conflicts of interest. I urge that you vote against the Act.

Please contact me or Bryan Lantagne, Director of the Massachusetts Securities Division, at (617) 727-3548, if you have questions or we can assist in any way.

Sincerely,

William F. Galvin
Secretary of the Commonwealth
Commonwealth of Massachusetts

amalgamated bank

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**I'm the CEO of an American bank. This is why I support Dodd-Frank.**
By Keith Mestrich
April 2, 2017

The lending and credit markets are on a hot streak. Credit card lending is higher than it's been in six years, and just hit a record high of $996 billion at the end of last year. Auto loans peaked at over $1 trillion in the fourth quarter of 2016, up from just $634 million in the same quarter of 2010. Mortgage rates fell to 3.65 percent by the end of 2016, down from 4.69 percent in 2010.

The recession caused by 2008's financial collapse tore apart these industries, left millions of Americans out of work, and obliterated any and all trust in the country's largest financial institutions. We are finally seeing true recovery and growth again, under the watchful eye of careful regulatory oversight and in the wake of years of careful policymaking designed to encourage recovery while preventing the country from ever experiencing a crisis of that scale again.

Yet even as we watch this progress continue, some federal lawmakers insist the regulations formed in the wake of the crisis are holding markets back – claims which fly in the face of reality. These lawmakers are demanding a rollback of the Dodd-Frank Reform Act, despite the protections it offers to both consumers and our national economy. The opponents of oversight and regulation insist the "red tape" of Dodd-Frank's reforms are driving up mortgage and credit costs for consumers, even though the costs are consistently hitting record lows.

An American Banker piece published recently used the figures above to dispel these falsehoods about the lending industry, proving Dodd-Frank is not holding back opportunities for consumers. In reality, interest rates on mortgages are at a long-term low point, mortgages are being given more freely than at any point since the crisis, auto lending is already well above pre-recession levels, and auto loan rates are lower now than they were in 2010.

It's difficult to argue with the point that scrapping Dodd-Frank would make it easier for banks to issue credit and loans. However, the protections offered under this law are the only thing standing between consumers and the predatory lending practices which fomented the greatest economic crisis in 70 years. Dodd-Frank helps prevent any small handful of banking institutions from holding the keys to the country's economy. By limiting investment by banks and forcing accountability to federal regulators, we are preventing the rebirth of "too big to fail" institutions.

There is certainly a middle ground of regulation which can be reached. Dodd-Frank is not a perfect law. It's unlikely even its Congressional supporters would call it one, given how heavily it was amended and changed before finally being enacted. However, its key provisions actively safeguard against the bad

corporate behaviors which wreaked havoc on the wellbeing of banks and customers alike less than a decade ago.
Orchestrating a smear campaign against a law which as its sole purpose and directive — protects customers from the predatory practices of profit-driven financial institutions is simply not how forward-thinking policy is made. Conversations about regulations of the financial sector should revolve around how to improve banks' and lenders' ability to satisfy the needs of their clients and customers — not just how to improve their ability to make as much money as they can, as quickly as they can.

If we are going to be serious about reforming financial regulations, it must be done with the best interests of working Americans first, and not the revenue targets of banks. Our responsibility is to protect the wealth and economic stability of our customers, not exploit their money to make more for ourselves. This responsibility is the foundation of Dodd-Frank, and a wholesale rollback of the law opens us up to the negligent practices which necessitated its passage in the first place.

PCI
Property Casualty Insurers
Association of America
Advocacy Leadership Results

**Statement for the Record**

**Property Casualty Insurers Association of America (PCI)**

**Hearing on the Financial CHOICE Act**

**House Committee on Financial Services**

**April 26, 20017**

The Property Casualty Insurers Association of America (PCI) strongly supports the Financial CHOICE Act, which would benefit consumers, uphold proven effective state-based insurance regulation, strengthen the financial marketplace, and at the same time reduce Federal regulatory overreach. PCI is composed of 1,000 member companies, representing the broadest cross section of insurers of any national trade association. PCI members write over $200 billion in annual premium in the U.S. and around the world, including 35 percent of the nation's property casualty insurance. Member companies write 42 percent of the U.S. automobile insurance market, 27 percent of the homeowners market, 33 percent of the commercial property and liability market and 34 percent of the private workers compensation market.

Regulatory compliance costs for insurers have been skyrocketing, increasing 19% over the last two years.[1] Over 13,000 pages of new Dodd-Frank Act regulations have been imposed since 2009, and the burden has been especially taxing for small insurers who have to reallocate three times as much of their revenue on compliance costs as large financial companies.[2] While insurance has been successfully regulated at the state level for over 160 years, Dodd-Frank has created extra layers of federal banking related regulation that have spilled over into insurance that often duplicate or undermine consumer-focused state regulation. PCI greatly appreciates the Committee's work in the last Congress to enact the Policyholder Protection Act, which reaffirmed that state regulators have primary authority to resolve failing insurers and to protect insurance consumer where the insurer is affiliated with a bank or thrift that is subject to federal regulation.

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[1] Property-Casualty Insurance Association of America and Aon Hewitt Ward Group, *Corporate and Regulatory Compliance Practices*, 2016, p. 8.
[2] *Id.*

Many community financial institutions are being hit particularly hard. For example, one PCI member insurer has a very small community depository institution with only $30.5 million in assets – less than 0.2 percent of the assets of the holding company. Since the beginning of its regulation under the Federal Reserve, this company has had significantly increased administrative burdens on their compliance and regulatory staff. In fact, *twenty-five percent* of its regulatory and compliance staff time is now spent communicating with the Federal Reserve on regulation of an entity that comprises only 0.2 percent of the company's assets. Federal Reserve Board Governor Jerome Powell just last week acknowledged that "In too many cases new regulation has been inappropriately applied to small and medium-sized institutions. We need to go back and broadly raise thresholds of applicability and look for other ways to reduce burden on smaller firms."[3] Board Chairman Janet Yellen similarly stated in testimony for the Financial Services Committee that "rules and supervisory approaches should be tailored to different types of institutions."[4] Despite the increasing recognition of the suffocating regulatory burden on particularly smaller insurers and other community financial institutions, relief is unlikely unless and until Congress can clarify its regulatory priorities and eliminate Fed supervision of insurers or at a minimum make that supervision more proportional to the risk.

The Financial CHOICE Act includes several provisions that could reduce unproductive regulatory duplication and overreach and thereby support more financial activity and economic growth. At the same time, however, it assures the continued viability of our proven effective state-based insurance regulation.

In particular, the redesign of the Federal Insurance Office (FIO) would be a helpful start in refocusing federal involvement in insurance to become more supportive of existing state insurance regulation by requiring it to advocate on behalf of the proven effective U.S. insurance system against harmful international threats that would actually undermine our consumer protection and our competitive markets. PCI suggests several additional amendments to this portion of the CHOICE Act to further support state regulatory efforts to protect consumers and strengthen private competitive markets. PCI

[3] Jerome Powell, Governor, Federal Reserve Board, *Brief Remarks* before the Global Finance Forum, Washington, DC, April 20, 2017.

[4] Statement by Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System before the Committee on Financial Services, U.S. House of Representatives, September 28, 2016.

also strongly supports changes to the Financial Stability Oversight Council's (FSOC) authority that recognize the consensus of insurance regulators and experts that traditional insurance is not systemically risky and state regulated insurers should not be forced under an additional layer of banking regulation merely because they are large and well diversified. PCI would suggest further amendments to the ongoing bank-like supervision of community insurers by the Federal Reserve Board to require more proportionality and risk-based supervision, with deference to insurance functional regulators.

PCI strongly supports provisions of the CHOICE Act that: (1) subject the Financial Stability Oversight Council's (FSOC) funding to the appropriations process and reforming FSOC's authority to designate firms as systemically important financial institutions; (2) requiring greater transparency in the federal agencies' participating in international insurance standard setting negotiations; and (3) clarifying priorities of the Federal Insurance Office (FIO) and requiring it to consult with state regulators (as part of the restructuring of FIO and FSOC's Independent Member with Insurance Expertise). The following will summarize several key amendments to the CHOICE Act, which we believe would improve an already excellent bill.

**Redefine and Limit the Role of Federal Insurance Office**

The CHOICE Act already limits the role of FIO and merges it with the Office of the Independent Member with Insurance Expertise. However, PCI recommends that FIO's role be further limited to international functions only and that its domestic functions be eliminated entirely. The primary reason Congress created the Federal Insurance Office (FIO) was to work with the states to provide a stable and consistent voice for the U.S. to support our regulatory system in international insurance discussions. That is still an appropriate role for FIO (or a successor entity).

But additional domestic mandates that were not included in initial FIO proposals were subsequently layered on that can undermine, conflict with or duplicate core activities of state insurance regulators. For example, state insurance departments have conducted numerous studies on auto insurance rates. Every state has extensive laws and regulations governing auto insurance underwriting accompanied by rate approval authority and antidiscrimination laws. The auto insurance marketplace is one of the most competitive commercial sectors with almost no availability problems. However, even though the states are continuing to vigorously monitor the marketplace and issue periodic data calls, FIO duplicated state efforts, imposed its own studies, triggered a series of data calls in addition to what states already were requesting, and created a conflicting Federal definition of affordability.

FIO issued several other reports that gratuitously criticized state regulation, ignoring such metrics and the large amount of competition, the extensive consumer protection laws and the few consumer complaints. FIO has also initiated similar dueling data calls with the states on terrorism insurance, despite specific statutory direction to coordinate data collection through the state regulators. FIO is not a regulator, but its subpoena authority to compel responses to data calls implies regulatory authority that is not in FIO's mandate and that is appropriately the purview of state regulators and other law enforcement entities. State insurance commissioners rely on 11,300 staff to protect insurance consumers and regulate insurance market activities and should not be undermined by a Treasury office with fewer than a dozen.[5] The states collectively spend in excess of $1 billion regulating insurers[6] and the National Association of Insurance Commissioners has a 2017 budget of $101.9 million and a staff of roughly 490 on top of that.[7]

In addition to refocusing FIO (or a successor entity) on international activities, Title V of Dodd-Frank should further be amended to: (1) eliminate FIO's authority to issue duplicative data calls and its unprecedented subpoena authority; (2) limit FIO's headcount to its international staff; and (3) require FIO to consult with and represent the views of the state insurance regulatory community in international negotiations and discussions and provide greater congressional oversight of and transparency on international insurance standards setting processes.

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[5] National Association of Insurance Commissioners, *Insurance Department Resources Report*, 2016.
[6] *Id.*
[7] NAIC Budget, 2017.

**Require Targeted and Proportional Regulation of Insurance Companies Subject to Federal Reserve Board Supervision**

The Board of Governors of the Federal Reserve System (Federal Reserve) was granted jurisdiction over insurance companies that are affiliated with thrift institutions. Only 14 remain, of which many only have tiny depository institutions. Nonetheless, the Federal Reserve supervision is quite onerous. Legislation is needed to provide for more tailored and proportional supervision of the depository institution -- and not the business of insurance, which has robust holding company supervision run by state-led supervisory colleges. As noted above, current Federal Reserve regulation is often not proportional and results in tremendous costs to the affected insurer. Consumer costs are unnecessarily increased as a result of companies having to expend and often waste significant resources for inside and external counsel to interpret and respond to requests for information or interpretation of rules, some of which are duplicative to their current OCC and state regulatory requirements.

The CHOICE Act should therefore explicitly require more targeted and proportional Federal Reserve regulation of insurance companies only to the extent necessary to regulate the affiliated depository institution This would be entirely consistent with recent comments from high level Federal Reserve officials that supervision should be appropriately tailored. PCI will be pleased to work with Committee and its staff on suggested legislative language.

**Restrict Federal Reserve Ability to Conduct Examinations of Insurers Controlled by Banks or Thrifts**

The Federal Reserve Board should not be permitted to conduct examinations of, or require reports from, any insurance company that is controlled by a bank or savings and loan holding company or of a company (and its subsidiaries) that simply holds the shares of the insurance companies. Under current law, the Federal Reserve may obtain information about the financial condition and activities of insurance companies that are subsidiaries of bank and savings and loan holding companies from state insurance authorities, who have complete authority to examine insurance companies and obtain reports regarding their activities. The Federal Reserve can avoid duplicating state efforts by obtaining information directly from state insurance authorities rather than imposing additional burdens on insurance companies and their consumers.

Within the insurance sector, regulatory overreach and duplication limits insurers ability to grow their business and invest in innovation. Unnecessary or duplicative regulatory requirements imposed on insurers add costs that are ultimately paid by personal and commercial consumers through higher premiums. These costs in turn reduce productivity and prevent more beneficial expenditures such as businesses investing in research and offering new products or services and related job creation.

Rising regulatory costs that create higher costs for consumers restrict their ability to buy more beneficial coverage. PCI, in conjunction with the Ward Group (AON Hewitt), conducted a corporate/regulatory compliance cost survey in 2016 which showed these expenses continue to increase annually, including a 19 percent overall increase from 2013 to 2015. In addition, because regulatory costs disproportionately impact small and medium-sized insurers, they can force consolidation and reduce competition.

PCI recommends that the Bank Holding Company Act and the Home Owners' Loan Act should be amended to more appropriately target the Federal Reserve's examination authority for insurers controlled by a bank of thrift to focus on systemic risks or risks to the federal deposit insurance fund. PCI will be pleased to work with the Committee and its staff on suggested legislative language.

**Elimination of Federal Reserve Authority Over Insurers That Are Holding Companies**

Some insurance holding companies now supervised by the Federal Reserve have an insurance company as the controlling entity. In this case the primary functional regulator, the insurer's state insurance department, is supervising the entire group, and Federal Reserve supervision risks duplication and conflict. The Bank Holding Company Act and the Home Owners' Loan Act should be amended to provide that an insurance company that (1) controls a bank or another bank holding company is not a bank holding company for purposes of the Bank Holding Company Act, or (2) controls a savings association or another savings and loan holding company is not a savings and loan holding company for purposes of the Home Owners' Loan Act if it is principally engaged in the business of insurance. A company should be deemed to be principally engaged in the business of insurance if the company's assets attributable to the company's insurance activities are more than 50 percent of the consolidated assets of the company. If the insurance company is not a bank holding company, a subsidiary of the company (such as an intermediate company that directly or indirectly control the bank or savings association) also will not be a bank or savings and loan holding company.

The Bank Holding Company Act and the Home Owners' Loan Act should be amended to eliminate Federal Reserve authority over controlling insurers. PCI will be pleased to work with the Committee and its staff on suggested legislative language.

**Reform the Financial Stability Oversight Council (FSOC), Eliminate Non-Bank Systemic Risk Designations and Strengthen the Independent Insurance Expert**

FSOC has designated multiple insurance companies as SIFIs (systemically important financial institutions) over the objection of its insurance expert and the state regulators. In addition, it has failed to create uniform criteria for designation or a clear and unambiguous exit ramp, and its procedures lack fundamental transparency.

There may continue to be a role for FSOC in "looking over the horizon" and coordinating with functional regulators, including state insurance commissioners. For these reasons, PCI supports CHOICE Act provisions that retain the FSOC, but limit its ability to designate systemically important financial institutions. If FSOC is continued, however, the Independent Insurance Expert's office should be enhanced with employees that are selected and managed by the

Independent Expert, not by Treasury, and the office should be funded independent of the Treasury Department. The Independent Insurance Expert's office is disadvantaged in comparison with other FSOC members by its lack of independent staff and resources. PCI also recommends that a representative of the state insurance regulatory community should be added as a voting member of FSOC. In addition, PCI has recommended the creation of a State-Federal Insurance Coordination Partnership to provide a structure under which FIO (or a successor agency) can coordinate with states and better represent state regulators views in international discussions.

**Other CHOICE Act Provisions**

PCI also strongly supports several non-insurance-specific provisions of the CHOICE Act, including, (1) requiring federal financial regulators to conduct a cost-benefit analysis before issuing rules; (2) increasing the accountability of the Consumer Financial Protection Bureau (CFPB), including repealing the CFPB's authority to band financial products it finds "abusive," and clarifying that insurance is beyond the CFPB's jurisdiction and (3) elimination the *Chevron* deference doctrine under which the courts defer to agency interpretations in judicial review of federal financial agencies' rules.

**Conclusion**

PCI strongly supports the regulatory improvements embodied in the Financial CHOICE Act, which could be further strengthened by the recommended amendments. If enacted, the legislation will better focus regulatory efforts, better protect state-based consumer protections and better support a competitive U.S. insurance market.

# AN EXAMINATION OF ATTACKS AGAINST THE FINANCIAL CRISIS INQUIRY COMMISSION

**Democratic Staff**
**Committee on Oversight and Government Reform**
**U.S. House of Representatives**

**Prepared for Ranking Member Elijah E. Cummings**

**July 13, 2011**

**http://democrats.oversight.house.gov/**

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**EXECUTIVE SUMMARY**

In the wake of the most severe economic crisis since the Great Depression, Congress established the Financial Crisis Inquiry Commission in May 2009 to "examine the causes, domestic and global, of the current financial and economic crisis in the United States." There were ten Commissioners, including six Democrats and four Republicans, led by Democratic Chairman Phil Angelides and Republican Vice Chairman Bill Thomas.

In July 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act. Based on testimony from former Federal Reserve Chairman Alan Greenspan and others that there had been deficient regulation of the financial markets leading up to the crisis, the Dodd-Frank Act included significant new protections for consumers of financial products.

House Republicans voted almost unanimously against the Dodd-Frank Act. On the day it passed the Senate, then-House Minority Leader John Boehner stated: "I think it ought to be repealed." Since then, House Republicans have been aggressive in their efforts to repeal the Act and prevent its protections from being implemented.

On July 27, 2010, then-Ranking Member Issa announced an investigation into the activities of the Commission. In a letter to Chairman Angelides, Ranking Member Issa wrote that, although he had hoped that the Commission would "be able to conduct a fair and effective investigation which would help Congress as it considered financial regulatory reform legislation," he was launching his investigation in part because "the Administration and congressional Democrats have instead chosen to ram through a partisan financial regulation bill before the FCIC has completed its work."

Ranking Member Issa made a number of allegations focused almost exclusively on Democratic Commissioners and staff. He asserted that "potential financial mismanagement" caused the Commission to "run out of money"; that "commissioners and staff of the FCIC may have conflicts of interest"; that some senior staff had "extensive ties" to "partisan Democrat politics"; and that the decision to delay the Commission's final report by a month and a half was caused by "continued management problems."

As part of Chairman Issa's investigation, he requested a wide range of internal Commission documents. In response, the Committee has now obtained more than 400,000 e-mails, memoranda, draft reports, and other documents from both Democratic and Republican Commissioners and staff.

These documents indicate that Chairman Issa's allegations are largely unsubstantiated, and this report addresses each allegation in turn. In contrast, the documents raise significant new questions about whether Republican Commissioners geared their efforts on the Commission toward helping House Republicans in their campaign to repeal the Dodd-Frank Act, rather than determining the facts that led to the economic crisis. The documents also raise a host of new ethical questions about Republican Commissioners and staff, including evidence that they leaked confidential information to outside parties on multiple occasions.

***Work Guided by Politics Rather Than Fact-Finding***

Although the purpose of the Commission was supposed to be to conduct in-depth fact-finding to determine the causes of the economic crisis, internal Commission documents obtained by the Committee include e-mails from a Republican Commissioner urging his colleagues to use their positions on the Commission to help House Republicans in their efforts to repeal the Dodd-Frank Act.

For example, on November 3, 2010, the day after the mid-term congressional elections in which Republicans took control of the House, Republican Commissioner Peter Wallison e-mailed Republican Commissioner Douglas Holtz-Eakin: "It's very important, I think, that what we say in our separate statements not undermine the ability of the new House GOP to modify or repeal Dodd-Frank."

The next day, he sent a similar e-mail to Vice Chairman Thomas, attaching an article entitled "GOP Pledges Major Changes to Dodd-Frank, Fannie and Freddie, CFPB." He wrote: "Garrett [Rep. Scott Garrett] has also suggested in the past a complete repeal of Dodd-Frank. This effort should not be undermined. That law will suppress economic growth because it was based on the idea that more regulation was necessary. Boehner also said yesterday that changing this law was a priority."

By December, Republican Commissioners had decided not to join the Commission's report. Instead, they issued their own paper on December 15 providing dissenting views about the causes of the economic crisis. In addition, on January 27, 2011, Commissioner Wallison wrote in his dissenting views that "the Dodd-Frank Act was legislative overreach and unnecessary." He added: "The appropriate policy choice was to reduce or eliminate the government's involvement in the residential mortgage markets, not to impose significant new regulation on the financial system."

On January 3, 2011, *Politico* reported that Chairman Issa planned to hold a hearing with Chairman Angelides and Vice Chairman Thomas "to determine whether there was any agreement in relation to the cause of the meltdown." Two days later, Chairman Issa joined several other Members in introducing H.R. 87 to repeal the Dodd-Frank Act in its entirety.

***Campaign to Blame Economic Crisis on Government Housing Policy***

Internal Commission documents indicate that Commissioner Wallison used his position to promote a theory of the economic crisis supported by Chairman Issa and put forth by Edward Pinto, a Resident Fellow at the American Enterprise Institute (AEI). This theory, that government housing policy was the primary cause of the nation's economic crisis, was ultimately rejected as flawed by every other member of the Commission.

Before joining AEI in 1999, Commissioner Wallison served as White House Counsel and as General Counsel at the Treasury Department under President Reagan where, according to his biography, "he had a significant role in the development of the Reagan administration's proposals for the deregulation of the financial services industry." Mr. Pinto is a former Fannie Mae official whose work at AEI focuses "on the role of housing policies in the financial crisis."

Internal Commission documents indicate that Commissioner Wallison violated the Commission's ethics provisions by leaking confidential information to Mr. Pinto on several occasions. In response to one of these violations, the Commission's General Counsel concluded that Commissioner Wallison disclosed "a confidential Commission staff memorandum" to Mr. Pinto, and that this "was a violation of the Commission's Ethics Guidelines, and our written confidentiality agreement with the Federal Reserve."

Internal Commission e-mails indicate that Republican Vice Chairman Thomas and his staff became worried that Commissioner Wallison was unduly influenced by AEI. In one exchange, Vice Chairman Thomas' special assistant referred to Commissioner Wallison as "intractable" and wrote: "Everyone agrees that there is simply no way to make Peter happy." Later in the exchange, he wrote:

> I can't tell re: who is the leader and who is the follower. If Peter is really a parrot for Pinto, he's putting a lot of faith in the guy.

In response, a colleague at Vice Chairman Thomas' law firm wrote: "I think wmt [William M. Thomas] is going to push to find out if pinto is being paid by anyone."

Despite repeated claims by Commissioner Wallison that the Commission failed to consider AEI's position that the economic crisis was caused by government housing policies, internal Commission documents demonstrate that Commission staff went above and beyond in fully considering the AEI position, and that all of the other Commissioners—including the three other Republicans—rejected this position as fundamentally flawed.

For example, Republican Commissioner Holtz-Eakin sent an e-mail to Vice Chairman Thomas stating: "I continue to think that Peter overplays the mortgage issue." In addition, the separate dissent issued by Republican Commissioners Thomas, Hennessey, and Holtz-Eakin stated that such "single-cause explanations" are "too simplistic."

Chairman Angelides sent an e-mail to Commissioner Wallison explaining that the Commission staff had fully considered the AEI position, but concluded it was "flawed." He added: "the staff has spent more time responding to your questions and requests for information than any other Commissioner."

***Questions About Vice Chairman Thomas and the CEO of a Political Consulting Firm***

Internal Commission documents raise questions about the extent to which Vice Chairman Thomas and his Commission staff were providing information to, and receiving information from, a CEO of a political consulting firm who is also employed by the Vice Chairman's law firm.

Alex Brill is the CEO of Matrix Global Advisors, a firm that provides "economic and political consulting services for clients seeking to effect change in Washington" and "works with clients spanning a variety of industries and has advised both small firms and large corporations," including a "Wall Street investment bank" seeking insights into "financial services legislation."

Mr. Brill is also an Economic Policy Advisor at the law firm of Buchanan, Ingersoll, and Rooney in Washington, DC, where Vice Chairman Thomas is a Senior Advisor, and where Mr. Brill "provides clients with economic and legislative insight" into "financial markets and policies affecting capital investment." Mr. Brill is also a Research Fellow at AEI and previously served as "senior advisor to former chairman of the House Ways and Means Committee Bill Thomas."

Although some Commissioners utilized non-Commission staff for scheduling, appointments, and other administrative functions, Mr. Brill received confidential information about the Commission's work and provided substantive input based on that information. According to the internal Commission documents, Mr. Brill was provided:

- copies of outlines of internal drafts of Commission staff memos;
- information about internal conversations among Commissioners and staff about deliberations regarding potential witnesses for upcoming hearings;
- a media advisory that had not yet been made public;
- information about the Commission's plans to investigate foreign banks (including the identities of target banks); and
- information about how the Commission staff would treat specific corporations under investigation (such as Citigroup).

Committee staff have identified no record of Mr. Brill being an official, employee, consultant, contractor, or adviser to the Commission. Similarly, Committee staff have identified no record of Mr. Brill signing a confidentiality agreement.

The documents produced to the Committee do not indicate whether Mr. Brill conveyed any of this internal Commission information to corporate clients, entities represented by his company or his law firm, or any other outside parties. However, Mr. Brill's law firm aggressively markets his services by stating that they "use this influence to advance causes and cases for clients all over the nation."

As the culmination of a year-long investigation, Chairmen Issa and McHenry scheduled a hearing on these matters for July 13, 2011. Despite previous reports, Chairman Issa did not invite Vice Chairman Thomas to testify. For this reason, on July 1, 2011, Ranking Members Cummings and Quigley requested that Committee staff conduct a bipartisan staff interview of Vice Chairman Thomas, as they had done with Chairman Angelides. Chairman Issa declined to grant this request. Instead, he notified the Committee that the hearing had been postponed indefinitely.

**BACKGROUND**

The Financial Crisis Inquiry Commission was established by the Fraud Enforcement and Recovery Act of 2009, which was passed by Congress and signed by the President in May 2009.[1] The Commission was created in the wake of the most severe financial crisis in the United States since the Great Depression to "examine the causes, domestic and global, of the current financial and economic crisis in the United States."[2]

The Act authorized the appropriation of "such sums as are necessary."[3] The Commission received an initial appropriation of $8 million from the Supplemental Appropriations Act of 2009 (enacted June 24, 2009).[4] The Commission was subsequently appropriated an additional $1.8 million by the Supplemental Appropriations Act of 2010, which was enacted on July 29, 2010.[5]

The Commission was required to "submit to the President and to the Congress a report containing the findings and conclusions of the Commission on the causes of the current financial and economic crisis in the United States" on December 15, 2010, and it was then to "terminate 60 days after the date on which the final report is submitted."[6]

On November 17, 2010, the Commission announced it "had resolved, by majority vote, to deliver its report in January 2011, rather than on December 15, 2010."[7] The Commission indicated that this delay would "allow the Commission to produce and disseminate a report which best serves the public interest and more fully informs the President, the Congress and the American people about the facts and causes of the crisis."[8] On December 15, 2010, the four Republican commissioners, Bill Thomas, Peter Wallison, Keith Hennessey, and Douglas Holtz-Eakin, sent to the President and Congress a nine-page primer entitled "Financial Crisis Primer: Questions and Answers on the Cause of the Financial Crisis."[9]

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[1] P.L. 111-21.

[2] *Id.*

[3] *Id.*

[4] P.L. 111-32.

[5] P.L. 111-212.

[6] P.L. 111-21.

[7] Financial Crisis Inquiry Commission, *Financial Crisis Inquiry Commission Announces New Date for Final Report* (Nov. 17, 2010).

[8] *Id.*

[9] Republican Commissioners on the Financial Crisis Inquiry Commission, *Financial Crisis Primer: Questions and Answers on the Causes of the Financial Crisis* (Dec. 15, 2010) (online at http://keithhennessey.com/wp-content/uploads/2010/12/Financial-Crisis-Primer.pdf).

The Commission issued its final report on January 27, 2011.[10] The report concluded that "the crisis was avoidable" and was caused by "[w]idespread failures in financial regulation," "[d]ramatic breakdowns in corporate governance," and "[a]n explosive mix of excessive borrowing and risk by households and Wall Street," among other factors.[11] The Commission also published on its website "nearly 2,000 documents and more than 300 witness interviews in audio, transcript or summary form" on which its report was based.[12]

The six Democratic Commissioners voted in favor of the report.[13] The four Republican Commissioners issued two separate dissenting views. Commissioners Bill Thomas, Keith Hennessey, and Douglas Holtz-Eakin issued a joint dissenting statement.[14] Commissioner Peter Wallison issued a separate dissenting statement.[15]

The Commission ceased work on February 13, 2011. The Commission's website is now maintained by the Rock Center for Corporate Governance at Stanford University, and materials associated with its work were deposited at the National Archives and Records Administration.[16]

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[10] Financial Crisis Inquiry Commission, *Financial Crisis Inquiry Commission Releases Report on the Causes of the Financial Crisis* (Jan. 27, 2010) (online at http://fcic-static.law.stanford.edu/cdn_media/fcic-news/2011-0127-fcic-releases-report.pdf).

[11] *Id.*

[12] Financial Crisis Inquiry Commission, *Financial Crisis Inquiry Commission Releases Additional Material and Concludes Work* (Feb. 10, 2011) (online at http://fcic-static.law.stanford.edu/cdn_media/fcic-news/Press_Release_2.10.11.pdf).

[13] Financial Crisis Inquiry Commission, *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (online at http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_commissioner_votes.pdf).

[14] Financial Crisis Inquiry Commission, *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States – Dissenting Statement of Commissioner Keith Hennessy, Commissioner Douglas Holtz-Eakin, and Vice Chairman Bill Thomas* (Jan. 2011) (online at http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_hennessey_holtz-eakin_thomas_dissent.pdf).

[15] Financial Crisis Inquiry Commission, *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States – Dissenting Statement of Peter J. Wallison* (Jan. 2011) (online at http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_wallison_dissent.pdf).

[16] *Id.*

## I. WORK GUIDED BY POLITICS RATHER THAN FACT-FINDING

Although the purpose of the Commission was to conduct in-depth fact-finding to determine the causes of the economic crisis, internal Commission documents obtained by the Committee include e-mails from a Republican Commissioner urging his colleagues to use their positions on the Commission to help House Republicans in their efforts to repeal the Dodd-Frank Act.

In July 2010, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protections Act in response to the 2008 economic crisis.[17] Based on testimony from former Federal Reserve Chairman Alan Greenspan and others that there had been inadequate and insufficient regulation of the financial markets leading up to the crisis, the Dodd-Frank Act included significant new protections for consumers of financial products.[18]

When the Dodd-Frank Act passed the House in 2010, House Republicans voted almost unanimously against it.[19] On the day it passed the Senate, then-House Minority Leader John Boehner stated: "I think it ought to be repealed."[20]

Less than two weeks later, then-Ranking Member Issa announced an investigation into the activities of the Commission. In a letter to Chairman Angelides on July 27, 2010, Rep. Issa stated that, although he had hoped that the Commission would "be able to conduct a fair and effective investigation which would help Congress as it considered financial regulatory reform legislation," he was launching his investigation in part because "the Administration and congressional Democrats have instead chosen to ram through a partisan financial regulation bill before the FCIC has completed its work."[21]

On November 3, 2010, the day after the mid-term congressional elections in which Republicans took control of the House, Commissioner Wallison sent an e-mail to Republican Commissioner Douglas Holtz-Eakin. He wrote:

> It's very important, I think, that what we say in our separate statements not undermine the ability of the new House GOP to modify or repeal Dodd-Frank.[22]

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[17] P.L. 111-203.

[18] *The Dodd-Frank Wall Street Reform and Consumer Protection Act: Issues and Summary*, Congressional Research Service (July 29, 2010) (online at www.llsdc.org/attachments/files/232/CRS-R41350.pdf).

[19] H.R. 4173, Dodd-Frank Wall Street Reform and Consumer Protection Act (June 30, 2010) (House vote on conference report) (online at thomas.gov/cgi-bin/bdquery/z?d111:HR04173:@@@R).

[20] *Senate Passes Wall Street Reform,* The Hill (July 15, 2010) (online at thehill.com/homenews/senate/109053-senate-passes-wall-st-reform).

[21] Letter from Darrell E. Issa to Phil Angelides (July 27, 2010).

[22] E-mail from Peter J. Wallison to Douglas Holtz-Eakin (Nov. 3, 2010).

The next day, on November 4, 2010, Commissioner Wallison sent an e-mail to Republican Vice Chairman Bill Thomas, again underscoring support for efforts to repeal the Dodd-Frank Act. Attaching an article entitled "GOP Pledges Major Changes to Dodd-Frank, Fannie and Freddie, CFPB," Commissioner Wallison wrote:

> Bill: In case this did not make the main media sources, I thought you should see this. Garrett [Rep. Scott Garrett] has also suggested in the past a complete repeal of Dodd-Frank. This effort should not be undermined. That law will suppress economic growth because it was based on the idea that more regulation was necessary. Boehner also said yesterday that changing this law was a priority.[23]

By December, Republican Commissioners had decided not to join the Commission's report. On December 15, 2010, the four Republican commissioners, Bill Thomas, Peter Wallison, Keith Hennessey, and Douglas Holtz-Eakin, sent to the President and Congress a nine-page primer entitled "Financial Crisis Primer: Questions and Answers on the Cause of the Financial Crisis."[24]

On January 3, 2011, an article in *Politico* reported that Rep. Issa planned an inquiry into the Commission's activities as one of his first investigations. It stated:

> Issa also wants to study why the financial crisis commission couldn't reach consensus last year. He'd like to call commission Chairman Phil Angelides and former Rep. Bill Thomas (R-Calif.), vice chairman of the panel, to determine whether there was any agreement in relation to the cause of the meltdown.[25]

Two days later, on January 5, 2011, Chairman Issa joined seven other Members in introducing H.R. 87 to repeal the Dodd-Frank Act in its entirety.[26]

Although the Commission was scheduled to issue its report on January 27, 2011, Chairman Issa sent a letter to Chairman Angelides two days earlier, on January 25, 2011, to "renew the request for documents in the original letter." He directed the production of all documents in less than a week, by January 31, 2011.[27]

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[23] E-mail from Peter Wallison to Bill Thomas (Nov. 4, 2010).

[24] Republican Commissioners on the Financial Crisis Inquiry Commission, *Financial Crisis Primer: Questions and Answers on the Causes of the Financial Crisis* (Dec. 15, 2010) (online at http://keithhennessey.com/wp-content/uploads/2010/12/Financial-Crisis-Primer.pdf).

[25] *Darrell Issa Reveals List of Investigations*, Politico (Jan. 3, 2011) (online at www.politico.com/news/stories/0111/46952.html#ixzz1RSoPXlnR).

[26] H.R. 87, To Repeal the Dodd-Frank Wall Street Reform and Consumer Protection Act (introduced Jan. 5, 2011) (online at http://thomas.loc.gov/cgi-bin/bdquery/z?d112:HR00087:@@@P/|).

[27] Letter from Darrell E. Issa, *et al.*, to Phil Angelides (Jan. 25, 2011).

Two days later, when the Commission issued its final report, Commissioner Wallison's dissent stated that "the Dodd-Frank Act was legislative overreach and unnecessary." He concluded: "The appropriate policy choice was to reduce or eliminate the government's involvement in the residential mortgage markets, not to impose significant new regulation on the financial system."[28]

On May 23, 2011, Chairman Issa sent letters to former Chairman Angelides, former Commissioner Byron Georgiou, former General Counsel Gary Cohen, and former Executive Director Wendy Edelberg, requesting that they make themselves available for transcribed interviews with Committee staff.[29]

On July 1, 2011, Representatives Elijah Cummings and Mike Quigley, Ranking Members of the Oversight Committee and Subcommittee on TARP, Financial Services, and Bailouts of Public and Private Programs, sent a letter to Chairmen Issa and Patrick McHenry requesting that the Committee also conduct bipartisan staff interviews of former Vice Chairman Thomas and Commissioner Peter Wallison.[30] Chairman Issa declined to grant this request.

## II. CAMPAIGN TO BLAME ECONOMIC CRISIS ON GOVERNMENT HOUSING POLICY

Internal Commission documents obtained by the Committee indicate that Commissioner Peter J. Wallison used his position on the Commission to promote a theory supported by Rep. Issa and put forth by Edward Pinto, a Resident Fellow at the American Enterprise Institute (AEI), that was ultimately rejected as flawed by every other member of the Commission—namely, that government housing policy was the primary cause of the nation's economic crisis.

Peter Wallison joined AEI in 1999 and became the Arthur F. Burns Fellow in Financial Policy Studies in 2007.[31] In his previous positions as White House Counsel and General Counsel at the Treasury Department under President Reagan, "he had a significant role in the development of the Reagan administration's proposals for the deregulation of the financial

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[28] Financial Crisis Inquiry Commission, *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States – Dissenting Statement of Commissioner Peter Wallison* (Jan. 2011) (online at http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_wallison_dissent.pdf).

[29] *See, e.g.,* Letter from Darrell E. Issa to Phil Angelides (May 23, 2011).

[30] Letter from Elijah E. Cummings and Mike Quigley to Darrell E. Issa and Patrick McHenry (July 1, 2011).

[31] American Enterprise Institute, *Peter J. Wallison Appointed to the AEI's Arthur F. Burns Chair* (May 10, 2007) (online at www.aei.org/press/26156).

services industry."[32] Mr. Wallison was appointed to the Commission by then-House Republican Leader John Boehner and Senate Republican Leader Mitch McConnell.[33]

Edward Pinto's biography states that he was an "executive vice president and chief credit officer for Fannie Mae until the late 1980s," and he focuses now "on the role of housing policies in the financial crisis and researching policy considerations and options for rebuilding our housing-finance sector."[34] On August 14, 2010, Mr. Pinto published a paper arguing that government housing policy was to blame for the economic crisis.[35]

Then-Ranking Member Issa published reports and an article espousing the same position. A minority staff report originally issued on July 1, 2009, argued: "The housing bubble that burst in 2007 and led to a financial crisis can be traced back to federal government intervention in the U.S. housing market intended to help provide homeownership opportunities for more Americans."[36] Similarly, in March 2010, then-Ranking Member Issa published an article in the Harvard Journal of Law and Public Policy arguing that the economic crisis "is directly tied to an over-inflated housing bubble" and that the loans that created the bubble "were given in record number to over-extended, under-qualified borrowers to satisfy an increasingly aggressive government drive for home ownership."[37]

### A. Wallison Leaked Confidential Information

Internal Commission documents obtained by the Committee indicate that Commissioner Wallison violated the Commission's ethics provisions by leaking confidential information.

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[32] American Enterprise Institute, *Biography of Peter J. Wallison* (accessed July 8, 2011) (online at www.aei.org/scholar/58).

[33] *California's Angelides to Lead Financial Crisis Probe,* Bloomberg (July 15, 2009) (online at www.bloomberg.com/apps/news?pid=newsarchive&sid=a7zD382h2EM8).

[34] American Enterprise Institute, *Biography of Edward Pinto* (accessed July 8, 2011) (online at www.aei.org/scholar/100080).

[35] *Government Housing Policies in the Lead-Up to the Financial Crisis: A Forensic Study,* (Aug. 14, 2010) (online at www.aei.org/docLib/Pinto-Government-Housing-Policies-Crisis.pdf).

[36] Minority Staff, House Committee on Oversight and Government Reform, *The Role of Government Affordable Housing Policy in Creating the Global Financial Crisis of 2008* (July 1, 2009; updated May 12, 2010) (online at http://oversight.house.gov/images/stories/Reports/20100512affordablehousingpolicyandthefinancialcrisis.pdf).

[37] Rep. Darrell E. Issa, *Unaffordable Housing and Political Kickbacks Rocked the American Economy,* Harvard Journal of Law & Public Policy (Mar. 22, 2010) (online at www.harvard-jlpp.com/33-2/407.pdf).

On August 9, 2010, Commission staff prepared a memo to Commissioners entitled "Analysis of Housing Data and Comparison with Ed Pinto's Analysis."[38] This memo compared information provided by Mr. Pinto to the Commission on March 16, 2010, against confidential data provided by the Federal Reserve and not otherwise available to the public or AEI.

Several days later, on August 14, 2010, Commissioner Wallison sent an e-mail announcing to Commissioners and various staff that he had provided a copy of this confidential staff memo to Mr. Pinto.[39]

After receiving this information, Chairman Angelides forwarded the e-mail to Gary Cohen, the Commission's General Counsel. Chairman Angelides wrote that he was "very concerned that the dissemination of this non-public staff report violates the FCIC's ethics guidelines for commissioners as well as our agreement with the Federal Reserve." He asked the General Counsel for his legal opinion on the matter.[40] In response, the General Counsel wrote:

> The confidential Commission staff memorandum and the information obtained therein (part of which was obtained from the Federal Reserve under both written and oral confidentiality understanding), clearly constitute Commission Confidential Information and, as such, may not be disclosed by a Commissioner outside of the Commission without prior consent as above.
>
> Sharing this information with Mr. Pinto was a violation of the Commission's Ethics Guidelines, and our written confidentiality agreement with the Federal Reserve, and our staff's understanding with staff members of the Federal Reserve.
>
> Our agreement with the Fed provides for a Commission vote or approval of the Chair and Vice Chair, after prior consultation with the Fed, to release their information. That was not done here. ...
>
> Disclosure of Commission Confidential information will gravely impair the Commission's ability to conduct its business in the future by making it hard to secure the cooperation of other information providers in accessing their confidential information, and could expose the Commission to damage claims for the improper release thereof.[41]

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[38] *Analysis of Housing Data and Comparison with Ed Pinto's Analysis*, Memorandum from Ron Borzekowski and Wendy Edelberg to Commissioners, Financial Crisis Inquiry Commission (Aug. 9, 2010) (online at fcic-static.law.stanford.edu/cdn_media/fcic-docs/2010-08-09%20FCIC%20Staff%20Analysis%20of%20Housing%20Data%20and%20Comparison%20with%20Ed%20Pinto%20Analysis.pdf).

[39] E-mail from Peter J. Wallison to Wendy Edelberg, All Commissioners, et al. (Aug.14, 2010 11:11 AM).

[40] E-mail from Phil Angelides to Gary Cohen (Aug. 14, 2010 1:25).

[41] E-mail from Gary Cohen to Phil Angelides (Aug. 14, 2010 7:13 PM).

On August 14, 2010, the General Counsel sent an e-mail to Mr. Pinto warning him about Commissioner Wallison's violation. He wrote:

> I understand that Commissioner Wallison gave you a confidential staff memorandum for your review and comment. ... The memorandum and the information therein are Commission Confidential Information and must not be disseminated outside of the Commission in any manner. Please respect the Commission's rules and the confidentiality restrictions under which the Commission received that information by maintaining it in confidence in all respects.[42]

On August 17, 2010, the Commission held a telephone business meeting during which Commissioners Thompson, Georgiou, Born, and Murren all expressed concerns about Commissioner Wallison's unauthorized disclosure to Mr. Pinto.[43] Chairman Angelides reminded Commissioners that they must act in accordance with Commission procedures relating to the release of confidential information.[44]

Documents obtained by the Committee indicate that this was not the only occasion on which Commissioner Wallison released confidential information. For example, on January 26, 2011, the Commission's Deputy General Counsel sent an e-mail to Commissioner Wallison stating that "the American Enterprise Institute posted a copy of your 'Dissent from the Majority Report of the Financial Crisis Inquiry Commission' on its website" and that "its posting violates the Commission resolution which is attached to this email."[45]

In addition, in May 2010, Commissioner Wallison wrote an article published in the AEI Financial Services Outlook.[46] On May 24, 2010, Vice Chairman Thomas' special assistant sent an e-mail to Alex Brill, who works at Vice Chairman Thomas' law firm, Buchanan, Ingersoll, and Rooney. He wrote:

> Peter crossed a line here that I wonder if he realizes he crossed. (I'm 75 percent sure he leaked confidential information—although it was information that nobody will dispute is true.)[47]

It is unclear from the documents obtained by the Committee whether this incident was reported to the Commission's General Counsel for further investigation.

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[42] E-mail from Gary Cohen to Edward Pinto (Aug. 14, 2010 2:43 PM).

[43] Approved Meeting Minutes of Telephonic Business Meeting of August 17, 2010, Financial Crisis Inquiry Commission (Aug. 17, 2010).

[44] *Id.*

[45] E-mail from Deputy General Counsel to Peter Wallison (Jan. 26, 2011).

[46] *Ideas Have Consequences: The Importance of a Narrative*, AEI Outlook Series, American Enterprise Institute (May 2010) (online at www.aei.org/outlook/100960).

[47] E-mail from Special Assistant to the Vice Chairman to Alex Brill (May 24, 2010).

**B. Other Republicans Called Wallison a "Parrot" for Pinto**

Internal Commission documents obtained by the Committee indicate that staff for Republican Vice Chairman Bill Thomas worried that Commissioner Wallison was unduly influenced by AEI Resident Fellow Edward Pinto's discredited theory that the primary cause of the economic crisis related to government housing policy.

On March 31, 2010, Vice Chairman Thomas' special assistant at the Commission sent an e-mail to Mr. Brill, who works at Vice Chairman Thomas' law firm. In the e-mail, the Vice Chairman's special assistant explained problems Commissioners and staff were having with Commissioner Wallison. He wrote:

> Bill spoke to Phil [Angelides] and Wendy [Edelberg, Executive Director] and gave them his thoughts. Doug [Holtz-Eakin, Commissioner] was around the office today, so Bill looped him in and I explained to Doug what was going on. Doug said that he has some experience dealing with an intractable Peter before. Everyone agrees that there is simply no way to make Peter happy re: these staff reports. However, hopefully, we can keep him engaged enough so that when the time comes, we can sit down and have a reasonable conversation about the most effective way to describe the mortgage market. Wendy is going to reach out to Ed Pinto, and, hopefully, if we can get Ed to sign on, then Peter will really be sitting alone on this one.
>
> My guess is that the best we are going to do is to get Peter to agree that he really can't say anything until we get all of the data in front of us and that the data is coming. At that point, this debate over what kinds of mortgages are out there will be a little more public, since the FHFA is coming out with a report that discusses the loan performance of their loans in the next two weeks (apparently, they are trying to beat us to the punch). And, this conversation really doesn't need to happen until September, so we can all cool off from these hysterics and worry about other things for a little while. Then, Peter is going to have to sit in a room and tell everyone why his way is the best way to describe the universe.[48]

In response, Mr. Brill wrote back:

> Re: peter, it seems that if you get pinto on your side, peter can't complain. But is peter thinking idependently [sic] or is he just a parrot for pinto?[49]

The Vice Chairman's special assistant responded:

> I can't tell re: who is the leader and who is the follower. If Peter is really a parrot for Pinto, he's putting a lot of faith in the guy. Pinto called tonight, and Wendy scheduled a

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[48] E-mail from Special Assistant to the Vice Chairman to Alex Brill (Mar. 31, 2010 4:28 PM).

[49] E-mail from Alex Brill to Special Assistant to the Vice Chairman (Mar. 31, 2010 6:48 PM).

> call with him for tomorrow morning. I am going to sit in on the call (quietly). I want to get a sense of whether this is a strategy that we really can use, or whether Pinto is just like Peter.[50]

Two days later, Mr. Brill followed up with another e-mail to the Vice Chairman's special assistant relaying a conversation in which Vice Chairman Thomas expressed concern that Mr. Pinto might be receiving outside funds for his efforts to influence the Commission. Mr. Brill wrote:

> Maybe this email is reaching you too late but I think wmt [William M. Thomas] is going to push to find out if pinto is being paid by anyone.[51]

### C. <u>Wallison Inaccurately Claimed Commission Ignored AEI Position</u>

Despite repeated claims by Commissioner Wallison that the Commission failed to consider AEI's position, as represented by Mr. Pinto, that the economic crisis was caused by government housing policies, internal documents obtained by the Committee demonstrate that the Commission went above and beyond in fully considering the flawed AEI position.

In testimony before the Committee on Financial Services on February 16, 2011, Commissioner Wallison stated that the Commission ignored Mr. Pinto's position:

> Any objective investigation of the causes of the financial crisis would have looked carefully at this research, exposed it to the members of the Commission, taken Pinto's testimony, and tested the accuracy of Pinto's research. But the Commission took none of these steps. Pinto's research was never made available to the other members of the FCIC, or even to the commissioners who were members of the subcommittee charged with considering the role of housing policy in the financial crisis.
>
> Accordingly, the Commission majority's report ignores hypotheses about the causes of the financial crisis that any objective investigation would have considered, while focusing solely on theories that confirm one political narrative about the financial crisis. This is not the way a serious and objective inquiry should have been carried out, but that is how the Commission used its resources and its mandate.[52]

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[50] E-mail from Special Assistant to the Vice Chairman to Alex Brill (Mar. 31, 2010 7:12 PM).

[51] E-mail from Alex Brill to Special Assistant to the Vice Chairman (Apr. 2, 2010).

[52] House Committee on Financial Services, Testimony of Peter J. Wallison, *The Final Report of the Financial Crisis Inquiry Commission* (Feb. 16, 2011) (online at financialservices.house.gov/media/pdf/021611wallison.pdf).

Commissioner Wallison made the identical complaint in his dissent to the Commission's final report.[53]

Internal Commission documents obtained by the Committee contradict this claim. Commission staff conducted a recorded interview of Mr. Pinto on July 19, 2010.[54] On August 9, 2010, the Commission's Executive Director, Wendy Edelberg, sent an e-mail to all Commissioners regarding Mr. Pinto's work. In addition to referencing previous materials that had been circulated to Commissioners, Ms. Edelberg attached a new memo prepared by Commission staff analyzing Mr. Pinto's work. She wrote:

> Commissioners: Our July 7, 2010 memo to Commissioners with the subject "Analysis of housing data," provided a summary of the performance of various segments of the mortgage market during the crisis. Following up on this previous memo, the attached memo presents additional analysis that more directly compares our results to the analysis provided to the commission by Mr. Ed Pinto in his "Triggers" memo.[55]

Commission staff also prepared a summary of all of the work they conducted analyzing Mr. Pinto's work in response to Commissioner Wallison's requests. The summary states:

> The Commission did look carefully at Ed Pinto's research, took Pinto's testimony and tested the accuracy of his research. On March 16, 2010 Commissioner Wallison emailed Ed Pinto's "Trigger" memos to all commissioners. FCIC staff spent a great deal of time looking at Ed Pinto's work. The FCIC allocated approximately 12 hours of staff interviews and meetings with Mr. Pinto, and spent approximately 20 hours reviewing Mr. Pinto's documents and data. Specifically Wendy Edelberg met with Ed Pinto once for several hours (in December 2009) and had at least 2 extensive phone calls with him (one in April and another in August). [Two Commission staff] met with Ed Pinto early on and reviewed all of his materials with him. This meeting was 3-4 hours (on 2/2/10). [A third staff member] spent 3.5-4 hours with Ed Pinto and [a fourth staff member] for review of Pinto's materials. [The third staff member] also participated in another meeting wherein Ed and Commissioner Wallison came to FCIC offices. And the staff formally interviewed him on July 19, 2010 for more than an hour. ...
>
> [The first staff member] spent 20+ hours going through his document and came to the conclusion that Pinto's data didn't correctly add up. Aside from some arithmetic errors, it became apparent that the analysis was likely based on faulty premises. He then focused on two tasks. First, using tabulated data provided by the Federal Reserve (other sources

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[53] Financial Crisis Inquiry Commission, *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States – Dissenting Statement of Commissioner Peter J. Wallison* (Jan. 2011) (online at http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_wallison_dissent.pdf).

[54] Financial Crisis Inquiry Commission, Staff Audiotape of Interview with Ed Pinto, Fannie Mae (July 19, 2010) (online at fcic.law.stanford.edu/interviews/view/378).

[55] E-mail from Wendy Edelberg to All Commissioners and Personal Staff (Aug. 9, 2010).

were also pursued), he analyzed the relevant performance of the varied loans Pinto lumps together in his analysis. The results of this work are in the housing PSR, two memos to the Commission and in the book.

He then began creating and gathering an extensive set of loan-level data to further examine the question of how many high-risk loans there were before the crisis, as measured by ex-ante risk. He interviewed several prominent mortgage economists for advice regarding the best data and methodology to use and began discussions with FHFA, FHA, private data vendors and others in an effort to gather the data. Special computer resources were being built in-house when this latter effort was halted after being deemed infeasible, and after the determination was made that the initial analyzes were sufficient to analyze Pinto's main claim.[56]

### D. All Other Republican Commissioners Rejected AEI Position

After praising Commission staff for fully considering the position put forth by Mr. Pinto, the three other Republican Commissioners rejected this position and refused to join Commissioner Wallison's dissent, which asserted that the primary cause of the economic crisis was government housing policies.

For example, on August 15, 2010, Republican Commissioner Holtz-Eakin sent an e-mail to Vice Chairman Thomas criticizing Commissioner Wallison and commending Commission staff for their work on this issue. He wrote:

> I continue to think that Peter overplays the mortgage issue, but the staff memo did not dismiss it in any way.[57]

In their separate statement, Commissioners Thomas, Hennessey, and Holtz-Eakin rejected the idea that government housing policy—or any one factor—was the single largest contributor to the economic crisis. They wrote:

> During the course of the Commission's hearings and investigations, we heard frequent arguments that there was a single cause of the crisis. For some it was international capital flows or monetary policy; for others, housing policy; and for still others, it was insufficient regulation of an ambiguously defined shadow banking sector, or unregulated over-the-counter derivatives, or the greed of those in the financial sector and the political influence they had in Washington.
>
> In each case, these arguments, when used as single-cause explanations, are too simplistic because they are incomplete. While some of these factors were essential contributors to the crisis, each is insufficient as a standalone explanation.[58]

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[56] Memorandum, Commission Staff (Jan. 23, 2011).

[57] E-mail from Douglas Holtz-Eakin to Bill Thomas (Aug. 15, 2010).

[58] Financial Crisis Inquiry Commission, *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States – Dissenting Statement of*

Instead, they described not one, but "ten causes, global and domestic ... essential to explaining the financial and economic crisis." They were:

(1) the credit bubble;
(2) the housing bubble;
(3) nontraditional mortgages;
(4) credit ratings and securitizations;
(5) financial institutions concentrated correlated risk;
(6) leverage and liquidity risk;
(7) risk of contagion;
(8) common shock;
(9) financial shock and panic; and
(10) financial crisis causes economic crisis.[59]

In addition, the three Republican Commissioners commended the Commission staff for their professionalism. They wrote:

> We wish to compliment the Commission staff for their investigative work. In many ways it helped shape our thinking and conclusions.[60]

Similarly, the other Commissioners also rejected Commissioner Wallison's argument that the Commission did not fully evaluate the role of the Community Reinvestment Act (CRA) in the economic crisis. Commissioner Wallison's dissent blamed the CRA for significantly driving the growth of non-traditional mortgages and the decline in underwriting standards.[61] After examining the CRA in detail, the Commission's final report concluded that "CRA-related subprime loans appeared to perform better than other subprime loans" and "CRA-covered loans in the low- and moderate-income areas they serve were half as likely to default as similar loans by independent mortgage companies."[62]

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*Commissioner Keith Hennessy, Commissioner Douglas Holtz-Eakin, and Vice Chairman Bill Thomas* (Jan. 2011) (online at http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_hennessey_holtz-eakin_thomas_dissent.pdf).

[59] *Id.*

[60] *Id.*

[61] Financial Crisis Inquiry Commission, *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States – Dissenting Statement of Commissioner Peter J. Wallison* (Jan. 2011) (online at http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_wallison_dissent.pdf).

[62] Financial Crisis Inquiry Commission, *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (Jan. 2011).

Commissioners Thomas, Hennessey, and Holtz-Eakin also rejected Commissioner Wallison's assertion that the CRA was a significant cause of the financial crisis. Their joint dissent stated:

> Neither the Community Reinvestment Act nor removal of the Glass-Steagall firewall was a significant cause. The crisis can be explained without resorting to these factors.[63]

Despite the fact that the other Republican Commissioners were satisfied that Mr. Pinto's views were thoroughly considered, Commissioner Wallison repeatedly expressed anger that the AEI position was being rejected based on its faulty data and assumptions.

For example, on May 13, 2010, Chairman Angelides sent an e-mail to Commissioner Wallison explaining that the Commission staff had fully considered Mr. Pinto's position, but that it was fundamentally flawed. He wrote:

> With respect to Mr. Pinto, the staff has indicated to me that they have conveyed to both Mr. Pinto and you their view that his approach is flawed. ... For what I have seen, the staff has spent more time responding to your questions and requests for information than any other Commissioner.[64]

Rather than accepting the conclusion that Mr. Pinto's data and assumptions were flawed, Commissioner Wallison continued to complain that Commission staff were ignoring him. On July 26, 2010, Commissioner Wallison and several other Commissioners held a working group conference call. After the call, Commissioner Wallison sent an e-mail to all Commissioners, the Commission's Executive Director and General Counsel, and other Commission staff. He wrote:

> I don't like being told that I disagree with everything. I believe that I disagree with the things that are wrong and my point of view is valid and entitled to be heard. In this message, I'm going to explain why I raised the questions I did, and why I will continue to raise these questions. You should know that I have no compunction about filing a separate statement if I am not persuaded by data, by facts that have been tested and are not subject to dispute. Many of the statements I heard and read today are part of conventional wisdom; that in itself does not recommend them to me. I heard that we should accept the point of view of "experts" as evidence, as in a trial. As we all should know, in a trial each side can select its experts. All the experts I have ever suggested for

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[63] Financial Crisis Inquiry Commission, *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States – Dissenting Statement of Commissioner Keith Hennessy, Commissioner Douglas Holtz-Eakin, and Vice Chairman Bill Thomas* (Jan. 2011) (online at http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_hennessey_holtz-eakin_thomas_dissent.pdf).

[64] *Id.*

the Commission's hearings have been rejected or ignored. There is a price to pay for that.[65]

## III. QUESTIONS ABOUT VICE CHAIRMAN THOMAS AND THE CEO OF A POLITICAL CONSULTING FIRM

Internal Commission documents obtained by the Committee raise questions about the extent to which Vice Chairman Thomas and his Commission staff were providing information to, and receiving information from, a CEO of a political consulting firm who is also employed by the Vice Chairman's law firm.

Alex Brill is the CEO of Matrix Global Advisors, a firm that provides "economic and political consulting services for clients seeking to effect change in Washington." The firm advertises that it "works with clients spanning a variety of industries and has advised both small firms and large corporations," including a "Wall Street investment bank seeking insights into tax policy [and] financial services legislation."[66]

Mr. Brill is also an Economic Policy Advisor at the law firm of Buchanan, Ingersoll, and Rooney in Washington, DC. His biography states that he is "a consulting advisor to Buchanan Ingersoll & Rooney's Federal Government Relations Section," where Vice Chairman Thomas is a Senior Advisor. In this role, Mr. Brill "provides clients with economic and legislative insight" into matters including "financial markets and policies affecting capital investment." His biography does not disclose the firm's clients.[67]

Mr. Brill's biography states that he previously "served as senior advisor to former chairman of the House Ways and Means Committee Bill Thomas," and that he was "Congressman Thomas' top policy and political advisor." His biography states that he "is also a research fellow at the public policy think tank American Enterprise Institute."[68]

The law firm aggressively markets both Vice Chairman Thomas and Mr. Brill to obtain clients. Its website states:

> Our team includes many professionals who have served in high-level government positions, including a former chair of the Committee on Ways and Means of the United States House of Representatives, the former chief economist and senior advisor to the former chair of the House Committee on Ways and Means.

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[65] E-mail from Peter Wallison to Wendy Edelberg, Derivatives Commissioners, et al. (July 26, 2010 8:33 PM).

[66] Matrix Global Advisors, *Our Clients* (accessed July 8, 2010) (online at www.matrixglobaladvisors.com/our-clients/).

[67] Buchanan, Ingersoll, and Rooney, *Biography of Alex M. Brill* (accessed July 8, 2011) (online at www.bipc.com/alex-m-brill/).

[68] *Id.*

The firm's website also states:

> In 2010, *Influence Magazine* ranked us as the 15th largest law firm for lobbying revenue and 21st among all law firms and lobbying firms. **Our bi-partisan team of government affairs professionals has the attention—and the ear—of the federal government, and we use this influence to advance causes and cases for clients all over the nation.**[69]

The Ethics Guidelines for Commission Staff state that the internal workings of the Commission may not be disclosed to individuals outside the Commission. The Guidelines state:

> All information concerning the internal non-public workings of the Commission, confidential information obtained by the Commission during the course of its investigations, and confidential non-public work product of the Commission, shall be maintained as "Commission Confidential Information," and shall be held in confidence and not disclosed outside of the Commission.[70]

In addition, Commission staff signed Confidentiality and Non-Disclosure Agreements establishing procedures to maintain the confidentiality of the deliberative processes and materials the Commission received.[71]

Committee staff have identified no record of Mr. Brill being an official employee, consultant, contractor, or adviser to the Commission. Although some Commissioners utilized non-Commission staff for scheduling, appointments, and other administrative functions, the documents obtained by the Committee indicate that, by virtue of his relationship with Vice Chairman Thomas, Mr. Brill received a significant amount of internal information about the Committee's work and provided substantive input.

For example, on August 17, 2010, Vice Chairman Thomas' special assistant at the Commission sent an e-mail to Mr. Brill with a draft outline of a preliminary investigative report prepared by Commission staff that addressed Wells Fargo's acquisition of Wachovia. Mr. Brill replied to the e-mail with comments on the outline. He wrote:

> III. Wells Fargo Acquired Wachovia Without "Government Assistance" After Change in the Tax Code
>
> that's humor, right? The "govt asst" IS the tax code change. And the word "code" refers to the statute—something that can only be changed by Congress, not Treasury. Maybe it is just staff shorthand but I hope III gets filled out a lot.[72]

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[69] Buchanan, Ingersoll, and Rooney, *Federal Government Relations* (accessed July 8, 2011) (online at www.bipc.com/federalgovernmentrelations/) (emphasis in original).

[70] Financial Crisis Inquiry Commission, Ethics Guidelines for Staff (online at fcic.law.stanford.edu/about/policies/staff-ethics)

[71] Financial Crisis Inquiry Commission, Confidentiality and Nondisclosure Agreement (online at http://fcic.law.stanford.edu/about/policies/staff-confidentiality-agreement)

Mr. Brill went on to suggest that Vice Chairman Thomas' special assistant monitor this issue:

> I'd suggest you stay on top of this one still. I'm tired of tarp this, tarp that. I haver [sic] no idea how to value this regulatory tax gift but it could be significant and somewhat off the radar. Its the only tax thing so it is the only thing where wmt [Vice Chairman Bill Thomas] can say he's got a value-add perspective. And, from the outline you shared, I wonder if this was done because Bair wasn't enthusiastic about doing something herself.[73]

During this e-mail exchange, the Vice Chairman's special assistant also described conversations among Commissioners and staff about deliberations regarding potential witnesses for an upcoming hearing. He wrote to Mr. Brill:

> We also had a big conversation yesterday about witnesses. We left it at (big surprise) that the staff recommendations would be fine. Bill expressed a general interest in not having CEOs. But, all of the big-wigs (Kovacevich, Steel, Fuld, et. al.) are very much on the table. I think that our research director really wants Jamie Dimon there because he thinks that Dimon knows more about the markets than anyone else. But, Bill and Phil were in agreement that their preference was not to call Dimon for a second time.[74]

In another incident, on March 10, 2010, the Vice Chairman's special assistant forwarded to Mr. Brill a Commission media advisory about an upcoming hearing that had not yet been released publicly. He also forwarded an internal Commission e-mail discussing a *Wall Street Journal* article that exposed information about the upcoming hearing that was leaked.[75]

In response, Mr. Brill wrote:

> What's your guess on the source of this info to wsj? The witnesses or the commissioners? Probably both. The release seems like a good idea as it defines the hearing more accurately than a story saying it is greenspan/citi/fannie when it actually has other regulators as well.[76]

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[72] E-mail from Alex Brill to Special Assistant to the Vice Chairman (Aug. 18, 2010 7:55 AM).

[73] E-mail from Alex Brill to Special Assistant to the Vice Chairman (Aug. 18, 2010 9:47 AM). *See also Wells Fargo Sweetened Wachovia Bid for Tax Gain, Bair Told FCIC,* Bloomberg (Jan. 26, 2011) (online at www.businessweek.com/news/2011-01-26/wells-fargo-sweetened-wachovia-bid-for-tax-gain-bair-told-fcic.html).

[74] E-mail from Special Assistant to the Vice Chairman to Alex Brill (Aug. 18, 2010 8:16).

[75] Financial Crisis Inquiry Commission, *Media Advisory: Financial Crisis Inquiry Commission Announces Next Public Hearing* (Mar. 11, 2010) (online at fcic-static.law.stanford.edu/cdn_media/fcic-news/2010-0311-Advisory.pdf).

[76] E-mail from Alex Brill to Special Assistant to the Vice Chairman (Mar. 10, 2010 5:07 PM).

During this exchange, Mr. Brill sought information regarding the Commission's plans to investigate foreign banks. Mr. Brill wrote:

> Also—you don't need to answer this if you don't want if its confidential but are you guys asking hard questions to foreign banks too? Are they a good control group maybe or perhaps they are just as responsible for being stupid as the domestic banks. I have no idea but I assume that DB, UBS, that weird french bank, bbva, etc are also worth studying. Did Iceland collapse completely in some manner? Would probably be popular with commissioners too. Just a suggestion.[77]

In response, the Vice Chairman's special assistant confirmed internal Commission plans to investigate foreign banks and listed several targets by name. He wrote:

> We are going to be questioning foreign banks. I know that we have people from Deutche, UBS, BNP Paribas, RBS and Lazard Freres on our list for various purposes. However, we don't have the stick (subpoena power) with them. So, we can't push too hard.[78]

In another incident, on March 31, 2010, Mr. Brill sent an e-mail to the Vice Chairman's special assistant seeking internal Commission information about an upcoming hearing with Citigroup. He wrote:

> Fyi, just heard from my friend who represents Citi. I guess Citi feels afraid that they will be painted as one of the worst offenders of subprime when really they think that they only dabbled in subprime. I don't know the truth in any of this but I guess the titles of the panels make this look like citi is the subprime devil while WMT was explaining to me that Citi is a great target to study because the did a bit of everything and that is more true for Citi than for anyone else. Any thoughts?[79]

The Vice Chairman's special assistant replied to Mr. Brill by providing an assessment of how the Commission would treat Citigroup at the hearing. He wrote:

> They aren't going to be painted as a particularly bad offender of subprime origination, because they weren't a bad offender in that area. However, they ended up taking \$55B in losses associated with subprime and then got \$45B in TARP and a government guarantee on \$300B of assets. And their risk management re: their subprime exposure was, by any account, pretty awful. And, it is true that they are a good example because they did a little of everything, which means that we can discuss the entire subprime-universe during

[77] E-mail from Alex Brill to Special Assistant to the Vice Chairman (Mar. 10, 2010 9:43 PM).

[78] E-mail from Alex Brill to Special Assistant to the Vice Chairman (Mar. 11, 2010 7:11 PM).

[79] E-mail from Alex Brill to Special Assistant to the Vice Chairman (Mar. 31, 2010 5:18 PM).

their hearing. So, while I don't think they will come across as the person who was ripping off the American public, I think they may come across as a pretty poorly managed company.[80]

The documents produced to the Committee do not indicate whether Mr. Brill conveyed this information to Citigroup officials. Similarly, the documents do not indicate whether any of Mr. Brill's business interests at his company or the law firm benefitted from any of the other internal Commission information he obtained.

## IV. UNSUBSTANTIATED ALLEGATIONS BY CHAIRMAN ISSA

Internal Commission documents obtained by the Committee indicate that allegations made by Chairman Issa about problems within the Commission are largely unsubstantiated, overtly partisan, and unjustified by the record before the Committee.

### A. Financial Mismanagement

In his July 27, 2010, letter, Chairman Issa alleged that "potential financial mismanagement" caused the Commission to seek a budget increase from $8 million to $9.8 million. Chairman Issa stated:

> It is unclear how the FCIC has run out of money so quickly. ... [A]ccording to the FCIC's records, it had spent just $1.4 million on staff salaries as of March 31, 2010, a fraction of its $8 million budget. Furthermore, at least twelve FCIC staff members are on loan from other federal agencies, meaning their salaries are paid not by the FCIC but by their parent agencies. In light of these facts, the American people have a right to know how the FCIC has exhausted its $8 million budget and why it deserves another $1.8 million of taxpayer funds.[81]

Chairman Issa's allegations reflect a misunderstanding of the Commission's budget process. Internal Commission documents obtained by the Committee indicate that the Commission had not "run out of money" at this time, but had determined months earlier, based on investigative planning, and on a bipartisan basis, that the budget increase was necessary to enable it to fulfill its mission.

The Commission was established in May 2009 when Congress passed the Fraud Enforcement and Recovery Act.[82] The Act authorized "such sums as are necessary" for the

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[80] E-mail from Special Assistant to the Vice Chairman to Alex Brill (Mar. 31, 2010 4:28 PM).

[81] Letter from Member Darrell E. Issa to Phil Angelides (July 27, 2010).

[82] P.L. 111-21.

Commission's operations.[83] The Commission received an initial appropriation of $8 million in the Supplemental Appropriations Act of 2009 enacted June 24, 2009.[84]

After the first few months of hiring and investigative planning, the Commission unanimously determined that the initial $8 million appropriation would not be sufficient for its planned activities for the following year. On November 17, 2009, the Commission held a closed meeting during which the Commissioners determined on a bipartisan basis that additional funds would be necessary and charged Republican Vice Chairman Bill Thomas with making the request to Congress. The approved minutes from the closed session stated:

> There was general consensus that the Commission's appropriation of $8 million dollars would not suffice to accomplish the work of the Commission in the manner desired and that an additional allocation should be sought. Vice-Chairman Thomas will take the lead with Congress on this matter.[85]

To implement this plan, Chairman Angelides and Vice Chairman Thomas sent a joint letter the following month, on December 10, 2009, to Senators Kent Conrad and Johnny Isakson, requesting the additional funds. They wrote:

> As Chairman and Vice Chairman of the Financial Crisis Inquiry Commission (the Commission), this letter will serve as a request that based upon our budget analysis, the Commission believes, to be reasonably successful in our statutory charge that the $8 million initial funding level should be increased to $11 million. This request is made in the full knowledge of the difficult budgetary conditions in which we find ourselves. We believe this request is sufficient to fulfill our duties. This letter will be the only request for additional funds during the existence of the Commission.[86]

The documents indicate that Vice Chairman Thomas was fully supportive of this request, based on the investigative planning that had occurred to date. On March 25, 2010, Vice Chairman Thomas' special assistant on the Commission sent an e-mail to Vice Chairman Thomas noting that the requested increase would actually be lower than the original estimate. He wrote:

> Attached is the budget memorandum. ... Included is our estimated additional budget required. Note that we've requested $2.66 million (down from $3), because we don't

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[83] *Id.*

[84] P.L. 111-32.

[85] Approved Minutes of Closed Session Meeting of Tuesday, Nov. 17, 2009, Financial Crisis Inquiry Commission (Nov. 17, 2009).

[86] Letter from Phil Angelides and Bill Thomas to Senators Kent Conrad and Johnny Isakson (Dec. 10, 2009). *See also* Letter from Phil Angelides and Bill Thomas to House Appropriations Committee Chairman David Obey and Ranking Member Jerry Lewis (Dec. 11, 2009).

believe that we need the additional funding beyond what we have outlined in the memo. Can you take a look and approve for sending?[87]

In response, Vice Chairman Thomas replied, "It is ok by me."[88]

The final increase to the Commission's budget was less than the estimate in March. On July 29, 2010, Congress appropriated an additional $1.8 million in the Supplemental Appropriations Act of 2010.[89] There is no indication that the request for additional funds was a result of mismanagement, as Chairman Issa alleged.

### B. Conflicts of Interest and Partisan Staff

In his July 27, 2010 letter, Chairman Issa alleged that various Democratic Commissioners and staff had conflicts of interest that compromised their ability to work on the Commission. He also alleged that staff who previously worked for Democrats would be incapable of working on the Commission in an objective way. He stated:

> In addition to potential financial mismanagement, it appears that commissioners and staff of the FCIC may have conflicts of interest created by their previous roles in the public and private sectors which may interfere with the Commission's ability to conduct a thorough and even-handed investigation. ...
>
> I am troubled by the extensive ties of some of the senior staff at a putatively bipartisan commission to partisan Democrat politics. ... [T]he FCIC's efforts will have been wasted if the American people come to believe that it has served as nothing more than a cheering section for the Administration and congressional Democrats in their efforts to defend a partisan and ineffective financial regulatory reform bill.[90]

Chairman Issa's letter focused its accusations on only one Commissioner, Democrat Byron Georgiou, who is currently running for U.S. Senate. In addition, Mr. Georgiou previously ran for the congressional seat in Chairman Issa's district. According to the *Las Vegas Sun*, Mr. Georgiou made multiple congressional "runs in California in the early 1990s, including one for the 49th District, the seat now held by Darrell Issa."[91]

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[87] E-mail from Special Assistant to the Vice Chairman to Bill Thomas (Mar. 25, 2010, 3:07 PM).

[88] E-mail from Bill Thomas to Special Assistant to the Vice Chairman (Mar. 25, 2010, 4:08 PM).

[89] P.L. 111-212.

[90] Letter from Darrell E. Issa to Phil Angedlides (July 27, 2011).

[91] *Who is Byron Georgiou and Why Should He Scare the Democratic Establishment?*, Las Vegas Sun (Mar. 28, 2011) (online at www.lasvegassun.com/blogs/ralstons-flash/2011/mar/28/who-byron-georgiou-and-why-he-should-scare-democra/).

With respect to the Commission staff targeted by Chairman Issa, internal Commission documents obtained by the Committee indicate that staffing decisions were made with the approval of both the Democratic Chairman, Phil Angelides, and the Republican Vice Chairman, Bill Thomas, and the staff was not separated by party lines. According to the Commission's Rules of Procedure, approved and ratified by the Commission on September 16, 2009:

> All staff shall be appointed and terminated by the Chairman and Vice Chairman, acting jointly.[92]

The only exceptions to this policy were the special assistants to the Chairman and Vice Chairman.

During a transcribed interview with Committee staff, Executive Director Wendy Edelberg explained that the Commission had a unified staff. When asked whether staff were organized on a partisan basis, she replied: "Oh, no, there was no structuring along party lines. We were structured by tasks."[93]

In addition, the Commission implemented several policies on a bipartisan basis to prevent potential conflicts of interest. For example, the Commission adopted an ethics policy for Commissioners and staff that provided guidance regarding avoiding conflicts of interest.[94] The Commission also walled-off staff from investigations when there was an appearance of a conflict. The documents obtained by the Committee included instances of voluntary staff recusals, as well as instances in which the General Counsel, as Chief Ethics Officer, provided advice regarding ethical issues.

For example, the former Assistant Director and Deputy General Counsel for the Commission disclosed potential conflicts of interest and withdrew himself from certain Commission matters.[95]

Similarly, on March 23, 2010, Chairman Angelides sent an e-mail seeking an ethics opinion from the Commission's General Counsel concerning political contributions made to his campaign for Treasurer in 2002 by an officer of JPMorgan Chase. The General Counsel concluded that these actions "do not create a conflict or require that you take any action to recuse yourself from Commission deliberations concerning J.P. Morgan Chase."[96]

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[92] Financial Crisis Inquiry Commission, Rules of Procedure (Sept. 16, 2009).

[93] House Committee on Oversight and Government Reform, Transcribed Interview of Wendy Edelberg, at 117 (June 9, 2011).

[94] In addition to the ethics policy, the Commission had a records management policy, employee handbook, and a confidentiality and nondisclosure policy. All employees, detailees, and consultants were required to sign a Confidentiality and Nondisclosure Agreement.

[95] E-mail from Assistant Director and Deputy General Counsel to Gary Cohen (July 16, 2010).

[96] E-mail from Gary Cohen to Phil Angelides (Mar. 23, 2010).

In another example, the General Counsel provided ethics advice concerning Commissioners and staff staying at the MGM Grand in connection with a Commission field hearing in Las Vegas, Nevada, finding no conflict with the Commission being charged a government rate or with the Commissioners receiving fruit baskets upon their arrival.[97]

Chairman Issa's letter focused exclusively on Democratic Commissioners and staff, providing no analysis of the potential conflicts or partisanship among Republican Commissioners or staff. For example, Chairman Issa failed to mention that Vice Chairman Thomas works at the law firm of Buchanan, Ingersoll, and Rooney, which markets the Vice Chairman's ties to corporate clients and boasts that the firm's lobbyists "use this influence to advance causes and cases for clients all over the nation." Chairman Issa's letter also failed to provide any analysis of the potential influence of the conservative American Enterprise Institute among Republican Commissioners and staff. Vice Chairman Bill Thomas, Commissioner Peter Wallison, Commissioner Douglas Holtz-Eakin, and Vice Chairman Thomas' special assistant were all connected to AEI. (See Section II, above).

### C. <u>Decision to Delay Report</u>

On January 25, 2011, Chairman Issa sent a letter to Chairman Angelides alleging that the Commission's decision to issue its report on January 27, 2011, instead of December 15, 2010, was a result of "continued management problems." He wrote:

> [O]n November 17, 2010, the FCIC voted to extend its mandatory reporting deadline of December 15, 2010. It is unclear on what legal authority this action was taken since the law states that the FCIC was to report to Congress no later than December 15 and does not provide for any procedure to grant an extension. The inability of the FCIC to report to Congress by its statutory deadline points to continued mismanagement problems.[98]

Chairman Issa's letter failed to note that short delays of this kind are typical and have occurred numerous times in the past on similar commissions, including those led by both Republicans and Democrats. For example, in 1999, then-Rep. Bill Thomas co-chaired the National Bipartisan Commission on the Future of Medicare. Although the Commission's report was due on March 1, 1999, it was not submitted until March 16, 1999.[99]

Other examples include the following:

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[97] E-mail from Gary Cohen to Phil Angelides (Sept. 7, 2010).

[98] Financial Crisis Inquiry Commission, *Financial Crisis Inquiry Commission Announces New Date for Final Report* (Nov. 17, 2010).

[99] Press Release, National Bipartisan Commission on the Future of Medicare, *National Medicare Commission to Continue Working to Make Recommendations; Panel Will Meet During the Week of March 8 in Washington, D.C.* (Feb. 26, 1999).

- A report by the Commission on Wartime Contracting in Iraq and Afghanistan was due on March 1, 2009, but was not submitted until June 10, 2009.[100]

- A report by the Congressional Commission on the Strategic Posture of the United States was due on December 1, 2008, but was not submitted until May 6, 2009.[101]

- A report by the Commission on the Prevention of Weapons of Mass Destruction Proliferation and Terrorism was due on November 12, 2008, but was not submitted until December 3, 2008.[102]

- A report by the Commission on Military Training and Gender-Related Issues was due on September 16, 1998, but was not submitted until July 30, 1999.[103]

- A report by the Commission on Affordable Housing and Health Facility Needs for Seniors in the 21st Century was due on December 31, 2001, but was not submitted until June 30, 2002.[104]

- A report by the Commission to Assess the Organization of the Federal Government to Combat the Proliferation of Weapons of Mass Destruction was due on April 11, 1998, but was not submitted until July 14, 1999.[105]

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[100] P.L. 110-181. *See* Commission on Wartime Contracting in Iraq and Afghanistan, *At What Cost? Contingency in Iraq and Afghanistan* (June 10, 2009) (online at www.wartimecontracting.gov/index.php/reports).

[101] P.L. 110-181. P.L. 110-417, section 1060. *See* Congressional Commission on the Strategic Posture of the United States, *America's Strategic Posture* (May 6, 2009) (online at www.usip.org/programs/initiatives/congressional-commission-the-strategic-posture-the-united-states).

[102] Press Release, Commission on the Prevention of Weapons of Mass Destruction Proliferation and Terrorism, *WMD Commission to Report Findings on Preventing Nuclear and Biological Terrorism Threats* (Nov. 18, 2008).

[103] P.L. 105-85. *See* Congressional Commission on Military Training and Gender-Related Issues, *Final Report Findings and Recommendations* (July 30, 1999) (online at www.dtic.mil/dtfs/doc_research/p18_16v1.pdf).

[104] P.L. 106-74. *See* Commission on Affordable Housing and Health, *A Quiet Crisis in America* (June 30, 2001) (online at govinfo.library.unt.edu/seniorscommission/pages/final_report/finalreport.pdf).

[105] P.L. 104-293. *See* Commission to Assess the Organization of the Federal Government to Combat the Proliferation of Weapons of Mass Destruction, *Combating Proliferation of Weapons of Mass Destruction* (July 14, 1999) (online at www.fas.org/spp/starwars/program/deutch/11910book.pdf).

**D. Disclosure of Confidential Information**

On June 21, 2011, Chairmen Issa and McHenry sent a letter to the Office of the Comptroller of the Currency (OCC) expressing concern that the Commission may have improperly disclosed sensitive information that the Commission obtained from OCC. They wrote:

> We are concerned that a significant amount of this information may have been made public in violation of a confidentiality agreement reached between the FCIC and the OCC. While we believe in maximizing transparency, we are concerned that the FCIC may have violated its agreement with the OCC and unduly aided the plaintiff's bar to launch lawsuits against financial firms.[106]

Chairmen Issa and McHenry requested a "summary of the OCC's concerns related to the release of confidential OCC information by the FCIC" and a "description of any challenges the OCC has encountered in performing its regulatory responsibilities as a result."[107]

On June 30, 2011, the OCC responded to the letter sent by Chairmen Issa and McHenry, confirming that "over OCC objection, the FCIC released Reports of Examination and Supervisory Letters for several large national banks" and "made public interviews with OCC officials regarding those institutions."[108]

Although Chairmen Issa and McHenry asked the OCC to provide "a description of any challenges the OCC has encountered in performing regulatory responsibilities," the OCC did not cite any specific challenges it had encountered.[109] Instead, the OCC asserted broadly that "release of this information is not only disruptive to the examination process, but could have a destabilizing effect on the banks involved, impact financial markets, trigger shareholder and other lawsuits, and set a dangerous precedent."[110]

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[106] Letter from Congressman Darrell Issa, Chairman of the Committee on Oversight and Government Reform, and Congressman Patrick McHenry, Chairman of the Subcommittee on TARP, Financial Services, and Bailouts of Public and Private Programs, to Julie L. Williams, Chief Counsel, Office of the Comptroller of the Currency (June 21, 2011).

[107] *Id.*

[108] Letter from Daniel P. Stipano, Deputy Chief Counsel, Office of the Comptroller of the Currency, to Congressman Darrell Issa, Chairman, Committee on Oversight and Government Reform (June 30, 2011).

[109] *Id.*

[110] *Id.*

***Commission Approval of Review Process***

Internal Commission documents obtained by the Committee indicate that the release of information by the Commission was proper, did not violate the confidentiality agreement, and assisted Congress and the public by revealing the significant deficiencies at Citigroup.

The Commission voted unanimously on multiple occasions to implement a detailed process for determining when to make public sensitive documents it obtained from corporations and their regulators. On November 16, 2010, the Commission's General Counsel presented a memo to the Commissioners entitled, "Considerations with Respect to the Public Release of Confidential Documents and Materials in the Report, the E-Book and Website."[111] The memo proposed a process for determining how to handle sensitive documents. It stated:

> [T]he Commission has received millions of pages of documents, conducted numerous surveys, interviewed hundreds of witnesses, held 19 days of hearings, compiled video records of testimony, and completed numerous reports. ... It is our intent to use in the Report and our e-book both public and nonpublic documents and to create on our website a resource of public and nonpublic documents relevant to the Commission's Report and inquiry, all with the purpose of meeting our statutory mandate to report to the President, Congress and the public on the causes of the financial and economic crisis.[112]

Regarding the release of sensitive materials, the General Counsel wrote:

> The decision to release publicly confidential documents is one which should be made by the full Commission, either directly or through a process of delegation. ... It is unwieldy and impractical to expect that the full Commission will review all of the Web Elements and Report Elements, so a procedure for approval should be considered. ...I recommend that the Executive Director or General Counsel determine which documents should be recommended to the Commission for a determination in accordance with its processes for inclusion in Report Elements or Web Elements. This will primarily occur in situations where the staff has received objections to disclosure and the determination to override the objections must be made.[113]

The General Counsel explained that the Commission's authority to release documents publicly was the same as that of congressional committees, including the Oversight Committee. He wrote:

> The Commission is formed under Congress, and is entitled to the benefit of Congress's authority and power to obtain information, including but not limited to proprietary

[111] Memo to Commissioners of the FCIC on "Considerations with Respect to the Public Release of Confidential Documents and Materials in the Report, the E-Book and Website," Gary J. Cohen (Nov. 16, 2010).

[112] *Id.*

[113] *Id.*

information. ...While there is no express provision of the Constitution or specific statute authorizing the conduct of congressional investigations, the Supreme Court has firmly established that such power is so essential to the legislative function as to be implied from the general vesting of legislative powers in Congress. ... As the Commission's enabling legislation manifests the clear congressional intent to establish an independent legislative branch entity with investigative powers, authorities and prerogatives equivalent to those of past and present standing and special investigatory committees, the decision to release confidential documents or materials as part of its statutory duty to report on the causes of the crisis rests in the Commission's discretionary determination that such public release will further fulfillment of its mandated statutory mission, a decision that cannot be limited by any court ruling or regulatory or statutory standard.[114]

The General Counsel also made clear that all of the confidentiality agreements between the Commission and outside entities allowed the Commission to disclose confidential information. He wrote:

> The FCIC has entered into at least 69 confidentiality agreements of various forms pursuant to which it has committed to a process concerning the Commission's use of documents and other information submitted to it. ... [A]ll allow the FCIC to disclose the confidential information it determines appropriate in any interim or final report or in connection with public hearings upon the agreement of the Chairman and the Vice Chairman or upon a majority vote of the FCIC. .. Many of the agreements specifically reference, for example, certain bank regulatory reports confidentiality provisions, trade secrets and similar items protected from disclosure by statute or regulation as examples of the types of the documents entitled to confidential treatment in accordance with the letters. But that does not override the Commission's ability to release the documents if it so determines.[115]

After reviewing the General Counsel's memo, all nine Commissioners who participated in the meeting approved the proposed process. According to the minutes of the November 17, 2010, meeting:

> Chairman Angelides and General Counsel Gary Cohen introduced Mr. Cohen's memo on suggested procedures for review and approval with respect to the public release of confidential documents and materials in the Report, the E-Book, and the Website. Discussion ensued among Commissioners on this matter. Mr. Cohen clarified that if there are unresolved matters concerning the release of confidential documents and materials that have been objected to by the submitting party and have not been resolved, these matters will come before the Commission for review and action prior to public release. It was further clarified that no confidential items can be publicly released except in accordance with Commission rules and, where there are confidentiality agreements, under the terms of those agreements. ...

[114] *Id.*

[115] *Id.*

MOTION: Born moved and Thompson seconded a motion to approve review and clearance process as outlined in Gary Cohen's memo (attached).

APPROVED: 9-0 (Commissioner Holtz-Eakin was absent.)[116]

***Commission Approval of Disclosure Process***

In preparing for the release of the Commission's report, the Commission held a meeting on January 24, 2011. During this meeting, the Commission reviewed a memo from the General Counsel entitled "Further Considerations with Respect to the Release of Confidential Documents and Materials in the Report, the E-Book, and Website."[117]

In that memo, the General Counsel wrote that "all documents referred to in the Report and the dissents have been cleared for use herein (clearance was confirmed by the Commissioners at their meeting of January 6, 2011), and on the date the Report is released the Commission's website will be populated by substantially all of the written documents referred to in the Report."[118]

The General Counsel also explained the process for "clearing and posting" additional documents, including "documents and follow-up answers to questions asked at public hearings," "audio tapes and transcripts of interviews to which objections have been raised after the objections are resolved or overruled," and "other materials relevant to our inquiry and the Report which were requested, received and reviewed or prepared by the staff during the course of our investigation."[119]

The General Counsel highlighted for Commissioners that this process "will likely result in posting a substantial number of documents ... to which objections have been raised by the document providers," including "[r]equests by various bank regulatory agencies such as the Fed, the OTS or OCC, the FDIC or the SEC that bank examination material not be released due to the chilling effect that such release would have on banks willingness to be candid in future examinations."[120] He added that, although "regulatory agencies have generally requested that bank examination reports not be released," "what these examinations revealed comprises a significant portion of the Commission's Report, and staff believes that disclosing these materials is merited."[121]

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[116] APPROVED Minutes of Telephonic Business Meeting of November 17, 2010 (Agenda Item 3 for FCIC Meeting of Dec. 15, 2010).

[117] Memo to Commissioners of the FCIC on Further Considerations with Respect to the Public Release of Confidential Documents and Materials in the Report, the E-Book and Website, Gary J. Cohen (Jan. 21, 2011).

[118] *Id.*

[119] *Id.*

[120] *Id.*

[121] *Id.*

According to minutes of the January 24, 2011, meeting, the Commissioners unanimously approved the resolution. The minutes state:

> RESOLVED, that the Commission delegates to the Executive Director, the General Counsel and Deputy General Counsel the power to review, resolve or override, on behalf of the Commission, objections made to the public release of confidential documents or interviews, on a case-by-case basis, after weighing the nature of the objections against the benefit to the report and the American public of such public release, and to approve the posting of such documents in the electronic presentations;
>
> **RESOLVED, that if the Executive Director, the General Counsel and Deputy General Counsel determine necessary or appropriate, they may seek the advice of the Chairman and Vice Chairman regarding whether to override objections made to the public release of confidential documents or interviews;**
>
> RESOLVED FURTHER, that the Commission adopts as the action of the Commission the recommendations of the Executive Director, General Counsel and Deputy General Counsel regarding the release and posting of such confidential documents, interviews or other materials, as well as public documents, for inclusion in the Commission's electronic presentations.[122]

***Information Disclosed Citigroup's Deficiencies***

The information disclosed to the public by the Commission fully supported the Commission's finding that Citigroup's management exercised deficient risk management and valuation functions.

In conjunction with its final report, the Commission released an OCC review of Citigroup's management and oversight originally issued on February 14, 2008. This review, Supervisory Letter 2008-5, presents "the results of reviews we conducted in light of the substantial financial losses realized in the third and fourth quarter of 2007" and covers two specific examinations of Citigroup, including "a review of director and management oversight and governance" and an "examination focused on the valuation and risk management practices against Citigroup Markets and Banking Group positions."[123] The review found that Citigroup's "[b]oard and senior management have not ensured an effective and independent risk management process is in place," that "management was more focused on short-term performance and profitability along with achieving top industry rankings across many major products rather than on risk or potential loss," and that "[o]ver-reliance was placed on credit

[122] Minutes of FCIC Meeting of January 24, 2011 (Agenda Item 3 for FCIC Business Meeting of Feb. 9, 2011) (emphasis in original).

[123] Office of the Comptroller of the Currency, Supervisory Letter 2008-5 Issued to Citigroup Inc. (Feb. 14, 2008) (online at http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2008-02-14_OCC_Letter_from_John_C_Lyons_to_Vikram_Pandit_Serious_Problems_at_Citibank.pdf).

rating agency ratings without considering the appropriateness of these ratings to specific products or the true risk of the underlying collateral."[124]

In addition to releasing OCC's Supervisory Letter, the Commission also released a 2007 annual inspection report of Citigroup issued by the Federal Reserve Bank of New York on April 15, 2008. This report "reflects a downgrade to fair or '3' from satisfactory at the previous inspection."[125] The report noted that a "fair" rating reflects "a combination of weaknesses in risk management and financial condition that range from fair to moderately severe."[126] The report also noted that this downgrade "reflects serious deficiencies in Board & Senior Management oversight, policies/procedures/limits, monitoring & MIS, and internal controls."[127] The report concluded:

> Because of the nature and seriousness of the overall weaknesses, it is our intention to enter into an enforcement action with the firm, whereby both Citigroup and the Federal Reserve System agree on remedial action that must promptly be taken.[128]

According to the final Commission report, Citigroup's former CEO downplayed the significance of these findings. He argued that this "was not a fundamental situation, it was not about the capital we had, not about the funding we had at that time, but with the stock price where it was ... perception becomes reality." [129]

The Commission disagreed and detailed many problems with Citigroup's management, including its risk management and valuation functions. The Commission report found that Citigroup was so highly leveraged in late 2008 that its "own calculations suggested that a drop in deposits of just 7.2% would wipe out its cash surplus."[130]

Similarly, in their dissent, Commissioners Thomas, Hennessey, and Holtz-Eakin wrote that an "essential cause of the financial and economic crisis was appallingly bad risk management by the leaders of some of the largest financial institutions in the United States and

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[124] *Id.*

[125] Letter from John J. Ruocco, Assistant Vice President, Federal Reserve Bank of New York, to Board of Directors (c/o Vikram Pandit, CEO), Citigroup Inc. (Apr. 15, 2008) (online at http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2008-04-15_FRBNY_Letter_from_John_J_Ruocco_from_Board_of_Directorrs_Re_annual_report_for_Citigroup_Inc_as_of_December_31_2007.pdf).

[126] *Id.*

[127] *Id.*

[128] *Id.*

[129] Financial Crisis Inquiry Commission, *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (Jan. 2011).

[130] *Id.*

Europe."[131] They noted that, like other CEOs who appeared before the Commission, the former CEO of Citigroup was "willing to admit that he had poorly managed his firm's liquidity risk, but unwilling to admit that his firm was insolvent or nearly so."[132] Commissioners Thomas, Hennessey, and Holtz-Eakin noted that these "claims were highly unpersuasive."[133]

[131] Financial Crisis Inquiry Commission, *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States – Dissenting Statement of Commissioner Keith Hennessy, Commissioner Douglas Holtz-Eakin, and Vice Chairman Bill Thomas* (Jan. 2011) (online at http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_hennessey_holtz-eakin_thomas_dissent.pdf).

[132] *Id.*

[133] *Id.*

Responses to Representative Ellison's questions from John Allison

April 26, 2017 hearing

Question One: Say-on-Pay

As a CEO I would not have an objection to a shareholder vote on my compensation. However, I strongly believe this is an issue to be decided by shareholders not Congress. One of the primary responsibilities of the Corporate Board is to evaluate the CEO and establish appropriate compensation. As a shareholder I do not want to get in the way of the relationship between the board and the CEO. If the board is not doing its role effectively I would vote to change the board. Using the law to force shareholders to do the job the board is suppose to do and using regulators to force the board to do management's job ( which banking regulators are doing today) reduces corporate efficiency and thereby slows productivity growth.

Question Two: BB&T and Automobile Financing Discrimination

I am no longer on the board of BB&T so I do not have any inside information, therefore my response will be somewhat speculative. BB&T has long had a strong culture that objective decision making in the foundation for treating our customers fairly. We do not discriminate based on race, sex, religion, etc, but we do make loan decisions based on the customers ability to repay.

The non discretionary auto dealer compensation program may reflect concern on BB&T's part that some dealers were not treating customers consistently. Or it may reflect regulatory pressure to adopt the program. In today's world, bankers are primarily concerned with making regulators happy, not with good business decisions.

Taking away discretion from dealers may reduce the risk of unconscious discrimination, but it will either raise loan prices or more likely make it harder for high risk borrowers to get loans. A bank will either have to raise prices on all car loans to reflect the inability to allocate risk by borrower or tighten lending standards to exclude higher risk borrowers. BB&T has always been a lower risk lender so tight standards will have little impact on its lending. However, the banks that take higher risk would be significantly impacted by a non discretionary standard . They would have to raise their standards and not make loans to higher risk borrowers. The effect would be less credit availability to lower income/higher risk borrowers.

Question Three: TARP

I was adamantly opposed to TARP. We were forced to take TARP by our regulators because they wanted healthy banks to participate so it would not look like the government was bailing out unhealthy banks, but was instead helping the banking industry. BB& T did not need TARP as we were buried with cash. There was a flight to quality which TARP stopped. TARP was a major negative for healthy banks and a massive subsidy for high roller firms --so called Wall Street. The contagion risk was grossly exaggerated. If the bad banks had been allowed to fail, i.e.taken over by the FDIC, the economy would have recovered far faster and the standard of living in the US would be higher today.

This total issue is too complex to explain in a few paragraphs. I refer you to my book, The Financial Crisis and the Free Market Cure. You should read it. It is the only insider account of how the crisis actually arose and reflects how the banking regulators made this correction so much worse than other post war corrections. Markets did not fail. Regulators caused the crisis and ironically received more power to do damage in the future.

Question Four: Full Balance Sheet vs Leverage Only

Risk based capital standards, which are the alternative to pure capital standards, are guaranteed to fail. With risk based standards, regulators must determine the risk in various assets. Unfortunately, they are often driven by political vs economic considerations. Before the financial crisis a bank had to have one half the capital for a subprime mortgage loan then to a loan to Exxon. In Europe banks did not have to have any capital for a loan to Greece. It is not surprising that banks made a lot of subprime mortgage loans and lent a lot of money to Greece.

More recently regulators rated energy loans low risk, until long after it was obvious they were higher risk. The very act of rating a loan category low risk will bring substantial capital to that loan category and thereby make it more risky.

Regulatory capture by large financial institutions always occurs. Even though pre crisis Citigroup had practically no real capital it had convinced the regulators using complex mathematical models that its risked based capital was strong.

We can debate whether 10% is the proper leverage ratio vs 15%, but the historical evidence is that better capitalized banks seldom fail and the possibility of a financial crisis with properly capitalized banks is remote. However, banks can not survive with the huge regulatory burden of Dodd Frank and proper capital. The regulators have chosen more regulations over more capital.

Markets do a far better job disciplining banks then regulators. Citigroup would never have been allowed to leverage the way it did if the market had not perceived it had a government guarantee i.e. that it was too big to fail. The market under Dodd Frank still believes Citi has a government guarantee.

Again, this is a complex issue and I refer you to my book , The Financial Crisis and the Free Market Cure.

**"A Legislative Proposal to Create Hope and Opportunity for Investors, Consumers, and Entrepreneurs"**
*Wednesday, April 26, 2017*

**Questions for the Record submitted by Rep. Keith Ellison**

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**Questions for Peter Wallison, American Enterprise Institute**

**Question One: False Statements**

You assert that the financial crisis was not caused by loose financial regulation, but instead caused by the Federal government's affordable housing goals Fannie Mae, Freddie Mac, and the Community Reinvestment Act ("CRA"). However, the suggestion that the financial crisis was caused by banks' lending irresponsibly to comply with the CRA has been widely discredited for some time now by several bipartisan research groups and experts. In fact, the *New York Times* even called this notion "The Big Lie," noting that about 84.3 percent of subprime loans in 2006 were made by financial institutions not governed by the CRA, and Fannie Mae and Freddie Mac never securitized subprime loans. It seems intellectually dishonest to say affordable housing goals were a catalyst for the crisis instead of Wall Street greed.

According to a July 13, 2011 report published by the Committee on Oversight and Government Reform entitled, *An Examination of Attacks Against the Financial Crisis Inquiry Commission,* your resistance to any challenge to your belief that the Financial Crisis was the fault of the GSEs became a major point of contention among your fellow members of the Financial Crisis Inquiry Commission.

On page 11 of the report, it says you used your position on the Commission to promote a theory supported by Rep. Issa and put forth by Edward Pinto, a Resident Fellow at the American Enterprise Institute (AEI), that was ultimately **rejected as flawed** by every other member of the Commission— namely, that government housing policy was the primary cause of the nation's economic crisis.

The report also notes your fellow Republican commissioners thought you were really just a "parrot for Pinto."

What is your response to these assertions in this Congressional report?

Can you please explain how the H.R. 10 would stop another financial meltdown, even though the proposal focuses on removing oversight of the kind of non-bank financial institutions that caused the crisis in the first place?

**Response from Peter J. Wallison**

**Question 1. False Statements.**

I'm delighted that you asked this question, Congressman, because you seem to be confused about key elements of housing policy. I'm assuming, perhaps incorrectly, that you will read this response.

First, I can't agree with your statement that "the suggestion that the financial crisis was caused by banks' lending irresponsibly to comply with the CRA has been widely discredited for some time now by several bipartisan research groups and experts."

In fact, these "research groups and experts" –whoever you were referring to--can't have any firm idea about the role of the CRA in the financial crisis—let alone discredit it—because there isn't sufficient data available to make any judgment about the role of CRA. CRA data is known to the banks that make the loans and to their examiners, but it is not collected effectively anywhere else. Banks generally do not report it publicly. The Fed receives data on what are called "high cost" loans—meaning loans with high interest rates—and they treat that as a rough approximation of the number of CRA loans that have been made. But that data is unreliable, because an unknown number of CRA loans are made by banks at concessionary rates in order to meet the requirements of their regulators and examiners, and are not reported as high cost loans.

For that reason, I have never tried to include CRA lending as one of the causes of the financial crisis, but simply said in my book about the financial crisis that there is insufficient data to make any judgment about CRA, and why.

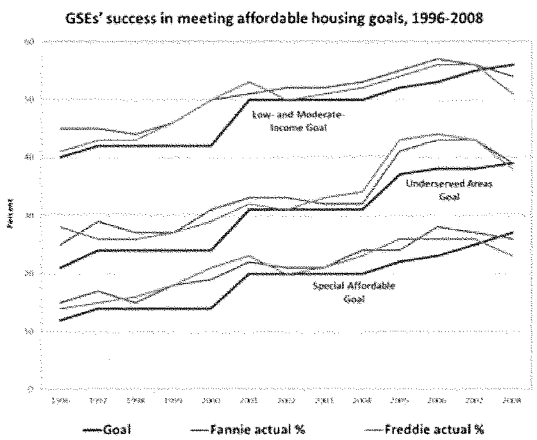
In other words, those who have "discredited" the idea that CRA caused the financial crisis did not know what they were talking about, and—as has occurred again and again since the crisis—were speaking politically, to avert responsibility for policies they supported or voted for, and certainly without adequate knowledge.

But it's also possible that you don't know what CRA is. You seem to be confusing CRA with the Affordable Housing Goals. Many people who do not know much about the housing market confuse these two different programs, and you could be one of them. CRA was initially enacted in 1977, and was updated with new regulations in the Clinton administration. It definitely required banks to make loans they would not have otherwise made—not because of racial animus, incidentally, but because the loans are highly risky. Nevertheless, no one knows how many such loans were made or what effect, if any, they had on the crisis.

The columnist for the *New York Times*, who you say called the reference to CRA "The Big Lie," did not make your mistake. He knew at least that much. He was referring to Affordable Housing Goals, which I will describe below, but he called my position a lie because he and other leftwing critics had and have no data with which to refute it. This, unfortunately, is a characteristic of the left—calling names instead of dealing with facts or data.

My position, as fully described in the book I wrote about the financial crisis ("Hidden In Plain Sight: What Really Caused the World's Worst Financial Crisis and Why It Could Happen Again" Encounter Books, 2015) was based primarily on the effect of the Affordable Housing Goals—legislation enacted by Congress in 1992 that required Fannie Mae and Freddie Mac to meet certain quotas when they acquired mortgages from banks and other originators.

HUD was given authority to increase the quotas, and did so—aggressively—beginning in 1996. Below is a chart showing the increase in the goals for the three categories they covered—low and moderate income borrowers (those at or below median income where they lived), special affordable (very low income borrowers at or below 80% or 60% of median), and underserved (minority areas, largely African-American and Hispanic).

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As you can see from the chart (based on data published by the GSEs' regulator), by 2008, 56% of all mortgages that Fannie and Freddie acquired had to be made to borrowers at or below median income. In addition, about 39% had to be made to underserved borrowers, and about 27% had to be made to very low income borrowers. The black line is the goals as established by HUD and the red and green lines show the compliance by Fannie and Freddie. As the goals rose, they were required to increase their purchases of mortgages that met the goals.

Before 1992, Fannie and Freddie made almost exclusively prime loans. These were loans with 10-20% downpayments, FICO scores of at least 660 and debt-to-income (DTI) ratios no greater than 38%. The default rate on these loans in non-stress times was less than 1%. However, because of complaints from community activists (this is all clear in the House and Senate reports on the legislation) that these "high" underwriting standards were making it difficult for low and moderate income borrowers to buy homes, Congress enacted the goals in the hope that it would increase home ownership by low and moderate income Americans as well as very low income and minority Americans.

It was a disastrous policy, based on a lack of understanding in Congress about the role of Fannie and Freddie in the US housing market. The GSEs were the dominant players in that market, by far the largest buyers of mortgages. If they changed their underwriting standards, the whole market would follow—and that is exactly what happened. As the goals were tightened between 1996 and 2008, Fannie and Freddie had to reduce their underwriting standards—they simply could not find enough prime loans among borrowers who met the goals—and these new lower standards spread to the market as a whole. Banks and other originators began to make subprime and other low quality mortgages, because they could sell them to the GSEs, which needed them to meet the goals, and because other borrowers, who were not goals-eligible, also wanted mortgages with low or no downpayments. This started the massive deterioration of all mortgage underwriting standards which ultimately caused the financial crisis.

As the new lower underwriting standards spread to the wider market, they built an enormous housing price bubble between 1997 and 2007. How this can happen is easy to understand. If a person has $10,000 to buy a home, and the downpayment is 10%, he can buy a $100,000 home. But if the downpayment falls to 5% he can buy a $200,000 home. Instead of borrowing $90,000, he borrows $190,000. This puts upward pressure on home prices and makes him a weaker credit because he's borrowed more. Under pressure from the goals, Fannie and Freddie reduced their downpayment requirements to 3% by the late 1990s and to zero by 2000. This built a huge and unprecedented 10 year bubble. By 2007, housing prices had risen so high that people could no longer afford the homes, no matter how concessionary the rates, and the bubble collapsed.

By 2008, because of the goals, more than half of all mortgages in the US were subprime or Alt-A (weak and risky loans that the GSEs wouldn't buy before 1992), and of those 76% were on the books of government agencies, primarily Fannie and Freddie. This makes it crystal clear that the government created the *demand* for these loans.

The losses on mortgages when the bubble collapsed would have caused losses to banks and other investors—and did cause Fannie and Freddie to become insolvent—but the US economy would have weathered the storm if it weren't for enormous blunders by the officials then in office, particularly Hank Paulson, the secretary of the Treasury. He made the major mistake of rescuing Bear Stearns. This wasn't necessary, but caused investors and managements of other companies to believe that all other large nonbank financial firms would be rescued if they got into trouble. Then Paulson reversed himself and refused to rescue Lehman Brothers, which was 50% larger than Bear. This sudden, illogical and inexplicable reversal of policy caused the market panic that we know as the financial crisis. To compound his errors, Paulson then forced the largest banks to take TARP money, which they didn't need, didn't want, and repaid within months. This, however, allows you and others to claim that they were "bailed out" by the government.

Whatever the facts were, people with your views, Congressman—not understanding or wanting to understand any of this—could only rush ahead to authorize more regulations through the Dodd-Frank Act, without investigating what really happened. You rushed to judgment before the 2010 elections because you knew you would lose control of the House that year, and the important thing was to fasten these regulations on the US economy before anyone could stop it. The result has been the slowest recovery from a recession since at the 1960s, and untold pain for your constituents and others.

The Financial Crisis Inquiry Commission was also a sham, a waste of taxpayer funds to do a fake study that would justify more regulation. I cannot fully excuse the Republican members of the FCIC, who may have thought that they were protecting the Bush administration from blame for the crisis. They disagreed with me, but it is now clear that a lot of data that the FCIC collected was not made available to them—and much of it contradicted what was said in the FCIC's report. If they had known this, their views might have been different.

Indeed, after the FCIC closed down, I found a lot of material in its files that the chairman and staff ignored in the headlong rush to prove that the financial system needed more regulation. This material was in part the foundation for my book, and I collected some of it in a paper that is posted at www.aei.org/publication/new-questions-about-the-financial-crisis-inquiry-commission. The paper shows how haphazard and unserious the FCIC really was, and that it was not dedicated to finding the truth.

The report you cite—referring to me as "Pinto's Parrot" –is a product of the Democratic staff of a House committee and is certainly of a piece with everything else you and others in your party have done to obscure the truth and cause the problems that have occurred in our country—leading, ironically, to the election of Donald Trump. Character assassination is what anyone would call it, not facts or data. Yes, I did use the data collected and analyzed by my AEI colleague Edward Pinto, because the FCIC refused—for the reasons stated above—to consider any of it, and made that clear in their report on the crisis. Happily, Pinto is an honest man and a superb researcher, with a long history in the housing market. His analysis has stood the test of time, as the FCIC's report has not.

When a taxpayer-funded inquiry into a serious national event is completely perverted by a political ideology to produce a false report, the only recourse for someone who is interested in the facts is to use whatever other resources are available. Eventually, despite the efforts of those who wrote the report you are quoting, the truth will come out. I hope it happens before you have retired from public life, so you will be required to answer for adopting far-reaching and harmful legislation without adequate investigation.

In your last paragraph you asked how the CHOICE Act would stop another financial meltdown. This would be funny if it weren't so sad. The Dodd-Frank Act, which the CHOICE Act is seeking to reform, has several features that are likely to *cause* the next financial crisis—including the Volcker Rule, the Fed's support for clearinghouses, the FSOC's power to declare firms outside banking as too big to fail, and the general decline in economic growth caused by excessive regulation. The CHOICE Act is designed to return the economy to growth and avoid these crises. After that is accomplished, we can turn our attention to the housing policies of the US, which are largely still in place and have begun to cause the same growth in housing prices that started in the late 1990s.

**Question Two: Confidentiality Agreement Violation**

According to the report, Mr. Wallison, while you served on the Commission, you repeatedly leaked confidential information Mr. Pinto. During your oral testimony you said that when you were told you leaked confidential information to Mr. Pinto that the rules did not apply to you.

- Did you receive a warning from the General Counsel that you violated the confidentiality requirements to serve on the Financial Crisis Inquiry Commission?
- Did Mr. Pinto receive a warning that by reviewing the materials you shared that he violated confidentiality requirements related to the Commission.
- What materials did you share with Mr. Pinto?
- When did you share them? Did you share information after being told to stop violating confidentiality agreements?

- Why did you share them?

**Response from Peter J. Wallison**

I was a bit surprised to find that you raised a question about my supposed "violation" of the confidentiality agreement I signed as a member of the FCIC. This is another element of the Democratic staff of House committee to defend the Dodd-Frank Act with a partisan hatchet job that you chose to quote at the hearing in April. I was surprised, Congressman, because you yourself have been charged with something you claim is false. As I recall, you have been identified as an Anti-Semite because of things you said in the past. You denied it, of course, but one would think that you would have learned something about making false charges about others. You should also know the difference between a charge and a conviction.

Nevertheless, you still believe you can cast the first stone.

I don't suppose you have read the confidentiality agreement that every staff member and FCIC commissioner signed, but it said in pertinent part:

"I agree not to disclose any Confidential Information outside the FCIC except as may be reasonably required in connection with the work of the FCIC, and then only to persons who are informed of the confidential nature of the material and agree to maintain the confidentiality thereof."

Confidential Information was defined as "trade secrets, proprietary information, technical data, or computer software and documentation submitted to the FCIC by witnesses and other persons."

The information that was supposedly transmitted in violation of the confidentiality agreement was none of these things. I had received from Mr. Pinto and transmitted to the FCIC staff a great deal of data about mortgages and the housing market that the FCIC had made a show of considering, but duly ignored in its report. At one point, as I recall, I received information from the commission staff that was inconsistent with information I had received from Mr. Pinto and—since I was an intermediary between the FCIC and Mr. Pinto and his data—I asked Pinto whether the information I had received was correct. It seems to me that this was not only reasonable, but part of my obligation as someone who was trying to get at the facts of what happened in the financial system. Pinto told me the data was wrong, and showed me why, and I reported that to the staff.

This resulted in a ridiculous episode in which I was charged with revealing confidential information in violation of the confidentiality agreement.

One of the reasons this was ridiculous is that the information I had received in my capacity as a commissioner was not within the definition of Confidential Information in the confidentiality agreement. Nevertheless, it didn't really matter; the whole episode was just part of the hostility shown to me because I didn't agree with the chairman and the other Democratic members of the commission. Because I had already made very clear that I was not on board with the sham report that was being created, charging me with a violation of the confidentiality agreement was just one more effort to intimidate me. I argued that it was not a violation, but didn't take it seriously, and of course nothing was done.

I don't remember receiving anything so formal as a "warning," and if I had I would have ignored it if it interfered with my obligation as a commissioner to find the truth about what happened in the financial crisis. As I said in my testimony before the HFSC last month, I didn't think the language of the confidentiality agreement quoted above applied to me. I was attempting solely to determine the accuracy of data, and the data itself was not within the definition of Confidential Information.

As to your other questions, I don't know whether Mr. Pinto received any kind of warning. I doubt it, because the whole episode was a charade, as described above.

I don't recall whether I shared additional information with Mr. Pinto, but would have done so if in my judgment it was not confidential information within the meaning of the confidentiality agreement.

**Questions for John Allison, Former President and Chief Executive Officer, Cato Institute**

**Question One: Say-on-Pay**

As a CEO, you are answerable to your shareholders, who are the owners of the corporation. As a CEO, would you have a problem with shareholders taking a "say-on-pay" vote related to your compensation every year, every two years, or every three years, as they see fit?

The bill seeks to make these "say-on-pay" votes less frequent – requiring them only when there's been a material change in compensation. That means a CEO could catastrophically fail at their job one year, and yet shareholders wouldn't get to vote on their compensation plan unless it happened to change.

As a business leader, does avoiding shareholder votes on your or other bankers' compensation erode the market discipline you extoll in your testimony?

**Question Two: BB&T and Automobile Financing Discrimination**

Previously you were the CEO of BB&T Bank. I assume you established a strong culture of compliance there, and one that very much valued your customers. As you may be aware, since you left BB&T, and after several years of market research, the bank voluntarily adopted what they called a "*nondiscretionary automobile dealer compensation program*" , citing "*fair and equal treatment of all consumers.*"

That makes the bank an industry leader in this space. Why did your former colleagues at BB&T chose to establish a nondiscretionary auto financing process to provide for quote, "fair and equal treatment to all consumers?"

The American Financial Services Association has stated to this Committee that banks which switch to nondiscretionary financing for auto loans won't be competitive in the automobile financing market. They also say car buyers will pay more.

Do you think consumers will get a worse deal on their auto loan if they choose BB&T rather than a lender that uses discretionary markups?

**Question Three: TARP**

Congress and the Federal Reserve took extraordinary actions in 2008 to shore-up the financial system – whether through TARP, emergency lending facilities, money market fund assistance, or other measures.

You have noted that as CEO of BB&T, your bank never experienced any losses for a single quarter during the financial crisis. However, BB&T took $3.1 billion in TARP bailout money.

Didn't the assistance provided to your financial institution, and to the financial system more broadly, perhaps contribute to BB&T's financial health during that crisis period?

Is it really appropriate for a bank to discuss their profitability during that period in a vacuum?

Did not all of this assistance provide significant support for the entire financial system, which complicates any effort to look at an individual bank's success?

**Question: Full Balance Sheet vs. Leverage Only**

Title 1 of the bill proposes to allow banks to opt-out of regulation if they reach the 10% leverage requirement. The leverage requirement regulates the amount of equity a bank must hold on its balance sheet. However, banks' balance sheets include three components: assets, equity, and liabilities. Leverage requirements regulate equity alone.

Why should we deny financial regulators a more flexible toolkit that includes all three aspects of a bank's balance sheet?

Why do you think regulating one and not the others is enough to ensure financial stability?

RESPONSES OF HESTER PEIRCE, MERCATUS CENTER AT GEORGE MASON UNIVERSITY, TO QUESTIONS OF REPRESENTATIVE EMMER

1) Based on the changes proposed by the CFPB and are set to take effect in 2018, mortgage lenders will need to provide 110 pieces of data for each mortgage application they take under the Home Mortgage Disclosure Act rule. This rule will more than double the amount of information that must be collected and reported on each application. This seems like a significant new burden, especially for community banks and credit unions. While I understand there are some very limited exemptions for smaller-volume lenders, in my opinion they do not go nearly far enough to reduce the significant burdens imposed by the new rule. What, in your view, is preventing the Bureau from increasing the smaller-volume exemptions so a greater number of community lenders might benefit?

Dodd-Frank required the CFPB to expand the Home Mortgage Disclosure Act information that lenders collect. On its own initiative, the CFPB further expanded the required data fields, additions that will increase the reporting cost materially. In response to concerns about ambiguities in its final rule, the CFPB recently issued a proposal to provide additional clarification. Nevertheless, even if that proposal goes into effect, HMDA requirements are set to become markedly more onerous in 2018.

The CFPB has the legal authority to expand its small lender exemption, which currently covers most institutions that make up to twenty-five mortgage loans. Raising the threshold to one hundred mortgage loans would be consistent with the pre-rule threshold applicable to non-depository institutions. When writing rules, the CFPB is required to consider the "potential reduction of access by consumers to consumer financial products or services" and the impact on small banks and credit unions.[1] The CFPB, therefore, needs to consider not only the value of additional HMDA data, but the costs of requiring the additional data.[2] These costs are likely to be passed on to consumers. Along with commenters, the Small Business Review Panel that was convened pursuant to Regulatory Flexibility Act requirements provided the CFPB detailed insight about those costs.[3] The CFPB acknowledged that it could raise the threshold without

[1] Dodd-Frank §1022(b)(2)(A) [12 U.S.C. § 5512(b)(2)(A)].

[2] The costs include, not only compliance costs, but potential enforcement costs for banks that make mistakes in their reporting. See, for example, Regulatory Landscape: Burdens on Small Financial Institutions, Hearing before the Subcommittee on Investigations, Oversight, and Regulations of the House Committee on Small Business, pp. 21-22, 26 (Dec. 3, 2013) (testimony of B. Doyle Mitchell, Jr., President and Chief Executive Officer, Industrial Bank), https://www.gpo.gov/fdsys/pkg/CHRG-113hhrg85741/pdf/CHRG-113hhrg85741.pdf (". . . if you look at HMDA regulations . . . the number of different data points and the number of different fields that have to be compiled and accurately compiled, many institutions even now get it wrong and the penalties are very high. So it can be very expensive. It is definitely very expensive. . . . I speak to bankers all the time and all bankers have problems with HMDA because it is a lot of boxchecking. And if you make a mistake with one field, you know, there could be 16 or 20 different fields just for one loan, and if you make a mistake with one field, you have made a mistake for that entire loan. We are administratively pretty well run when it comes to compliance and we continue to struggle with HMDA."). All of these costs are likely passed on to consumers.

[3] See Final Report of the Small Business Review Panel on the CFPB's Proposals Under Consideration for the Home Mortgage Disclosure Act (HMDA) Rulemaking (April 24, 2014),

compromising the value of national data. Nevertheless, without weighing the cost to lenders and consumers, it chose a 25-mortgage threshold anyway to ensure that the data would be meaningful at the local level.[4] A step taken for the sake of expanding the pool of data on credit access, which is important, may impair credit access, which is more important. The CFPB's unusual structure—single director, special judicial deference, lack of congressional appropriations, separation from safety-and-soundness regulators, and unique independence from presidential control—makes the CFPB less responsive to legitimate concerns about the adverse effects its rules will have on lenders and borrowers.[5]

2) Ms. Peirce, I read with interest your April 17 public interest comment letter in response to the Presidential Memorandum on the Fiduciary Rule. I first want to note that as a public interest comment letter, and as you state in your opening paragraph, the letter *'does not represent the views of any particular affected party or special interest group, but is designed to assist the Department of Labor in creating a regulatory environment that will facilitate increased innovation, competition, and access to financial services to the benefit to the public.'* While the focus of our hearing was not the Labor Department, but instead how we can correct mistakes made under Dodd-Frank to improve investor protections and efficient financial regulations, could you comment on what the role of Congress should be in correcting agencies like the DOL that have gone too far in regulating securities markets where they have little prior expertise or understanding?"

Congress has an important role to play in ensuring that agencies promulgate effective regulations within their authority. The effects of the Department of Labor's fiduciary rule are being felt far outside the context of employee benefit plans. The rule has already affected huge swaths of the financial services industry, most of which is regulated by the Securities and Exchange Commission. The SEC is the appropriate regulator to address concerns about the relationship between retail investors and their financial professionals. The SEC has a deep understanding, developed over eight decades, of the governmental and self-regulatory rules under which investment advisers and broker-dealers operate. The DOL did not draw on the SEC's experience writing rules, monitoring compliance, enforcing rules, working with investors, and overseeing self-regulators. Indeed, Secretary of Labor Alexander Acosta acknowledged in an op-ed in the Wall Street Journal on May 23, 2017, that "the SEC has critical expertise in this area."

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http://files.consumerfinance.gov/f/201407_cfpb_report_hmda_sbrefa.pdf. Representatives of participating entities provided substantive comments about potential problems for small entities, which are available as appendices to the report.

[4] Specifically, in the final rule, the CFPB acknowledged that "it is possible to maintain reporting of a significant percentage of the national mortgage market with a closed-end mortgage loan-volume threshold higher than 25 loans annually" and that "it may also be true that data reported by some institutions that satisfy the proposed 25-loan-volume threshold may not be as useful for statistical analysis as data reported by institutions with much higher loan volumes." Nevertheless, the CFPB decided not to use a higher threshold because it "would have a material negative impact on the availability of data about patterns and trends at the local level." Bureau of Consumer Financial Protection, Home Mortgage Disclosure (Regulation C); Final Rule, 80 Fed. Reg. 66128, 66147 (Oct. 28, 2015).

[5] See, for example, PHH v. Consumer Financial Protection Bureau, 839 F.3d 1 (D.C. Cir. 2016); Todd Zywicki, The Consumer Financial Protection Bureau: Savior or Menace?, George Washington Law Review, Vol. 81, pp. 856-928 (2013); Hester Peirce, Revisting Dodd-Frank, Mercatus Policy Primer (Mercatus Center at George Mason University, pp.19-20 (2017), https://www.mercatus.org/system/files/peirce-revisiting-dodd-frank-primer-v1.pdf.

Congress, the granter of agency jurisdiction, is well positioned to identify ways in which agencies are regulating in a conflicting or redundant manner. Agencies often do not take the broader regulatory framework into account. Phyllis Borzi, who spearheaded DOL's rulemaking process, took the position that "our job is not to let the industry have only one standard. There are multiple fiduciary rules that apply to every industry."[6] In this situation of admitted jurisdictional overlap, Congress has the power to clarify that the SEC, rather than the DOL, should take the lead in building the regulatory framework within which financial professionals serve investors. As Secretary Acosta noted, once a rule is on an agency's books, certain procedures govern amendments to, or repeal of, the rule. Congress, however, drawing on real-time information, can step in at any time during the rulemaking and rule implementation process. To limit investor harm, Congress is able to prevent a rule, such as the fiduciary rule, from taking effect. It can also direct any future federal rulemaking in this area to be conducted by the SEC, the agency that is best able to accommodate investors' varying needs for financial products and services, while ensuring that investors have clear, objective information about all material aspects of those products and services.

3) When CFPB Director Cordray has come before the Committee in the past, he continues to testify that he needs more data to prove that manufactured housing consumers are being harmed. While data was not used to impose these regulations on manufactured housing financing, data about the harm of these regulations exists. People are suffering and the data shows it. In fact, recent Home Mortgage Disclosure Act (HMDA) data shows that lenders made manufactured housing loans before the Dodd-Frank Act rules went into effect, and access to such loans decreased significantly after Dodd- Frank implementation. Cordray continues to tell our Committee that we need more information about the impact of the regulations on the manufactured housing market. Don't you think the recent HMDA data calls for changes to the DFA?

While I have not had a chance to conduct an analysis of the recent HMDA data, now that we have several years of experience with many Dodd-Frank rules, it makes sense to assess how they are working and what unintended consequences they are producing. The CFPB, which collects a lot of data, should use the data to explore concerns being raised about credit access. Asking questions about credit access in the context of manufactured housing is particularly important. As the CFPB acknowledges, purchasers of manufactured housing tend to be less wealthy and lower-income than purchasers of other types of housing.[7] As a consequence, it is important to ensure that regulations intended to protect them do not instead harm them. The best way to help purchasers of manufactured housing is to expand the number of lenders competing for their business. Rules adopted pursuant to Dodd-Frank and other rules that increase the legal risk of financing manufactured housing make it less likely that lenders will want to compete in this space.

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[6] Redefining 'Fiduciary': Assessing the Impact of the Labor Department's Proposal on Workers and Retirees, Hearing Before the Subcommittee on Health, Employment, Labor, and Pensions of the House Committee on Education and the Workforce (July 26, 2011), p. 43, https://www.gpo.gov/fdsys/pkg/CHRG-112hhrg67444/pdf/CHRG-112hhrg67444.pdf.

[7] Bureau of Consumer Financial Protection, Manufactured-Housing Consumer Finance in the United States, p. 44 (2014, http://files.consumerfinance.gov/f/201409_cfpb_report_manufactured-housing.pdf).

4) Section 501 would ensure that manufactured home retailers are not unfairly considered loan originators, provided they don't receive compensation for the referral. Similar to real estate agents, manufactured housing retailers and salespeople are fundamentally in the business of selling homes, not originating loans. Their compensation is solely derived from the sale of a home. Just as a real estate agent's sales commission does not make them an LO under CFPB rules, a similar distinction is needed for those selling manufactured homes. What are your thoughts on providing the same compensation distinction?

   Section 501 of the Choice Act would remove from the definition of loan originator manufactured home retailers and their employees who do not receive compensation for the loan. This change would address a concern that the definition of mortgage origination has expanded to include people whose business is selling manufactured homes, not originating mortgages. Unnecessarily broad application of complex rules could harm the consumers those rules are designed to help by impeding their access to information and financing options.

5) I am not familiar with any effort that is being made by the CFPB to reverse the decline in manufactured housing lending to ensure the most affordable, and often the best housing choices in certain areas of the country, are available. Are you? In fact, it is my understanding that the CFPB has just ignored our concerns. Manufactured homes are the largest form of unsubsidized homeownership. What is the benefit of the federal government restricting access to credit for manufactured housing?

   Unwarranted restrictions on access to credit for manufactured housing harm the consumers they are intended to help. Competitive markets offer consumers access to credit at prices commensurate with the risk. As with any form of housing, the government should avoid trying to shape consumer preferences for manufactured homes by restricting or subsidizing loans. As we saw in the last financial crisis, the involvement of the government in housing finance distorted the markets in a way that—in combination with other factors—harmed people all across this country.[8] The government does have important roles to play in insuring that borrowers have access to clear information about the costs and terms of a loan and in pursuing fraud. The CFPB's regulatory efforts, however, tend to go beyond these purposes into the territory of so-called merit regulation. As a merit regulator, the CFPB sometimes removes options from consumers that it deems to be too expensive or otherwise unacceptable. When the CFPB makes these one-size-fits-all determinations, it cannot take into account consumers' unique circumstances and preferences, regional variations, and consumers' superior ability to assess their own present and future needs.

[8] See, for example, Arnold Kling, Not What They Had in Mind: A History of Policies that Produced the Financial Crisis of 2008 (Mercatus Center at George Mason University (2009).

# Revisiting Dodd-Frank

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## PROBLEM

Drafted and enacted in response to the 2007–2009 financial crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) became law in 2010.[1] Dodd-Frank's drafters hoped the law would repair the flaws in the financial system that had so painfully manifested themselves during the financial crisis. Rather than addressing the regulatory failures that led to the crisis, Dodd-Frank's core solution was to shift decision-making from the private sector to regulators—the same regulators whose lapses had contributed to the crisis. Dodd-Frank has been costly in the short term, as any major regulatory overhaul would be. The financial industry and regulators have poured countless hours and dollars into implementing the new law. Of greater concern than these short-term implementation costs are Dodd-Frank's potential long-run costs. Rather than averting crises, Dodd-Frank's rejiggering of the financial system has created the preconditions for a future crisis, while inhibiting economic growth and dynamism.

## SOLUTION

Reinstituting precrisis financial regulation is not the answer. The precrisis financial regulatory system was broken, but Dodd-Frank is not the proper repair kit. The current rationale for financial regulation is misguided. A piece-by-piece assessment of Dodd-Frank to see what should be repealed is important, but it is not enough. To be effective, financial regulation also needs a perspective shift—a shift away from the current regulator-centric approach to a regulatory system that is grounded in the superior ability and incentives of market participants to collect, process, and act on information. An effective regulatory system pun-

1. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

ishes fraud, holds the institutions and people who take risks responsible for any resulting losses, avoids nonregulatory social objectives, forecloses bailout opportunities, embraces creative destruction, presumptively fosters innovation, and removes roadblocks to competition in the financial system.

## EXPLANATION

Dodd-Frank is a sprawling law, many pieces of which are unrelated to any financial crisis—past or future. What unifies the disparate pieces is an unquestioning faith in regulatory omniscience and broad grants of power to these infallible regulators. The law calls on regulators to step in where the rest of us—individuals, firms, and nongovernmental institutions—are supposedly destined to fail, namely, to identify and address all systemic and a wide array of nonsystemic risks. In giving such heavy responsibilities to regulators, Dodd-Frank's drafters overlooked the fact that precrisis regulators missed risks and that precrisis regulatory design contributed to the buildup of risk. By giving regulators an outsized role, Dodd-Frank suppresses the market's intrinsic disciplining mechanisms and builds bailout expectations. Revisiting Dodd-Frank thus requires a marked change in perspective—a shift away from the comforting but ineffective "entrust the financial system to the skilled hands of the all-knowing regulators" approach to financial regulation, as well as a piece-by-piece substantive overhaul.

## SHIFTING THE REGULATORY PERSPECTIVE

Dodd-Frank favors regulatory discretion over market-based regulation. It empowers regulators to use their discretion to make risk-management decisions for companies and individuals, who would otherwise respond to direction from their shareholders, customers, and creditors. Dodd-Frank not only embraces more prescriptive microprudential regulation for individual financial institutions, but it also adds another regulatory layer designed to target ill-defined and elusive "systemic risk." This so-called macroprudential regulation allows government lawyers and economists to overrule a financial institution's decisions—even if those decisions are legal and appropriate for the individual firm—for fear that they might endanger the broader financial system.

Financial regulators thus become central planners charged with carefully balancing the interests and risk-taking of all market participants, ensuring that firms do not fail, keeping the financial system functioning smoothly, and managing firms' relationships with one another. This form of regulation turns regulators into allocators of credit: regulators decide who gets financed and who does not, which, in turn, affects how the economy develops, which consumer and business needs are met, and where innovation occurs.

Regulators, driven by an evolving understanding of the inscrutable "systemic risk," override the clear market signals through which consumers and Main Street businesses communicate their needs to financial service providers. Macroprudential regulation also displaces the market mechanisms that signal impending trouble at a financial company or in a financial sector. Regulators, who rely on imperfect, delayed information, try to foresee and forestall problems. The customers, shareholders, and creditors, who have access to more immediate information and would otherwise be monitoring the firms with which they interact, instead get the message not to worry. Regulators' very public and costly efforts at managing the financial system and keeping risk-taking in check blunt market discipline and train market participants to look to the government for solutions. With deposit insurance and assurances of federal oversight in place, how often do you check your bank's balance sheet?[2] When the next financial crisis comes, the calls for government bailouts will be even louder than they were in the last crisis.

The next crisis is likely to be worse than the last because Dodd-Frank concentrates so much power in the hands of a few regulators. If these powerful regulators make mistakes, exercise poor judgment, or miss a key market development (all of which are inevitable because they are human), the consequences will be far-reaching. Every firm that has reordered its business to satisfy a regulatory directive will find itself in trouble if that directive proves unsound. And once a crisis happens, widely applicable regulatory mandates, such as liquidity rules, could intensify it. By contrast, if firms and individuals retain decision-making authority, their errors will be contained and firms will not walk in lockstep with one another.

That the framers of Dodd-Frank embraced enhanced regulatory authority and discretion as the answer in the heat of the crisis is perhaps understandable. The crisis hurt many people, and policymakers wanted to prevent similar harm in the future. In the years since the crisis, however, research has shown that regulatory errors lay at the heart of the crisis. Regulatory decisions drove firms and individuals to make poor choices that they otherwise would not have made. For example, Stephen Matteo Miller has demonstrated that regulation created

2. Anat Admati asked this question on David Beckworth's Macro Musings podcast. David Beckworth, "Macro Musings 40: Anat Admati on Debt, Equity, and Financial Instability," Mercatus Center at George Mason University, January 16, 2017.

a demand by financial institutions for mortgage-related, structured products by classifying them as safer than the underlying mortgages.[3] Arnold Kling and Russell Roberts likewise point to the government's inadvertent contributions to the financial crisis through misguided regulatory and housing policies.[4] Lawrence White has highlighted the role that credit rating agency regulation—which forced firms to rely on government-credentialed credit rating agencies and kept competitors out—played in the crisis.[5]

This research demonstrates the false promise of a top-down approach that relies on regulators to identify and address risks. While neither regulators nor markets perfectly rein in bad behavior, markets hold those who make mistakes more promptly and mercilessly to account—if the government does not stand in the way—than regulators can. To raise money, a firm needs to show investors that it has a plan to make money. And to make money, a firm needs to provide something people want. The market will walk away from firms that fail on either of these counts. Regulators have difficulty obtaining and processing information, but price signals readily transmit information among market participants.[6] Moreover, individuals and firms rapidly and rationally adjust their behavior—without the need for regulatory intervention—in response to these signals.[7] But under the current regulatory framework, regulators *do* intervene to drive financial firms' behavior.

A new perspective should guide the new approach to financial regulation: regulation sets broad parameters within which market participants have freedom to act, as long as they bear the consequences of their actions. There is a role

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3. See Stephen Matteo Miller, "The Recourse Rule, Regulatory Arbitrage, and the Crisis" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, forthcoming). See also "Stephen Miller on the Recourse Rule and the Financial Crisis," YouTube video, June 3, 2015, https://www.youtube.com/watch?v=LwsMbz8yQ-8.
4. Arnold Kling, *Not What They Had in Mind: A History of Policies that Produced the Financial Crisis of 2008* (Arlington, VA: Mercatus Center at George Mason University, 2009); Russell Roberts, *Gambling with Other People's Money: How Perverted Incentives Caused the Financial Crisis* (Arlington, VA: Mercatus Center at George Mason University, 2010). See also Peter J. Wallison, *Hidden in Plain Sight: What Really Caused the World's Worst Financial Crisis and Why It Could Happen Again* (New York: Encounter Books, 2015).
5. Lawrence J. White, "An Assessment of the Credit Rating Agencies: Background, Analysis, and Policy" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, September 2013); Lawrence J. White, "A Brief History of Credit Rating Agencies: How Financial Regulation Entrenched This Industry's Role in the Subprime Mortgage Debacle of 2007–2008" (Mercatus on Policy, Mercatus Center at George Mason University, Arlington, VA, October 2009).
6. F. A. Hayek, "The Use of Knowledge in Society," *American Economic Review* 35, no. 4 (1945): 519–30.
7. See, for example, Alex Tabarrok, "A Price Is a Signal Wrapped Up in an Incentive," Marginal Revolution University, accessed January 16, 2017.

for regulators to establish clear ground rules, monitor the markets, and punish fraud, but decision-making, and the attendant responsibility for bad decisions, should be left to market participants. Market participants respond to price signals, which function well as a guide for individual and firm decisions, as long as regulators do not dampen competition, obstruct innovation, or subsidize activities or industries. Private ordering can address many problems without resort to regulatory intervention. When regulation is necessary, it should be rooted in solid economic analysis[8] and notice-and-comment rulemaking.[9] Regulatory enforcement likewise should be grounded in due process and informed by economic analysis.[10] And supervision, while an important component of the regulatory system, must not become an opaque and easily abused substitute for rulemaking or enforcement.

## SUBSTANTIVE REFORM

A change in perspective cannot be effectuated without revisiting Dodd-Frank and other financial regulation on the books. Most of Dodd-Frank's provisions place responsibilities on regulators that they cannot fulfill, albeit not for lack of good intentions, creative thinking, and hard work. Dodd-Frank is divided into 16 titles covering a wide array of subjects.[11] To ensure that regulators are not asked to do the impossible and taxpayers are not asked to pay for mistakes, each of these titles must be reformed.

Title I is devoted to systemic risk. Its key features include the establishment of the Financial Stability Oversight Council (FSOC) and the Office of Financial Research (OFR) and the introduction of formalized systemic risk identification and regulation. The FSOC brings together the heads of other financial

8. See, for example, Jerry Ellig and Vera Soliman, "Is Regulatory Impact Analysis of Financial Regulations Possible?," in *Reframing Financial Regulation: Enhancing Stability and Protecting Consumers*, ed. Hester Peirce and Benjamin Klutsey (Arlington, VA: Mercatus Center at George Mason University, 2016); Jerry Ellig, "Improvements in SEC Economic Analysis since *Business Roundtable*: A Structured Assessment" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, December 2016); Hester Peirce, "Economic Analysis by Federal Regulators," *Journal of Law, Economics & Public Policy* 9, no. 4 (2013): 569–613; Abby McCloskey and Hester Peirce, "Holding Financial Regulators Accountable: A Case for Economic Analysis" (American Enterprise Institute, Washington, DC, May 2014).
9. Hester Peirce, "Regulating through the Back Door at the Commodity Futures Trading Commission," *Harvard Journal of Law and Public Policy*, Federalist Edition 2, no. 2 (2014): 321–93.
10. J.W. Verret, "Economic Analysis in Securities Enforcement: The Next Frontier at the SEC," *University of Cincinnati Law Review* 82, no. 2 (2013): 491–504.
11. For an overview of Dodd-Frank, see Hester Peirce and James Broughel, eds., *Dodd-Frank: What It Does and Why It's Flawed* (Arlington, VA: Mercatus Center at George Mason University, 2012).

regulators, state regulators, and an insurance expert to identify systemically important financial institutions, activities, and so-called financial market utilities.[12] The identified institutions and activities are subject to additional regulation, particularly from the Board of Governors of the Federal Reserve System (Fed). The FSOC also is empowered to make recommendations to other financial regulators. The OFR's job is to standardize financial data collection, collect data from other financial regulators and from financial institutions, perform research, and measure financial system risks.

The FSOC's most valuable function—one that has traditionally been performed by the President's Working Group on Financial Markets (PWG)—is to bring together financial regulators to discuss issues of common interest. The FSOC, which is more formal than the PWG, could be retained to facilitate interagency discussions, assessments of the financial system, and analyses of the costs and benefits of multiagency regulatory initiatives. Even if the FSOC is retained for these purposes, the FSOC's other functions—identifying systemically important institutions and activities and recommending courses of action for other regulators—should be eliminated to avoid distracting from and hindering the FSOC's role in fostering regulatory cooperation and information sharing. The OFR, which has a problematic design and a nebulous mission,[13] could be disbanded, and its data standardization remit could be transferred to the FSOC. The OFR has commissioned some interesting research, but research on systemic risk and other financial markets issues will occur with or without OFR involvement.[14] In any case, markets are likely better at tracking systemic risk than regulators, who receive, process, and transmit information less efficiently and comprehensively than markets.[15]

12. For a discussion of the FSOC's SIFI designations, see Hester Peirce, "Gaining and Shedding Dodd-Frank's 'Systemically Important Financial Institution' (SIFI) Label," in *Legal Risk Management, Governance and Compliance: Interdisciplinary Case Studies from Leading Experts*, ed. Stuart Weinstein and Charles Wild (Globe Law and Business, 2016), 33–61.
13. For a brief overview of some of these concerns, see Hester Peirce, "Dodd-Frank's Office of Financial Research Is an Affront to Privacy," *RealClearMarkets*, April 19, 2012.
14. In addition to academic interest in the subject of financial stability, the Fed has a division devoted to financial stability. Specifically, the division "identifies and analyzes potential threats to financial stability; monitors financial markets, institutions, and structures; and assesses and recommends policy alternatives to address these threats. In addition, the division fosters broader understanding of financial stability issues by undertaking longer term research, primarily in banking, finance, and macroeconomics." Board of Governors of the Federal Reserve System, "Financial Stability," January 30, 2017.
15. See Matthew Beville, Dino Falaschetti, and Michael J. Orlando, "An Information Market Proposal for Regulating Systemic Risk," *University of Pennsylvania Journal of Business Law* 12, no. 3 (2010): 849–98.

For financial firms that regulators deem too big to fail, Title II of Dodd-Frank allows regulators to bypass bankruptcy in favor of a resolution process run by the Federal Deposit Insurance Corporation (FDIC). Specifically, Title II empowers the FDIC, after a government finding that default is on the horizon and there is "no viable private sector alternative," to take over nonbank financial institutions (an area in which the FDIC lacks any particular expertise) and allows the agency to borrow from the Treasury to fund the resolution.[16] Introducing uncertainty about whether, where, by whom, and how a financial firm's failure will be managed undermines sound risk management by financial institutions and their counterparties. A better approach would be to amend the bankruptcy code to make it workable for large financial companies.[17] In addition to or instead of Dodd-Frank's requirement that financial companies prepare living wills, other actions can be taken in advance to make failure less likely and more manageable.[18]

Title III of Dodd-Frank eliminates the Office of Thrift Supervision, an agency that need not be resuscitated. That title also makes permanent a temporary increase in the deposit insurance coverage cap from $100,000 to $250,000 per depositor.[19] Academic research shows that government-provided deposit insurance undermines financial stability.[20] For that reason, a revision of Dodd-Frank should go in the opposite direction and substantially decrease coverage levels. The average household has far less than $100,000 in deposits and therefore would be unaffected by such a change. Alternatives to FDIC insurance

16. See Paul H. Kupiec, "Title II: Is Orderly Liquidation Authority Necessary to Fix 'Too Big to Fail'?," in *The Case against Dodd-Frank: How the "Consumer Protection" Law Endangers Americans*, ed. Norbert J. Michel (Washington, DC: Heritage Foundation, 2016), 60–61.

17. See, for example, Emily Kapur, "The Next Lehman Bankruptcy," in *Making Failure Feasible*, ed. Thomas Jackson, Kenneth E. Scott, and John B. Taylor (Stanford, CA: Hoover Institution Press, 2015).

18. See, for example, Garett Jones, "The Rise of Bail-Ins and the Quest for Credible Laissez-Faire Banking," in *Reframing Financial Regulation*, ed. Peirce and Klutsey; Peter J. Wallison, "Title II of Dodd-Frank," in *Reframing Financial Regulation*, ed. Peirce and Klutsey.

19. During the crisis, the cap was temporarily raised to $250,000. Federal Deposit Insurance Corporation, "Emergency Economic Stabilization Act of 2008 Temporarily Increases Basic FDIC Insurance Coverage from $100,000 to $250,000 per Depositor," October 7, 2008.

20. For a discussion of the literature, see Thomas L. Hogan and Kristine Johnson, "Alternatives to the Federal Deposit Insurance Corporation," in *Reframing Financial Regulation*, ed. Peirce and Klutsey, 60. See also William J. Luther and Thomas L. Hogan, "The Implicit Costs of Deposit Insurance," in *Journal of Private Enterprise* 31, no. 2 (2016): 1–13; William J. Luther and Thomas L. Hogan, "Deposit Insurance Is Not Fair" (working paper, 2015), available through SSRN; William J. Luther and Thomas L. Hogan, "Deposit Insurance Is Not Free" (Mercatus on Policy, Mercatus Center at George Mason University, Arlington, VA, December 2012).

include privately administered or provided insurance.[21] Particularly in combination with simpler, higher capital requirements,[22] such an approach could do more for financial stability than expanding FDIC deposit insurance.

Title IV of Dodd-Frank requires hedge fund and certain other private fund advisers to register with the Securities and Exchange Commission (SEC).[23] The resulting influx of private fund advisers has diverted SEC examiners away from funds that serve a far greater number of less sophisticated investors. Concerns about diversion are particularly acute given the inability of the SEC to examine investment advisers regularly. Although many advisers are likely to remain registered even if the requirement is eliminated, allowing advisers the option of deregistering would enable the SEC to redirect its resources to areas of greater need. Title IV also imposes extensive reporting requirements on private fund advisers to meet federal systemic risk regulators' needs. The Form PF arguably has fallen short of expectations,[24] so it could be eliminated or modified to make its information more useful to regulators. Title IV tightened the accredited investor definition, which determines who can invest in certain nonpublic securities offerings, by excluding investors' primary residences. Narrowing the universe of accredited investors harms the economy and investors by artificially constraining the flow of capital and investors' options. To foster economic growth and investor autonomy, reform instead should allow more investors to qualify as accredited.[25]

Title V of Dodd-Frank covers insurance. Although Title V leaves the existing state regulatory system intact, it (along with the systemic designations of Title I) opens the door to federal regulation of insurance. Title V creates the Federal Insurance Office, which has the ability to nudge state regulators through, for example, reports and so-called covered agreements with international regu-

21. Hogan and Johnson discuss alternatives to FDIC insurance. Hogan and Johnson, "Alternatives to the Federal Deposit Insurance Corporation."

22. Stephen Matteo Miller, "On Simpler, Higher Capital Requirements," in *Reframing Financial Regulation*, ed. Peirce and Klutsey, 35; James R. Barth and Stephen Matteo Miller, "Benefits and Costs of a Higher Leverage Ratio" (Mercatus Working Paper, Mercatus Center at George Mason University, February 2017).

23. For a discussion of Title IV, see J.W. Verret, "Revisiting Title IV: Why Mandatory SEC Registration for Hedge-Fund Advisers Is Not Necessary," in *The Case against Dodd-Frank*, ed. Michel.

24. Office of Financial Research, "Asset Management and Financial Stability," September 2013.

25. See, for example, Hester Peirce, "Statement of Dissent from the Investor Advisory Committee Recommendation Regarding Accredited Investor Definition," US Securities and Exchange Commission, February 9, 2015; J.W. Verret, "Time for a Trump/Reagan Revolution at the SEC," *The Hill*, December 13, 2016.

lators.[26] There are good reasons for contemplating a federal charter option for an industry that is increasingly national in character.[27] But an optional federal charter might lay the groundwork for a federal bailout.[28] A better option—an approach that builds on states' expertise in insurance regulation—might be to allow state competition in chartering under which an insurance company would need only one state charter to operate nationally.[29]

Title VI of Dodd-Frank expands the Fed's powers to regulate systemic risk associated with large financial institutions and introduces the so-called Volcker Rule to ban banks from proprietary trading and private fund ownership. Expanded Fed oversight and new activity limits do not effectively address the problems that caused distress throughout the financial system during the crisis; financial institutions failed not because of proprietary trading but because of government-induced holdings of the highly rated securitization tranches.[30] Rather than solving problems manifested during the financial crisis, Title VI introduces new ones.

The Volcker Rule could make financial institutions less stable. Although the intention of the Volcker Rule—stopping banks from trading with deposit insurance backing—is commendable, there are better ways to address this problem, including requiring banks to be well capitalized.[31] Forcing banks to forgo the benefits of diversification by narrowing the activities in which they are engaged may actually weaken the banks and make them more vulnerable to risk.[32] Indeed, the history of banking is littered with examples of the problems

26. For a discussion of the potential federalization of insurance regulation under Dodd-Frank, see Hester Peirce, "Title V and the Creeping Federalization of Insurance Regulation," in *The Case against Dodd-Frank*, ed. Michel; Hester Peirce, "Insurance Regulation in the Dodd-Frank Era" (Policy Brief No. 2015-PB-02, Networks Financial Institute, Indiana State University, Terre Haute, IN, March 2015).
27. For a discussion of the optional federal charter, see the AEI book on optional federal chartering. Peter J. Wallison, ed., *Optional Federal Chartering and Regulation of Insurance Companies* (Washington, DC: AEI Press, 2000).
28. Scott E. Harrington, "Insurance Regulation and the Dodd-Frank Act" (Policy Brief No. 2009-PB-01, Networks Financial Institute, Indiana State University, Terre Haute, IN, March 2011).
29. See Henry N. Butler and Larry E. Ribstein, "A Single-License Approach to Regulating Insurance" (Faculty Working Papers 154, Northwestern University School of Law, Chicago, IL, 2008). See also Hester Peirce, "Title V and the Creeping Federalization of Insurance Regulation."
30. Miller, "The Recourse Rule, Regulatory Arbitrage, and the Crisis."
31. See Stephen Matteo Miller and J.W. Verret. "No Need for Title VI with Simpler, Higher Capital," in *The Case against Dodd-Frank*, ed. Michel. See also Hester Peirce and Robert Greene, "Rethinking the Volcker Rule" (Mercatus on Policy, Mercatus Center at George Mason University, January 2013).
32. As J.W. Verret has explained, restrictions on the commodities activities of banks raise similar concerns. J.W. Verret, "How the Price of Beer Cans Led to a Politicized Proposal from the Fed," *The Hill*, October 12, 2016.

caused by arbitrary regulatory lines on bank activities and geographic reach.[33] While it limits diversification in some areas, the Volcker Rule could cause financial institutions as a group to move into new types of risk-taking.[34] Regulators and banks have struggled to implement the Volcker Rule in a way that does not cut off legitimate market making and hedging and does not impair liquidity.[35]

As augmented by Title VI,[36] the Fed's power over holding companies and subsidiaries across the financial industry raises concerns about homogenized regulation. Because the Fed's remit has expanded to include nonbanks, all financial institutions—baked into the same mold by the Fed—will increasingly share vulnerability to regulatory mistakes by the Fed and market events.[37] An error made by the Fed will affect not only banks and bank holding companies, but the whole financial industry landscape.[38] In revisiting Title VI of Dodd-Frank, policymakers should consider whether the Fed's role in monetary policy conflicts with its regulatory and supervisory roles and creates undue temptation for the central bank to use its monetary policy tools to cover up regulatory mistakes.[39]

33. For a detailed discussion, see Charles W. Calomiris and Stephen H. Haber, *Fragile by Design: The Political Origins of Banking Crises and Scarce Credit* (Princeton, NJ: Princeton University Press, 2014); Michael D. Bordo, Angela Redish, and Hugh Rockoff, "Why Didn't Canada Have a Banking Crisis in 2008 (or in 1930, or 1907, or . . .)?," *Economic History Review* 68, no. 1 (2015): 218–43. For a short summary, see Stephen Matteo Miller, "The Path to 'Too Big to Fail': How We Got Holding Companies and Left Market Discipline Behind," *U.S. News and World Report*, December 19, 2016.
34. See, for example, Hester Peirce, "The Volcker Rule Increases the Likelihood that Banks Will Default," *RealClearMarkets*, March 26, 2014. As the op-ed notes, the benefit-cost analysis for the Volcker Rule warned, for example, of a potential "change in the composition of the banks' portfolio of government agency securities." Office of the Comptroller of the Currency, "Analysis of 12 CFR Part 44," accessed February 3, 2017, https://web.archive.org/web/20140321144523/http:/www.occ.gov/topics/laws-regulations/legislation-of-interest/volcker-analysis.pdf.
35. See, for example, Vern McKinley, "After the Crisis: Revisiting the 'Banks Are Special' and 'Safety Net' Doctrines" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, June 2015), 34–39. A recent Fed study found that the Volcker Rule has adversely affected corporate bond liquidity. Jack Bao, Maureen O'Hara, and Alex Zhao, "The Volcker Rule and Market-Making in Times of Stress" (Finance and Economics Discussion Series 2016-102, Board of Governors of the Federal Reserve System, Washington, DC, September 2016).
36. For an illustration of the expansion, see Hester Peirce and Robert Greene, "The Federal Reserve's Expanding Regulatory Authority Initiated by Dodd-Frank," Mercatus Center at George Mason University, November 13, 2013.
37. See Mark Calabria, Norbert Michel, and Hester Peirce, "Reforming the Regulators," in *Prosperity Unleashed: Smarter Financial Regulation* (Washington, DC: Heritage Foundation, forthcoming).
38. For a discussion of these and other problems with the Fed's regulatory approach, see Hester Peirce, "Legislation to Reform the Federal Reserve on Its 100-Year Anniversary" (Testimony before the House Financial Services Committee, Mercatus Center at George Mason University, Arlington, VA, July 10, 2014).
39. Ibid.

Under Titles VII and VIII of Dodd-Frank, regulators establish a new regulatory framework for over-the-counter derivatives (swaps) and the clearinghouses that now manage many of these contracts. Derivatives are financial contracts that derive their value from something else, such as a commodity, a bond, an interest rate, or a currency. They help financial and Main Street companies to manage risk and are also valuable sources of information to individuals, firms, and regulators.[40] Dodd-Frank mandates that central clearinghouses act as seller to every buyer and buyer to every seller in standardized swap transactions, and it also requires that these transactions be traded on exchange-like platforms.[41] Because of the size and complexity of the affected derivatives markets, this is an ambitious and dangerous undertaking. While central clearing moves some risk out of large financial firms, it introduces new risks for these firms, their customers, and the broader financial system.[42] Clearinghouses are inherently difficult to manage properly, and the introduction of government clearing mandates only complicates risk management.[43] Given that virtually all of the major financial institutions now interact with clearinghouses in at least one and usually more capacities, a clearinghouse misstep or a market event that causes the clearinghouse to collect additional margin to protect itself could spark a crisis. A better approach would drop the clearing mandate and allow market participants to decide when to use a clearinghouse.[44] Regardless of where clearing occurs, regulators should be able to see what is happening in these markets,[45] which Title

40. For a discussion of the role that derivatives play in the economy, see Bruce Tuckman, "In Defense of Derivatives: From Beer to the Financial Crisis" (Policy Analysis No. 781, Cato Institute, Washington, DC, September 29, 2015).
41. The focus on derivatives was driven by an incomplete understanding of the problems American International Group experienced during the crisis. See, for example, Hester Peirce, "Securities Lending and the Untold Story in the Collapse of AIG" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, May 2014). In any event, the tailored nature of AIG's swap transactions would have precluded them from being centrally cleared.
42. See, for example, Craig Pirrong, "The Inefficiency of Clearing Mandates" (Policy Analysis No. 665, Cato Institute, Washington, DC, July 21, 2010). Professor Craig Pirrong, an early skeptic of mandatory clearing, explains that "fundamental economic considerations suggest that a clearing mandate is likely to reduce market efficiency and pose its own systemic risks in a world where information is costly."
43. See generally Hester Peirce, "Derivatives Clearinghouses: Clearing the Way to Failure," *Cleveland State Law Review* 64, no. 3 (2016): 589–660, and sources cited therein.
44. See, for example, Hester Peirce and Vera Soliman, "Rethinking the Swaps Clearing Mandate," in *Reframing Financial Regulation*, ed. Peirce and Klutsey.
45. Despite claims to the contrary, prior to Dodd-Frank, regulators did have information about these markets. See, for example, Norbert J. Michel, "Fixing the Dodd-Frank Derivatives Mess: Repealing Titles VII and VIII," in *The Case against Dodd-Frank*, ed. Michel. Dodd-Frank improved the SEC's and CFTC's view into these markets.

VII reporting requirements may be able to achieve. In contrast, the clearing and trading mandates at the heart of the title fundamentally change these important markets by introducing new risks that are not fully understood.[46] Policymakers should modify Title XVI, which relates to the tax treatment of derivatives, as needed to reflect the changes in clearing and trading mandates.

Title VIII, an outgrowth of the clearing mandate of Title VII, should be modified to focus on coordination of principles-based regulatory oversight of clearinghouses, rather than on systemic designations. Title VIII allows regulators to prescribe special regulation for designated clearinghouses and other so-called financial market utilities (a term that implies intense regulatory control) and firms engaged in designated payment, clearing, or settlement activities. Title VIII therefore gives regulators a free hand to reshape a large swath of financial firms through the imposition of new "risk management standards," a term that the statute defines broadly.[47] Title VIII also allows the Fed to grant special privileges—including the ability to set up accounts at the Fed, the ability to earn money on Fed balances, and borrowing privileges—to designated financial market utilities.[48] Title VIII, following the lead of Title I, causes the firms that deal with clearinghouses and other financial market infrastructure firms to look to government regulators to oversee these entities and address any problems. A natural outgrowth of regulators' displacement of private monitoring and discipline is an expectation that the Fed will step in to bail out these entities if they fail. Bolstering this expectation is Title VIII's establishment of the avenues (Federal Reserve accounts and services) through which such bailouts could be carried out.[49] To avoid bailouts, the special designations of and privileges for clearinghouses and the broad regulatory delegations in Title VIII should be eliminated.

Title IX of Dodd-Frank addresses a large number of topics, most within the SEC's purview. The title warrants piece-by-piece consideration so that effective provisions can be retained. For example, expanding the SEC's ability to engage in investor testing is a useful rulemaking tool, particularly in combination with the

46. CFTC Commissioner J. Christopher Giancarlo makes specific recommendations for modifying swaps trading rules. Christopher Giancarlo, "Reconsidering the Dodd-Frank Swaps Trading Regulatory Framework," in *Reframing Financial Regulation*, ed. Peirce and Klutsey.
47. See Dodd-Frank § 805.
48. Clearinghouses, for example, are opening accounts at the Federal Reserve. Katy Burne, "Clearinghouses Park Billions in New Fed Accounts," *Wall Street Journal*, November 23, 2016.
49. For a discussion of Title VIII, see Norbert J. Michel, "Fixing the Dodd-Frank Derivatives Mess," in *The Case Against Dodd-Frank*, ed. Michel, 131; Peirce and Broughel, eds., *Dodd-Frank: What It Does and Why It's Flawed*, 91–98; Daniel M. Gallagher, "Bank Regulators at the Gates: The Misguided Quest for Prudential Regulation of Asset Managers: Remarks at the 2015 Virginia Law and Business Review Symposium," US Securities and Exchange Commission, April 10, 2015.

agency's new emphasis on rigorous economic analysis.[50] The Investor Advisory Committee and the Investor Advocate serve a useful role in advising the SEC, but the agency's five commissioners should bear ultimate responsibility for the agency's agenda and actions. Less clear is the need for the investor ombudsman, a position that Dodd-Frank created, but whose duties seem to overlap with the SEC's preexisting Office of Investor Education and Advocacy.

The SEC has not taken regulatory action under Title IX's provisions related to the duties that broker-dealers and investment advisers have toward their clients. A recent rulemaking by the Department of Labor may have effectively superseded those provisions and thus undermined the ability of the SEC—the primary governmental regulator of retail investors' relationship with their brokers—to effectively regulate in this area.[51] To ensure consistency, Congress should consider constraining the Department of Labor's regulatory authority under the Employee Retirement Income Security Act to eliminate potential conflicts with SEC rules.[52]

Title IX also deals with the SEC's relationships with self-regulatory organizations (SROs) such as the stock exchanges and Financial Industry Regulatory Authority (FINRA). Although Dodd-Frank's procedural changes to speed consideration of SRO rulemakings may have helped on the margins, any Dodd-Frank rewrite should focus on bigger issues related to the propriety of the role SROs play given their nongovernmental status and nontransparent methods.[53] As part of the reconsideration of the role of SROs in financial regulation, FINRA's arbitration process warrants review. However, research on the value of arbitration provisions in other contexts[54] should give the SEC pause before it acts on its Title IX authority to override mandatory arbitration clauses in private contracts.

50. Ellig, "Improvements in SEC Economic Analysis." For comparison, see Jerry Ellig and Hester Peirce, "SEC Regulatory Analysis: 'A Long Way to Go and a Short Time to Get There,'" *Brooklyn Journal of Corporate, Financial & Commercial Law* 8, no. 2 (2014): 361–437.
51. See, for example, Daniel M. Gallagher, Commissioner, US Securities and Exchange Commission, Comment Letter to Thomas Perez, Secretary, Department of Labor, July 21, 2015.
52. See, for example, Calabria, Michel, and Peirce, "Reforming the Regulators," in *Prosperity Unleashed: Smarter Financial Regulation*.
53. For a discussion of some of these issues, see Hester Peirce, "The Financial Industry Regulatory Authority: Not Self-Regulation after All" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, January 2015). See also Daniel M. Gallagher, "US Broker-Dealer Regulation," in *Reframing Financial Regulation*, ed. Peirce and Klutsey; David Burton, "Reforming FINRA" (Report, Heritage Foundation, Washington, DC, February 2017).
54. Jason Scott Johnston and Todd Zywicki, "The Consumer Financial Protection Bureau's Arbitration Study: A Summary and Critique" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, August 2015).

Title IX includes a number of enforcement-related provisions. Some of these—such as permitting collateral bars for different types of SEC registrants—have contributed to the SEC's ability to protect investors, but others have raised due process concerns.[55] For example, Dodd-Frank expanded the SEC's authority to impose penalties in administrative proceedings—enforcement cases run through the SEC's in-house tribunal rather than a federal court. After making active use of its authority, the SEC has faced a number of challenges to the legality of its administrative proceedings.[56] To address due process concerns, policymakers might consider retracting the expanded penalty authority in Dodd-Frank and adding protections for subjects of administrative proceedings. The infamous Madoff Ponzi scheme highlighted the valuable role that whistleblowers can play in rooting out fraud.[57] In response, Dodd-Frank established a new program for rewarding and protecting SEC whistleblowers. While this program (and a similar one at the CFTC) has generated useful information and should be retained, certain elements—particularly mandatory minimum payouts and permissible circumvention of internal reporting channels—should be studied in the light of the agencies' experience with their whistleblower programs.[58]

Title IX addresses credit ratings, which contributed to the crisis by masking asset risks and dissuading market participants from engaging in their own due diligence. Dodd-Frank took the positive step of requiring the removal of mandates to use credit ratings from statutes and regulations; these government mandates encouraged financial institutions to rely blindly on credit ratings.[59] Another part of Title IX, however, counteracts the positive effect of removing rating mandates. Title IX created a new credit ratings bureaucracy within the SEC, which encourages reliance on ratings and the government regulators that oversee them.[60] Title IX also gives the SEC authority to establish a system to assign credit ratings, which would further solidify the dependence of the credit rating industry on the SEC's seal of approval and accordingly diminish the incentive for ratings users to make their own assessments of the rating agencies.

55. To the extent the SEC has exercised its collateral bar authority retroactively, due process concerns also exist. See, for example, Gregory Bartko v. Securities and Exchange Commission, Case No. 14-1070, --- F.3d ---, (D.C. Circuit, January 17, 2017).
56. See, for example, Bandimere v. SEC, No. 15-9586, 2016 WL 7439007, --- F.3d --- (10th Cir., December 27, 2016); Raymond J. Lucia Cos., Inc. v. SEC, 832 F.3d 277 (D.C. Cir. 2016).
57. Harry Markopolos, *No One Would Listen: A True Financial Thriller* (Hoboken, NJ: John Wiley & Sons, 2010).
58. Hester Peirce, "Blowing the Whistle on Whistleblowers," *RealClearMarkets*, September 26, 2012.
59. White, "An Assessment of the Credit Rating Agencies."
60. Peirce and Broughel, eds., *Dodd-Frank: What It Does and Why It's Flawed*, 102–103.

In addition to reforming credit ratings, Title IX attempts to improve securitization by requiring securitizers to retain "skin in the game." The "skin-in-the-game" problem was created by the Recourse Rule, which was finalized in late 2001 to encourage securitization but discourage risk-taking.[61] By setting risk-weighted capital requirements for securitizations according to credit ratings, the Recourse Rule pushed banks to hold the highest-rated tranches, which suffered catastrophic losses during the crisis.[62] In any event, the final rules are complex and riven with exceptions, including one for securities backed by Fannie Mae and Freddie Mac. A better approach, particularly in light of Dodd-Frank's provisions strengthening disclosure and representations and warranties, would allow risk retention to be a matter of private contract. More fundamentally, non-risk-based capital requirements could diminish the incentive to securitize assets.[63]

Another major objective of Title IX is to expand the SEC's role in managing how companies are governed. The provisions requiring companies to allow shareholders nonbinding votes on executive compensation and golden parachutes, independence requirements for compensation committees, and proxy access authorization[64] fall into this category. Rather than eliminating competition among states in corporate chartering by federalizing corporate law, policymakers should look for ways to enhance competition, including allowing corporations to select charters that are tailored to their business model or industry.[65] In revising this portion of Title IX, policymakers should take a close look

61. For a detailed discussion of the Recourse Rule, see Jeffrey Friedman and Wladimir Kraus, *Engineering the Financial Crisis: Systemic Risk and the Failure of Regulation* (Philadelphia: University of Pennsylvania Press, 2011).
62. For a discussion of why banks involved in securitizing assets held the highest-rated tranches, see Isil Erel, Taylor Nadauld, and René Stulz, "Why Did Holdings of Highly Rated Securitization Tranches Differ So Much across Banks?," *Review of Financial Studies* 27, no. 2 (2014): 404–53. Miller, "The Recourse Rule, Regulatory Arbitrage, and the Crisis," shows that it was the largest securitizing banks that increased their holdings of the highest-rated tranches the most, which explains why the largest banks featured prominently during the crisis.
63. See, for example, Thomas L. Hogan, Neil Meredith, and Xuhao Pan, "Evaluating Risk-Based Capital Regulation" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, January 2013); Arnold Kling, "Risk-Based Capital Rules," in *Reframing Financial Regulation*, ed. Peirce and Klutsey. See also Miller, "The Recourse Rule, Regulatory Arbitrage, and the Crisis," which shows that after the Recourse Rule was finalized, large securitizing banks increased their holdings.
64. For a discussion of proxy access, see Bernard S. Sharfman, "What Theory and Empirical Evidence Tell Us about Proxy Access" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, August 2016).
65. See, for example, J.W. Verret, "Uber-ized Corporate Law: Toward a 21st Century Corporate Governance for Crowdfunding and App-Based Investor Communications," *Journal of Corporation Law* 41, no. 4 (2016): 101–43.

at the related issue of the degree to which regulation has caused undue reliance on proxy advisers.[66]

The social disclosure provisions in Titles IX and XV of Dodd-Frank merit reconsideration. These provisions burden and distract both the SEC and issuers without clear benefit for the investors that pay for them. They require companies to make disclosures related to arbitrary employee compensation ratios, conflict minerals, resource extraction, and mining. In addition to forcing the SEC to regulate outside of its traditional bailiwick, these provisions have had harmful consequences.[67] The SEC's disclosure requirements more traditionally have served investors by providing them material information related to corporate value maximization.[68]

Title IX contains a section on municipal securities, which should be an important area of focus for the SEC because of the size of the market and the heavy participation by retail investors. The particular changes made by the statute warrant reconsideration with an eye toward identifying the problems in this market and assessing whether Dodd-Frank's solutions are working and when additional legislative changes are needed. Among other things, policymakers should review the structural changes to the Municipal Securities Rulemaking Board made by Dodd-Frank and the new municipal adviser registration regime.[69] Any review should take into account events since the passage of Dodd-Frank, including the Puerto Rican debt crisis[70] and the SEC's enforcement activity against municipal debt issuers.

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66. James K. Glassman and J.W. Verret, "How to Fix Our Broken Proxy Advisory System" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, April 2013); James K. Glassman and Hester Peirce, "How Proxy Advisory Services Became So Powerful" (Mercatus on Policy, Mercatus Center at George Mason University, Arlington, VA, June 2014).
67. For a discussion of some of these harms, see David Burton, "How Title XV Mandated Disclosures Harm, Rather than Protect, Investors," in *The Case Against Dodd-Frank*, ed. Michel; Dominic P. Parker and Bryan Vadheim, "Resource Cursed or Policy Cursed? US Regulation of Conflict Minerals and Violence in the Congo," *Journal of the Association of Environmental and Resource Economists* 4, no. 1 (2017): 1–49. See also Peirce and Broughel, eds., "Title XV: Requirements for Nonfinancial Companies," in *Dodd-Frank: What it Does and Why It's Flawed*, 153.
68. J.W. Verret, "The Securities Exchange Act Is a Material Girl, Living in a Material World: A Response to Bebchuk and Jackson's 'Shining Light on Corporate Political Spending,'" *Harvard Business Law Review* 3, no. 1 (2013): 453–71.
69. Peirce and Broughel, eds., *Dodd-Frank: What It Does and Why It's Flawed*, 105–6.
70. See, for example, Marc D. Joffe and Jesse Martinez, "Origins of the Puerto Rico Fiscal Crisis" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, April 2016); J.W. Verret, "Draft Bill for Puerto Rico Will Only Hurt the Island," *The Hill*, April 8, 2016; J.W. Verret and Marc Joffe, "Should Puerto Rico Be Allowed to Restructure Its Debt? A Mercatus Debate" (Policy Brief, Mercatus Center at George Mason University, Arlington, VA, April 2016).

Title X of Dodd-Frank established the Bureau of Consumer Financial Protection (CFPB) to regulate providers of consumer financial products and services. The structure of the CFPB and its actions have raised questions about its legitimacy and constitutionality. The CFPB's structure—a single director who is removable only for cause, funded but not overseen by the Fed, granted extraordinary discretion in interpreting its statutes—makes it uniquely independent from accountability.[71] In light of these bureaucratic peculiarities, the Court of Appeals for the DC Circuit recently held that the CFPB's design is unconstitutional.[72] As might be expected for an agency that answers to no one, the CFPB has taken actions that raise concerns about due process, jurisdictional overreach, and research integrity.[73] A commission structure, congressional appropriations, a more rigorous economic analysis requirement, and a narrower jurisdiction would help to moderate the CFPB's actions and make them more consistent over time, which would in turn provide welcome predictability to regulated entities and their customers and investors.[74] Eliminating the CFPB and transferring its appropriately narrowed responsibilities[75] to the other banking agencies and the Federal Trade Commission may be necessary given that the CFPB's bad habits—developed over half a decade—could be difficult to root out. Title X also includes the controversial Durbin

71. Todd Zywicki, "The Consumer Financial Protection Bureau: Savior or Menace?," *George Washington Law Review* 81, no. 3 (2013): 856–928.
72. PHH Corp. et al. v. Consumer Financial Protection Bureau, No. 15-1177 (D.C. Cir., Oct. 11, 2016).
73. See, for example, Todd Zywicki, "Assessing the Effects of Consumer Finance Regulations" (Testimony before the Senate Committee on Banking, Housing, and Urban Affairs, Law & Economics Center, George Mason University School of Law, Arlington, VA, April 5, 2016); Hester Peirce, "Increasing the Effectiveness of the Bureau of Consumer Financial Protection in Protecting Consumers" (Testimony before the Financial Institutions and Consumer Credit Subcommittee of the House Financial Services Committee, Mercatus Center at George Mason University, Arlington, VA, May 21, 2014); Hester Peirce and Vera Soliman, "Disclosure of Consumer Complaint Narrative Data" (Public Interest Comment, Mercatus Center at George Mason University, Arlington, VA, September 10, 2014); Johnston and Zywicki, "The Consumer Financial Protection Bureau's Arbitration Study"; Thomas W. Miller Jr., Todd Zywicki, and Brian Knight, "Comment on the CFPB's Rule on Payday, Vehicle Title, and Certain High-Cost Installment Loans" (Public Interest Comment, Mercatus Center at George Mason University, Arlington, VA, October 7, 2016).
74. Brian Knight, "Court Rulings Bruise Consumer Financial Protection Bureau's Authority," *The Hill*, May 2, 2016.
75. Among other things, the new authority should clearly circumscribe jurisdictional reach, avoid the ill-defined term "abusive" acts and practices introduced by Dodd-Frank, and limit consumer data collection. See, for example, Hester Peirce, "CFPB Knows Abuse When It Sees It," Expert Commentary, Mercatus Center at George Mason University, March 29, 2012; Zywicki, "Assessing the Effects of Consumer Finance Regulation."

Amendment, which should be reconsidered in light of evidence that it has not helped consumers as intended.[76]

Title XI makes changes to the Federal Reserve's governance and its emergency lending authority. On the governance side, Title XI creates a new vice chairman for supervision, a position that has not yet been filled. If the Federal Reserve retains its regulatory and supervisory powers, the position should be retained and filled to establish some measure of accountability for the Fed's exercise of these authorities. Title XI also changes the way in which the Federal Reserve district bank presidents are chosen. Concerns about potential conflicts of interest are better addressed by not asking the Federal Reserve to engage in regulatory policy and credit allocation, the areas in which the conflicts arise.[77] In making reforms in this area, policymakers should consider the important insights that the district banks, which maintain relationships with banks and businesses throughout the United States (and outside of Washington, DC), have on monetary policy.[78]

With respect to emergency lending, Title XI mandates some public transparency in emergency lending and limits the Fed's authority in Federal Reserve Act section 13(3) by requiring that such lending be broadly available—not targeted to a single company.[79] The Federal Reserve's implementing rule chafes against these new restrictions by reserving for the Fed as much latitude as possible to engage in emergency lending.[80] The objectives of section 13(3) are better met through standard monetary policy tools that provide system-wide liquidity,

76. Todd J. Zywicki, Geoffrey A. Manne, and Julian Morris, "Price Controls on Payment Card Interchange Fees: The US Experience" (Financial Regulatory Research Program White Paper 2014-2, International Center for Law and Economics, Portland, OR, 2014).
77. See Lawrence H. White, "Ending the Federal Reserve's Overreach into Credit Allocation" (Testimony before the Subcommittee on Monetary Policy and Trade of the House Financial Services Committee, Mercatus Center at George Mason University, Arlington, VA, March 12, 2014), 5–6. Professor White explains, "Potential conflicts of interest can be entirely avoided while retaining the FRB member banks' desirable indirect input into monetary policy via the FRB presidents only by removing the Fed entirely from credit allocation. If the Fed gives no institution favored credit allocation treatment in the form of a bailout or concessionary loan, it does not matter which institutions are represented on an FRB's board of directors."
78. Dino Falaschetti and Chad Reese, "Come Together, over the Fed?," *The Hill*, March 3, 2015. The authors explain that "better aligning the incentives of monetary policy-makers with productive policy objectives could establish a stronger first line of defense against monetary mischief."
79. See James Broughel, "Fed Transparency and Bailouts," in *Dodd-Frank: What It Does and Why It's Flawed*, ed. Peirce and Broughel, 120–33.
80. Extensions of Credit by Federal Reserve Banks, 80 Fed. Reg. 78959 (proposed December 18, 2015). For some of the concerns with the Federal Reserve's approach, see, for example, comments by J.W. Verret, summarized in Martin Neil Baily and John B. Taylor, eds., *Across the Great Divide: New Perspectives on the Financial Crisis* (Stanford, CA: Hoover Institution Press, 2014), 371.

rather than directing aid to specific companies.[81] Policymakers should consider additional actions to regularize monetary policy, including bounded discretion, meaningfully increased transparency, and subjecting the Fed's actions to a market check.[82]

Title XII seeks to increase "access to mainstream financial institutions," but it does this by subsidizing bank lending to low- and moderate-income individuals. A preferable approach would be to expand unsubsidized private lending by lowering regulatory and litigation obstacles.[83] Eliminating or reforming the CFPB, which—along with other legal and regulatory developments—has heightened the legal risk of engaging with low- and moderate-income customers (or at least restructuring it to facilitate accountability), would help.[84] Also helpful in this regard would be a mandate to regulators to provide the flexibility necessary to accommodate innovation in the customer financial services space, rather than using rules and enforcement actions as a signal to would-be innovators that serving low- and moderate-income consumers carries with it heightened legal liability. Lowering regulatory barriers to entry and reducing the regulatory privileges enjoyed by incumbent financial institutions are two ways to invite innovators to offer consumer financial services to underserved populations.[85]

Titles XIII and XIV represent missed opportunities to deal with housing finance. Title XIII generates a report on housing finance reform, but no actual housing reform. Title XIV makes extensive changes in the rules governing mortgage lending, including new rules for mortgage originators and the new qualified

81. See Norbert J. Michel, "Title XI Does Not End Federal Reserve Bailouts," in *The Case against Dodd-Frank*, ed. Michel, 173–74.
82. See, for example, David Beckworth and Joshua R. Hendrickson, "Nominal GDP Targeting and the Taylor Rule on an Even Playing Field" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, October 2016); Alexander William Salter, "An Introduction to Monetary Policy Rules" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, December 2014); Mercatus Center, "Monetary Rules for a Post-Crisis World," September 7, 2016; Scott Sumner, "A Market-Driven Nominal GDP Targeting Regime" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, July 2013).
83. See, for example, Thomas W. Miller Jr. and Harold A. Black, "Examining Arguments Made by Interest Rate Cap Advocates," in *Reframing Financial Regulation*, ed. Peirce and Klutsey; Todd J. Zywicki, "Market-Replacing versus Market-Reinforcing Consumer Finance Regulation," in *Reframing Financial Regulation*, ed. Peirce and Klutsey.
84. See, for example, Brian Knight, "Court Rulings Bruise Consumer Financial Protection Bureau's Authority." See also Brian Knight, "Risks to Innovative Credit Posed by Emerging Regulatory and Litigation Trends" (Mercatus on Policy, Mercatus Center at George Mason University, Arlington, VA, January 2017).
85. Brian Knight, "Regulating FinTech: Creating a Regulatory Regime that Enables Innovation While Providing Appropriate Consumer Protection" (Reply Comment, Mercatus Center at George Mason University, Arlington, VA, May 12, 2016).

mortgage rules that heighten liability for mortgages disfavored by policymakers.[86] The new layer of regulatory complexity is expensive and burdensome, but it may not be effective at reducing defaults.[87]

Neither Title XIII nor Title XIV tackles the difficult but core issue of ending the government's involvement in housing finance. Market discipline does not kick in when taxpayers are on the hook for sloppy underwriting, so poor mortgage practices will persist until the government backstop is gone. Rather than relying on the federal government to set mortgage standards, reforms in this area would make the private market responsible for financing mortgages and establishing and enforcing proper underwriting standards.[88] Although certain types of mortgages, such as 30-year fixed mortgages, might be less common and more expensive in a privatized housing finance market, other types of mortgages likely would emerge.[89]

## CONCLUSION

Repealing Dodd-Frank entails rethinking the prevailing perspective on financial regulation and making specific, substantive changes. Dodd-Frank relies on regulators to run the financial system by elevating their judgment over the decisions of the individuals and firms with access to the best, most up-to-date information and with the most at stake. Financial reform should restore decision-making and the consequences of those decisions to their rightful place, and it should allow regulators to be regulators, not central planners. Substantively, the complexity of Dodd-Frank should give way to simple, well-enforced rules that lower barriers to competition, accommodate innovation, and eliminate both the expectation and possibility of bailouts. Only then will the financial system effectively and safely serve consumers, businesses, investors, and the economy.

86. For a more comprehensive discussion of Title XIV, see Mark A. Calabria, "Title IX Subtitle D and Title XIV: Likely to Increase Cost of Mortgage Credit and Increase Foreclosures," in *The Case against Dodd-Frank*, ed. Michel.
87. Ibid., 190.
88. For a discussion of potential approaches to reforming housing finance, see Satya Thallam, ed., *House of Cards: Reforming America's Housing Finance System* (Arlington, VA: Mercatus Center at George Mason University, 2012).
89. See, for example, Michael Lea and Anthony Sanders, "Do We Need the 30-Year Fixed-Rate Mortgage?" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, March 2011).

## ABOUT THE AUTHOR

Hester Peirce is a senior research fellow and director of the Financial Markets Working Group at the Mercatus Center at George Mason University. Before joining the Mercatus Center, she served as a senior counsel to the Republican staff on the Senate Committee on Banking, Housing, and Urban Affairs. Before that, she served as counsel to Commissioner Paul S. Atkins at the US Securities and Exchange Commission and as a staff attorney in the Division of Investment Management at the US Securities and Exchange Commission. She earned her BA in economics from Case Western Reserve University and her JD from Yale Law School.

## ACKNOWLEDGMENTS

I am grateful for the very helpful comments of Nita Ghei, Brian Knight, Frank Medina, Norbert Michel, Stephen Matteo Miller, Vera Soliman, and J.W. Verret. Their input was invaluable. All errors are my own.

DUFF & PHELPS

**VIA EMAIL**

The Honorable Jeb Hensarling, Chairman
House Financial Services Committee
United States House of Representatives
Washington, D.C. 20515

**Re: Duff & Phelps Statement in Support of the Choice Act**

Dear Mr. Chairman:

I am writing to present the views of Duff & Phelps on proposed Section 822 of the CHOICE Act, which directs the SEC to prepare and publish an enforcement plan and report on an annual basis. I would appreciate you making this statement a part of the Congressional Record.

Duff & Phelps strongly supports this proposed legislation as we believe that it will:

- provide clarity to industry participants on the Commission's areas of concern;
- help the industry focus and direct resources to those areas identified by the Commission;
- offer participants the opportunity to contribute to the Commission's decision making process by sharing information on business-side risk and industry trends; and,
- serve as a tool to harmonize the government's and the industry's understanding of what constitutes improper and illegal activity.

We believe this will make industry participants more mindful of SEC rules and regulations, and more efficient in their use of resources to comply with them. Because a comment period is provided, we believe Section 822 will also foster a healthy and constructive dialogue regarding risk identification and mitigation.

The proposed rule calls for publication of an annual enforcement report that would:

- detail the Commission's priorities regarding enforcement and examination for the forthcoming year;
- report on the Commission's enforcement and examination activities for the previous year;
- analyze litigated decisions found not in favor of the Commission over the preceding year;

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- describe emerging trends the Commission has focused on as part of its enforcement program including whether the Commission has communicated these trends to the industry;
- describe new legal theories or standards employed by the Commission;
- provide an opportunity for public comment.

We think each of these requirements creates a sensible and workable enforcement framework and serves to increase communications between the Commission and the industry in a meaningful and constructive way. We address each of these requirements below.

**Enforcement Plan and Report**

**1. Enforcement and Examination Priorities**

The SEC's Office of Compliance Inspections and Examinations ("OCIE") currently publishes a list of Examination Priorities annually, at the beginning of every year. This list of priorities is extremely helpful as it reflects certain practices that the SEC perceives present heightened risk to investors and the integrity of the capital markets. Publishing such a list helps industry participants learn about risks they themselves may not have identified and focus on mitigating risks of which they are already aware.

However, there is not an available a comparable report on enforcement priorities. Accordingly, industry participants are uncertain as to whether the Commission views certain issues as a matter of "best practice" or whether the Commission intends to enforce them as a violation of law. Having an explicit identification and breakdown of enforcement priorities would help industry participants themselves prioritize risk areas.

Furthermore, the SEC states that its examination priorities were determined after consultation with the Commissioners, regional office staff, the policy-making divisions, the enforcement division, the SEC's investor advocate and fellow regulators. Missing from the list of sources is the voice of the industry. We support the CHOICE Act's effort to incorporate the perspective of the industry regarding risks by including a comment period.

**2. Enforcement and Examination Activities**

The CHOICE Act would also require the SEC to report on the prior year's enforcement and examination activities including an assessment of how such activities compare with the identified priorities. We agree that the Commission should disclose how its actual activities compared to the one identified in the prior year. We do not suggest that the Commission should be tied to issues identified early in the year, if its judgement leads it to focus on areas of greater or increasing concern. The Commission should have the flexibility – indeed it has the obligation – to follow fraud and malfeasance wherever it may lead. However, this may create the impression of a lack of transparency and undermine the Commission's effort to focus the industry on its key concerns. Accordingly, we respectfully suggest that the

Commission be required to update the Priorities Report to the extent new issues are deemed to warrant closer scrutiny.

Awareness of Commission inquiries, sweeps and exams is selectively and inconsistently available—often only anecdotally—and the industry is frequently unaware of the Commission's concerns or changed focus. Posting updates to supplement and change priorities keeps everyone "on the same page". Furthermore, industry expertise is readily available to assist the Commission in explaining and understanding new products, services and investment strategies. Disclosing new areas of concern would enable the industry to support or even assist the Commission in its fact finding or assessment of new areas. This will further make the process efficient and risk mitigation effective.

**3. An analysis of litigated decisions not found in the Commission's favor**

There is currently inconsistent transparency regarding litigated decisions not found in the Commission's favor. The Commission does not typically publicize unfavorable decisions and no collection of such decisions is readily available on the Commission's website. As a result, any subject of an inquiry or enforcement decision is limited to research of reported decisions, and is unable to easily access information relating to unpublished decisions or those handled internally at the SEC, such as by an Administrative Law Judge. This puts the subject at an unfair disadvantage, unable to access information that might be beneficial or even exculpatory. Making more readily available a list of decisions not found in the Commission's favor levels the playing field between the government and the industry, and enables the industry to better understand the Commission's concerns, and better able to address them.

**4. A description of new and novel legal theories**

From time to time, the Commission employs new and innovative legal theories to combat fraud or wrong doing. This creativity is to be commended, particularly when dealing with a fast-moving market place which regularly produces new products, strategies and services. However, the ability to establish new theories of liability should not go unchecked – particularly when not designated by Congress. Doing so fosters uncertainty and suspicion and reduces confidence in the integrity of the process. We support the requirement that new theories of liability be specifically identified, and that the elements of any new cause of action be set forth with specificity.

**5. Opportunity for comment**

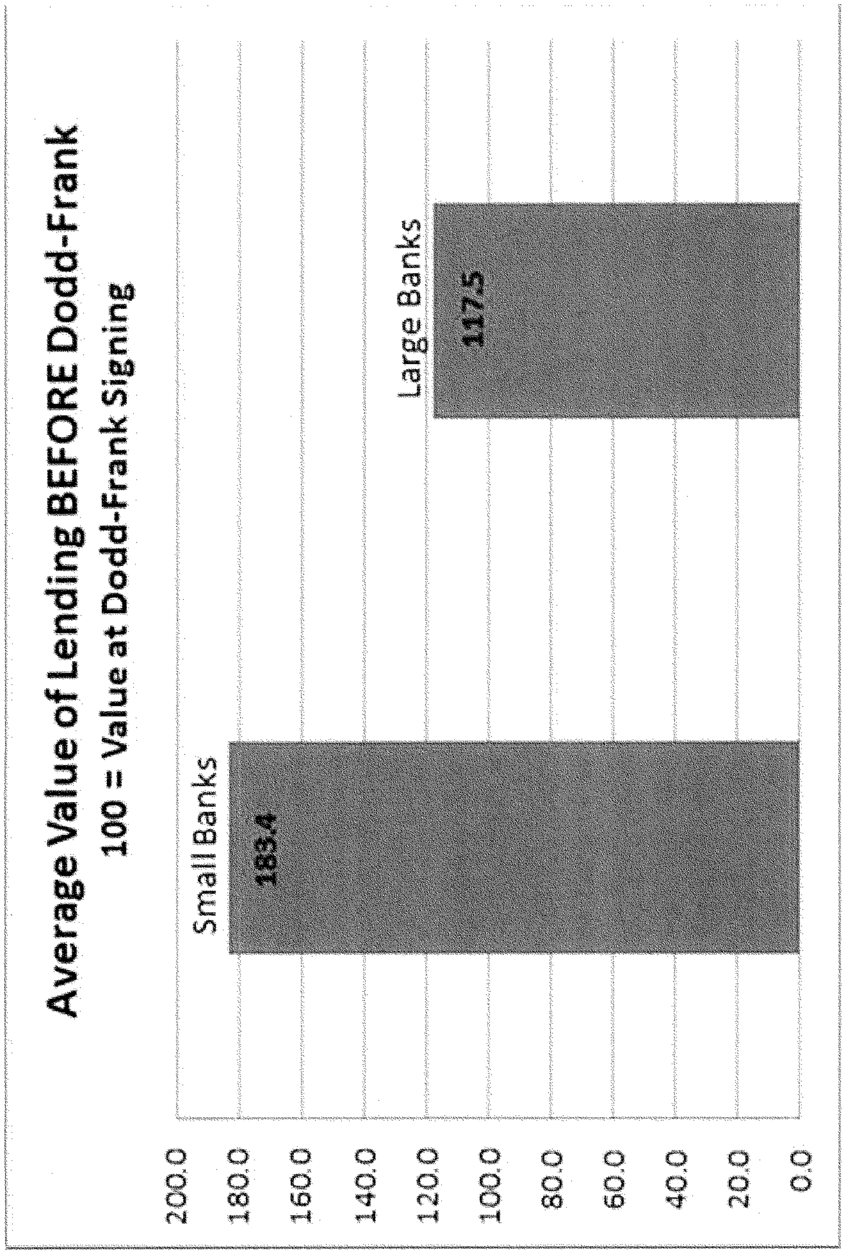
Finally, we very much appreciate that Congress has built into this new piece of legislation an opportunity for public comment. We believe the relationship between the industry and the Commission need not be adversarial or combative, but constructive and collaborative. By providing the industry an opportunity to comment on examination and enforcement activities, and weigh in on new theories of liability, Congress creates a very real opportunity for the Commission and the industry to work together to combat fraud and wrong-doing.

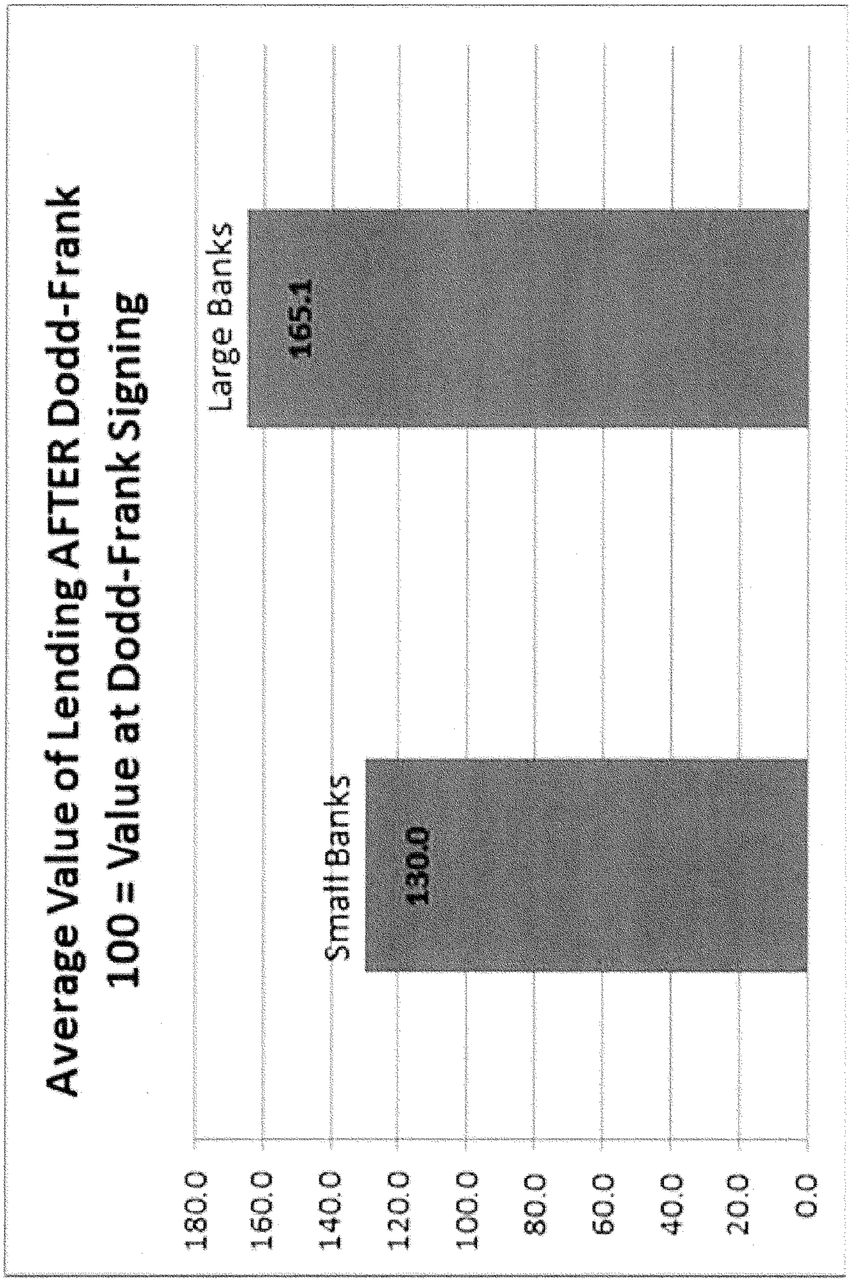
The great majority of industry participants make every good faith effort to do the right thing for their investors. This majority has every incentive to share with the Commission the manner in which investment services and products are sold, as it is difficult for law abiding advisers to compete with actual wrongdoers. Collaboration would help identify the real wrongdoers, mitigate key industry risks, and increase confidence in the enforcement process.

We fully support the Committee's efforts to increase transparency in the Commission's enforcement process. If you have any questions, please feel free to contact us at anytime.

Sincerely,

Rosemary Fanelli
Managing Director


Average Value of Lending BEFORE Dodd-Frank
100 = Value at Dodd-Frank Signing
Small Banks
183.4
Large Banks
117.5
200.0
180.0
160.0
140.0
120.0
100.0
80.0
60.0
40.0
20.0
0.0


Average Value of Lending AFTER Dodd-Frank
100 = Value at Dodd-Frank Signing
Small Banks
130.0
Large Banks
165.1
180.0
160.0
140.0
120.0
100.0
80.0
60.0
40.0
20.0
0.0

ELECTRONIC PAYMENTS COALITION

STATEMENT OF

MOLLY WILKINSON
EXECUTIVE DIRECTOR
ELECTRONIC PAYMENTS COALITION

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

HEARING ON

"A LEGISLATIVE PROPOSAL TO CREATE HOPE AND OPPORTUNITY FOR INVESTORS, CONSUMERS, AND ENTREPRENEURS"

PRESENTED
APRIL 26, 2017

ELECTRONIC PAYMENTS COALITION®

The Electronic Payments Coalition (EPC), which represents over 6,000 community banks, 7,000 credit unions, financial services trade associations, payment card networks, and banks, is pleased submit this testimony in support of section 735 of draft legislation titled the "Financial Choice Act of 2017." Repealing the Durbin amendment will reduce regulatory burdens on community banks and credits unions and will help foster economic growth. We commend you for your leadership on this this important effort, and respectfully urge all Members of the Committee on Financial Services to support your effort to repeal regulator burdens imposed by the Durbin amendment.

The Durbin amendment, which completely bypassed consideration by the Senate Banking Committee, has hurt consumers, small banks and credit unions.[1] In the nearly seven years since the enactment of the Durbin amendment, consumers have not seen savings at the register, big box retailers have pocketed over $42 billion, and small banks and credit unions have been squeezed by increased costs and lower interchange fee revenue. Conclusive evidence has been mounting for years that the price controls and regulatory mandates imposed by the Durbin amendment have been an abject failure. It is time that Congress addresses this market-distorting special interest giveaway by repealing the Durbin amendment.

Nearly seven years ago, with virtually no review or consideration – and no hearings or debate in any committee – the Senate added the Durbin amendment to the Dodd-Frank Act. In order to secure the votes needed from Senators concerned about hurting community banks and credit unions, Senator Durbin amended his original proposal to exempt small financial institutions from the interchange fee price control provisions. However, community banks and credit unions continued to object and argued that the exemption would not work. A bipartisan group of 131 House members (71 Democrats and 60 Republicans), led by Rep. Debbie Wasserman Schultz, sent a letter to members of the conference committee expressing "grave concerns" about the Durbin amendment. These concerns and those of the small banks and credit unions were ignored, and all of their predictions have come true.

Lobbyists representing the largest merchants claimed that the Durbin amendment has benefited small financial institutions. Even by Washington standards, this claim demonstrates an incredible amount of audacity. Our members, which represent thousands of small community banks and credit unions, do not support the Durbin amendment and have attested time and again – in testimony, letters, opinion articles, and speeches – that the Durbin amendment has adversely affected them in myriad ways. While community financial institutions are formally "exempt" from the interchange portion of the Durbin amendment, they are participants in an interconnected and interdependent electronic payment system. Tinkering with one part of that system impacts all parts. Knowing that the Durbin amendment would not give them a competitive advantage, small banks and credit unions opposed the Durbin amendment because they understood the

[1] The Electronic Payments Coalition submitted detailed comments in support of Durbin amendment repeal in a July 12, 2016 Letter from Molly Wilkinson to The Honorable Jeb Hensarling which can be found at: http://www.electronicpaymentscoalition.org/resource/epcs-letter-to-hfsc-on-durbin-amendment-repeal-in-financial-choice-act/.

system and knew that the exemption would not work. The Federal Reserve has released data confirming these predictions, indicating that the average interchange fee for so-called "exempt" issuers has fallen 19.7 percent for PIN transactions and 5 percent for signature transactions, thereby reducing total interchange revenue. This was yet another body blow to small banks and credit unions.

Furthermore, our members have been subjected to a backdoor price control that resulted from onerous rules mandating that all U.S. debit cards participate in an additional unaffiliated payment network without regard to security, reliability or acceptance rate. Prior to the Durbin amendment, financial institutions could select among competing networks based on the various features they offered, including security, reliability, and other consumer benefits. Financial institutions exercised their choice based on what served their customers best, and consumers selected cards based in part on these network features. Now, merchants dictate over which network consumers' transactions are routed.

These regulations have not benefited consumers one iota. Rather, consumers have been deprived of the benefits and protections they expect from the major networks under whose brand the card is issued. In many cases, consumers, who worry about the risk of fraud, are unaware of which network is used to route their transactions. Merchants' emphasis on minimizing costs weakens the incentive of issuers, networks, and others to invest in improvements to the quality and security of debit networks (e.g., strengthened fraud prevention services or protections) — despite consumer demand for these innovations. Before the Durbin amendment, networks competed to offer the best choices for consumers, and financial institutions could choose the networks that best served their cardholders, whether it was a single debit network or multiple networks. The routing provision means consumer interests have been cut out and the network choice is now made by merchants, inevitably leading merchants to choose the network which suits their bottom line over the security, reliability and benefits provided by networks that consumers likely prefer. Moreover, networks now compete less on innovation and system security and instead focus largely on pricing, further to the detriment of consumers. These provisions have imposed significant regulatory costs on our members. Small banks and credit unions need regulatory relief, not added regulatory burdens.

Retailers also told you that consumers have benefited from the Durbin amendment because merchants have passed on savings to them at the checkout. But their lobbying was not altruistic. Their intention was to benefit themselves, and many were honest about this at the time. For example, one large retailer executive in a 2011 earnings call commented that "the benefit to [Home Depot] could be $35 million a year."[2] Because the purpose of the Durbin amendment was to shift electronic transaction costs from merchants to banks, it should not be surprising that consumers have not seen lower checkout prices. Former Financial Services Committee Chairman Barney Frank understood the provision would not help consumers. He

[2] Statement of Carol Tomé, EVP Corporate Services and CFO, The Home Depot, Inc., Q4 2010 Home Depot Earnings Conference Call," Feb. 22, 2011; available at: http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9ODMwMTB8Q2hpbGRJRD0tMXxUeXBlPTM=&t=1.

stated, "I'm not a fan of the Durbin amendment. I think that's not going to help the consumer. That was intervening in a fight between two economic groups that should be left to their own."[3]

Barney Frank and others who predicted that this was a congressional giveaway to big box stores were correct. Compelling evidence demonstrates that which many had predicted – regulating interchange fees has had significant negative consequences which have been disproportionately borne by those who can least afford it. In their paper "Price Controls on Payment Card Interchange Fees: The U.S. Experience," Todd Zywicki, Geoffrey Manne, and Julian Morris concluded that "it is unambiguous that banking fees and other fees rose after the passage of the Durbin amendment and that eligibility for free accounts declined."[4] They found that as a result of the Durbin amendment, there will be a transfer of $6 to $8 billion annually to large merchants and their shareholders, which have been the primary beneficiaries of the Durbin amendment to date.

The Federal Reserve Bank of Richmond issued a report that contains compelling and directly relevant data regarding the minimal extent to which merchants pass interchange savings along to consumers, stating "few merchants are found to reduce prices or debit restrictions as debit costs decrease."[5] Specifically, the Richmond Fed surveyed a diverse set of merchants and found that more than three-fourths in the sample did not change their prices after the Durbin amendment was implemented. In fact, according to the study, nearly one in four merchants have actually increased prices since the Durbin amendment took effect—while just one percent of merchants reduced prices after the regulation was implemented. Other independent research corroborates the Richmond Fed's findings.[6]

Another predicable consequence of the Durbin amendment was that debit card issuers would look for new ways to offset at least part of the $6 to $8 billion loss of revenue. Issuers have responded in a variety of ways, including a 33 percent decline in debit rewards programs and a reduction in free checking. According to a recent Harvard study, relative to 2010 levels, the percentage of banks offering free checking accounts has declined by 42 percent, the average minimum balance required to avoid service fees has increased by 165 percent, and the average monthly service fee charged to consumers who do not maintain the minimum required balance has increased by 111 percent.[7]

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[3] New York Times, Dec. 11, 2012 (https://dealbook.nytimes.com/2012/12/11/an-architect-of-wall-street-reform-prepares-for-life-after-politics/?_r=0).

[4] Zywicki, Manne, and Morris, Price Controls on Payment Card Interchange Fees (2014).

[5] Wang, Schwartz, and Mitchell (2014). "The Impact of the Durbin Amendment on Merchants: A Survey Study."

[6] For example, see Evans, Chang, and Joyce, "The Impact of the U.S. Debit Card Interchange Fee Regulation on Consumer Welfare: An Event Study Analysis" (2013) ("Using an event study this paper finds that consumers have lost, on net, about $22 billion to $25 billion from the enactment of the Durbin Amendment. Those figures are present discounted values calculated over the lifetime of the interchange fee reductions. While retailers are expected to pass on some of their cost savings, that appears to be significantly outweighed by likely fee increases, or reductions in service quality, for checking accounts.").

[7] Marshal Lux & Robert Greene, *Out of Reach: Regressive Trends in Credit Card Access* (April 2016).

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Furthermore, the enactment of the Durbin amendment coincides with a significant reduction in the growth of debit cards, which a 2011 Boston Fed analysis concludes "low- and moderate-income consumers tend to use debit cards much more often than they use credit cards, are nearly twice as likely to use one for a given transaction, and in general, tend to rate them as being better payment instruments." This is not surprising, as caps on interchange fees have, in effect, made debit cards a less attractive business model to card issuers—especially credit unions and small community banks. The evidence is quite strong. According to data from Euromonitor International, debit card transaction volume grew 20 percent per year from 2002 – 2010, but slowed to just 4 percent from 2011 – 2016. Similarly, debit card transaction value grew at an annual rate of 20 percent from 2002 – 2010, but fell to just 3 percent from 2011 – 2016. The Durbin amendment has leveled a triple whammy on consumers: 1) they have not received the price reduction promised by the merchants; 2) they are now paying for previously free banking services; and 3) debit card users, who are principally low- and moderate-income consumers, get less benefits from those cards than they did pre-Durbin. A recent report explained:

> That a forced reduction in interchange fees would result in higher bank fees for consumers is a matter of basic economics. Retail banking in the United States is a highly competitive industry and there is no evidence of supra-normal profitability for retail banks. As such and over time, cost increases or revenue reductions will be passed on to bank customers in the form of higher bank fees or reduced services. It was simply inevitable that the removal of billions of dollars in interchange fee revenue would ultimately result in higher costs for bank consumers.[8]

Notwithstanding this mountain of evidence to the contrary, merchants continue to argue that the Durbin amendment benefited small banks and consumers. Quite the opposite occurred. The Durbin price control and regulatory mandates do not foster competition. Instead, they hinder innovation, favor incumbency, create shortages, and distort markets. Clearly, the Durbin amendment's price controls have had negative effects on small banks, credit unions and consumers, particularly low- and moderate-income consumers.

We understand why merchant trade associations, who generally eschew regulation of their industry, are fighting so hard to maintain their artificial, governmentally mandated preference. However, based on the evidence, we urge Congress to fix this undeniable mistake. Repealing the Durbin amendment is the right thing to do for both consumers and small community banks and credit unions, and we urge you to join in a bipartisan way to fix this problem by repealing the Durbin amendment.

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[8] Zywicki, Manne, and Morris, Unreasonable and Disproportionate: How the Durbin Amendment Harms Poorer Americans and Small Businesses (2017).

ICBA
INDEPENDENT COMMUNITY
BANKERS *of* AMERICA®



April 25, 2017

The Honorable Jeb Hensarling
Chairman
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Hensarling:

On behalf of the nearly 6,000 community banks represented by ICBA, I write to express our support for the "Financial CHOICE Act of 2017" (the CHOICE Act). The community banking sector nationwide is fully supportive of much-needed and overdue relief from the choking regulatory burden that impedes their ability to best serve the needs of their customers and local communities. ICBA strongly believes that a timely and aggressive approach to reform of our financial regulatory system is sorely needed to strengthen the financial services sector as well as the American economy. In particular, avoidance of rigid, inflexible rules is needed to ensure community banks can customize loans and other products to meet a customer's unique needs and provide personalized financing to purchase or improve a home, or start or grow a business. ICBA is pleased to see that the CHOICE Act advances key reforms of community bank regulatory relief bills that we have previously endorsed and many provisions from our Plan for Prosperity agenda. We are grateful for your recognition of the community bank perspective. ICBA is especially pleased that you dedicated Title V of the CHOICE Act to "Regulatory Relief for Main Street and Community Financial Institutions."

ICBA strongly supports full repeal of the Durbin Amendment artificial government price controls on debit card interchange which has created a windfall for big box retailers at the expense of consumers and Main Street financial institutions. Repealing new and unnecessary CFPB data collection and reporting requirements for every small business loan application will avert a pending bureaucratic nightmare for community banks which will only divert invaluable community lending resources and constrict the flow of small business credit.



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Higher exemption thresholds for the Home Mortgage Disclosure Act, automatic "qualified mortgage" status for loans held in portfolio, and escrow relief for community bank mortgages held in portfolio will all help keep community banks serving their communities' mortgage financing needs, particularly the needs of borrowers who may not meet standardized secondary market criteria.

Providing for short form call reports will restore proportionality to a call report that has grown exponentially in recent years. Advancing greater cost-benefit analysis for proposed and existing regulations and greater accountability in the bank exam environment is welcomed. Addressing the costly and duplicative SOX 404(b) internal controls will free up time and resources that can be better focused on serving the financial needs of customers. Increasing the asset threshold for the Federal Reserve's Small Bank Holding Company Policy Statement from $1 billion to $5 billion will provide much-needed capital-raising opportunities for hundreds of community bank holding companies. Additionally, the CHOICE Act allows federal savings associations the charter flexibility to more effectively serve their customers.

These provisions, together with other select provisions of the CHOICE Act, will help foster a more sensible and proportionate financial regulatory system that will facilitate economic growth and job creation.

ICBA has always advocated against the dangers of too-big-to-fail institutions. While we do have serious concerns with provisions in the bill that would alter the 10 percent deposit cap and the 10 percent liabilities cap, we trust these concerns can be resolved as we continue to work with you and the committee, and should not prevent the important work of regulatory relief and the CHOICE Act from moving forward so that its larger purposes can be realized.

Thank you again for introducing the Financial Choice Act of 2017. We look forward to working with you and the committee on this bold and forward thinking legislative proposal.

Sincerely,

/s/

Camden R. Fine
President & CEO

RILA
AIL INDUSTRY LEADERS ASSOCIATION
ucate.Collaborate.Advocate.

1700 North Moore Street, Suite 2250, Arlington, VA 22209

April 25, 2017

The Honorable Jeb Hensarling
Chairman
House Financial Services Committee
2129 Rayburn House Office Building
Washington, D.C. 20515

Dear Chairman Hensarling:

The Retail Industry Leaders Association (RILA) appreciates the opportunity to comment on the discussion draft for the Financial CHOICE Act of 2017. We commend the Chairman and the Financial Services Committee for their work to produce a substantive policy proposal to address a number of regulatory issues facing the U.S. economy. However, the inclusion of Section 735 to fully repeal the bipartisan debit swipe fee reforms contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act—more commonly known as the Durbin Amendment—is an unfortunate decision. RILA is strongly opposed to this draft in its current form.

RILA is the trade association of the world's largest and most innovative retail companies. RILA members include more than 200 retailers, product manufacturers, and service suppliers, which together account for more than $1.5 trillion in annual sales, millions of American jobs, and more than 100,000 stores, manufacturing facilities, and distribution centers domestically and abroad.

As outlined throughout this letter, the points being presented by the banking and credit union communities for the inclusion of Sec. 735 into the discussion draft—especially those coming from the largest financial institutions in the country—simply do not add up. It is important to remember the established voluntary threshold only covers banks with more than $10 billion in assets. This means 98.6% of banks and credit unions in the country can set fees at their discretion and these financial institutions have the benefits of the dual routing provision that allows the debit networks to compete against the major global card networks for their business.

There has also been a false argument that swipe fee reform has been harmful to smaller banks. The study by the Philadelphia Federal Reserve in the first quarter of 2016 indicated that, after the debit reforms went into place, "the volume of transactions conducted with cards issued by exempt banks grew faster than it did for large banks."[1] The study concluded, "The evidence does not support the claim that competitive forces have effectively imposed the interchange fee ceiling on small banks."

The banks have also claimed that swipe fee reform has resulted in consumers losing the benefit of free checking. However, the American Bankers Association's (ABA) own study shows more Americans have free checking today than they did before this policy passed. In 2010, the ABA reported that 53%[2] of consumers had free checking compared to 61%[3] last year.

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[1] James DiSalvo and Ryan Johnston, Federal Reserve Bank of Philadelphia Research Department, Banking Trends: How Dodd–Frank Affects Small Bank Costs (1st Quarter 2016)

[2] ABA Survey Shows Majority of Bank Customers Pay Nothing for Monthly Bank Services (Oct. 7, 2010), http://www.prnewswire.com/news-releases/aba-survey-shows-majority-of-bank-customers-pay-nothing-formonthly-bank-services-104516904.html.

[3] American Bankers Association, Survey: Most Americans Pay Nothing for Bank Services (Aug. 18, 2015)

RILA
'AIL INDUSTRY LEADERS ASSOCIATION
ucate.Collaborate.Advocate.

1700 North Moore Street, Suite 2250, Arlington, VA 22209

The dire predictions by the largest banks have never come to fruition. In fact, the only full comprehensive study done on this issue by economist Dr. Robert Shapiro shows the debit reforms saves consumers six billion dollars[4] per year and has created 37,000 jobs in the first year alone.

If the Financial Services Committee is intent on bringing substantial change to the payment ecosystem, RILA encourages the Chairman and Members of the Committee to consider the challenges of today and tomorrow and not re-litigate an issue from the past.

Visa and MasterCard's current dominance in the credit and debit markets prevents new players—who would offer robust competition and new technological advancements—from entering the payments world. This is one of the key reasons why RILA has supported legislation to bring more competition, disruption and innovation to the payment marketplace.

One of the primary pillars of swipe fee reform was to finally bring some competition and transparency to the debit market. This specific policy was paramount for retailers—especially small business who now have the ability to bring in other routing options outside of Visa and MasterCard and avoid their draconian fee structure. The ripple effect from this free market policy has allowed businesses to be more competitive in the economy.

RILA implores the Committee to listen to businesses of all sizes and understand swipe fee costs are second only to payroll for most businesses. Repealing swipe fee reform would give more control to the duopoly of Visa and MasterCard and additional revenue to the largest banks on the backs of Main Street retailers.

As this process moves forward over the coming weeks, RILA stands ready to have a thoughtful discussion on other provisions within the discussion draft but strongly encourages the Committee to remove Sec. 735 before it is introduced in the U.S. House of Representatives.

Sincerely,

Austen Jensen
Vice President,
Government Affairs

Cc: House Financial Services Committee Members

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http://www.aba.com/Press/Pages/081815SurveyonBankCosts.aspx.

[4] Robert J. Shapiro, Sonecon, LLC, *The Costs and Benefits of Half a Loaf: The Economic Effects of Recent Regulation of Debit Card Interchange Fees* (Oct.1, 2013).

THE VOICE OF FOOD RETAIL
Feeding Families Enriching Lives

April 25, 2017

Chairman Jeb Hensarling
House Financial Services Committee
2228 Rayburn House Office Building
Washington, DC 20515

Ranking Member Maxine Waters
House Financial Services Committee
2221 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Hensarling and Ranking Member Waters:

Food Marketing Institute[1] (FMI) respectfully requests to have this letter included in the record for the hearing entitled "A Legislative Proposal to Create Hope and Opportunity for Investors, Consumers, and Entrepreneurs." FMI proudly advocates on behalf of the supermarket industry, which employs 4.8 million people in the United States alone and has almost $650 billion in annual sales. Our membership includes retail stores ranging from a single family operated store to a large national chain, all operating in very competitive markets. Unfortunately, the current discussion draft of the Financial CHOICE Act of 2017 includes language that limits choice, competition and transparency and with its inclusion, our industry strongly opposes the legislation. FMI strongly opposes the bill as drafted and respectfully requests that Section 735 of the bill be removed.

The debit reform measures that were included in the *2010 Dodd-Frank Wall Street Reform and Consumer Protection Act* brought stability, transparency and competition into an area of grocers' operations where there previously was none. Repealing this successful law today would needlessly harm U.S. consumers while adding to grocers' cost of doing business, further impeding their ability to grow, create jobs and contribute to our economy. Repeal of the debit reforms would only benefit a few very large banks and card networks.

First, the debit reforms placed voluntary limits on the amount the largest banks in the country could charge merchants through swipe fees on debit card transactions when these fees are set centrally. These largest banks consist of only the top 1.4% of banks – each with over ten billion dollars in assets. These large banks could be exempt from any fee caps if they choose to set their own fees as opposed to relying on Visa and MasterCard to centrally set them. Even under the current cap set by the Federal Reserve Board, the covered banks are making a 500 percent profit on debit transactions, on average.

To put this into perspective, in 2016, Wells Fargo & Company was the largest issuer of debit cards in the United States with over 8 billion individual debit purchases totaling $306.8 billion. By collecting on average 23 cents per transaction, the bank made around $1.844 billion in debit interchange revenue last year. Repealing the law and allowing Wells Fargo to return to pre-reform rates would allow the bank to double the average interchange collected on a transaction, netting the bank an additional $1.844 billion in profits paid for by Main Street merchants and U.S. consumers.[2]

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[1] *Food Marketing Institute proudly advocates on behalf of the food retail industry. FMI's U.S. members operate nearly 40,000 retail food stores and 25,000 pharmacies, representing a combined annual sales volume of almost $770 billion. Through programs in public affairs, food safety, research, education and industry relations, FMI offers resources and provides valuable benefits to more than 1,225 food retail and wholesale member companies in the United States and around the world. FMI membership covers the spectrum of diverse venues where food is sold, including single owner grocery stores, large multi-store supermarket chains and mixed retail stores. For more information, visit www.fmi.org and for information regarding the FMI foundation, visit www.fmifoundation.org.*

[2] Nilson Report, April 2017 Issue 1107

2345 Crystal Drive, Suite 800, Arlington, VA 22202-4801 T 202.452.8444 F 202.429.4519 www.fmi.org

Even MasterCard recognizes that a reduction in interchange fees helps small businesses grow, innovate and compete. In February, MasterCard and the Canadian Federation of Independent Businesses (CFIB) announced that the card brand would reduce credit card interchange rates for CFIB members by 12%. Brian Lang, President of MasterCard in Canada commented that the reduction in interchange fees would "...help small businesses continue to grow and give them more opportunity to bring innovative products and services to Canadian consumers."[3] Main Street retailers in America continue to pay the highest interchange fees in the world, hampering their ability to grow and compete. Repealing the law would only harm them more while benefitting only a few of the very largest banks in the country.

FMI would like to note that the limits on what the giant banks can charge merchants only applies if they choose to have the major card brands, Visa and MasterCard, set their rates for them. These limits were established to encourage banks to step out of the central price setting schemes and set their own rates. If a bank chooses to set their own rates and compete on the open market, they are not bound by the Federal Reserve's limits. An example of this is JP Morgan Chase & Company's introduction of Chase Pay. This novel approach has Chase actually competing for merchant business by offering reduced transaction costs, greater security and visibility to customers. On the bank's website, Chase explains "Chase Pay actually lowers your cost of payments. Because it runs on our closed-loop platform called ChaseNet, we are able to offer special pricing and card present rates for Chase Pay transactions."[4] Innovation and open competition like this is driven by the debit reforms and are further proof of their success.

While much of the committee's focus has been on the interchange portion of the debit reform law, FMI would like to highlight two other pieces that drive competition and are allowing grocers to make decisions that best suit their business. First, the debit reform law required that the networks compete for merchant routing business. Prior to the reforms, the major card brands (Visa and MasterCard) paid many of the largest banks in the country to sign exclusivity contracts, ensuring the brands had monopolies on routing debit transactions from these large issuing banks. In 2010, five of Visa's ten largest issuing banks had signed contracts prohibiting competition. As a result, merchants were left with no options on the majority of cards presented in their stores but to route using a single network. As a result, Visa routed 79% of all debit transactions from its ten largest banks.[5] This lack of competition artificially inflated network fees and left grocers of all sizes without the ability to negotiate the cost, security or efficiency in routing. It also did not give grocers a backup plan, should the network be down and unavailable due to any type of emergency.

The law simply requires that each debit card have at least two unaffiliated networks. This requirement has been successful in increasing the efficiency and security of debit transactions while lowering grocers' cost for processing them. Since the law went into effect, there have been significant innovations in security tools as well as reliability in the networks. A repeal of this law would result in more costly and potentially less secure and less reliable transactions and would eliminate the competition in this space.

Debit reforms took the first step to address the restrictive and voluminous card brand acceptance rules for merchants. Prior to reforms, merchants risked significant fines and penalties from Visa and/or MasterCard if they offered a discount to a customer using a debit card. Additionally, the same merchant was subject to additional fines and fees if they made the business decision to set a minimum purchase amount for credit card transactions to avoid the fee exceeding the purchase price or profit margin. These rules unfairly restricted a merchant's ability to make decisions on how to run their business and try to contain the costs of accepting electronic payments. The debit reforms removed these restrictions. Merchants may now incentivize the use of debit cards or cash by offering a discount for those payment forms and a merchant can choose to set a minimum

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[3] http://www.cfib-fcei.ca/english/article/9162-canadian-federation-of-independent-business-partners-with-mastercard-to-meet-the-needs-of-small-business.html

[4] https://www.chase.com/digital/digital-payments/merchant-chasepay

[5] Digital Transactions, January 2011

for a credit card purchases without the risk of facing fines that can start at $5,000 a day. These useful tools for merchants will be taken away if the debit reforms are repealed.

Unfortunately, as drafted, the "CHOICE" Act ignores the clear success and competition that has resulted from the debit reform law. In its current form, by repealing all of the debit reform provisions, the "CHOICE" Act would allow for the return of the monopolistic exclusivity contracts eliminating the competition that we see today. Repeal of the reforms would ensure that the largest banks and networks can return to an anti-competitive market that leaves consumers and merchants paying the highest swipe fees in the world in an inherently less secure payment system. Repealing the law would prove to be a windfall for the largest banks that as an industry already enjoys a 24% profit margin paid for by merchants (1.9% profit margin) and consumers.[6] The American economy, merchants and consumers all deserve better.

Thank you for your consideration of FMI's concerns about the "CHOICE" Act. FMI will continue to oppose the "CHOICE" Act of the 2010 debit reforms are repealed. FMI stands ready to work with the Chairman and all House Financial Services Committee members on regulatory reform legislation that will truly foster more competition and benefit our economy, employers, and consumers.

Sincerely,

Jennifer Hatcher

Jennifer Hatcher
Chief Public Policy Officer & Senior Vice President
Government Relations

Cc: Members of the House Financial Services Committee

[6] http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/margin.html

April 25, 2017

Chairman Jeb Hensarling
House Financial Services Committee
2228 Rayburn House Office Building
Washington, DC 20515

Ranking Member Maxine Waters
House Financial Services Committee
2221 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Hensarling and Ranking Member Waters:

The Merchants Payments Coalition[1] respectfully requests to have this letter and the two attached letters entered into the record for the hearing entitled "A Legislative Proposal to Create Hope and Opportunity for Investors, Consumers, and Entrepreneurs". The MPC strongly opposes the so-called "Financial CHOICE Act of 2017" in its current form. Section 735 of the bill would repeal the pro-competitive 2010 debit reform law that has benefited millions of Main Street retailers across the country and the U.S. consumer. Repealing the law today will give more than $8 billion per year to largest of the large "mega banks" – and it will be paid for by consumers and Main Street merchants. As PayPal's Executive Vice President and Chief Operating Officer recently observed, repealing the debit reforms is "... bad for small business, not good for consumers. The only people who benefit are big banks..."[2] and Main Street retailers could not agree more.

Merchants compete in the open market every day on price, selection, quality and service. This competition benefits the U.S. consumer and is one of the pillars of our U.S. economy. Unfortunately, merchants' hands have been tied for too long with overwhelming hidden fees the card brands and banks collect every time a customer swipes a debit or credit card for payment in the United States. In fact, the U.S. pays the highest amount and rate of hidden swipe fees of any country in the industrialized world. These hidden fees take money from consumers' pockets and depress retail sales which hurts jobs.

**In the time the reforms have been in place, consumers and Main Street have saved $40 billion and more than 37,000 jobs per year have been supported.**

American merchants deserve a better solution than repealing the only reform that has fostered competition and opened what was previously a closed market. The "Financial CHOICE" Act attempts to return the debit card market to price-fixed fees set by Visa and MasterCard and

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[1] The Merchants Payments Coalition represents retailers, supermarkets, drug stores, convenience stores, gas stations, on-line merchants and others fighting for a more competitive and transparent card system that is fair to consumers and merchants. Member associations represent 2.7 million stores with 50 million employees.

[2] https://seekingalpha.com/article/4039989-paypal-holdings-pypl-ceo-dan-schulman-q4-2016-results-earnings-call-transcript?part=single

charged by the banks. These modest reforms touched three areas of the debit market to foster competition and transparency. First, the law directed the Federal Reserve to establish voluntary limits on what the largest 1.4% of banks in the country could collect in swipe fees if they chose to have Visa and MasterCard fix their prices for them. Conversely, if a bank, as J.P.Morgan Chase has now done with ChasePay, chooses to set its own prices and compete, they can freely set their rates as high as the market will bear.

In addition to the voluntary limits, the 2010 debit reforms stopped Visa and MasterCard from blocking all of their competitors from debit cards. Prior to reforms, Visa and MasterCard paid their largest issuing banks to sign exclusivity contracts that prohibited any other debit network from handling transactions on those debit cards. These contracts stopped competition among networks in its tracks. The 2010 debit reforms ensured that there would again be competition so that merchants could choose between at least two competitor networks to route their transactions.

The 2010 debit reforms have worked to open a previously closed, anti-competitive market. Repealing the established successful law now will be a blow to free enterprise and a boon for the largest of the large banks and card brands that do not want to compete in an open market. The MPC strongly opposes any bill that repeals or weakens the 2010 debit reform law and asks that section 735 of the "Financial Choice Act of 2017" be removed from the bill. If section 735 remains in the bill, merchants throughout the country will oppose passage of the bill.

Please see the attached letter from over 170 national, state and local trade associations and a letter signed by over 960 companies in support of the debit reforms.

Sincerely,

Merchants Payments Coalition

Cc: House Financial Services Committee Members

Statement of the

**National Retail Federation**

**and**

**National Council of Chain Restaurants**

submitted to the

**U.S. House of Representatives**
**Financial Services Committee**

for its hearing

**"A Legislative Proposal to Create Hope and Opportunity for Investors, Consumers, and Entrepreneurs"**

held on

April 26, 2017

**Mallory Duncan**
Senior Vice President,
General Counsel

On behalf of:

National Retail Federation
1101 New York Avenue, N.W., Suite 1200
Washington, D.C. 20004
(202) 783 –7971
www.nrf.com

Debit card reform has been a remarkable success. It has saved retailers and their customers billions of dollars and it has brought the beginnings of transparency and competition to a market where swipe fees were price-fixed and all banks linked arms to charge the same high fees. If reform is repealed, the big banks and card companies will go back to those practices. Nothing will stop them from returning to monopoly-high fees – driving up costs for Main Street merchants and the prices paid by their customers in the process. Moreover, reform reopened competitive markets for routing transactions, providing better prices and better security in the process. If reform is repealed, nothing will prevent them from again strangling innovative regional networks, further driving costs back up and hammering competition back down. This has been settled law for the better part of a decade. We should be looking at the future of payments rather than trying to re-legislate these important protections for transparency and incentives toward fair market competition.

Prior to the passage of Dodd-Frank, the costs associated with networked debit card transactions were not subject to true market competition. The problem was made worse by a lack of transparency.

Debit interchange fees were centrally fixed. As a consequence, every one of the more than 100 largest banks ultimately charged merchants exactly the same high rates for interchange fees. Year in, year out, all those banks consistently raised their identical fees by the same amount at the same time.

In addition, in the years immediately preceding the passage of Dodd Frank, the capacity for competitive routing of those transactions over more than a dozen robust networks was systematically being removed from the market by the actions of the dominant debit card players.

Market failures also were occurring in the credit card market. As a result, consumer prices were being forced up by the escalating fees. Main Street merchants in particular were being harmed, and card company rules effectively prohibited merchants from showing their customers the escalating costs of cards, which amounts to hundreds of dollars per year for the average household.

Section 1075 of Dodd-Frank enacted provisions designed to partially address these market failures, focusing on debit cards but also providing minor relief for credit cards as well. These are the three primary provisions.

1. For banks that continued to link arms and charge the same centrally fixed debit card interchange fees in lieu of competition, the Federal Reserve was ordered to develop standards that ensured those fees were reasonable and proportional to their actual cost. If a bank chose to unlink arms and compete independently, it would not be governed by the Fed standards and could charge whatever price the open market would accept.
2. To counter the fact that banks were being paid to eliminate the connectivity necessary for regional or smaller innovative networks to compete for the ability to route transactions, the law required that access to at least two unaffiliated networks be available for every debit transaction.

3. The law took a first step toward transparency by allowing merchants to set a minimum purchase amount for credit cards of up to $10. It did so by overturning card company rules that effectively prohibited merchants from doing so. This gave merchants the ability to suggest to consumers the high costs involved in accepting credit cards. And by moving some transactions away from credit cards, it ameliorated some of the credit card costs merchants (and ultimately consumers) bore.

These reforms have significantly improved the market.

As to routing, the competitive networks have increased their market share by offering services the dominant legacy players had not, such as less downtime, encrypted transactions to better protect merchants and their customers from breaches, and lower prices. As to debit interchange, the law has produced lower fees across the board, saving merchants and their customers more than $40 billion even while providing the regulated banks a 500 percent markup above their costs as calculated by the Fed. In addition, the incentives to compete outside the centrally fixed system have already induced one money center bank to offer an array of competitive services outside the Fed requirements that are mutually beneficial to merchants, their customers, and the bank. Finally, the freedom to post minimum credit card purchase signs has particularly helped small merchants. Low-dollar purchases are among the costliest to process, with the card fees often higher than the profit on the products sold.

The law's limited foray into debit reform has largely been a success. It has saved consumers billions of dollars. (For example, studies have shown that widely transparent gasoline prices result in vigorous competition. Gasoline prices at the pump track underlying costs nearly perfectly. The savings to station owners when interchange fees drop have allowed them to lower prices by several cents a gallon. That is one of many genuine consumer benefits.)

The Committee should explore ways to extend the benefits of increased transparency and enhanced incentives for competition to currently price-fixed credit cards. There is no rational reason why entrepreneurial networks should not be allowed to route credit transactions that dominant credit networks would like to preserve just for themselves; than there was a rational reason why entrepreneurial phone networks were for years not allowed to carry long distance calls that Ma Bell wanted for itself. A phone call is a phone call. A credit card transaction message is a credit card transaction message. The biggest players ought not to be allowed to blunt innovation and stymie this market.

Dodd-Frank has already demonstrated that competitive networks can route debit card transaction messages as fast, safer, and more cheaply than can today's Ma Bell equivalents. Competition in credit card routing would be a modest but important step toward a more robust, diverse, and redundancy-protected financial system.

Transparency works. As discussed, the debit reform provisions in Dodd-Frank have provided opportunities for the cost of cards to become more transparent and incentives for banks and card networks to openly compete to better route and service customers' transactions.

Repealing debit reform would block even the limited transparency and competition that exist today. Main Street merchants and their customers would once again be forced to blindly pay for subpar transactions.

April 24, 2017

The Honorable Mitch McConnell
Majority Leader
United States Senate
U.S. Capitol Building S-230
Washington, DC 20515

The Honorable Charles Schumer
Minority Leader
United States Senate
U.S. Capitol Building S-221
Washington, DC 20515

Speaker Paul Ryan
Speaker of the House of Representatives
H-232 The United States Capitol
Washington, DC 20515

Minority Leader Nancy Pelosi
House Democratic Leader
H-204 The United States Capitol
Washington, DC 20515

Dear Leader McConnell, Minority Leader Schumer, Speaker Ryan and Minority Leader Pelosi:

The below signed national and state merchant trade associations strongly support the debit reforms that were included in the 2010 *Dodd-Frank Wall Street Reform and Consumer Protection Act*. While we agree there are pieces of the law that should be addressed, the debit reforms contained in Dodd-Frank are unique in that they brought the first piece of competition and transparency into a market that was historically void of it. The reforms in the law have benefitted American consumers, merchants, small financial institutions, and the economy as a whole. Repealing or weakening the law will provide a windfall for fewer than two percent of the country's largest banks and remove any and all competition from the debit routing market. As representatives of retailers and employers from every state and congressional district in the country, we ask you to join us in opposing any effort to weaken or repeal these important debit reforms.

In 2010, American consumers and merchants earned a hard fought victory over escalating, uncontrollable fees with the inclusion of the debit reform measures in Dodd-Frank. These reforms brought a level of transparency (for the first time small businesses could see and know exactly how much they would be charged for a debit transaction from one of the covered institutions) and a level of competition into a market where fees were traditionally set collectively behind closed doors and without regard to the costs imposed on American consumers and Main Street retailers. It is important to note, this amendment passed with over sixty votes and strong bipartisan support after open debate on the Senate floor seven years ago. This was an essential first step to move America's electronic payments system toward a truly open and free market.

To fully appreciate the need for reform in this area, it is important to understand the history of the U.S. debit market. Banks originally began issuing debit cards as a less expensive and faster competitive alternative to the traditional paper check, and initially there were no "swipe fees" associated with debit cards, as with checks, which under federal law must clear at par. In time, the big credit card networks branded the cards as a way to make additional revenue for their banks by imposing swipe fees on the transactions. These fees were centrally set by the card networks, not the issuing banks, and merchants and their customers were required to pay these fees if they wanted to accept debit or credit cards issued by the card networks, without the ability to negotiate or even know the cost of acceptance.

The debit reforms included in Dodd-Frank directed the Federal Reserve to establish parameters on the allowable centrally-set fees that could be imposed on each of these check-replacement debit transactions by those banks with over $10 billion in assets. It is important to note that any bank with under $10 billion in assets is exempt from the fee limitation, and any bank above the threshold would be exempt if they simply choose to set their own fees as opposed to having them centrally set. These reforms took a balanced approach to achieve some level of transparency, predictability and competition with regard to the extreme growth in swipe fees, particularly among the very largest banks, realizing that over 98% of U.S. banks are exempt from the limit.

While critics of the reforms often focus on the limit on fees, which continue to guarantee the largest issuing banks in the country a 500 percent profit on debit transactions, the law also introduced competition into the debit routing space for the first time. The law requires that each debit card have a minimum of two unaffiliated networks enabled on the card. By requiring two networks, the large card brands, such as Visa, actually now have to compete with other debit networks for retailers' routing business. The result of the law has meant that networks compete on price, security and reliability in order to attract retailer business. Like the law's other reforms, consumers have benefited from routing competition as transactions have become not only less expensive, but also more secure. Repealing this provision would remove all competition from the debit market and make our national payment system less reliable and secure.

While the reforms were being debated in Congress in 2010, opponents raised several concerns that history has proven to be unsubstantiated. First, opponents of reforms claimed that small banks would be harmed and the exemption of 98% of the banks in the U.S. would not work. In fact, studies from the Federal Reserve Board[1] and the Government Accountability Office[2] have disproven this concern. In 2016, the Philadelphia Federal Reserve released a report that concluded small banks have not been harmed by the reforms, and in fact have benefitted. The report states, "...after the ceiling was imposed, the volume of transactions conducted with cards

[1] http://www.federalreserve.gov/paymentsystems/regii-average-interchange-fee.htm
[2] http://www.gao.gov/assets/650/648210.pdf

issued by exempt banks grew faster than it did for large banks."[3] The report further found that interchange revenue for exempt banks continued to rise for small banks.[4]

Some also expressed fears that free checking would be reduced if reforms passed. That has not happened. Instead, according to the American Bankers Association's own figures, the percentage of customers receiving free checking has increased from 53 percent to 61 percent since the reforms.[5] Debit reforms did not reduce free checking.

Opponents of debit reforms argued that merchants would not pass along any savings achieved from capping interchange fees along to the consumer. History has also disproven this concern as well. The retail industry functions on razor thin profit margins and our members compete for customers on price every day. As a point of comparison, the general retail industry survives on a 2.44% profit margin, with the grocery industry even lower at 1.9%. Conversely, the banking and financial services industries enjoy up to 24.49% profit margins, far exceeding the national total market average of 6.4%.[6] If a merchant can realize any savings in the system, it will use it to hold down prices, extend sales or increase value for its customers. The savings were proven in a study by economist Dr. Robert Shapiro who found that consumers have saved nearly $30 billion since the reforms have been in place and merchants have saved more than $10 billion. These savings have permitted merchants to reinvest in their businesses, which has supported tens-of-thousands more jobs and significant economic activity.[7]

Unfortunately, opponents of reforms simply look at the shelf price of goods from one year to the next without consideration of outside pricing fluctuations not tied to swipe fees. For example, grocers must consider numerous factors including drought, product recalls, gasoline/energy costs, labor and health care expenses, among many other factors, when establishing a shelf price for goods. What is clear since the implementation of the reforms is that merchants' profit margins have remained low, and instead, savings have been passed to customers due to intense competition in the retail marketplace.

The facts are clear; hidden swipe fees remain a $79 billion cash boon for the banks and card brands. The modest debit reforms are working, and if anything, Congress should act to strengthen them or address the excessive and hidden credit card fees American consumers and merchants pay every year. Banks' self-reported data have shown that their cost of processing

[3] https://www.philadelphiafed.org/-/media/research-and-data/publications/banking-trends/2016/bt-how_dodd_frank_affects_small_bank_costs.pdf?la=en

[4] https://www.philadelphiafed.org/-/media/research-and-data/publications/banking-trends/2016/bt-how_dodd_frank_affects_small_bank_costs.pdf?la=en

[5] http://www.aba.com/Press/Pages/081815SurveyonBankCosts.aspx & http://www.prnewswire.com/news-releases/aba-survey-shows-majority-of-bank-customers-pay-nothing-for-monthly-bank-services-104516904.html

[6] http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/margin.html

[7] See generally Robert J. Shapiro, The Costs and Benefits of Half a Loaf: The Economic Effects of Recent Regulation of Debit Card Interchange Fees (Oct. 1, 2013).

debit has actually decreased 44 percent since the reforms were implemented. By becoming more efficient, the largest issuers are now collecting a profit of almost 500 percent on a debit transaction currently under the cap.[8] This is even further evidence that the reforms are working and that competition and transparency are indeed a good thing.

Thank you for your consideration of our concerns and opposition to the current misguided attempts to repeal the debit reforms that have benefited so many. We will continue to actively oppose any efforts to repeal or weaken the law and ask every Member of Congress to do the same.

Sincerely,

American Beverage Licensees
Airlines for America
Food Marketing Institute
International Franchise Association
Merchant Advisory Group
National Association of College Stores
National Association of Convenience Stores
National Association of Shell Marketers
The National Association of Theatre Owners
National Association of Truck Stop Operators
National Council of Chain Restaurants
National Franchisee Association
National Grocers Association
National Restaurant Association
National Retail Federation
Petroleum Marketers Association of America
Service Station Dealers of American & Allied Trades
Society of Independent Gasoline Marketers of America
Retail Industry Leaders Association
Alabama Beverage Licensees Association
Alabama Grocers Association
Alabama Retail Association
American Petroleum and Convenience Store Association
Petroleum & Convenience Marketers of Alabama
Arizona Food Marketing Alliance
Arizona Petroleum Marketers Association

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[8] "Volume and Cost Trends in the Debit Card Industry", Merchants Advisory Group White Paper: https://files.ctctcdn.com/26db5c23201/8b43b2a5-993d-4c1a-ac9b-07c8acc488ea.pdf

Arizona Retailers Association
Arkansas Grocers and Retail Merchants Association
Arkansas Oil Marketers Association, Inc.
California Business Properties Association
California Grocers Association
California Independent Oil Marketers Association (CIOMA)
California Retailers Association
Coalition of Franchisee Associations
Colorado Licensed Beverage Association
Colorado Retail Council
Colorado/Wyoming Petroleum Marketers Association
Rocky Mountain Food Industry Association (Serving Colorado & Wyoming Grocers)
Connecticut Energy Marketers Association
Connecticut Food Association
Connecticut Retail Merchants Association
Delaware Food Industry Council
Florida Grocers Association
Florida Petroleum Marketers & Convenience Store Associations
Florida Retail Association
Florida Retail Federation
Franchisee Business Services
Georgia Alcohol Dealers Association
Georgia Association of Convenience Stores
Georgia Food Industry Association
Georgia Retail Association
Hawaii Food Industry Association
Horizon Retailers Association (representing Georgia)
Idaho Petroleum Marketer and Convenience Store Association
Idaho Retailers Association
Northwest Grocery Association (representing Idaho, Oregon and Washington grocers)
Illinois Food Retailers Association
Illinois Licensed Beverage Association
Illinois Petroleum Marketers Association
Illinois Retail Merchants Association
Indiana Grocery & Convenience Store Association
Indiana Retail Council
Indiana Petroleum Marketers & Convenience Store Association
Iowa Grocery Industry Association
Iowa Retail Federation
Petroleum Marketers & Convenience Stores of Iowa

Kansas Food Dealers Association
Kansas Licensed Beverage Association
Petroleum Marketers & Convenience Store Association of Kansas
Retail Grocers Association of Greater Kansas City
Kentucky Association of Beverage Retailers
Kentucky Grocers & Convenience Stores Association, Inc.
Kentucky Petroleum Marketers Association
Kentucky Retail Federation
Louisiana Oil Marketers & Convenience Stores Association
Louisiana Retailers Association
Maine Energy Marketers Association
Maine Grocers & Food Producers Association
Retail Association of Maine
Maryland Retailers Association
Maryland State Licensed Beverage Association
Massachusetts Food Association
Massachusetts Package Stores Association
Retailers Association of Massachusetts
Associated Food and Petroleum Dealers (Michigan, Ohio and surrounding States)
Michigan Association of Convenience Stores
Michigan Food and Beverage Association
Michigan Grocers Association
Michigan Petroleum Association
Michigan Retailers Association
Mid-Atlantic Petroleum Distributors' Association
Minnesota Grocers Association
Minnesota Petroleum Marketers Association
Minnesota Retailers Association
Minnesota Service Station & Convenience Stores Association
Tavern League of Minnesota
Mississippi Petroleum Marketers & Convenience Stores Association
Mississippi Retail and Grocers Association
Missouri Grocers Association
Missouri Petroleum Marketers & Convenience Store Association
Missouri Retailers Association
Montana Equipment Dealers Association
Montana Petroleum Marketers & Convenience Store Association
Montana Restaurant Association
Montana Retail Association
Montana Tire Dealers Association

Nebraska Grocery Industry Association
Nebraska Petroleum Marketers & Convenience Store Association
Nebraska Retail Federation
Ohio Council of Retail Merchants
Oklahoma Petroleum Marketers & Convenience Store Association
Retail Association of Nevada
New England Convenience Store and Energy Marketers Association
New Hampshire Retail Association
Fuel Merchants Association of New Jersey
New Jersey Food Council
New Jersey Liquor Stores Alliance
New Jersey Retail Merchants Association
New Mexico Grocers Association
New Mexico Petroleum Marketers Association
New Mexico Retail Association
Empire State Restaurant & Tavern Association
Food Industry Alliance of New York State
New York Association of Convenience Stores
New York Retail Council
New York State Liquor Stores Association
North Carolina Petroleum & Convenience Marketers Association
North Carolina Retail Merchants Association
North Dakota Petroleum Marketers Association
North Dakota Retail Association
Ohio Grocers Association
Ohio Petroleum Marketers & Convenience Store Association
Oklahoma Grocers Association
Retail Liquor Association of Oklahoma
Associated Oregon Industries
Oregon Neighborhood Store Association
Malt Beverage Distributors Association of Pennsylvania
Northwestern Pennsylvania Food Council
Pennsylvania Food Merchants Association
Pennsylvania Retailers' Association
Rhode Island Food Dealers Association
South Carolina Petroleum Marketers Association
South Carolina Retail Association
South Dakota Petroleum and Propane Marketers Association
South Dakota Retailers Association
Tennessee Fuel & Convenience Store Association

Tennessee Grocers & Convenience Store Association
Tennessee Retail Association
Tennessee Wine & Spirits Retailers Association
Greater Austin Merchants Association
South Texas Merchants Association
Texas Food and Fuel Association
Texas Package Stores Association
Texas Retailers Association
Utah Food Industry Association
Utah Retail Merchants Association
Vermont Retail & Grocers Association
Virginia Asian American Store Owners Association
Virginia Petroleum, Convenience & Grocery Association
Virginia Retail Federation
Virginia Retail Merchants Association
Washington Association of Neighborhood Stores
Washington Food Industry Association
Washington Retail Association
WMDA Service Station & Automotive Repair Association (Representing Washington D.C., Virginia & Maryland)
West Virginia Oil Marketers and Grocers Association
West Virginia Retailers Association
West Virginia Oil Marketers & Grocers Association
Alliance of Wisconsin Retailers
Tavern League of Wisconsin
Wisconsin Grocers Association
Wisconsin Petroleum Marketers and Convenience Store Association
Wyoming Retailers Association
Wyoming State Liquor Association

Cc: Members of the House of Representatives

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dberger@nafcu.org | nafcu.org

**NAFCU**
**National Association of Federally-Insured Credit Unions**

**B. Dan Berger**
President & Chief Executive Officer

April 25, 2017

The Honorable Jeb Hensarling
Chairman
House Financial Services Committee
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Maxine Waters
Ranking Member
House Financial Services Committee
U.S. House of Representatives
Washington, D.C. 20515

**Re: Tomorrow's hearing: "A Legislative Proposal to Create Hope and Opportunity for Investors, Consumers, and Entrepreneurs"**

Dear Chairman Hensarling and Ranking Member Waters:

On behalf of the National Association of Federally-Insured Credit Unions (NAFCU), the only trade association exclusively representing the federal interests of our nation's federally-insured credit unions, I write to share our thoughts on, and express our support for, the updated discussion draft language of the *Financial CHOICE Act* ahead of tomorrow's scheduled hearing on the legislation.

***Overview***

During the consideration of financial reform, NAFCU was concerned about the possibility of over-regulation of good actors, such as credit unions, and this is why NAFCU was the only financial services trade association to oppose the Consumer Financial Protection Bureau (CFPB) having authority over credit unions. Unfortunately, many of our concerns about the increased regulatory burdens that credit unions would face under the *Dodd-Frank Act* have proven true. While there are credible arguments to be made for the existence of the CFPB, its primary focus should be on regulating the unregulated bad actors, not adding new regulatory burdens to good actors, like credit unions, that already fall under a prudential regulator. As expected, the breadth and pace of the CFPB's rulemaking is troublesome, and the unprecedented new compliance burden placed on credit unions has been immense.

The impact of this growing compliance burden is evident as the number of credit unions continues to decline. Since the second quarter of 2010, we have lost 1,660 federally-insured credit unions – over 22% of the industry. The overwhelming majority (96%) of these were smaller institutions below $100 million in assets. While it is true that there has been a historical consolidation trend in the industry, this trend has accelerated since the passage of the *Dodd-Frank Act*. Many smaller institutions simply cannot keep up with the new regulatory tide and have had to merge out of business or simply shut their doors. There is an urgent need for Congress to enact meaningful regulatory relief.

Regulatory burden is the top challenge facing credit unions today. Reducing burdensome and unnecessary regulatory compliance costs is the only way for credit unions to thrive and continue to provide their member-owners with basic financial services and the exemplary service they need and

The Honorable Jeb Hensarling
The Honorable Maxine Waters
April 25, 2017
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deserve. NAFCU believes that credit unions must have a positive regulatory environment that allows them to succeed. We believe this environment includes:

- The ability to pursue healthy fields of membership that are not limited by outdated laws or regulatory red tape;
- The establishment of capital requirements appropriate to risk, and not a "one size fits all" approach that treats credit unions like riskier institutions or establishes regulatory capital regimes that are solutions in search of a problem;
- An independent federal regulator that can address the specific challenges of the industry by tailoring a regulatory regime that recognizes the unique nature of credit unions. This includes exempting credit unions from CFPB rulemaking and returning that authority to the National Credit Union Administration (NCUA);
- Removing outdated laws and regulations that hinder credit unions' ability to meet the lending needs of their members, whether natural persons or small businesses;
- Guaranteed access to a healthy secondary mortgage market that recognizes the quality of credit union loans and prices them fairly based on their quality.

We are pleased that the Committee has been a policy partner with NAFCU in addressing many of these issues in this Congress. We look forward to working with the Committee to bring additional relief to community institutions such as credit unions.

***The Financial CHOICE Act discussion draft***
The new discussion draft of the *Financial CHOICE Act* is a comprehensive bill that contains a number of NAFCU-supported initiatives:

✓ **NAFCU supports a strong and vibrant industry that allows credit unions to grow.** Many elements of the discussion draft will help create an environment that will allow credit unions to succeed. Changes to mortgage rules; changes to HMDA limits; and examining appropriate risk capital levels are key parts of the bill. The provision eliminating the Durbin interchange price cap and routing restrictions is among the most significant aspects of this discussion draft for credit unions and we strongly urge you to maintain it throughout the legislative process.

We would also encourage the Committee to go further in the final bill by adding provisions providing credit unions relief from the arbitrary member business lending cap and providing greater clarity on the ability for all credit unions to add underserved areas to their fields-of-membership. The Committee could improve the capital "off-ramp" provision for credit unions by adding language that recognizes their unique nature and limited ability to raise capital, which disadvantages them in returning to the 10% threshold envisioned in the bill.

✓ **NAFCU supports a strong, independent NCUA as the primary regulator for credit unions.** The discussion draft retains the cost-effective three-member structure of the NCUA Board as NAFCU had urged. It also brings the NCUA under the congressional appropriations process - a move that NAFCU feels is unnecessary given that credit unions fund the NCUA, and we would urge further revision of this provision to only require approval of NCUA budget increases above inflation.

The CFPB has usurped many areas of NCUA authority under the guise of consumer protection. NAFCU and our member credit unions support consumers every day. The discussion draft will convert the CFPB into a consumer law enforcement agency without supervision authority, eliminating many of its powers, including its authority with respect to unfair, deceptive or abusive acts and practices (UDAAP). This change will shift authority back to the NCUA. In addition, the CFPB will no longer have preemption over consumer laws in contrast to the functional regulators. The proposed CFPB reforms, taken overall, would provide credit unions with some comprehensive regulatory relief from the current CFPB, allowing them to focus on serving their members. We would encourage the Committee to go even further and expand CFPB exemption authority under Section 1022 of the *Dodd-Frank Act*. One way this could be addressed would be to include the language of H.R. 1264, the *Community Financial Institutions Exemption Act*.

- ✓ **NAFCU supports transparency and independent oversight.** The discussion draft creates many opportunities for appropriate oversight of NCUA. First, NCUA's budget will have the opportunity to be reviewed in a budget hearing. Second, an independent appeals process will be created for credit union exams. Third, transparency regarding the overhead transfer rate will be ensured.

- ✓ **NAFCU supports appropriate, tailored regulation for credit unions promulgated with appropriate debate and dialogue.** The discussion draft will ensure robust cost-benefit analyses for regulations and the ability for regulations to be reviewed by Congress. NAFCU supports cost-benefit analysis, and in any final legislation wants to ensure that we have an effective regulatory environment where positive regulations may be easily implemented and negative ones may be quickly eliminated. NAFCU believes that a board structure provides the appropriate mechanism for any agency to approve regulations since it ensures debate representative of multiple points of view. Accordingly, NAFCU believes a commission structure is the ideal way to govern the CFPB. NAFCU also believes that enforcement orders should not take the place of regulation.

- ✓ **NAFCU supports an even playing field.** NAFCU believes that credit unions should have as many opportunities as banks and non-regulated entities to provide provident credit to our nations' consumers and that the relief provided in the discussion draft will help. Many elements in the discussion draft do not directly impact credit unions, but NAFCU wants to ensure that all similarly situated depositories follow the same rules of the road and that unregulated entities do not escape all oversight. NAFCU believes that further examination of whether the 10% domestic deposit cap on banks should be lifted is warranted as the bill moves through the legislative process. We also would hope that the discussion draft could be further clarified to ensure that there is a federal regulatory structure, whether the new CFPB/Consumer Law Enforcement Agency or not, for non-bank financial services market players that do not have a prudential regulator.

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NAFCU thanks you for the opportunity to share our thoughts. We appreciate Chairman Hensarling's effort to provide regulatory relief and support the discussion draft of the *Financial CHOICE Act*. We would urge the Committee to support the legislation as well. We look forward to working with you on the *Financial CHOICE Act* as it moves through the legislative process. If you have any questions, or if my colleagues or I can be of assistance in any way, please do not hesitate to contact me or NAFCU's Vice President of Legislative Affairs, Brad Thaler, at 703-842-2204 or bthaler@nafcu.org.

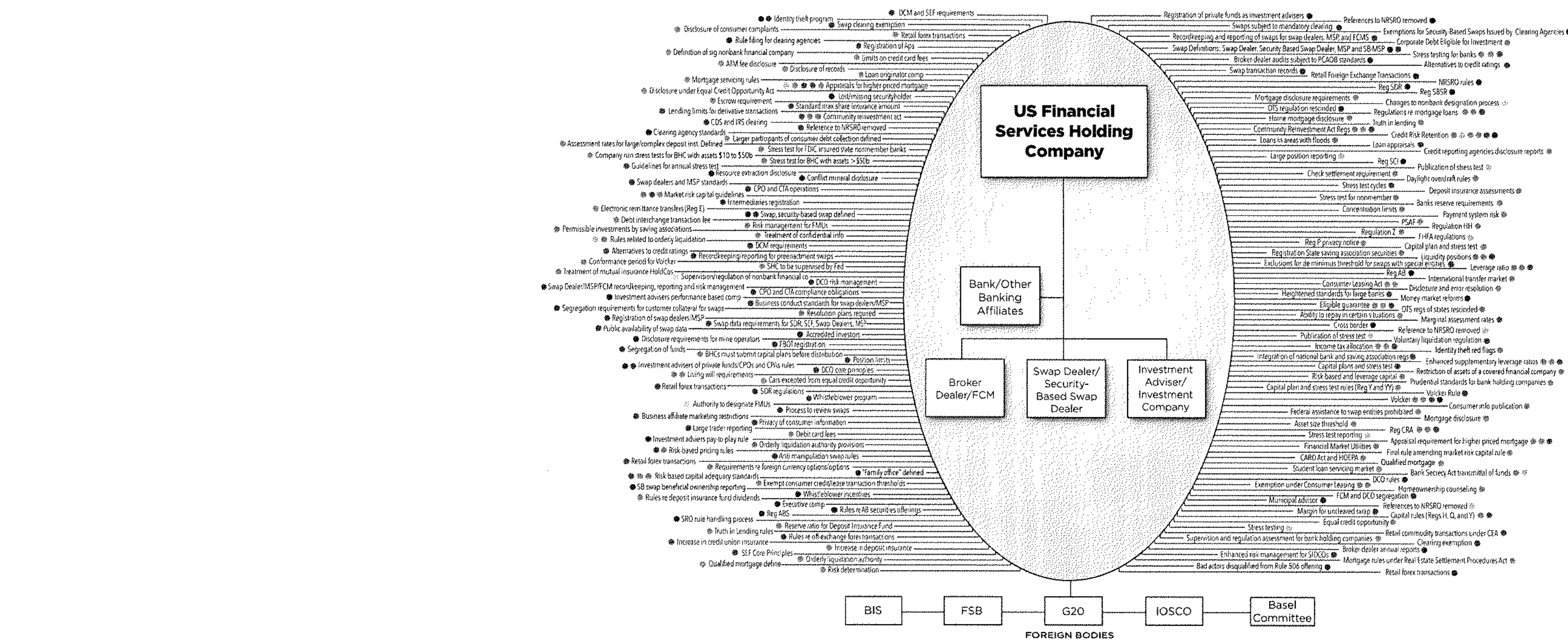
Sincerely,

B. Dan Berger
President and CEO

cc: Members of the House Financial Services Committee

SEC Commissioner Daniel M. Gallagher

## Rules Applicable to U.S. Financial Services Holding Companies Since July 2010




**Relevant Regulators Not Depicted**

- US SROs (e.g., FINRA, MSRB, NFA)
- Foreign country regulation of domestic activity
- US States

**LEGEND**

- SEC-Securities and Exchange Commission
- CFTC-Commodity Futures Trading Commission
- OCC-Office of the Comptroller of the Currency
- FDIC-Federal Deposit Insurance Corporation
- Treasury-Treasury Department
- CFPB-Consumer Financial Protection Bureau
- OFR-Office of Financial Research
- NCUA-National Credit Union Administration
- FSOC-Financial Stability Oversight Council
- FHFA-Federal Housing Finance Agency
- FRB-Federal Reserve Board of Governors
- HUD-U.S. Department of Housing and Urban Development
- FFIEC-Federal Financial Institutions Examination Council
- FinCEN-Financial Crimes Enforcement Network


# President Trump's Dangerous CHOICE

## Will He Embrace House Republicans' Plan to Gut Wall Street Reform?

By Gregg Gelzinis, Ethan Gurwitz, Sarah Edelman, and Joe Valenti April 2017

Center for American Progress

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# Contents

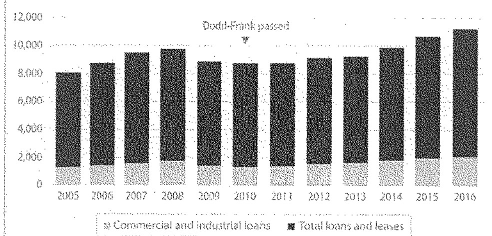
# Introduction and summary

During his campaign, Donald Trump promised a near-dismantling of the Dodd-Frank Act, the core piece of financial reform legislation enacted following the 2007-2008 financial crisis.[1] He doubled down on that promise once in office, vowing to both "do a big number" on and give "a very major haircut" to Dodd-Frank.[2] In early February, he took the first step in fulfilling this dangerous promise by signing an executive order directing U.S. Secretary of the Treasury Steve Mnuchin to conduct a review of Dodd-Frank.[3] Per the executive order, Secretary Mnuchin will present the findings in early June.[4] While the country waits for President Trump's plan, it is useful to analyze one prominent way Trump and Congress might choose to gut financial reform—through the Financial CHOICE Act, or FCA.[5]

Introduced in the last Congress by U.S. House of Representatives Financial Services Committee Chairman Jeb Hensarling (R-TX) and expected to be reintroduced in the coming weeks, the Financial CHOICE Act offers a blueprint for how Trump might view these issues. During the presidential campaign, Rep. Hensarling briefed Trump on his ideas regarding financial deregulation and was reportedly on Trump's short list for treasury secretary.[6] The FCA would deregulate the financial industry and put the U.S. economy in the same perilous position it was in right before the 2007–2008 financial crisis. The precrisis regime of weak regulation and little oversight created an environment of unchecked financial sector risk and widespread predatory consumer practices, which precipitated the Great Recession and brought the U.S. economy to the brink of collapse. And the argument repeated by President Trump and other advocates of financial deregulatory proposals—that bank lending has been crushed under the weight of financial regulations over the past six years—has been thoroughly debunked by bank lending data.[7]

Before delving into the specifics of the Financial CHOICE Act, it is helpful to put Rep. Hensarling's deregulatory efforts in context. To justify dismantling financial reform, President Trump and his congressional allies know that they must outline a problem. President Trump argues that the main problem with financial reform is bank lending. He believes that banks are not making enough loans due to the burdens of Dodd-Frank. What is his evidence? Nothing more than anecdotal remarks that his friends cannot get loans.[8] As Figure 1 demonstrates, a lack of loans is simply not the case. Overall lending and business lending in particular, has increased significantly since the financial crisis and the passage of Dodd-Frank. Moreover, credit card lending, auto lending, and mortgage lending have increased since 2010, when Dodd-Frank was passed.[9] Bank profits are also higher than ever.[10]

FIGURE 1
**Loans at commercial banks in the United States, in thousands of 2016 dollars, 2005–2016**

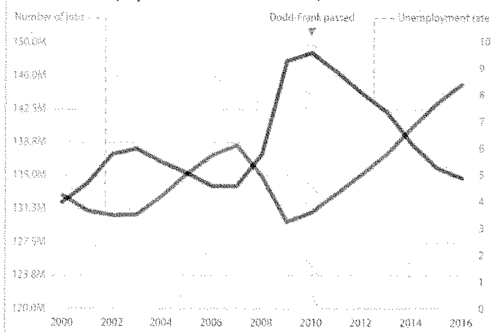



Source: Federal Reserve Bank of St. Louis, "Commercial and Industrial Loans, All Commercial Banks," available at https://fred.stlouisfed.org/series/BUSLOANS (last accessed March 2017); Federal Deposit Insurance Corporation, "Loans to Small Businesses and Farms, FDIC-Insured Institutions, 1995 - 2016," available at https://www.fdic.gov/bank/analytical/qbp/timeseries/SmallBusiness&FarmLoans.xls (last accessed March 2017).

Chairman Hensarling makes similar arguments about the perceived unavailability of credit, adding that financial reform has not encouraged economic growth and has hurt community banks.[11] Again, the data contradict these charges. Figure 2 highlights the steady economic growth the country experienced under President Barack Obama. And while the scars of the devastating Great Recession remain, the financial reforms put in place to prevent the recurrence of exactly that kind of economic catastrophe have not damaged growth. Indeed, since the end of the financial crisis and the passage of Dodd-Frank, community bank lending and profitability are both up.[12] It is fair to say that the number of community banks has declined over time. This trend, however, started in the 1980s and is caused by economies of scale, technology, and long-running trends toward banking deregulation, as well as other factors—not the 2010 passage of the Dodd-Frank Act.[13]

FIGURE 2

**Jobs and unemployment in the United States, 2000–2016**




Sources: Bureau of Labor Statistics, "Labor Force Statistics from the Current Population Survey," available at https://www.bls.gov/cps/tables.htm (last accessed March 2017); Federal Reserve Bank of St. Louis, "All Employees: Total Nonfarm Payrolls," available at https://fred.stlouisfed.org/series/PAYEMS (last accessed March 2017).

Hensarling presents his approach as a moderate adjustment to Dodd-Frank, but in reality it is a thorough demolition of financial reform. This report analyzes how Hensarling's approach erodes the financial stability safeguards that the real economy needs to thrive, from mitigation of systemic risk to financial sector accountability and consumer protection. It also explains how the bill further concentrates—and makes even more unaccountable—economic power in the hands of those that will serve their own interests at the expense of the real economy. Finally, this report details how the FCA eliminates the consumer and investor protections that guard against the predatory financial practices that wreaked havoc on consumers and investors prior to the financial crisis.

It is necessary to note that just about every provision in this report could fit under the rubric of financial stability safeguards. For example, consumer financial protection protects ordinary consumers from abuses and the broader financial system from the proliferation of dangerous consumer loans that can bring down entire firms and markets. Similarly, the Volcker Rule is a key bulwark against the high-risk bets that brought down major firms in 2008, and yet it also aims to reorient large bank trading toward real economy-serving purposes. That this report discusses certain provisions under one section rather than another should not be taken as a substantive comment on the merit or usefulness of the provision to financial stability. The report's different sections reflect an effort to highlight how the Dodd-Frank Act and financial reform yield a broad array of public benefits. Similarly, this report highlights examples of broader themes in the FCA rather than focusing on minute details: Failure to discuss any particular provision should not be read as a substantive judgment regarding its relative merits.

This report is based on the version of the Financial CHOICE Act released in September 2016, as well as a memo outlining this year's planned changes to that version.[14] A new version, which may have some further modifications, is expected to be released in the coming weeks.

Financial reform enacted through the Dodd-Frank Act has made a lot of necessary progress since the crisis. U.S. banks have more substantial loss-absorbing capital cushions, increasingly rely on stable sources of funding, undergo rigorous stress testing, and plan for their orderly failure. President Trump's intent to dismantle these reforms only helps Wall Street's bottom line—ignoring the memory of every family who lost their home, every worker who lost his or her job, and every consumer who was peddled a toxic financial product.[15]

The question remains: What is the problem President Trump and his allies in Congress are trying to solve? Lending is up. Bank profits are up. Consumer credit costs are down. The economy is steadily improving. Yes, much more needs to be done to make the economy work for hard-working Americans, but financial deregulation is not the path to that end.[16] In fact, it is a path toward exactly the opposite: booms and busts that leave taxpayers holding the bag for Wall Street's excesses, greater concentration of economic power and less accountability for wrongdoing that harms ordinary consumers and investors, and major changes to financial regulation and monetary policy that would damage the real economy. Now that is a problem.

# A return to financial instability that threatens the economy

Chairman Hensarling's Financial CHOICE Act would take a sledgehammer to the vital financial stability reforms established by the Dodd-Frank Wall Street Reform and Consumer Protection Act.[17] Enacted in 2010 following the financial crisis, this law represents the most significant financial sector regulatory reform effort since the Great Depression. Each prong of Dodd-Frank's financial stability reforms is directly related to clear and unmistakable lessons learned in the financial crisis. The desire to roll back these reforms demonstrates a willful ignorance of those very lessons at best and a malicious disregard at worst. It is clear, however, what the end result of the FCA's deregulatory efforts would be: returning the financial sector to its boom-and-bust ways at the expense of middle- and lower-class families and workers, as well as the financial stability that the U.S. economy needs to function. It is essential to remember that the financial crisis of 2007 and 2008 single-handedly destroyed 8.7 million jobs, sent the national unemployment rate to 10 percent, and eliminated 49 percent of the average middle class family's wealth compared with 2001 levels.[18]

The Financial CHOICE Act prescribes a wide range of steps that would jeopardize U.S. financial stability, including:

- **Bank deregulation:** The FCA allows banks of all sizes to opt out of the vital enhanced prudential standards mandated by the Dodd-Frank Act, such as living wills, liquidity standards, and stress testing, as long as they maintain a 10 percent leverage ratio, a far from sufficient level of capital to justify such drastic deregulation.

- **Systemic risk deregulation:** The bill repeals the Financial Stability Oversight Council's, or FSOC's, ability to plug the holes in financial regulation that invariably emerge over time as companies and markets evolve. The FCA eliminates the process for designating nonbank financial companies—such as American International Group Inc., or AIG—as systemically important, eviscerates FSOC's budget, ties up its processes, and prevents it from breaking up financial institutions that pose a grave threat to financial stability.

- **Fewer orderly shutdowns and more bailouts:** The bill also repeals the Orderly Liquidation Authority, or OLA, the legal authority that allows regulators to shut down large, complex banks in an orderly manner, without resorting to a taxpayer bailout.

- **Derivatives deregulation:** The bill repeals FSOC's authority to designate financial market utilities as systemically important.

- **Willful blindness on insurance:** The FCA also merges the Federal Insurance Office with FSOC's Office of the Independent Member with Insurance Expertise to create a severely weakened insurance office.

## Cost of the crisis

Thanks to the reckless practices and lax oversight of Wall Street's largest financial firms, the American people lost 8.7 million jobs, households lost at least $19 trillion in wealth, and almost 10 million households lost their homes as a direct result of the financial crisis.[19] Additionally, the real wealth of the average middle class family collapsed between 2007 and 2010, falling nearly $100,000, or 52 percent.[20] America's families were not bailed out. They suffered.

The same cannot be said about Wall Street. Many of the massive financial institutions that caused the crisis were bailed out with trillions of dollars in loans, stock purchases, and guarantees from the federal government.[21]

### Bank deregulation

Under the FCA, even the largest of banks can choose to opt out of some of the most important provisions in the Dodd-Frank Act, namely the enhanced prudential standards mandated by Section 165. If the bank maintains a 10 percent quarterly leverage ratio—which is only a modest increase from the 6 percent to 8 percent leverage ratios the big banks maintain today—then it can choose to opt out of: 1) risk-based capital requirements; 2) liquidity requirements; 3) risk management standards that improve banks' own internal risk frameworks; 4) resolution plans, also known as living wills, that outline how the bank can be wound down without a bailout if it fails; 5) credit-exposure reporting requirements that help regulators understand how interconnected firms are with the broader financial sector; 6) concentration limits to prevent a bank from becoming too connected to other financial companies; 7) contingent capital requirements that enable the conversion of debt to equity during financial stress to help avoid bailouts; 8) short-term debt limits to prevent banks from loading up on debt that could run during a time of stress; and 9) enhanced public disclosures that help the market better evaluate the health of firms and the competence of management.[22]

While some financial reformers have argued vigorously for a more aggressive leverage ratio—that is, a higher level of loss-absorbing common equity, as opposed to debt, relative to the total size of the bank—the FCA's approach is unfortunately a sham. The big banks currently maintain equity funding that puts them within striking distance of a 10 percent leverage ratio. But research suggests that the socially optimal leverage ratio—the amount of loss-absorbing equity that a bank would need to be able to withstand losses without shutting down lending, getting a bailout, or engaging in other socially problematic outcomes—is significantly higher than that.[23] It is also unclear how exactly the FCA's leverage ratio will be calculated—leaving open the possibility that Trump-appointed regulators will use more lenient measures that do not adequately account for many of the off-balance sheet exposures that tore down the financial system during the last financial crisis. Moreover, if an institution that opted out of these vital safety and soundness requirements fell below the 10 percent quarterly leverage ratio, it would have a full year to raise its quarterly leverage ratio back to 10 percent. It would be quite easy for a bank to fluctuate above and below the threshold, restarting the twelve-month clock over and over—gaming the system as they so choose.

But even if bank capital was closer to what they would really need in a crisis, there are other important anti-bailout protections in this important suite of tools. Giving Wall Street the choice to exempt themselves from these enhanced standards would leave multitrillion dollar banks without a solid first line of defense against real world shocks and financial sector mistakes that inevitably will arise. In doing so, the bill puts Main Street jobs and economic growth squarely at risk and puts taxpayers squarely back on the first line of defense.

For example, scrapping risk-based capital in favor of a modest leverage ratio incentivizes banks to load up on riskier assets to maximize profit, as they would no longer be constrained by the risk weighting approach of the Basel III international regulatory framework. Banks would also be exempt from important liquidity rules such as the Liquidity Coverage Ratio and the Net Stable Funding Ratio.[24] The former ensures that big banks hold enough liquid assets, such as Treasuries, that they can turn into cash quickly to meet their obligations for a full month during a time of market stress, and the latter makes sure that banks are not relying too heavily on short-term debt, which is less stable and can run during a crisis.

Eliminating these crucial rules disregards some of the most important lessons learned during the financial crisis. Indeed, banks with decent capital positions could be holding risky illiquid assets funded by short-term debt. If the market seizes up and the banks' short term creditors do not roll over the debt, the bank may all of a sudden be unable to keep itself afloat as it struggles to turn its risky assets into cash to meet its obligations. Struggling to turn the illiquid assets into cash, banks may take massive write-downs as they sell the assets at "fire sale" prices, those well below their real worth, which in turn forces others holding the same assets to take a loss on those assets.[25] This type of fire sale was one of the most dangerous negative feedback loops that turned 2008 from a U.S. mortgage and foreclosure crisis into a global financial near-meltdown.

Another first line of defense that the FCA puts on the chopping block is the stress testing that regulators apply to the largest banks every year.[26] Regulators test the balance sheets of big banks to make sure they can withstand a severe market downturn without failing and potentially sparking a financial crisis. If a big bank does not pass stress testing, it may be restricted in how much it can return to its shareholders in dividends. The stress tests are particularly useful because they both allow and force regulators to adapt to evolving market conditions and to prevent banks from using window dressing or financial engineering to disguise risk.[27] This makes them an important line of defense in addition to capital levels, which are set by regulation.

As if the opt-out were not enough, banks that do not opt out of the Dodd-Frank regulations would undergo severely watered down stress testing.[28] Wall Street would love these changes because banks would be able to pay more dividends to their shareholders every year. But those payouts would not take into account whether the money was coming directly at the expense of U.S. financial stability.

Systemic risk deregulation

The FCA also eviscerates the authority and funding of the Financial Stability Oversight Council, a core innovation of financial reform.[29] A key lesson from the financial crisis was that there were distinct regulatory blind spots. Regulators did not adequately communicate with one another, and no one regulatory body was tasked with looking at systemic risk across the financial system. FSOC was created to fill in this regulatory gap that had proven so costly during the crisis. It not only serves as a forum for all of the financial regulators to meet, share information across jurisdictions, and discuss risks to U.S. financial stability, but importantly, it has tools to close regulatory gaps in coverage.

In its investigative capacity, FSOC has done excellent work to examine potential systemic risk posed by the asset management industry broadly, as well as hedge funds specifically.[30] It has also made significant progress as a practical tool for getting the diverse regulatory agencies to work together. If anything, policymakers should consider strengthening FSOC's ability to coordinate among regulators and ensure rulemakings are fully implemented.

In order to give FSOC the data and research capacity necessary to successfully execute this much-needed role, Dodd-Frank created the Office of Financial Research, or OFR.[31] The OFR uses a data-driven approach to help FSOC analyze and evaluate potential risks to financial stability. Like FSOC, the OFR brings together thinking and analytics from across markets, enabling it to bridge analytic gaps. The OFR has also played an important role domestically and internationally in bringing regulators into the data age, pushing the use of uniform legal entity identifiers for corporations and other uniform product and transaction identifiers. Data-driven standardization was sorely lacking prior to the financial crisis, meaning that both regulators and market participants were unable to spot the build-up of dangerous risks across or even within complex financial firms. The FCA eliminates the OFR without even attempting to justify the action.

Critically, FSOC was designed not to just be a convening mechanism but also to have the authority to actually plug holes in regulation. The most important of these tools is its ability to designate for Federal Reserve Board supervision those nonbank financial companies, such as insurance companies or hedge funds, that may threaten U.S. financial stability. Once designated, these institutions are subjected to the appropriate enhanced regulation. FSOC has used this authority to ensure strong regulatory oversight over large insurance companies such as AIG, which was a key culprit during the financial crisis; it received the largest government bailout in U.S. history at more than $180 billion.[32] The case of AIG and other nonbank financial companies demonstrated that large threats to financial stability can also build up outside of the traditional banking sector. It is vital to have a regulatory body such as FSOC monitor these risks that build in the insurance or asset management sectors and take necessary action accordingly. The CHOICE Act, however, strips FSOC of this crucial authority. FSOC would no longer be able to subject companies such as AIG to enhanced oversight and prudential regulation. The FCA also takes away FSOC's power to break up a financial institution that poses a grave threat to financial stability—sending precisely the wrong signal about how regulators should monitor and combat systemic risk. This is what the Financial CHOICE Act means for ordinary Americans: less regulation of the biggest threats to the economy, less accountability, and more bailouts.

## Fewer orderly shutdowns and more bailouts

In September 2008, regulators faced two awful choices: let a large, complex financial institution fail and exacerbate the crisis or use taxpayer money to bail out the company.[33] The government chose to let Lehman Brothers Holdings Inc. fail and go through bankruptcy, severely worsening the financial crisis. The next day taxpayer money was used to bail out AIG.

Dodd-Frank created a third option, the Orderly Liquidation Authority, in which the Federal Deposit Insurance Corporation can quickly wind down a failing financial institution and charge the financial industry for any costs incurred during the resolution process, taking taxpayers off the hook.[34] The CHOICE Act, however, eliminates this third option and replaces it with an insufficient tweak to the bankruptcy code, which would bring the country back to Lehman Brothers-style catastrophes and AIG-style bailouts.

Former Chairman of the Federal Reserve Ben Bernanke recently outlined the reasons why modifications to the bankruptcy code fall short during a crisis and underscored the need to preserve the OLA.[35] He argues that financial regulators are better equipped to manage the failure of a complex financial firm during a crisis, compared with a bankruptcy judge that does not have the necessary expertise or familiarity with the financial firm. Moreover, winding down massive financial institutions with sprawling international business lines and legal entities requires coordination between regulators across international jurisdictions—a role that a bankruptcy judge is not situated to fulfill. Bernanke also points out that it is unlikely that during a crisis, a complex financial firm would have access to private financing while in bankruptcy, making OLA's liquidity role—with the financial industry on the hook for any losses—so important.

At this point, it should be clear that the FCA is the height of folly. It strips regulators of the tools necessary to fight financial crises once they have developed and to wind down failing institutions in an orderly manner to avoid government bailouts.

## Derivatives deregulation

Taking the financial regulatory system back to its precrisis condition is a common theme in Hensarling's Financial CHOICE Act. This theme holds true when analyzing the FCA's impact on the regulation of financial market utilities, which is a vital component of derivatives regulation. Derivatives, such as futures that are traded on regulated exchanges, and swaps, which prior to Dodd-Frank were unregulated, are both financial contracts that derive their price from an underlying asset. During the financial crisis, unregulated swaps exemplified the reckless, unchecked risk in the financial sector. When used appropriately and under strong regulatory oversight, swaps and futures can help companies hedge against risks such as drought, fuel price changes, and currency fluctuations. When used aggressively in the shadows, however, these financial instruments can help tear down the financial sector.

Dodd-Frank brought many more derivatives out of the shadows and into transparent markets. A large swath of swaps is now also subject to clearing, which means that a third party institution must ensure that the two sides of the swaps contract put up the necessary collateral to cover potential losses. This also serves as mutual insurance among the exchange participants since the exchange provides some limited protection against member losses with its own capital. The risk management standards at these third party institutions, called financial market utilities, are highly regulated because they are critical to preventing swaps contracts from tearing down the financial system during a crisis. Changes by Dodd-Frank brought swaps out of the shadows and have made sure that companies can cover the risks that they pose.

## AIG and derivatives during the financial crisis

In the run-up to the financial crisis, AIG sold large amounts of credit default swaps, or CDS, against the supposedly very safe super-senior tranches of subprime collateralized debt obligations, or CDOs.[36] In essence, AIG used these derivatives to insure against the default risk of these subprime mortgage CDOs that were considered extremely unlikely to actually default. AIG loaded up on these derivatives because it was a way for them to earn premiums insuring a risk they never thought would require payouts. The collapse of the subprime mortgage market triggered the defaults on the CDOs, including the super senior tranches, which in turn triggered the CDS and required AIG to make the payouts they never thought would be necessary. The magnitude of these payouts and subsequent collateral calls following AIG's own credit downgrade threatened the solvency of the company and the open CDS contracts.[37] Because banks and other firms trading these swaps were linked together in a daisy chain of risk, the Federal Reserve concluded that major banks—which relied on the CDS contracts with AIG to protect against subprime CDO defaults—would fail unless the CDS contracts were made good, thus leading the U.S. government to bail out AIG.[38]

This is just one example of why swaps need to be subject to regulations, such as those in Title VII of the Dodd-Frank Act that ensure transparency and market stability.

The FCA eliminates the enhanced oversight of these financial market utilities. As these institutions handle transactions or ownership management functions in the trillions of dollars, weak standards at these institutions could spell disaster for the U.S. economy and every single American who owns a stock or bond or has a pension. The CHOICE Act repeals Title VIII of the Dodd-Frank Act, which gives FSOC the authority to subject financial market utilities to appropriate regulatory oversight, including but not limited to new requirements for governance standards, credit risk management, liquidity risk management, collateral and margin frameworks, and recovery and wind-down plans. These are basic, commonsense requirements for institutions essential to the plumbing of the markets. Without them, U.S. financial stability would once again be at grave risk.[39]

## Willful blindness on insurance

While primarily impacting the banking and securities sectors, the financial crisis also put severe stress on the insurance industry.[40] The international insurance giant AIG was on the brink of collapse and required the largest taxpayer bailout in American history.[41] Because insurance is largely regulated at the state level, in the lead up to and during the financial crisis, the federal government possessed little insurance expertise.[42] This proved to be an unmistakable regulatory blind spot.[43] In addition to the FSOC designation authority noted above, the Dodd-Frank Act created the Federal Insurance Office within the U.S. Department of the Treasury to address the insurance expertise void.[44] The Federal Insurance Office supports FSOC in monitoring systemic risks related to insurance companies. The Federal Insurance Office also monitors and reports on consumer issues across the insurance industry and represents the United States, along with the Fed, at international standard-setting bodies.[45]

The FCA merges the Federal Insurance Office with FSOC's independent member with insurance expertise—a voting position created in part to give someone with state-based insurance experience a voice in FSOC's deliberations—to create the severely weakened Office of the Independent Insurance Advocate. For example, the FCA eliminates the insurance office's authority to study and report on low- and moderate-income households' and traditionally underserved communities' access to affordable insurance products across the country. Moreover, the new office would not be allowed to recommend to FSOC that it should designate an insurance company for heightened oversight or subpoena insurance companies for data or information. In short, the new merged office would be severely limited in its ability to look out for consumers, to advise FSOC on potential systemic risks, and to access the data and information it needs to analyze risks across the insurance industry.

# Concentration, accountability, and the real economy

Financial firms with hundreds of billions and even trillions of dollars in assets are the real winners in the Financial CHOICE Act, while accountability and the real economy end up the losers. Firms would get even bigger and even more powerful. Massive banks would be able to gamble and bet once again against their customers—such as middle-class retirees with pension funds and 401(k)s—and would be allowed to grow in both size and complexity, unchecked by regulators. All financial firms would be less accountable, as many U.S. Securities and Exchange Commission, or SEC, oversight tools would be gutted. And monetary policy would be undermined at the expense of full employment. These dramatic changes are direct threats to jobs on Main Street and the real economy.

The CHOICE Act takes a wide range of steps to further concentrate economic power, undermine accountability, and damage the real economy, including:

- **Reopening the Wall Street casino:** The FCA repeals the Volcker rule, allowing banks to engage in risky proprietary trading, as well as sponsor and invest in private equity and hedge funds for their own profit.

- **Concentration limits and a return to mega-mergers:** The FCA rolls back Dodd-Frank Act provisions ensuring that regulators consider financial stability and concentration when reviewing mergers and acquisitions of financial institutions.

- **Bringing the SEC to heel:** The FCA shifts SEC enforcement of complex cases away from administrative hearings and toward federal court proceedings, removing an important tool for overseeing regulated industries, and eliminates for certain asset classes provisions of Dodd-Frank meant to realign perverse securitization incentives that contributed to the financial crisis.

- **Removing transparency in private equity:** The bill eliminates registration and reporting requirements for private equity firms, preventing regulators from having access to important data on hundreds of billions of dollars in assets and leaving investors in these funds to once again fend for themselves.

- **Excessively compensating the wealthy and powerful:** The FCA also eliminates regulators' authority to curb risky compensation practices that created perverse incentives for CEOs and eliminates the requirement that companies disclose the pay ratio comparing the median employee compensation with the CEO's compensation.

- **Undermining the goals of monetary policy:** The FCA turns monetary policymaking into a highly political process, a grave departure from past precedent.

## Reopening the Wall Street casino

Broadly speaking, the Financial CHOICE Act would reconcentrate power in the hands of a wealthy few, reduce accountability, and undermine the financial system's obligations to serve the real economy. Its attempt to repeal the Volcker rule in its entirety is a distinct example of this.

The Volcker rule, named for former Chairman of the Federal Reserve Paul Volcker, was put in place to ban proprietary trading—when banks make bets to increase their own profits rather than on behalf of their clients—by banks and their affiliates.[46] It also establishes limits on their investments in private equity and hedge funds—the practical equivalent of proprietary trading.[47] Eliminating the Volcker rule would return the country to the precrisis financial engineering that allowed banks and other massive financial institutions to pursue speculative activity in the market and sponsor hedge funds and private equity funds that engaged in unsound, risky strategies. These high-risk activities were at the heart of the banks' losses and bailouts.[48] Effectively, Republicans in Congress want to let banks gamble with government-insured money, thus reopening the Wall Street casino and increasing the likelihood of failure and bailouts.

As was demonstrated as recently as 2012 by the massive trading loss at J.P. Morgan known as the "London Whale," large proprietary trading positions can be excessively risky, instantaneously exposing banks to potentially enormous losses.[49] Such behavior grows even more serious when you consider that many of these same institutions are of systemic importance. And for anyone who touts this as a net benefit for economic growth, proprietary trading does nothing to support manufacturing, construction, or service jobs.

Once again legitimizing "speculative, impersonal, short-term trading activities" in lieu of more modest and safer commercial banking and customer-serving market-making, as Volcker has put it, would have deeply pernicious cultural repercussions within firms.[50] Indeed, it would set the financial sector back on a path toward even more severely concentrating power in the hands of a small number of banks that are actively in the business of betting against their customers and clients, who are retirees, savers, and other investors in American capital markets and farmers and commodity users in American derivatives markets, among others.

Banking should be boring, as others have noted.[51] Banks should be in the business of serving the real economy, not gambling on the markets for their own profits, and the ups and downs of the capital and derivatives markets should be established by the diverse opinions of millions of market participants—not by the traders at a small handful of banks. The FCA's termination of the Volcker rule is a clear example of the bill choosing banks' immediate profits over the long-term economic success of ordinary Americans.

## Concentration limits and a return to mega-mergers

For a bill that claims to be against bailouts, the Financial CHOICE Act seems awfully comfortable with mega-institutions. Why else would the FCA exempt banks from regulatory oversight of mergers and acquisitions that could result in firms being "too big to fail"?[52] The FCA is giving the green light for firms to consolidate. And consolidation could mean fewer community banks serving local small businesses. Or worse, it could mean the creation of more institutions that are perceived to be too big to fail.

Supporters of the FCA may ascribe such a move to the value of simplification and a belief that as long as these institutions, regardless of their size, have a quarterly leverage ratio of at least 10 percent, that will prove enough. But this belief is insufficient. The U.S. banking sector, and the real economy in general, needs more competition and less concentration.[53] As the Office of Financial Research noted in its 2016 report, eight of the largest U.S. banks hold almost three-fourths of all assets of U.S. bank holding companies, and "the potential impact of a large bank failure remains substantial."[54] There are also concerns that merging one firm with another while not creating observable aggregate concentration could lead to substantial concentration within particular types of markets, a significant financial stability risk. Moreover, there is not clear evidence that mid- to large-size banks experience increasing returns to scale.[55] Hence, mergers that concentrate assets in larger banks do not necessarily raise efficiency and lower costs for consumers. In fact, the well-documented increase in financial sector concentration has done nothing to lower costs of intermediation.[56]

The concentration of the financial sector increases systemic risk and threatens financial stability without offering clear efficiency gains. It also transfers important decision-making over who gets loans in the real economy to a smaller and smaller set of large firms. The Dodd-Frank Act ensured that the Federal Reserve would review mergers and acquisitions of financial institutions to specifically consider financial stability risks and concentration.[57] Rolling back such oversight is akin to calling for more concentration of economic wealth and, ultimately, another destructive financial crisis. This is deeply troubling for those who believe that a diverse financial sector is the foundation for a diverse and competitive real economy.

## Bringing the SEC to heel

The Financial CHOICE Act further contributes to the concentration of economic power and reduced accountability by letting financial institutions play by a different set of rules than everyone else. It guts the authority of the Securities and Exchange Commission to hold repeat offender firms accountable for their repeated violations and thereby protect investors on a going-forward basis. This is not simply an authority that the SEC has; it has long been the standing requirement of the law to automatically disqualify from certain privileges under federal securities law—privileges such as expediting securities offerings or selling securities without registering with the SEC—anyone that violates the federal securities laws or certain other financial regulatory laws, especially if the violation is criminal. Prior to the arrival of Commissioner Kara Stein at the SEC, the commission regularly waived that disqualification for the largest firms. But since the beginning of her tenure, the SEC has started to curtail that practice and has begun, albeit slowly and incompletely, to hold firms of all sizes equally accountable.[58] Eliminating automatic disqualification would give repeat offenders a competitive advantage over better managed competitors. And by undermining trust in the markets—something sorely tested in the repeated criminal behavior of some of the largest firms—it puts the diversity and vibrancy of U.S. capital markets at risk and concentrates market power in the worst offending firms.[59]

Supporters of the bill may insist that it significantly increases the SEC's civil and criminal penalty authority. In reality, though, it would undermine SEC enforcement by taking away the important tool of administrative hearings and moving toward using federal court proceedings, a venue that is generally far more expensive and cumbersome, making enforcement less likely.[60]

In addition to a series of other steps, the FCA also eliminates the requirement that banks have some skin in the game for asset-backed securities other than residential mortgages. Prior to the financial crisis, banks and lenders had created a structure that allowed them to profit from the origination and securitization of loans but absolved them of the risk of loans going bad.[61] In late 2014, rules were finalized that reformed the system by requiring banks to retain at least a 5 percent interest in any security transaction that they sponsor.[62] The goal was to ensure that the incentives of the institutions that package these deals matched up with those of investors, reinstituting the checks that originally governed the financial system.[63] The FCA would no longer require compliance for particular assets, once again permitting dangerous incentive structures that helped cause the financial crisis and further disadvantaging those that do business the fair way while concentrating power in those institutions that could mislead and manipulate the system.

The bill also ties the hands of the SEC, and other financial regulators, by adding a series of procedural hurdles to its ability to act, as well as by granting Congress the authority to veto any "major" financial regulation simply by doing nothing.[64] By tying the hands of regulators, the FCA cedes power to a sector that packs overwhelming lobbying firepower. This should be deeply troubling to anyone who believes that the markets should not police themselves.

## Removing transparency in private equity

It was evident during the financial crisis that regulators did not have sufficient oversight tools to address challenges arising in growing segments of Wall Street that rested outside the traditional banking sector. One such area was the alternative asset management industry, including hedge funds and private equity firms. Some of the largest private equity firms and hedge funds manage hundreds of billions of dollars in assets, making it crucial for regulators to have quality data on and appropriate oversight of this industry. During the 2007–2008 financial crisis, hedge funds played a key role in major losses and even failures of some of the biggest financial firms, including, most notably, Bear Stearns Companies Inc.[65]

And it was only a decade prior to this crisis when the giant hedge fund Long-Term Capital Management had to be bailed out by an orchestrated series of big bank investments under the auspices of the Federal Reserve Bank of New York.[66] Morgan Stanley's private equity business also incurred serious losses during the financial crisis, contributing to the stress on the institution.[67]

Dodd-Frank required these firms, for the first time, to register with the SEC, submit themselves to examinations, and report on their activities. Utilizing these new tools, the SEC has already found a series of investor protection failings at these firms, imposing millions of fines and leveling the playing field toward more transparency and investor empowerment.[68] More recently, the Financial Stability Oversight Council has also identified a series of possible systemic risks arising from hedge funds specifically. The FCA is quite consistent on private funds: Regulators should not have access to information on or oversight of this industry. The FCA removes SEC registration and reporting requirements for private equity firms. It also eliminates the ability of the SEC to require certain records for the purposes of monitoring systemic risk. But taking the cop off the beat would return power to the hands of the fund managers that take advantage of investors, such as teachers and firefighters who trust these firms with their retirement funds. It would also disadvantage those that are doing the right thing, as well as expose taxpayers once again to financial stability risks.

## Excessively compensating the wealthy and powerful

The concentration of wealth and power and a reduction in accountability are main themes in this bill, so it is not surprising that it eliminates Dodd-Frank's restrictions on incentive-based compensation packages and executive compensation disclosure requirements. Before the financial crisis, Wall Street compensation packages often created perverse incentives for bank employees to take excessive risks for huge bonuses tied to short-term gains and little downside if massive losses were incurred.[69] Such activities occurred at regional banks such as Washington Mutual Inc. that make and securitize high-risk loans just as much as at top Wall Street trading firms, and compensation structures incentivized employees at all levels, not just CEOs.[70] This mindset of encouraging excessive risk-taking to maximize profit while letting taxpayers foot the bill if the bets did not pay off was at the heart of the crisis. Dodd-Frank gave regulators the authority to curb risky incentive-based compensation practices, but the FCA erases those rules and enables Wall Street to put those precrisis compensation practices back in place.

The Financial CHOICE Act's approach to concentrating power extends to the real economy as well. Rules requiring companies to disclose the pay ratio comparing the median employee compensation with the CEO's compensation would also be eliminated by the FCA.

## Securitization's perverse incentives

During the financial crisis, Americans who had borrowed to purchase a home or car were often the victims of predatory lending. On their backs, as well as those of investors, banks and originators made historic profits. They did this by lowering underwriting standards and trapping Americans in home, credit, and auto loans they would never be able to pay off.[71] Instead of having a stake in the success of such loans, however, lenders and banks sold most of these loans to investors through private securitization markets. In many cases, in fact, banks made money when these assets lost value.[72] Dodd-Frank sought to ensure that incentives were better aligned between lenders and consumers by requiring banks to keep a representative and meaningful stake of the securitized loans in their portfolios and by prohibiting banks from engaging in any conflict of interest with their investors.[73] The Financial CHOICE Act severely erodes these requirements and makes toxic loans and malfeasance likely again, to the detriment of consumers, investors, and financial stability.

## Undermining the goals of monetary policy

The Financial CHOICE Act does not simply gut financial regulation. It also deforms monetary policy in two important ways. First, it introduces continual pressure on the Federal Reserve to make its interest rate policy conform to the statute's version of the Taylor rule, which economists have used as a stand in for the judgement of a central banker for research purposes, even when doing so could cause needless economic harm.[74] The FCA would require the Federal Reserve to calculate an interest rate target according to a version of the Taylor rule and then justify any deviation between that value and the interest rate target actually chosen, creating a pathway for Congress to politicize meetings that the Federal Open Market Committee holds every six weeks.

The adoption of this standard is ridiculous on its face. Staff at the Minneapolis Federal Reserve Bank estimate that if the Taylor rule had been in effect over the past five years, 2.5 million more Americans would be out of work today due to inappropriately high interest rates hurting employment.[75]

Nonetheless, putting this requirement into statute would have the effect of deterring the Federal Reserve from exercising its expertise and judgment when setting monetary policy. Members of the Federal Open Market Committee would be looking over their shoulders, anticipating the political pressure the committee would experience when taking action that is necessary to support the Federal Reserve's dual mandate but that is inconsistent with the statutory formula.

This concern has been expressed by Republican and Democratic Fed chairs, with former Chair Ben Bernanke noting the problematic nature of more abstract proposals and current Chair Janet Yellen advising the House of Representatives directly on these provisions when they were considered as a stand-alone bill.[76] Since stepping down as chair, Bernanke has commented, "The principal effect of the bill would be to make meeting-by-meeting monetary policy decisions subject to Congressional review and, potentially, Congressional pressure."[77]

The Financial CHOICE Act further diverts monetary policy from the dual mandate by making it more likely that the Fed will be forced to use monetary policy to deal with financial instability. With fewer regulatory and supervisory tools available to constrain excessive risk-taking by banks and other financial market actors, the Fed will need to conduct monetary policy with an eye towards reducing speculative bubbles. Bubbles can be deflated by raising interest rates, but this means lower real output and employment. Taking regulatory and supervisory tools off the table may be a win for the financial sector, but it also deflects the Federal Reserve's focus from full employment and stable prices.

# Consumer protection

The CHOICE Act also rejects the painful lessons about toxic financial products from the financial crisis and Great Recession in which 10 million families lost their homes and Americans collectively lost $19 trillion in wealth. Instead of continuing post-crisis reforms that have ensured the availability of safe and affordable financial products, it would give a free pass to financial institutions to once again sell harmful products that wreck family balance sheets, as well as entire communities, without fear of getting caught.

The CHOICE Act includes the following key provisions that would gut consumer financial protections across the board:

- **Crippling the Consumer Financial Protection Bureau, or CFPB:** The FCA takes away the CFPB's independence by politicizing its director and replacing direct funding from the Federal Reserve with annual congressional appropriations; it also shrinks the agency's ability to identify and address financial wrongdoing by ending its supervision authority, consumer complaint database, and research and education functions, as well as greatly limiting its regulation and enforcement authority.

- **Reopening the door to known predatory practices:** The bill also allows a creditor of any size to once again make most mortgages without regard to a consumer's ability to repay the loan as long as the creditor holds the mortgage in its portfolio; guts protections against overcharging consumers on title insurance through affiliated companies; strips consumer protections from manufactured home borrowers; enables recklessness by removing the CFPB's ability to pursue financial actors engaged in unfair, deceptive, or abusive practices and scaling back enforcement powers to exclude cash compensation to victims; blocks the U.S. Department of Labor's fiduciary rule governing retirement investment advice; and prohibits both the CFPB and the Securities and Exchange Commission from taking steps to limit the use of mandatory consumer arbitration.

The FCA would make numerous changes to the highly effective and independent Consumer Financial Protection Bureau. While it would not replace the agency with a weakened and conflicted Consumer Financial Opportunity Commission, as proposed in last year's bill, it would instead crush the agency's ability to defend consumers from predatory practices through other means.[78] The bill would replace independent funding—something every other bank regulator has—with annual appropriations subject to congressional approval, enabling members of Congress to defund the agency or pick and choose the types of predatory actors subject to its jurisdiction. It would politicize the CFPB by making its director removable by the president for any reason, subjecting it to the risks of constant special interest lobbying in ways from which every other financial regulatory agency is currently immune.

The agency would be unable to ultimately fulfill its mission—protecting consumers from financial harm—with many of its most significant legal tools taken away. For example, the FCA would end the CFPB's authority to supervise financial institutions for their consumer practices, which allows examiners to look under the hood and identify small problems before they become large ones. It would eliminate the ability of the agency to regulate a product for being unfair, deceptive, or abusive.[79] It would also end its research and education functions, which shed light on troubling market practices and help consumers across the country better navigate the financial system. And it would repeal its ability to maintain a consumer complaint database. Combined with other technical administrative requirements, such as cost-benefit analyses that may understate the benefits of regulation, these changes would radically change the nature of the agency, rendering it a toothless sham.

There is no doubt that the CFPB has been under attack because of—not in spite of—its strong track record defending working families. In its short history, the CFPB has returned nearly $12 billion to 29 million wronged consumers.[80] For every dollar of its funding, it has returned approximately $5 to victims.[81] It has processed more than 1 million complaints on behalf of consumers, enabling CFPB staff to identify patterns and to ensure that policy decisions made by bank leadership correspond with the actions of individual officials with whom consumers interact.[82] As noted above, this complaint system, a cornerstone of public accountability, would be dismantled by the bill.

To date, the CFPB's enforcement actions have addressed unfair or deceptive practices including overcharging on student loans, illegally threatening service members to collect on debts, and providing inaccurate information to credit reporting companies.[83] Its enforcement actions addressing discriminatory lending practices alone returned more than $450 million to approximately 1 million victims of fair lending violations.[84] Its rulemaking has rooted out abusive practices in the mortgage market, recently provided long-awaited clarity and consistency to prepaid cards, and is expected to address predatory payday and auto title lending.[85] Yet all of these regulatory and enforcement activities would be largely halted from moving forward under the FCA. The CFPB's newly limited enforcement authority would not include the ability to return cash to victims for predatory practices, only allowing the agency to issue cease-and-desist letters once the damage had already been done. And by ending the CFPB's ability to make rules and take enforcement actions against firms engaged in unfair, deceptive, or abusive acts or practices—beyond specific violations of pre-existing consumer finance laws—the FCA would freeze the CFPB in its tracks, while giving a free pass to the worst financial predators and putting good financial actors at significant competitive disadvantage.

All of these efforts rely on an agency that is independent from capture by special interests and conflicting mandates. Since the founding during the Civil War of America's first financial regulator, the Office of the Comptroller of the Currency, policymakers have recognized that a sound financial system must be insulated from political whims intended to weaken it. The existing structure of the CFPB is sound and specifically designed for the agency to be independent, effective, and accountable.[86] Making the CFPB director subject to the whims of the president would be a first of its kind action to centralize banking regulatory power solely in the hands of the president and would eliminate the independence long established by Congress.

The FCA also shreds the independence of other regulatory agencies, such as the Federal Housing Finance Agency.[87]

At its core, the FCA is about helping the worst financial firms escape accountability rather than making an agency more accountable. The CFPB already is accountable, with its officials testifying before Congress 63 times to date, and it is audited once a year by the Government Accountability Office.[88] Opponents in Congress just want to pick and choose which kinds of shady companies get a free pass.

## CFPB: An independent watchdog for the financial marketplace

The Consumer Financial Protection Bureau has held financial institutions accountable when consumers have been seriously wronged, returning, on average, more than $400 to victims.[89] Among other actions, last fall, the CFPB announced a settlement with Wells Fargo for opening as many as 2 million fraudulent, unauthorized customer accounts to meet sales quotas, while leaving consumers to unknowingly foot the bill.[90]

By crippling the CFPB, the FCA would let predatory practices continue to ravage communities, unchecked by regulation. The story of Naya Burks, a St. Louis-area parent, is instructive: She took out a $1,000 loan from a payday lender to cover bills and deal with an unpredictable work schedule only to see the 240 percent-interest loan balloon to $40,000 after she fell behind on payments.[91] The lender dropped a lawsuit against Burks due to public pressure, but a rulemaking currently being finalized by the CFPB would potentially end these debt traps that cost families across the country $8 billion each year in fees.[92] The Financial CHOICE Act would shred the CFPB's authority to address these practices, whether through processing consumer complaints to ensure that banks hear their customers' voices as problems arise, regulation designed to prevent future consumer harm, or enforcement to make victims whole after the fact.

### Reopening the door to known predatory practices

In the lead up to the housing crisis, unscrupulous lenders pushed predatory loans on homebuyers and existing homeowners. Before the Dodd-Frank mortgage protections were in place, lenders often received additional compensation for steering borrowers into higher-cost mortgages.[93]

As a result, lenders often peddled mortgage products, such as home purchase loans and refinance loans, that appeared attractive to consumers but included terms and fees that would later push many of them into foreclosure. These terms included teaser interest rates that increased to an unaffordable rate over time, prepayment penalties that made it difficult for a borrower to refinance the mortgage, and negatively amortizing payment schedules that allowed a consumer's debt to grow each month.[94]

To prevent a return to this predatory mortgage lending, the Dodd-Frank Act put common sense rules in place to ensure that lenders evaluate a borrower's ability to repay a loan and to provide consumers with additional protections against being pushed and locked into a loan designed to blow up on them.

The Financial CHOICE Act would turn back the clock to a time when mortgages were risky to consumers and for the banking system. Creditors of any size could once again make most mortgages without regard to a consumer's ability to repay the loan as long as the creditor holds the mortgage in its portfolio. While supporters of this proposal argue that a creditor is unlikely to originate an unsustainable loan if it is held on portfolio, Americans learned otherwise during the housing crisis. Some of the nation's most predatory lenders, including Washington Mutual, held some of the most explosive and predatory loans in their portfolios.[95]

The FCA also guts protections against overcharging consumers on title insurance through affiliated companies, which are companies that are often under the same corporate umbrella as the lender. Abuses related to affiliates abounded during the run-up to the crisis, with upselling rampant throughout the system. The points and fees cap for the Dodd-Frank qualified mortgage definition exempts bona fide third party charges but does not exempt charges for affiliate companies, removing the incentive for these harmful arrangements. The FCA would make it easy, once again, for lenders to enrich themselves at the expense of homeowners by steering borrowers into high-cost insurance plans.

Finally, the FCA strips consumer protections from manufactured home borrowers, many of whom are rural, lower-income, and seniors. For example, it raises the interest-rate trigger for the enhanced consumer protections Congress put in place for borrowers receiving high-cost loans. As a result, manufactured housing residents could be made to pay much higher interest rates before receiving the same protections that residents of site-built homes enjoy.

These are among many reversals in the bill that would harm family finances. As noted above, the FCA would largely strip the CFPB's authority to regulate predatory practices by excluding those not already covered by specific federal laws. This includes blocking the agency from taking action against high-cost payday loans and indirect auto lending, two areas where insufficient oversight has repeatedly led to consumer harm.[96] The FCA would also block the Department of Labor's conflict of interest rule, or fiduciary rule, until the SEC finalizes its own rule at some point in the future. The department's fiduciary rule, finalized last year and scheduled to be in place this year, requires that all retirement financial advisers act in the best interest of their clients, closes a 40-year-old loophole, and is expected to save retirees $17 billion annually.[97] Separate from the legislation, the Trump administration has also requested that the implementation of this rule be delayed, leaving these key protections for savers and retirees in limbo.[98]

What's more, the Financial CHOICE Act would also undermine access to justice for wronged consumers and investors. Specifically, it prohibits both the CFPB and the SEC from taking on the abuses of mandatory consumer arbitration clauses by financial firms. As the Wells Fargo and other cases have shown, arbitration clauses largely eliminate consumers' ability to obtain redress for consumer harm through the legal system. The abuses of this system—and incredible unfairness, since these very same firms avail themselves of the federal courts all the time when it pleases them—have been increasingly scrutinized by federal agencies in recent years.[99] Limiting agencies' ability to constrain unfair arbitration is a one-two punch to weaken enforcement and deterrence both within public agencies and among private attorneys and the class action system.[100]

# Conclusion

The fact that President Donald Trump and House Financial Services Committee Chairman Jeb Hensarling are well on their way to choosing Wall Street over Main Street and letting Wall Street choose its own rules is not surprising, but the lack of subtlety is striking. The provisions in the Financial CHOICE Act show a malicious disregard for the lessons learned in the financial crisis. Erasing the progress made on financial stability, consumer protection, and the concentration of economic power on Wall Street would make the real economy far more vulnerable to the daily ravages of the worst financial practices, as well as to another serious financial crisis and ensuing recession. Lack of accountability would grow worse, not better, devastating the societal fabric of trust that deeply needs to be rebuilt. Too many workers lost their jobs, too many families lost their homes and wealth, and too many consumers were wronged for the United States to go back to those precrisis ways.

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JEB HENSARLING, TX, CHAIRMAN

**United States House of Representatives**
**Committee on Financial Services**
Washington, D.C. 20515

MAXINE WATERS, CA, RANKING MEMBER

April 26, 2017

Representative Jeb Hensarling
United States House of Representatives
Financial Services Committee
2129 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Hensarling:

In accordance with Clause 2(j)(1) of Rule XI of the Rules of the House, and Clause (d)(5) of Rule 3 of the Rules of the Committee on Financial Services, we write to notify you of our intent to call witnesses selected by the Democrats to testify on the Financial CHOICE Act of 2017 discussion draft at a hearing separate from the Majority's hearing on April 26, 2017. Holding this hearing, also known as a "minority day hearing" will provide Democratic members of the Committee and the American public the opportunity to further examine your legislation and its potential effects on consumers and investors all across the country.

Given the scope and extent of the proposed legislative changes in the discussion draft, ranging from capital markets, banking, consumer protection, investor protection, financial stability, insurance, and monetary policy, it is critical that multiple hearings be convened to allow diverse and comprehensive testimony on these topics before the Committee marks up the measure. Our constituents and the American public deserve a thorough vetting of this nearly 600-page bill, which has the potential to significantly change our economy.

Convening multiple hearings to solicit testimony representing a broad set of viewpoints is not without precedent in this Committee. Following the worst financial crisis since the Great Depression, this Committee held 41 public hearings related to financial reform prior to the passage of the House version of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Mr. Chairman, while Democrats may not always agree with your policy proposals, we should all agree that the American public deserves nothing less than full transparency, accountability, and debate of the matters before this Committee. That is why Democrats will exercise our right to hold a minority day hearing on the Financial CHOICE Act discussion draft and we look forward to working with you to determine the date, time, and place of such hearing.

Sincerely,

Maxine Waters

The Honorable Maxine Waters
Ranking Member

The Honorable Jeb Hensarling
April 26, 2017
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Keith Ellison MN-5

Wm. Lacy Clay Mo-1

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Michael E. Capuano MA-07

Bill Foster

Ed Perlmutter

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Denny Heck

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Gregory W. Meeks NY-05

Carolyn B. Maloney

The Honorable Jeb Hensarling
April 26, 2017
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American Baptist
Home Mission
Societies

American Baptist Home Mission Societies
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www.abhms.org

April 26, 2017

Dear Chairman Hensarling and Ranking Member Waters,

I am writing in response to the House Financial Services Committee consideration of legislation that would effectively stop shareholders from engaging corporations through the shareholder proposal process. I am asking you to oppose any attempt to limit the current shareholder proposal rule, as contemplated by Chairman Jeb Hensarling (R. Texas) in Section 844 of the Discussion Draft of the Financial CHOICE Act.[1] The existing shareholder proposal process under Securities and Exchange Commission rule 14a-8 is well functioning - it should not be changed as proposed in Section 844.

The American Baptist Home Mission Societies (ABHMS), founded in 1832, manages a $215 Million Common Investment Fund. We have a strong history of managing our investments in ways that consistently provided strong financial returns. And we've done so while using our voice to influence corporate leaders to broaden their view of risks and consider the social and environmental impacts of corporate decisions. The idea that our voice, along with the voices of other investors, would be considered too small to count while efforts are underway to prop up institutions considered 'too big to fail' flies in the face of our democratic and Christian values.

In partnership with the Interfaith Center for Corporate Responsibility (ICCR), ABHMS as a founding member has pressed companies such as Chevron, ExxonMobil, and Tyson Foods to improve management of environmental, social and governance risks. Through dialogue we educate companies about their impact and work with them to develop and implement strategies that affect positive systemic change. When we find that dialogue does not address the risks in an adequate manner, we file a shareholder proposal to bring an issue before all shareholders for consideration on the proxy. We feel this process is an important tool for our ability to mitigate risk and carry out our fiduciary duty.

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1 https://financialservices.house.gov/uploadedfiles/choice_2.0_discussion_draft.pdf

Highlights of ABHMS 2016 shareholder engagements include:

- ABHMS continued to lead engagement with Tyson Foods on water stewardship because of Tyson's history of water contamination incidents, both within their own facilities and among their contract farmers and supply chain. ABHMS led the filing of a shareholder proposal that requests that the Board of Directors "adopt and implement a water stewardship policy designed to reduce risks of water contamination at: Tyson-owned facilities; facilities under contract to Tyson; and Tyson's suppliers." Shareholder support for the resolution increased, to 14.6% at the 2017 Annual Meeting. As a result of ABHMS and broad investor engagement, Tyson agreed to begin to disclose their water data to the CDP Platform, a significant step in increasing their water management. If the proposed changes to the shareholder proposal rule were implemented requiring ownership of 1% of shares, ABHMS would not have had sufficient shares to file this important proposal.

- Climate Change engagement continues to be a high priority, particularly in the context of the Paris Climate Agreement. In 2016 ABHMS co-filed a shareholder proposal asking Chevron to establish science-based GHG emissions targets that received an 8% proxy vote. For consideration at the 2017 meeting ABHMS has co-filed a proposal on the transition plan to mitigate climate change in line with the goals of the Paris Climate Agreement. At ExxonMobil, investors faced a challenge to the Securities and Exchange Commission, but prevailed, and a vote was held on the resolution to adopt a policy to acknowledge the moral imperative to limit global warming to 2°C. Our moral obligation resolution received 18.5% of the vote. This was a novel resolution, but clearly resonated with shareholders and received a strong vote in its first year and our ability to file this resolution brought an important issue before the company. For the 2017 Annual Meeting, ABHMS has co-filed a proposal along with nearly 45 other investors on the Business Plan for aligning with the Paris Climate Agreement. If the rules were changed as proposed in the Discussion Draft, ABHMS would not have been able to file either of these important proposals.

- ABHMS continues to engage with the major financial institutions to promote a culture of ethics and responsible risk management. A dialogue with Wells Fargo in 2016 resulted in the filing of a resolution requesting them: 1) to undertake a business standards review; 2) develop a framework that integrates governance risk management into environmental and social risk mitigation; implement the bank's human rights policy; address that fact that its executive compensation (according to the ICCR Bank Survey) exceeded industry norms. Given the recent scandal involving 2 million fraudulent accounts, Wells Fargo acknowledged that they need to do a better job of connecting other bank documents, policies and procedures to their Vision and Values statement. This resolution received a 22% approval vote indicating strong support at the April 25, 2017 Annual Meeting. If the shareholder proposal rule were changed as suggested in Section 844 of the discussion draft, it would be required for an investor in Wells Fargo to own $2.5 billion in shares in order to file a proposal – none of the proponents of the resolution considered this year would have been able to file this resolution.

For an overview of some of the additional issues considered in shareholder proposals this year, I refer you to the ICCR Proxy Book.

We are deeply concerned about Section 844. Section 844 proposes changes to the SEC shareholder proposal by (1) changing the holding requirement to 1% ownership over a three year period (vs. 1% or $2000 for one year) to submit a proposal; (2) dramatically increasing resubmission thresholds to unreasonable levels; and (3) prohibiting proposal by a proxy other than the shareholder.

It is clear that Section 844 is an overreach, representing radical and dramatic interference with an important shareholder right:

- 1% ownership over a three year period to submit a proposal: As referenced above, this would require an investor in Wells Fargo to own $2.5 billion in shares in order to file a proposal. Only 11 investors have held those shares long enough: Berkshire Hathaway, Vanguard, State Street, BlackRock, Fidelity, Capital Research & Management, Wellington, JPMorgan, Dodge & Cox, and Northern Trust. Those investors do not file shareholder proposals at all, let alone shareholder proposals that have been filed at Wells Fargo on matters such as customer fraud, independent board chairman, proxy access, and irregularities in mortgage practices. The language in the discussion draft effectively kills any ability of shareholders to file proposals on these important issues. Improvements in business are driven by the marketplace of ideas, and minority shareholders are also important stakeholders.

- Increase resubmission thresholds consistent with previous SEC proposal: This would mean resubmission thresholds of 6% (year 1, from 3%); 15% (year 2, from 6%); and 30% (year 3, from 10%). From 2007 through 2009 only about 17 percent of the proposals that came to a vote achieved the support of 30 percent of the shares voted, and from 2010 onwards, this has been approximately 30 percent of proposals filed.[2] This amendment would negatively impact shareholder re-filing of proposals on new and emerging issues. Change does not come quickly to large and complex corporations and ideas often require years of consideration before they are accepted. Take for example the issue of declassified boards where directors stand for election each year – support of shareholder proposals on this issue was regularly below 10% in 1987 and below 30% for many years, but eventually grew to 81% in 2012. With 15% and 30% resubmission thresholds these proposals would have died long before they had the chance to be adopted. Declassified boards are now common practice, with two-thirds of S&P 500 companies holding annual votes, up from 40% 10 years ago.

- Prohibit proposal by a proxy other than the shareholder: Investors have a fundamental right to empower their representatives to act on their behalf and the proxy is a basic mechanism for well-functioning corporate governance.

As an investor, ABHMS is adamantly opposed to these recommendations that would interfere with shareholder rights. For over 45 years the shareholder proposal process has served as a cost effective way for corporate management and boards to gain a better understanding of shareholder priorities and concerns.

As currently structured, the shareholder proposal rule:

- **Facilitates communication between shareholders and companies**. It provides shareholders of all types and sizes, from large pension funds to individual investors, an opportunity to communicate directly with corporate boards and management on issues of importance. Resolutions that are not withdrawn can be voted on by all holders of voting stock – giving the board and management input far beyond that of the shareholder(s) who initially filed the resolution.

- **Protects shareholder value and improves financial performance.** Over the years, the shareholder proposal process has contributed to many reforms that protect and enhance shareholder value, both at specific companies and in many cases to the benefit of the entire corporate and shareholder community. A 2015 study found that successful

[2] Report on US Sustainable, Responsible and Impact Investing Trends, 2016 - http://www.ussif.org/trends

shareholder engagements can generate cumulative excess returns of +7.1%.[3] In another example, a 2012 and 2014 Credit Suisse Research Report "Gender Diversity and Corporate Performance" links board diversity – an issue that has been raised through dozens of shareholder proposals – to better stock market and financial performance (higher return on equity, lower leverage, and higher price/book ratios).[4]

- **Protects shareholder rights.** The right to file a proposal is part of the bundle of rights that an investor acquires when acquiring shares. Radically curtailing those rights and taking away this process through which investors can bring concerns to management's attention would undermine investor confidence in the stability of our arrangement of rights associated with share ownership. All trustees and fiduciaries have a duty to monitor risk, many extend that duty to filing proposals when necessary to probe risks and potential weaknesses, as well as improve performance.

For further consideration of this issue, I refer you to a letter from organizations representing $65 trillion in opposition to these proposals and an in-depth briefing document and the attached Background Document. I am happy to speak about this at your convenience and can provide additional details on the impact of shareholder proposals. I urge you to oppose this attempt to limit shareholder rights.

Sincerely,

Jeffrey Haggray

Dr. Jeffrey Haggray
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Director of Public Witness and Advocacy
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[3] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2154724
[4] https://www.credit-suisse.com/us/en/articles/articles/news-and-expertise/2015/06/en/diveristy-on-board.html

**AFR Americans for Financial Reform**

April 25, 2017

Dear Representative,

On behalf of Americans for Financial Reform (AFR),[1] we are writing to express our opposition to the "Financial CHOICE Act" and to urge you to oppose this measure. This legislation would be better dubbed "Wall Street's CHOICE Act," as it would have a devastating effect on the ability of regulators to protect consumers and investors from Wall Street exploitation and the economy from financial risks created by too-big-to-fail megabanks. It would expose consumers, investors, and the public to greatly heightened risk of abuse in their regular dealings with the financial system, and our economy as a whole to a far greater risk of instability and crisis.

This nearly 600-page bill is a radical piece of legislation. Not only does it eliminate numerous major elements of the Dodd-Frank protections passed in the wake of the disastrous financial crisis of 2008, it would also weaken regulatory powers that long pre-date Dodd-Frank. If this bill passed, it would make financial regulation significantly weaker than it was even in the years leading up to the 2008 crisis.

Proponents of the CHOICE Act claim that certain portions of the bill actually improve financial protections. This claim is deeply misleading. In fact, the so-called protections in the bill are in many cases simply more disguised deregulation. For example, the bill exempts banks that meet a ten percent leverage capital ratio from a broad range of risk controls that have been part of bank regulation since the 1950s, if not before. While an increase in leverage capital would be a positive development, banks which took advantage of this provision could still pose major risks to the financial system, risks which would not be adequately addressed by a leverage capital ratio of just 10 percent. By exempting these banks from almost all other regulatory controls, the CHOICE Act would strip regulators of their ability to address such risks.

This legislation is crammed with deregulatory gifts to every kind of financial institution, including giant mega-banks who want to return to the excessive borrowing and risky practices that led to the financial crisis, private equity and hedge funds who want to manipulate the financial system and exploit investors, lenders who want to sell predatory subprime mortgages, payday lenders pushing products that trap consumers in a cycle of ever-increasing debt, and more. Among other changes, the Wall Street's CHOICE Act would:

- Create unprecedented barriers to regulatory action that would effectively give large financial institutions veto power to overturn or avoid government oversight.

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[1] Americans for Financial Reform is an unprecedented coalition of more than 200 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith based and business groups. A list of coalition members is available at http://ourfinancialsecurity.org/about/our-coalition/.

- Practically eliminate the powers of the Consumer Financial Protection Bureau to act forcefully against unlawful practices in consumer lending markets.
- Eliminate critical elements of regulatory reforms passed since the crisis, including restrictions on subprime mortgage lending, the Volcker Rule ban on banks engaging in hedge-fund like speculation, restrictions on excessive Wall Street bonuses, and more.
- Increase the ability of "too big to fail" financial institutions to hold up taxpayers for a bailout by threatening economic disaster if they failed.
- Weaken investor protections and accountability in the capital markets, including the elimination of crucial new fiduciary protections for retirement savers.

Evidence is lacking that any significant deregulatory measures are called for, let alone the radical assault on financial oversight contained in this bill. Since the passage of Dodd-Frank in 2010, the U.S. economy has grown twice as fast as the other advanced economies like the European Union and Japan which had a weaker regulatory response to the financial crisis.[2] Over the past three years, real (inflation adjusted) commercial bank loan growth has been almost 6 percent, much higher than the historical average of 4 percent annual growth in commercial bank lending.[3] Loans at community banks have been growing even faster, with community bank loan growth exceeding loan growth among larger banks for each of the past two years.[4] The capital markets have also thrived since the passage of the Dodd-Frank Act – according to recent research by the New York Federal Reserve, bond issuance and trading volume have shown strong growth and end-user trading costs have declined significantly since 2010.[5]

In contrast to the lack of evidence for negative effects of post-crisis measures to improve financial regulation, we know exactly how disastrous failures of financial oversight can be. Non-partisan sources such as the Federal Reserve Bank of Dallas and the Government Accounting Office have estimated that the financial crisis cost from $6 to $14 trillion in lost economic output

[2] Americans for Financial Reform, *Dodd-Frank And Economic Growth*, Fact Sheet, January 2017. Available at http://ourfinancialsecurity.org/wp-content/uploads/2017/01/Dodd-Frank-and-Economic-Growth-Final.pdf

[3] AFR analysis of total loans and leases in bank credit, deflated using Implicit Price Deflator for Gross Domestic Product. Long run average calculated using all data available since 1973. Source Federal Reserve Board Release H.8, Assets and Liabilities of Commercial Banks In The United States. Available at https://fred.stlouisfed.org/series/TOTLL; GDP deflator U.S. Bureau of Economic Analysis. Available at https://fred.stlouisfed.org/series/GDPDEF/

[4] Federal Deposit Insurance Commission, "Quarterly Banking Profile", Various Dates. Available at https://www.fdic.gov/bank/analytical/qbp/

[5] Adrian, Tobias, Michael Fleming, Or Shachar, and Erik Vogt (2016), "Market Liquidity After the Financial Crisis", Federal Reserve Bank of New York Staff Reports No. 796, October, 2016. https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr796.pdf?la=en

alone.[6] This figure does not incorporate the full human cost of millions of jobs lost and the millions of families who lost their homes due to foreclosure.[7] Extensive research also shows that the negative economic impacts of such major financial crises drag on for years, slowing recovery from recession.[8] Eliminating safeguards against these kinds of catastrophic outcomes is profoundly short-sighted.

Below, we provide additional discussion of some of the major ways in which the CHOICE Act attacks the ability of regulators to hold Wall Street accountable to the public. We provide selected examples but do not address all of the objectionable provisions in this massive bill. We then examine why claims that the CHOICE Act will improve industry accountability are deceptive and false.

## THE CHOICE ACT'S ASSAULT ON WALL STREET OVERSIGHT

### *The CHOICE Act Eviscerates the Consumer Financial Protection Bureau, and Returns to an Era of Fractured Consumer Regulation that Allowed Abuses to Flourish.*

The first five-and-a-half years of the CFPB's history has vindicated the decision that Congress made in the Dodd-Frank Act to create a strong, independent agency to protect consumers from fraud and abuse in the financial marketplace.

Before the CFPB was established, consumer financial protection was split among several prudential banking regulators as their secondary mission. These regulators prioritized bank revenues over consumer protection. They systematically failed to address predatory mortgage lending abuses that contributed to the 2008 financial crisis, despite years of warnings from consumer advocates.[9] In fact, some bank regulators, such as the Office of the Comptroller of the Currency (OCC), even intervened to prevent state regulators from addressing abuses at banks.[10] This seeming inability to act forcefully on consumer issues continues even today at prudential banking regulators, as shown by the admitted failure of the OCC to control recent consumer

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[6] United States Government Accountability Office, "Financial Regulatory Reform: Financial Crisis Losses and The Potential Impact of the Dodd-Frank Act", GAO 13-180, January 2013. Luttrell, David, Tyler Atkinson and Harvey Rosenblum, "How Bad Was It? The Costs and Consequences of the 2007-2009 Financial Crisis and Its Aftermath", Federal Reserve Bank of Dallas Staff Paper No, 20, July, 2013.

[7] Americans for Financial Reform, "Costs of the Crisis," Briefing Paper, Updated July 2015.

[8] Reinhart, Carmen and Kenneth Rogoff, "Recovery From Financial Crises: Evidence From 100 Episodes", American Economic Review, Volume 104, No.5, 2014. Available at http://scholar.harvard.edu/files/rogoff/files/aer_104-5_50-55.pdf.

[9] United States Congress, House Committee on Financial Services, Subcommittee on Monetary Policy, *Hearing on Regulatory Restructuring: Safeguarding Consumers and The Role of the Federal Reserve*, Statement of Lauren Saunders, National Consumer Law Center and Americans for Financial Reform, July 16, 2009. Available at http://archives.financialservices.house.gov/media/file/hearings/111/saunders_testimony.pdf

[10] Elizabeth Renuart and Margot Saunders, *Banking Activities and Operations; Real Estate Lending and Appraisals,* OCC Docket No. 03-16, Oct. 6, 2003. Available at http://www.consumerlaw.org/issues/preemption/10_6_occ.shtml

abuses at Wells Fargo.[11] Moreover, these prudential banking agencies lack jurisdiction over non-bank financial companies – which have been and continue to be among the worst actors.

The American public paid a severe price for the failure to enforce consumer protections. In the wake of a destructive financial crisis and millions of unnecessary foreclosures, Congress addressed the problem of fragmented and ineffective consumer protection by creating a single agency, the CFPB, which has the clear mission and comprehensive jurisdiction needed to protect consumers. By exercising its rulemaking, supervision, and enforcement authorities over all large actors – banks and non-banks – the CFPB has made major strides in making the financial marketplace fairer to consumers. The CFPB has successfully resolved more than 100 cases and secured more than $11.8 billion in relief for 29 million consumers who suffered a financial loss due to a financial company's lawbreaking.[12] There remains much important work for the CFPB to do, including significant ongoing rulemakings that this legislation would totally block.

The changes to CFPB authority in the CHOICE Act would demolish all the progress made toward the establishment of a rational and effective framework for consumer protection. This legislation makes consumer protection authority even more fragmented and confusing than it was before the 2008 crisis, and returns key authorities back to the very same regulators who proved themselves ineffective in the past. By depriving the CFPB of enforcement powers and supervision of banks, as well as dramatically scaling back its other authorities, the CHOICE Act creates an unworkable consumer financial protection scheme that would be even weaker than the one which allowed devastating mortgage abuses to flourish in the lead up to the financial crisis. These changes are sensible only if you are trying to make it easier for Wall Street and predatory lenders to profit from cheating the public.

**The CHOICE Act Eliminates the CFPB's Supervision and Enforcement Authority for Large Banks.**[13] This legislation would end the CFPB's ability to examine or enforce the law against large banks. Instead, the bill would disperse that supervision and enforcement authority to a set of other agencies that failed to use it effectively in the past and are much more likely to act in an uncoordinated fashion and to provide opportunities for firms to play one regulator off against another. As previously discussed, that was a root cause of the regulatory failure that contributed to the financial crisis – and the central problem the CFPB was created to solve. The recent internal report by the OCC on its dramatic failures in examining Wells Fargo in the many years before the CFPB and the Los Angeles City Attorney led a joint action against the bank for

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[11] Office of the Comptroller of the Currency, "Lessons Learned: Review of Supervision of Sales Practices at Wells Fargo", Enterprise Governance Supervision, April 19, 2017. Available at https://www.occ.gov/publications/publications-by-type/other-publications-reports/pub-wells-fargo-supervision-lessons-learned-41917.pdf

[12] Consumer Financial Protection Bureau, *Consumer Financial Protection Bureau: By the Numbers*, Fact Sheet, January, 2017. Available at http://files.consumerfinance.gov/f/documents/201701_cfpb_CFPB-By-the-Numbers-Factsheet.pdf

[13] Section 727(a)(5) & 727(a)(6), Discussion Draft.

opening some 2 million fake accounts provides yet another compelling example of the irreplaceable importance of CFPB's consumer-focused supervision and enforcement.[14]

**The CHOICE Act Sharply Curtails CFPB Supervision of Non-Banks.**[15] With regard to non-banks, the bill takes the particularly nonsensical step of eliminating the CFPB's authority to begin examinations of nonbank financial companies it does not currently examine, while permitting it to continue to examine those it examines now. This means that any new or growing credit reporting agency, debt collector, student loan servicer, remittance provider, or auto lender, or non-bank entities in new consumer markets, would be forever exempt from CFPB examinations regardless of size or significance. This would create an unlevel playing field and allow fraud and abuse of consumers by newer companies to go undetected and undeterred. Non-bank entities are not subject to comprehensive consumer protection examination by any other federal regulator, so they would go totally unsupervised. This structure would of course also incentivize firms to artificially reconstitute themselves to evade regulation. Regular examination or audits check that companies are following the law and addressing compliance issues before they cause consumer harm or require enforcement action. They also allow the Bureau to comprehensively see and understand market developments. The CFPB employs more examiners than any other job category, demonstrating the centrality of examinations to the CFPB's work.[16]

**The CHOICE Act Repeals CFPB Authority To Stop Unfair, Deceptive, and Abusive Acts and Practices.**[17] The CFPB has used this authority to stop Wells Fargo from opening fake accounts in their customers' names,[18] stop lenders from making false threats in debt collection,[19] and require refunds to consumers tricked into paying for worthless credit card add-on services and fake protections.[20] The bill totally eliminates the Federal prohibition on *abusive* acts and practices, taking a major step backwards on an important principle of consumer protection.

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[14] Office of the Comptroller of the Currency, "Lessons Learned: Review of Supervision of Sales Practices at Wells Fargo," Enterprise Governance Supervision, April 19, 2017. Available at https://www.occ.gov/publications/publications-by-type/other-publications-reports/pub-wells-fargo-supervision-lessons-learned-41917.pdf

[15] Section 727(a)(4).

[16] CFPB, "Office of Minority and Women Inclusion Annual Report to Congress," March 2017, p. 17. Available at https://s3.amazonaws.com/files.consumerfinance.gov/f/documents/201703_cfpb_OMWI-2016-annual-report.pdf

[17] Section 736, Discussion Draft.

[18] Summary and legal documents available at https://www.consumerfinance.gov/about-us/newsroom/consumer-financial-protection-bureau-fines-wells-fargo-100-million-widespread-illegal-practice-secretly-opening-unauthorized-accounts/

[19] See, e.g., summary and legal documents available at https://www.consumerfinance.gov/about-us/newsroom/cfpb-orders-navy-federal-credit-union-pay-285-million-improper-debt-collection-actions/.

[20] Summaries and legal documents available at https://www.consumerfinance.gov/about-us/newsroom/cfpb-orders-bank-of-america-to-pay-727-million-in-consumer-relief-for-illegal-credit-card-practices/; https://www.consumerfinance.gov/about-us/newsroom/cfpb-orders-citibank-to-pay-700-million-in-consumer-relief-for-illegal-credit-card-practices/; https://www.consumerfinance.gov/about-

In the case of unfair and deceptive acts and practices (UDAP), it strips the CFPB of the power to enforce these standards or to write rules to define them. Instead, only the prudential regulators and that Federal Trade Commission (FTC) would have this essential consumer protection authority. The FTC would be the only agency able to write UDAP rules that apply to non-banks and the only agency able to trigger uniform UDAP rules.[21] But, as a practical matter, no such rules would be written because of unique and unworkable requirements for FTC rulemaking.[22] This would leave important areas of consumer protection, such as first-party debt collection by non-banks (i.e., collection by lenders themselves), without comprehensive and uniform rules.

Besides stripping the CFPB of fundamental areas of its authority, the bill also undermines the independence and other structural features of the Bureau that have allowed it to stand up for consumers:

- The bill would end the CFPB's status as an independent agency, allowing the President to fire the Director without cause,[23] effectively requiring the CFPB to answer to White House political staffers. It would also specifically require CFPB rules – unlike the rules of the other independent banking agencies – to be reviewed by non-experts in the White House, directly politicizing consumer financial protection.[24]

- The bill would further undermine the agency by subjecting it to the appropriations process.[25]

- The bill would also mandate the creation of a new, unnecessary, duplicative bureaucracy within the agency,[26] while eliminating the CFPB's market monitoring functions that allow it to gather information and base its actions on responsible data collection.[27] The

us/newsroom/cfpb-orders-chase-and-jpmorgan-chase-to-pay-309-million-refund-for-illegal-credit-card-practices/.

[21] Section 737, Discussion Draft.

[22] For a description of these requirements and their effects, see AFR Letter Opposing HR 5112, May 20, 2016. Available at http://ourfinancialsecurity.org/wp-content/uploads/2016/05/OppoLetterHR5112-5-12-16-1.pdf.

[23] Section 711(a)(1)(D), Discussion Draft.

[24] Section 712, Discussion Draft.

[25] Section 713, Discussion Draft.

[26] Section 717, Discussion Draft (establishing an Office of Economic Analysis). For a detailed discussion of these harmful provisions, see Letter to Congress: AFR Opposes H.R. 5211, Legislation to Weaken the CFPB (June 21, 2016), http://ourfinancialsecurity.org/2016/06/letter-congress-afr-opposes-hr-5211-legislation-weaken-cfpb/.

[27] Section 724, Discussion Draft.

bill would also threaten the advisory boards that help the Bureau's work be informed by consumer advocates, academics, community banks, and credit unions.[28]

- The bill would also weaken the CFPB by requiring it to pay its employees less than employees of all other federal financial regulators,[29] undermining the agency's capacity to attract and retain highly-qualified financial professionals.

In addition to dramatically weakening the CFPB across-the-board, the bill also specifically blocks CFPB efforts to protect consumers in a number of key specific areas:

- The bill would eliminate all CFPB jurisdiction over payday and title loans.[30] This provision would not only stop the rule the CFPB is working on now to take on the unaffordable lending that is at the heart of the payday debt trap, but also prevent the CFPB from taking action against payday lenders for violating existing consumer protection laws and rules.[31] To make matters worse, the bill includes a provision expanding preemption of state interest rate caps.[32]

- The bill would prevent the CFPB from finalizing its proposed rule against forced arbitration clauses.[33] These clauses deny consumers access to the courts when financial institutions break the law. It is particularly notable that this legislation, which does so much to assist large financial companies in using lawsuits to overturn rules, would block consumer access to the courts.

- The bill would end the release of information about consumer complaints,[34] eliminating an important public resource for understanding and avoiding consumer abuses.

The legislation would also undermine enforcement of anti-discrimination laws:

[28] Section 726, Discussion Draft.

[29] Section 723, Discussion Draft.

[30] Section 733, Discussion Draft.

[31] Consumer Financial Protection Bureau, "CFPB Takes Action Against Money Tree For Deceptive Advertising and Collection Practices," December 16, 2016. Available at https://www.consumerfinance.gov/about-us/newsroom/cfpb-takes-action-against-moneytree-deceptive-advertising-and-collection-practices/ & Consumer Financial Protection Bureau, "CFPB Takes Second Action Against Military Credit Services," December 20, 2016. Available at https://www.consumerfinance.gov/about-us/newsroom/consumer-financial-protection-bureau-takes-second-action-against-military-credit-services-improper-contract-disclosures/

[32] Section 581, Discussion Draft.

[33] Section 738, Discussion Draft. *See also* Letter to Congress: Reject Proposals That Interfere with CPFB's Authority on Mandatory Arbitration (May 19, 2016) (AFR and 70 organizations), http://ourfinancialsecurity.org/2016/05/letter-congress-2-2/.

[34] Section 725, Discussion Draft.

- The bill seeks to stall the CFPB's enforcement of anti-discrimination laws in the auto industry, thereby allowing racial discrimination in auto lending to go unchecked.[35]

- The bill would scale back data collection under the Home Mortgage Database Act, weakening a critical tool to fight redlining.[36]

- The bill would abandon the effort required by Dodd-Frank to learn more about small business lending through systematic data collection,[37] undermining enforcement of the Equal Credit Opportunity Act and missing a badly needed opportunity to better understand the small business lending market and help small businesses access credit.

In aggregate, these provisions would leave the CFPB powerless to achieve its mission of protecting consumers.

***The CHOICE Act Disempowers All Financial Regulators By Creating Unprecedented Legal and Analytic Hurdles Before Regulators Can Act***

The CHOICE Act contains a set of drastic new analytic, legislative, and legal requirements that financial regulatory agencies must fulfill before engaging in oversight of financial institutions or practices. These requirements go far beyond any reasonable attempt to improve regulatory procedures and create unprecedented roadblocks to effective action. Indeed, in combination these changes would reduce the effective authority of Federal financial regulators to its weakest point since prior to the Great Depression.

By mounting a lawsuit based on an agency's failure to comply with these extensive new requirements, regulated financial institutions could stop agency action dead in its tracks. The new roadblocks to action include:

- A requirement that regulators complete dozens of additional analyses prior to issuing any new regulation, guidance, or interpretation. Required analyses include broad and vague mandates such as measuring all "direct and indirect" costs and benefits of a regulation and assessing "all available alternatives" to a regulation. The adequacy of any of these analyses could be challenged in court.[38]

[35] Section 734, Discussion Draft. *See also* Letter to Congress: AFR, 65 Organizations Urge Congress to Stand Against Discriminatory Auto Lending and Reject HR 1737 (Nov. 16, 2015), http://ourfinancialsecurity.org/2015/11/letter-to-congress-afr-65-organizations-urge-congress-to-stand-against-discriminatory-auto-lending-and-reject-hr-1737/.

[36] Section 576, Discussion Draft.

[37] Section 561, Discussion Draft.

[38] Subtitle A of Title III, Discussion Draft; additional analytic requirements for banking agencies are included in Subtitle J of Title V, Discussion Draft.

- A requirement that both houses of Congress approve any major regulation, guidance or interpretation, or any rule for which measured quantitative benefits did not exceed measured quantitative costs.[39] This would vastly increase the delay and complication of regulatory action.

- The legislation empowers financial institutions to stop agency action in court by eviscerating longstanding precedents requiring courts to defer to experts in regulatory agencies. Instead, courts would be encouraged to evaluate technical issues "de novo," ignoring agency judgement and allowing the judge to substitute their views for those of subject matter experts at the agency.[40]

Collectively, these new mandates would create enormous barriers to completing any new rulemaking, interpretation, or guidance that was opposed by any financial interest with the resources to mount a lawsuit or lobby Congress to halt a rule.

***<u>The CHOICE Act Eliminates Protections Against Unaffordable Mortgage Lending</u>***

At Congress' direction, the CFPB has enacted a series of reforms to make mortgage loans fairer and simpler, and reduce the risk of default and foreclosure. These "Qualified Mortgage" rules are designed to ensure that mortgage loans are not made to home buyers who cannot afford them, and that loans do not include "tricks and traps" that lead to loans that cost far more than the should or that borrowers expect they will.

The CHOICE Act would greatly weaken these protections by exempting all mortgages held on bank portfolios – including those originated by the largest Wall Street banks – from these new rules.[41] The justification for these changes is that banks will not have an incentive to make predatory or exploitative loans if it continues to hold the loan rather than selling it to another party. But experience shows this to be false. Washington Mutual and Wachovia—two large regional banks—failed in the aftermath of the financial crisis because of the significant losses in mortgage loans held in their own portfolios. The bill would allow large financial institutions to return to those practices and strip consumers of any meaningful legal recourse. In addition, the bill would further weaken protections against hidden fees and other traps by changing the calculation for determining a Qualified Mortgage and high-cost loan protections, making it easier for predatory mortgage loans to be made.[42] The bill also would subject vulnerable homeowners

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[39] Subtitle B of Title III, Discussion Draft; Section 312(b)(4) in Subtitle A of Title III of Discussion Draft

[40] Subtitle C of Title III, Discussion Draft.

[41] Section 516, Discussion Draft. For a detailed discussion of this provision, see Letter to Congress: Oppose HR 1210, the "Portfolio Lending and Mortgage Access Act," July 27, 2015. Available at http://ourfinancialsecurity.org/wp-content/uploads/2015/07/Oppose-HR-1210-Barr-Portfolio-with-sign-ons-final-7.27.15.pdf.

[42] Section 506, Discussion Draft. For a detailed discussion of this provision, see Letter to Congress: Oppose HR 685, March 18, 2015. Available at http://ourfinancialsecurity.org/wp-content/uploads/2015/04/CRL-Oppose-H.R.-685-Mortgage-Choice-Act-3.18.15.pdf

with higher-priced mortgages to deceptive mortgage marketing by allowing many lenders to exclude escrow payments from the loan.[43]

Separately, the bill would also eliminate a wide range of consumer protections for home buyers who borrow to purchase manufactured housing, including by permitting higher interest rates in this market before basic consumer protections applied.[44] These loans are generally made to lower income people, and there is a record of both past and recent abuses in this market.[45]

The bill would also eliminate the independence of the Federal Housing Finance Agency, giving the White House direct control over the conservatorships of Fannie Mae and Freddie Mac, which finance 46% of the home mortgages in the United States.[46]

***The CHOICE Act Attacks The Capacity To Do Basic Supervision of Big Banks***

The legislation contains a number of provisions that would extend crippling procedural requirements to prudential bank supervision. While some of these supervisory activities were mandated by the Dodd-Frank Act, they fall squarely within safety-and-soundness authorities that have been broadly accepted powers of bank regulators for many decades if not centuries. The CHOICE Act would sharply restrict these supervisory powers, in the following ways:

- When regulators do "stress tests" – forward-looking analyses of whether big banks have enough resources to absorb potential future losses – they would be required to release in advance for public comment the exact models used to test the banks portfolios and predict losses.[47] Like showing a test to students in advance, this would permit big banks to game the system by rigging their portfolios to match the models. Banks could also sue in court to challenge any detail of the regulatory oversight model that was used, taking advantage of ways in which the CHOICE Act facilitates industry lawsuits.

- The CHOICE Act would permit a bank to appeal any important supervisory determination made during a bank examination to an independent ombudsman. Since hundreds of such determinations can be made during a bank examination, this process

[43] Section 531, Discussion Draft.

[44] Sections 501 & 502, Discussion Draft. For a detailed discussion of these provisions, see Joint Letter: AFR Joins 15 Organizations in Supporting Low Income Families, Opposing HR 650 (Feb. 26, 2015), http://ourfinancialsecurity.org/2015/02/joint-letter-afr-joins-15-organizations-in-supporting-low-income-families-opposing-hr-650/.

[45] Baker, Mike and Daniel Wagner, "The Mobile-Home Trap: How A Warren Buffet Empire Preys on the Poor," Seattle Times / Center for Public Integrity, April 2, 2015. Available at http://www.seattletimes.com/business/real-estate/the-mobile-home-trap-how-a-warren-buffett-empire-preys-on-the-poor/.

[46] Section 352, Discussion Draft. Urban Institute, "Housing Finance At A Glance: Monthly Chartbook," March 2017. Available at http://www.urban.org/research/publication/housing-finance-glance-monthly-chartbook-march-2017/view/full_report

[47] Title I, Section 151(b)(6)(J), Discussion Draft.

would permit banks to stonewall supervisory authority for long periods of time. In addition, supervisors would be banned from making independent assessments of bank underwriting for commercial loans.[48]

- As discussed further below, the CHOICE Act exempts banks that meet a 10 percent leverage capital ratio from a wide range of supervisory rules and authorities.[49] Regulators would be effectively unable to address major risks in such banks, even though a 10-percent leverage ratio alone is inadequate to ensure that a bank is not taking irresponsible risks that threaten the bank's solvency or the broader financial system.

Especially in combination with the new legal and analytic barriers to every financial agency rulemaking, guidance, and interpretation (as described above), these restrictions on supervision would make basic safety and soundness supervision of regulated banks more restricted than it has likely ever been since prior to the New Deal, if not before.

In addition to these provisions, other elements of the bill would eliminate the long-standing practice of independent funding for banking regulators.[50] This practice helps to shield financial regulators from the political pressures that can be brought to bear by well-funded financial interests through the appropriations process. Subtitle F would also impose major new barriers to international coordination between regulators.

***The CHOICE Act Destroys Other Protections Against "Too Big To Fail" and Financial Instability***

During the 2008 financial crisis, regulators provided unprecedented assistance to the largest Wall Street financial institutions, using the excuse that they lacked the necessary tools to liquidate a failing financial firm without creating unacceptable economic fallout. Title II of the Dodd-Frank Act removed this excuse by creating an Orderly Liquidation Authority (OLA) under which the FDIC could take a large financial firm into receivership, liquidate the firm while limiting economic fallout using a temporary Treasury credit line, and hold the executives, directors, and officers of the firm responsible for reckless decisions leading to the firm's failure.

The CHOICE Act completely eliminates the Dodd-Frank liquidation authority and with it critical tools to prevent large financial institutions from again holding the economy for ransom.[51] The bill would replace OLA with a bankruptcy procedure that is unrealistic to the point of being unworkable.[52] It assumes an insolvent trillion-dollar financial entity could be safely reorganized

[48] Subtitle H of Title V, Discussion Draft.

[49] Section 602 of Title VI, Discussion Draft.

[50] Subtitle E of Title VI and Section 312, Discussion Draft.

[51] Subtitle A of Title I, Discussion Draft.

[52] Subtitle B of Title I, Discussion Draft. *See Also* pp. 16-21 in United States Congress, House Committee on Financial Services, *Hearing on Making A Financial Choice*, Statement of Adam J. Levitin, Georgetown University Law Center, July 12, 2016. Available at http://financialservices.house.gov/uploadedfiles/hhrg-114-ba00-wstate-alevitin-20160712.pdf

over the course of a weekend, with no special provisions for liquidity assistance, simply by converting some long-term debt into equity. Furthermore, this procedure would grant numerous special privileges to large financial institutions and their key directors, including potentially immunizing top executives for the consequences of actions that contributed to the failure of the firm.[53] Replacing liquidation authority with an unworkable bankruptcy procedure simply sets the stage for more ad hoc bailouts of large financial institutions.

Other provisions in the legislation would enormously weaken the Financial Stability Oversight Council (FSOC), which was established in response to the grave failures of regulatory coordination revealed in the 2008 financial crisis. The purpose of the FSOC is to provide a mechanism for cooperation so regulators do not again fail to identify and take action to stop an emerging crisis. This includes ensuring that large non-banks are properly supervised. However, the CHOICE Act would cripple the FSOC and other mechanisms for regulatory cooperation:

- It would strip the Financial Stability Oversight Council (FSOC) of most of its powers. The Office of Financial Research, which is the FSOC's tool for monitoring risks to financial stability, would be completely eliminated. Even more importantly, the bill eliminates the FSOC's power to designate large non-banks such as the insurance giant AIG for increased regulatory oversight. During the 2008 financial crisis, AIG received the largest public bailout in U.S. history.[54]

- The CHOICE Act would also cripple the capacity of different financial regulators to cooperate effectively in market oversight by opening up any meetings between personnel of different financial regulators to dozens or even hundreds of outside attendees, including numerous Congressional staff of both parties.[55]

- The CHOICE Act would eliminate Dodd-Frank provisions for increased oversight and joint monitoring of giant financial market utilities such as derivatives clearinghouses, which are crucial to financial stability.[56]

***The CHOICE Act Would Once Again Permit Big Banks To Speculate Like Hedge Funds***

A crucial reform included in the Dodd-Frank Act is the Volcker Rule, which bans banks from acting like hedge funds and taking proprietary financial gambles with depositor and customer money.

During the 2008 financial crisis some failing investment banks, such as Bear Stearns, were brought down directly by their hedge fund investments. All of the big Wall Street banks bailed

[53] See United States Congress, House Judiciary Committee, *Hearing on Financial Institution Bankruptcy Act of 2017*, Statement of Bruce Grohsgal, University of Delaware, March 23, 2017. Available at https://judiciary.house.gov/hearing/subject-h-r-financial-institution-bankruptcy-act-2017/

[54] Subtitle E of Title I, Section 151(a), Discussion Draft.

[55] Subtitle E of Title I, Section 151(b), Discussion Draft.

[56] Subtitle D of Title I, Discussion Draft.

out by the public held enormous internal trading inventories stuffed with subprime mortgage securities, which amounted to a hedge-fund like market bet that eventually created enormous losses. Big banks used their privileged position at the center of the financial system not to serve customers but to exploit them. Not only did they make destructive proprietary trading bets, but they engaging in conflicts of interest by designing and selling their own toxic securities which banks themselves knew would fail and harm investors.

The CHOICE Act would simply repeal the Volcker Rule, leaving the door open for banks to resume proprietary trading. It would also repeal rules against banks betting against securities that they sell their own customers.[57]

***The CHOICE Act Would Eliminate Limits on Out-of-Control Wall Street Bonuses***

Numerous investigations have found that the practice of giving giant bonuses to Wall Street traders based on short-term performance contributed to irresponsible risk-taking that helped crash the economy.[58] This "take the money and run" bonus culture led traders at big banks to take risks that paid them huge rewards in the short term but in the long term led to significant losses for the bank and eventually for the public as a whole.

The Dodd-Frank Act established new limits that required banks to end "take the money and run" pay practices and instead reward bankers and traders in ways that tied their salaries to the long-term success of their choices. The CHOICE Act would entirely repeal this section of Dodd-Frank, eliminating the mandate for regulators to act to control these kind of bonuses that encourage excessive risk-taking.[59]

The CHOICE Act goes even further by gutting Dodd-Frank provisions that require bonus payments to be clawed back when they are based on erroneous information or misstatements of earnings, unless the person receiving the bonus actively conspired in such misstatements. [60]

***The CHOICE Act Gravely Weakens Accountability in Capital Markets***

Not only does the CHOICE Act significantly weaken oversight of large financial institutions, it also contains a host of provisions that would eliminate key protections for investors and for the integrity of capital markets and corporate governance. A few examples include:

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[57] Title IX, Section 901(a)(3) and 901(a)(5), Discussion Draft.

[58] See discussion of the role of bank pay practices in United States Senate, Permanent Subcommittee on Investigations, "Wall Street and the Financial Crisis: Anatomy of a Financial Collapse," April 13, 2011. Available at https://www.hsgac.senate.gov/imo/media/doc/Financial_Crisis/FinancialCrisisReport.pdf. Financial Crisis Inquiry Commission, "Financial Crisis Inquiry Report," February 25, 2011. Available at https://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf

[59] Section 827(a)(26), Discussion Draft.

[60] Section 849 of Title VIII, Discussion Draft.

- The legislation repeals new protections for retirement investors that are designed to ensure that those providing investment advice put the best interests of their clients first.[61] Repealing these protections would cost ordinary retirement savers tens of billions of dollars a year.[62]

- The legislation would exempt private equity funds from parts of the Dodd-Frank Act that require these funds to observe stronger investor protection duties and to register with the SEC to ensure compliance with rules.[63] Exercising these Dodd-Frank powers has led the SEC to find numerous violations of securities laws that harmed private equity investors.[64] The CHOICE Act eliminates these powers.

- The legislation contains numerous provisions that would harm the ability of regulators to enforce securities laws. For example, one section would forbid the SEC to automatically prohibit "bad actors" (those convicted of felonies or otherwise found guilty of serious regulatory violations) from participating in securities markets.[65] Other examples include provisions that would prevent the SEC from levying fines in administrative proceedings where there were findings of wrongdoing, a provision greatly expanding pre-emption of state securities enforcement, and a provision that deprives regulators of key information needed to monitor potentially fraudulent offerings.[66]

- Other provisions eliminate needed investor protections in cases of risky investment products. For example, one section deregulates risky "crowdfunding" offerings, increasing investment caps so ordinary investors can risk potentially unlimited amounts on these very risky offerings, while simultaneously eliminating key investor protections such as public disclosures of the details of the company.[67] Another provision would double the amount of leverage permitted to Business Development Companies (BDCs),

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[61] Section 801, Discussion Draft.

[62] United States Department of Labor, *Regulating Advice Markets: Conflicts of Interest – Retirement Investment Advice, Regulatory Impact Analysis for Final Rule and Exemptions*, April, 2016. Available at https://www.dol.gov/sites/default/files/ebsa/laws-and-regulations/rules-and-regulations/completed-rulemaking/1210-AB32-2/conflict-of-interest-ria.pdf

[63] Section 858, Discussion Draft.

[64] *See* SEC Director of Enforcement Andrew Ceresney, "Remarks at the Securities Enforcement Forum West; 2016 Keynote Address – Private Equity Enforcement" (May 12, 2016), available at: https://www.sec.gov/news/speech/private-equity-enforcement.html; Nili, Yaron, "Takeaways from the Past Year of SEC Private Equity Enforcement," Harvard Law School Forum on Corporate Governance and Financial Regulation, available at: http://blogs.law.harvard.edu/corpgov/2014/12/17/takeaways-from-the-past-year-of-sec-private-equity-enforcement/

[65] Section 827, Discussion Draft.

[66] Section 823, Discussion Draft; Subtitle S of Title IV, Discussion Draft; Section 466, Discussion Draft.

[67] Subtitle P of Title IV; Discussion Draft

increasing the chance of large losses in this rapidly growing product segment, and also greatly expand the range of their permissible investments.[68]

The CHOICE Act also weakens or repeals numerous provisions of Dodd-Frank aimed at addressing weaknesses in the capital markets revealed during the financial crisis.

To take just one example, the financial crisis revealed major conflicts of interest at the large credit rating agencies such as Moody's and S&P -- critical capital market gatekeepers. These ratings agencies certified tens of thousands of "toxic" bonds based on subprime mortgages as high-quality, investment grade assets that were safe to hold for investors and banks. Such bonds in fact had massive losses, and later Justice Department investigations found that the ratings agencies misrepresented risks due to their desire to preserve revenues from the securities issuers who paid them.[69] The Dodd-Frank Act required the SEC to institute a stronger inspection regime for these ratings agencies, a mild response given the magnitude of the issues revealed in the crisis. But the CHOICE Act significantly weakens even this inspection regime, lowering the number of inspections and eliminating requirements that ratings agencies executives personally attest that their companies are following the rules.[70]

***<u>The CHOICE Act Repeals Limits on Debit Card Fees</u>***

The bill would repeal a requirement passed in the Dodd-Frank Act that debit card fees charged by banks with more than $10 billion in assets be limited to the reasonable cost of the transaction.[71] Even those who oppose this regulation agree that eliminating it would allow the nation's largest banks to charge retailers and customers an additional $6 – $8 billion per year in card fees.[72] It would do nothing to aid community banks, which are not covered by the rule and have actually increased their share of debit transactions since the regulation was implemented.[73]

[68] Subtitle H of Title IV; Discussion Draft. *See Also,* AFR Letter to Congress on HR 3868. Available at http://ourfinancialsecurity.org/wp-content/uploads/2015/11/AFR-Oppo-Letter-HR-3868-1.pdf

[69] Department of Justice, *Justice Department and State Partners Secure $1.375 Billion Settlement With S&P For Defrauding Investors,* Office of Public Affairs, February 3, 2015. Available at https://www.justice.gov/opa/pr/justice-department-and-state-partners-secure-1375-billion-settlement-sp-defrauding-investors

[70] Sections 850 to 856, Discussion Draft; Section 857(a)15-22, Discussion Draft

[71] Section 735, Discussion Draft.

[72] Todd Zywicki, et al., *Price Controls on Payment Card Interchange Fees: The U.S. Experience* (June 4, 2014). Available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2446080

[73] James Disalvo & Ryan Johnston, Federal Reserve Bank of Philadelphia Research Department, *Banking Trends* at 4 (First Quarter 2016), https://www.philadelphiafed.org/-/media/research-and-data/publications/banking-trends/2016/bt-how_dodd_frank_affects_small_bank_costs.pdf?la=en

**CLAIMS THAT THE CHOICE ACT WOULD IMPROVE WALL STREET ACCOUNTABILITY ARE FALSE**

Advocates of the Financial CHOICE Act falsely claim that several sections of the bill would actually improve Wall Street accountability. For example, Title VI of the bill proposes to exempt banks that meet a 10-percent leverage capital ratio from a broad range of supervisory risk controls. Proponents of the bill claim that maintaining a 10-percent leverage ratio will be so effective in protecting against irresponsible bank risk-taking that other risk controls will not be necessary and can thus be eliminated. This is deeply misleading.

Currently, the six largest U.S. banks have an average leverage capital ratio of less than 7 percent, so it is accurate that a 10-percent leverage ratio would require them to raise a moderate but still significant level of additional capital.[74] That would be a positive development.

However, leverage ratios are not adjusted to take account of the riskiness of bank assets or activities, so banks could still take potentially very large financial risks while maintaining a 10 percent leverage ratio. Indeed, it is precisely those banks which desire to invest in such risky assets that will have the greatest incentive to choose a somewhat higher level of capital while gaining immunity from all other supervisory risk controls. A leverage ratio of 10 percent, which continue to permit banks to borrow nine dollars for each dollar of hard capital, is far too low to provide protection against the incentives toward irresponsible risk taking that would be created by offering banks the option of immunity from regulatory supervision.

For this reason, even advocates of a "choice-based" approach to increased bank capital have called for much larger minimum capital ratios than 10 percent. For example, the Heritage Foundation, no friend of Dodd-Frank regulations, has argued that banks should be required to attain a leverage ratio of 20 percent, twice the capital level proposed in the CHOICE Act, in order to qualify for any regulatory exemptions.[75]

Exemptions in this bill strip regulators of effectively all the tools they use to address the significant bank risks that could remain even if banks maintained 10% leverage.[76] For example:

- Bank regulators would be forbidden to require additional capital for especially risky bank activities that might create higher losses. They would be forbidden even to require forward-looking stress test analyses to determine if risks could materialize in the future.

[74] Supplementary leverage ratios drawn from Q4 2016 earnings reports of JP Morgan, Bank of America, Wells Fargo, Citibank, Goldman Sachs, and Morgan Stanley.

[75] Kevin Dowd, "A Simple Proposal to Recapitalize the U.S. Banking System", Chapter 2 in Prosperity Unleashed: Smarter Financial Regulation, Heritage Foundation, February 28, 2017. Available at http://www.heritage.org/prosperity-unleashed

[76] Section 602 (Title VI), Discussion Draft.

- Regulators would be forbidden to impose any liquidity requirements at all, even though liquidity failure (the lack of cash to meet current obligations) directly causes bank failure.

- Regulators would be required to let even the riskiest banks pay out capital to stockholders, rather than reserving it to cover potential losses, even if they saw that banks were undertaking activities that risked large future losses.

- Regulators would actually be *banned* from taking into account the risk the bank's activities posed to the financial stability of the United States. Regulators would also be forbidden from preventing bank mergers that led to the creation of "too big to fail" entities or had an unacceptable effect on competitiveness in the banking system.

Exempting banks from such a wide range of risk-related rules would leave bank examinations as the only possible tool for addressing risks at major banks. But as we have discussed above, other sections of the CHOICE Act would also gut the authority of bank examiners to take action on risk-related issues.[77]

While we support higher leverage capital ratios for banks, it is absurd to believe that the leverage requirement included in this bill would protect the public from risks to the financial system under a regulatory regime where regulators were systematically barred from taking action to control bank risks.

***<u>Other Elements Of The Bill Would Not Substantially Increase Wall Street Accountability</u>***

Title II of the bill, which increases maximum civil monetary penalties for various types of financial misconduct, is also held up as an example of increased financial sector accountability under the Financial CHOICE Act. It is a positive step to increase these penalties, as current statutory penalties are significantly outdated. But other elements of the bill will work against any increased accountability by reducing the ability of regulatory agencies to hold wrongdoers accountable through rulemakings or administrative proceedings.

For example, as discussed above, the changes to the authority of the Securities and Exchange Commission (SEC) elsewhere in the bill would greatly weaken the agency's ability to win administrative cases and levy civil monetary penalties in the first place. The bill would allow a defendant to opt-out of the administrative process in favor of court enforcement,[78] making it much more difficult and cumbersome for the SEC to impose civil monetary penalties at all. It would also greatly narrow the SEC's ability to bar individuals found guilty of wrongdoing from working in a wide range of Wall Street jobs.[79]

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[77] Subtitle H of Title V, Discussion Draft. See also AFR Letter to Congress Opposing the Exam Fairness Act (June 10, 2015), http://ourfinancialsecurity.org/wp-content/uploads/2015/07/AFR-HR-1941-Letter-Final-7.28.15.pdf.

[78] Section 823, Discussion Draft.

[79] Sections 825 & 827, Discussion Draft.

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In sum, the Financial CHOICE Act would be an unprecedented blow to effective oversight of the nation's financial sector and to the protection of ordinary consumers, investors, and members of the public who depend on the fairness, transparency, and stability of the financial system. We urge you to reject it.

Thank you for your consideration. For more information, please contact AFR's Policy Director, Marcus Stanley at marcus@ourfinancialsecurity.org or 202-466-3672.

Sincerely,

Americans for Financial Reform

crc

CALIFORNIA REINVESTMENT COALITION

April 24, 2017

Re: *CRC Strongly Opposes Financial CHOICE Act*

Dear Member of Congress:

The California Reinvestment Coalition (CRC) writes to express our strong opposition to the Financial CHOICE Act, and urge all members of the committee to vote against this harmful measure.

CRC builds an inclusive and fair economy that meets the needs of communities of color and low-income communities by ensuring that banks and other corporations invest and conduct business in our communities in a just and equitable manner. CRC has a membership of three hundred (300) nonprofit organizations and public agencies throughout California.

It is difficult to imagine how anyone who lived through the financial crisis could now propose to WEAKEN the regulatory framework that was designed to protect our economy from another crisis, and WEAKEN the one agency that has succeeded in both protecting American families from various forms of financial abuse and in holding bad actors accountable.

There are numerous provisions of the bill, that are highly problematic, representing threats to consumers and their financial wellbeing, and a gift to scammers and other financial predators who would seek to take advantage of the public.

CRC is especially concerned about any provisions that would:

- Weaken the position of CFPB Director, and/or jeopardize the tenure of current Director Cordray who has done an excellent job of protecting consumers;
- Weaken the funding of the CFPB and/or the salaries of its staff which need to be immune from politics and able to take all steps necessary to protect consumers and our financial system;
- Weaken the authority of the CFPB by diminishing its authority to take actions against unfair, deceptive and abusive practices. This authority goes to the heart of consumer need, as scammers will always seek to be one step ahead of existing rules;
- Weaken the authority of the CFPB by diminishing its supervisory authority, by which CFPB has effectively overseen financial institutions and prevented financial abuses (see the story of Wells Fargo, below);
- Weaken the integrity of the consumer complaint database, which has empowered over a million consumers to share their experiences, while educating both the public, as well as policymaking and enforcement agencies about the problems consumers are facing. We believe that going forward, the complaint database should be **expanded** to more effectively capture the problems and **needs of small business owners seeking credit to sustain and expand their businesses.**

crc

CALIFORNIA REINVESTMENT COALITION

- Weaken the ability of most shareholders to bring shareholder resolutions and to otherwise participate as engaged investors. CRC has co-filed a shareholder resolution with other socially responsible investor groups, urging Wells Fargo to conduct a much needed comprehensive business standards review of the entire corporation to finally determine what enabled the corporation to so wildly ignore the rights and needs of its customers. This ability to engage as a shareholder would be restricted to a very small subset of investors under the Choice Act; and
- Weaken collection of racial, ethnic, and other data, or otherwise weaken efforts to investigate and enforce fair lending and fair housing obligations.

To provide just two recent examples of the importance of these protections:

1. The CFPB last week brought an enforcement action against Ocwen, a loan servicer that failed consumers at every stage of the foreclosure process. Nonprofit housing counselors in California had rated Ocwen poorly in the last two of CRC's survey of housing counselors. No other agency has been able to hold Ocwen accountable for processing unnecessary foreclosures and creating untold stress and heartache for thousands of working families.

2. Last year, the CFPB worked with the LA City Attorney's office and Office of the Comptroller of the Currency (OCC) to hold Wells Fargo accountable for opening over two million unauthorized bank accounts. In reviewing the bank's practices and uncovering fraudulent and egregious behavior, the CFPB presumably relied on its supervisory power, the very power the CHOICE Act seeks to take away from the CFPB. The egregious practices uncovered, including a high pressure sales environment that drove employees to commit fraudulent behavior, in some instances by reportedly targeting Limited English Proficient and immigrant communities, apparently existed for years before the creation of the CFPB, when Wells Fargo was mainly regulated by the OCC. To his credit, the Comptroller of the Currency ordered a review of the OCC's failed oversight of Wells Fargo during this time. That review yielded a report that acknowledged significant regulatory errors at the OCC. Consumers are left to wonder, if the CFPB did not exist in its current form, would Wells Fargo have been effectively held accountable, or would the egregious practices have continued to this day?

It is astonishing that we have to raise these questions. The CFPB and the Dodd Frank have been clear success stories for Americans of all stripes. Consumers and communities are clearly better off for Congress having determined in its wisdom that something had to be done to address the financial crisis, to ensure it would not be repeated, and to protect consumers from the greed of bad actors who are motivated only by money, regardless of the rules of law or decent values of the American people.

Yet, clearly, the CFPB and the Dodd Frank Act are not successes in the eyes of certain corporations and certain politicians. We understand that corporations will fight in their perceived interests, and politicians will vote in theirs.

crc

CALIFORNIA REINVESTMENT COALITION

But no one should or will be fooled into thinking that the Financial Choice Act is in the interest of hard working families and consumers.

CRC must strongly object to the proposal and to all similar proposals that may yet come. Should you have any questions about this letter, feel free to contact Kevin Stein at (415) 864-3980. Thank you for your consideration of our views.

Very Truly Yours,

Kevin Stein
Deputy Director

**Jack Ehnes**
*Chief Executive Officer*

CALSTRS
HOW WILL YOU SPEND YOUR FUTURE?

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April 25, 2017

The Honorable Maxine Waters
Ranking Member, House Committee on Financial Services
4340 Thomas P. O'Neill, Jr. Federal Office Building
Washington, DC 20515

RE: The Financial CHOICE Act

Dear Ranking Member Waters:

CalSTRS was established more than 100 years ago to provide retirement benefits for California's public school teachers and is the largest educator-only pension fund in the world. The CalSTRS portfolio is currently valued at approximately $202 billion, which we carefully invest, as patient capital with a long-term investment horizon, to meet the retirement needs of more than 900,000 plan participants and their families. [1]

As the CEO of CalSTRS, I am writing in response to reports that the Financial Services Committee will be holding a hearing on a revised Financial CHOICE Act (the CHOICE Act 2.0 or revised CHOICE Act) on April 26. I want to preemptively highlight specific provisions of the discussion draft of the bill posted on April 19. We acknowledge that the primary goal of the revised CHOICE Act is financial deregulation, but there are several provisions that CalSTRS is deeply concerned about, beyond financial deregulation. We want to focus our letter on those revisions we find most alarming to ensure they are not lost amongst the rhetoric of financial deregulation. We respectfully request that our letter be entered in to the public record when the revised bill is considered by the Committee.

**Shareholder Proposal Process**

The discussion draft includes a provision to dramatically change the shareholder proposal process. Currently under the Securities and Exchange Commission's (SEC) Rule 14a-8, shareholders who own one percent or $2,000 worth of outstanding shares for at least one year can submit a proposal to be included on the company's proxy statement. The CHOICE Act 2.0 would eliminate the $2,000 threshold and require investors to own a minimum of one percent of the issuer's voting securities over a three year period. While one percent may sound like a small amount, even a large investor like the $200 billion CalSTRS fund does not own one percent of publicly traded companies. In fact, one percent of Apple Inc., the largest U.S. company by market capitalization, would equate to more than $7 billion worth of stock. If enacted, we believe these changes would effectively prevent investors, like CalSTRS from participating in the shareholder proposal process. The current shareholder proposal process allows shareholders, even small investors, the ability to communicate their concerns

[1] California State Teachers' Retirement System Current Investment Portfolio as of February 28, 2017. http://www.calstrs.com/current-investment-portfolio and At-a-Glance http://www.calstrs.com/glance.

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April 25, 2017
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to public companies and, in fact, has had a significant and positive impact on corporate policies and practices on a wide range of issues. As a fund that has filed more than 300 proposals over the past five years, this provision would have a chilling impact on company/shareholder relations.

**Universal Proxy Ballot**

In October of 2016, the SEC voted to propose amendments to the proxy rules that would require parties in a contested election to use universal proxy cards that would include the names of all board of director nominees. Subsequently, a public comment period opened, and CalSTRS submitted comments supporting the proposed rule. [2] At present if a shareholder wants to vote for candidates on different proxy cards, we have to travel to the shareholder meeting. Not only does the current practice disenfranchise shareholders, it creates a different process for voting in contested elections, a mechanism designed solely to protect incumbent directors. This proposal would give shareholders the ability to vote by proxy for their preferred combination of board candidates and would replicate how shareholders can vote in person at the shareholder meeting. The CHOICE Act 2.0 eliminates the SEC's ability to enact a universal proxy rule. Voting for director nominees is a fundamental right, and as a long-term investor, CalSTRS supports the ability to choose among the best suited candidates to represent their interests inside the boardroom.

**Sarbanes-Oxley Act Sec. 404 (b) Exemptions**

Section 404(b) of the Sarbanes-Oxley Act required companies to have an outside auditor attest to a company's internal financial controls. Following the scandals at Enron and WorldCom, investors welcomed the protection this would provide. Section 989G of Dodd-Frank allowed a permanent exemption for those companies whose market capitalization was less than $75 million. A new provision in the revised CHOICE Act would raise this exemption to companies with market capitalizations of $500 million or $1 billion in assets for banks. There are approximately 680 companies currently in the Russell 2000 Index with market capitalizations less than $500 million. Under this proposed legislation, investors in these 680 companies, including CalSTRS, would not have the protection of an outside auditor's oversight of the company's financial statements. While we appreciate that the cost of compliance is often cited as a concern by small issuers, we believe it is a necessary cost for receiving investments from the public markets and an important source for risk mitigation.

**Proxy Advisory Firms**

The CHOICE Act 2.0 includes provisions that would impose new regulatory burdens and restrictions on proxy advisors, could weaken the governance of public companies in the U.S. and does not reflect the needs of the customers of proxy advisory firms who are primarily institutional investors, such as CalSTRS. As a large institutional investor which holds over 7,000 public companies in our investment portfolio, we use proxy advisors as a research tool to aide in making proxy voting decisions at our portfolio companies. Proxy advisory firms provide useful research regarding the governance and finances at these companies to supplement our own due diligence and research and play an important and helpful role in enabling cost effective proxy voting with respect to these 7,000 companies in our investment portfolio. We do not outsource our proxy voting to these proxy advisors. Rather, our Investment staff, in consultation with our governing Teachers' Retirement Board, develops carefully

[2] https://www.sec.gov/comments/s7-24-16/s72416-1471415-130426.pdf.

thought-out proxy voting guidelines, and then we vote our own proxies based on those well-established guidelines. While we understand some funds may utilize proxy advisory firms to assist them in executing their proxy voting responsibilities, the SEC has taken steps to make sure investors are properly carrying out their due diligence obligations. In fact as recently as 2014, the SEC acknowledged the important role the proxy advisors play in the oversight of proxy voting of fund fiduciaries and in 2014 issued updated regulatory guidance on the responsibilities of investment advisers who utilize proxy advisory firms in their proxy voting. In addition, the SEC has authority under current law to address any conflicts at these proxy advisory firms. Accordingly, we believe that the existing SEC regulatory regime already protects our interests with respect to proxy advisory firms and that new legislation is both unnecessary and counter-productive.

**Private Equity Fund Advisers**

"Private fund advisers" implies a certain type of investor — private. In fact, public pension funds such as CalSTRS are very much invested in these private funds and support the current law with respect to registration of these advisers and oversight by the SEC of these funds. This proposed legislation would actually rollback the important investor protections provided to funds like CalSTRS from Dodd Frank, which required transparency in the form of registration and certain reporting from these fund advisers. This legislation will enable private fund advisers to retreat back into the shadows by exempting them from certain disclosure requirements they must now undertake to investors and to the SEC. The information provided by these required disclosures has helped to expedite the elimination of certain types of fund adviser fees that we regard as inappropriate, such as monitoring fees charged by certain private fund advisers. Accordingly, I would strongly urge you and your colleagues to oppose this legislation and not rollback these important requirements, which provide critical investor protections to CalSTRS and other public pension funds.

We respectfully ask that our views be entered into the record. We plan to provide more detailed comments once we have reviewed the discussion draft in its entirety and would be happy to discuss our perspective on these issues with you or your staff at your convenience. Thank you for your consideration.

Sincerely,

Jack Ehnes

Jack Ehnes
Chief Executive Officer

THE CENTER FOR POPULAR DEMOCRACY

THE NATIONAL CAMPAIGN FOR A STRONG ECONOMY FED UP

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11 Dupont Circle, Suite 240
Washington, DC 20036

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April 25, 2017

Dear Representative,

On behalf of the Center for Popular Democracy's Fed Up coalition, we are writing to express concerns about the Financial CHOICE Act, and urge you to oppose the measure. The Fed Up coalition consists of economists, low-wage workers, labor groups, and community leaders throughout the country, and partners with economic justice organizations in each of the 12 Federal Reserve districts. Our coalition's mission is to make the Federal Reserve's policymaking decisions more responsive to the economic interests of low-wage workers and communities of color. As such, we are not wedded to the status quo at the Fed, and in fact have proposed sensible reforms to the Fed's governance and structure that would make the Fed more accountable and publicly representative. We believe a fully public Federal Reserve would enact monetary and regulatory policies that facilitate a full employment economy while protecting our financial system from Wall Street excess.

Unfortunately, the proposed Federal Reserve reforms in the Financial CHOICE Act would achieve none of these goals. Instead, the Financial CHOICE Act would constrain Fed policymakers' ability to pursue its full employment mandate by eliminating Fed policymakers' discretion, allowing intrusive reviews of Fed decision-making, and increasing the number of monetary policy decision-makers who are private officials serving corporate and financial interests, rather than the public.

The Financial CHOICE Act would hamper policymakers' discretion to respond to changes in economic conditions by mandating a so-called "Taylor Rule" that the Fed must follow when setting interest rates. Estimates that guide the Taylor Rule (estimates of inflation and the current output gap, or unemployment gap) are just that: estimates. They can change rapidly over time. For example, given actual growth in gross domestic product (GDP) since the Great Recession, estimates of trend GDP growth made in 2008 by the Congressional Budget Office would indicate that the output gap today was over 10 percent of potential GDP. But since 2008, estimates of trend GDP growth have been rapidly reduced, so the actual output gap as measured by the CBO today is under 3 percent. Judgment and discretion are needed to know when and by how much to discount the mechanical prescriptions of any monetary policy rule.

If a strict Taylor Rule like the one mandated by the Financial CHOICE Act was followed during a period of time when the "neutral" real interest rate was secularly changing, it would lead to very large policy errors. The neutral real interest rate is the federal funds rate consistent with the economy growing at trend with stable inflation. However, extensive research indicates exactly that the neutral real interest rate in the

United States (and likely globally as well) has indeed been changing significantly in recent years (see Laubach and Williams (2015), for example).[1] Put simply, if the Financial CHOICE Act's Taylor Rule mandate had been in effect over the past decade and had been followed, monetary policy would have made very large policy errors that would have led to millions of fewer Americans working today. Indeed, a recent analysis by economists Carola Binder and Alex Rodrigue found that "requiring the Fed to follow a Taylor rule would likely be detrimental to the full employment goal." Binder and Rodrigue concluded that the Taylor Rule's measures were insufficient to capture how far the economy is from full employment, and point to numerous examples where flexibility and discretion by the Fed has enabled faster recovery from economic downturns. [2] The Minneapolis Federal Reserve Bank recently confirmed Binder and Rodrigue's conclusion, estimating that 2.5 million fewer jobs would have been added to the economy had the Fed followed the prescriptions of the Taylor Rule over the past five years.[3]

It is also not clear what problem the Financial Choice Act is meant to solve. Inflation has been running consistently below the Fed's 2.0 percent target. If the Fed had followed a more contractionary policy, as would be implied by this measure, presumably it would be even further undershooting its inflation target.

To keep Fed policymakers on the prescribed Taylor Rule pathway, the Financial Choice Act allows any congressional committee to initiate a full and immediate GAO audit of the Fed's monetary policy if the GAO determines that a specific FOMC decision hasn't strictly followed the mathematical rule. While proponents of the bill insist that the Fed would have discretion to develop its own rule, language in the bill requiring that the Fed explain how and why it has strayed from the Taylor Rule makes it clear that the bill's intent is to constrain the Fed's ability to pursue policy outside the Taylor guidelines. Allowing abrupt, congressionally-mandated second-guessing of monetary policy decisions would exert strong pressure for the Fed to mechanically follow a simple rule, which is fundamentally inconsistent with the way that the creator of the rule himself has characterized the purpose of these benchmarks:

*"...in my view, a policy rule need not be a mechanical formula...A policy rule can be implemented and operated more informally by policymakers who recognize the general instrument responses that underlie the policy rule, but who also recognize that* ***operating the rule requires judgment and cannot be done by computer.****"*

*Stanford economist John Taylor*[4]

Any increased oversight of the Fed should be independent and nonpartisan, and should be aimed at improving management and operations, not at constraining the operational independence of Fed officials to set monetary policy. Specific commentary on monetary policy should remain outside of the purview of

[1] Thomas Laubach and John Williams, *Measuring the Natural Rate of Interest Redux* (October 31, 2015), http://www.frbsf.org/economic-research/files/wp2015-16.pdf

[2] Carola Binder and Alex Rodrigue, *Monetary Rules and Targets: Finding the Best Path to Full Employment* (September 1, 2016), http://www.cbpp.org/research/full-employment/monetary-rules-and-targets-finding-the-best-path-to-full-employment

[3] Neel Kashkari, *Taylor Rule Would Have Kept Millions Out of Work* (January 5, 2017), https://www.minneapolisfed.org/news-and-events/messages/taylor-rule-would-have-kept-millions-out-of-work

[4] John Taylor, *Discretion versus policy rules in practice* (1993), https://web.stanford.edu/~johntayl/Papers/Discretion.PDF

the GAO. GAO reviews of the Fed, if authorized, should be undertaken by the nonpartisan officials at the GAO itself, not triggered by Congress. GAO oversight should be aimed at ensuring effective management, protection against fraud, proper maintenance of Federal Reserve units that interact with the international financial system, and efficient use of taxpayer resources. GAO audits should not be used as a partisan tool to question the monetary policy course of Fed decision-makers.

The Financial CHOICE Act would also undermine decision-making at the Fed by expanding the number of unaccountable, private officials on the Federal Open Market Committee. The FOMC was created with the intention of ensuring that the Federal Reserve Bank presidents—as heads of private institutions—would only constitute a minority of the voting members of the FOMC. In recent years, however, the Fed's Board of Governors has regularly experienced multiple vacancies, reflecting a more extensive timeframe for vetting potential nominees as well as a more protracted duration of the Senate confirmation process. Thus, the members of the Board of Governors have constituted a voting majority at only half of the FOMC meetings from 2001 to 2008 and less than one-third of the FOMC meetings since then.[5] In effect, increased political gridlock has expanded the influence of the Federal Reserve Bank presidents in setting the nation's monetary policy. By expanding the number of Reserve Bank presidents sitting on the FOMC from five to six, the Financial CHOICE Act would lock this dynamic in permanently, increasing the likelihood that private Reserve Bank presidents will control the FOMC. Indeed, if the Financial CHOICE Act became law today, Reserve Bank presidents would further increase the majority they hold on the current FOMC due to vacancies at the Board of Governors.

The Financial CHOICE Act purports to strengthen the Federal Reserve's accountability to the public. It is hard to imagine a worse way of achieving that than by increasing the policymaking power of private officials with no public accountability. Despite the crucial role of Reserve Bank presidents in determining the nation's monetary policy, the process for selecting them takes place entirely behind closed doors. Recent Reserve Bank presidential selections and re-appointments have revealed a process that is opaque, inbred, and largely *pro forma*.

Reserve Bank presidents are chosen by each Reserve Banks' board of directors. Reserve Banks' boards are disproportionately white and male, and come largely from corporate and financial backgrounds, despite the Federal Reserve Act's requirement that directors "represent the public."[6] Consequently, directors tend to choose longtime Fed insiders and bankers who share their economic perspectives and background. In 2015, three straight individuals with strong ties to Goldman Sachs were chosen to lead the Reserve Banks of Philadelphia, Dallas, and Minneapolis. In Dallas and Philadelphia, the individuals chosen were involved in their own selection, and the selection processes contravened the spirit of a Dodd-Frank Act reform intended to limit commercial bankers' influence on the selection process. Retiring Dallas Fed president

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[5] Peter Conti-Brown, *The twelve Federal Reserve banks: Governance and accountability in the 21st century* (March 2, 2015), https://www.brookings.edu/research/the-twelve-federal-reserve-banks-governance-and-accountability-in-the-21st-century/

[6] Connie Razza and Jordan Haedtler, *To Represent the Public: The Federal Reserve's Continual Failure to Represent the American People* (February 5, 2016), http://populardemocracy.org/news/represent-public-federal-reserves-continued-failure-represent-american-people

Richard Fisher convened his own advisory committee to undertake the search for his successor.[7] Philadelphia Fed President Patrick Harker was a banker-elected, Class B director at the Philadelphia Fed, and cleared the way for his selection by stepping down as chair of the search committee tasked with finding a new president.[8]

The cozy relationship between the financial sector and Reserve Bank presidents was highlighted dramatically by the resignation of Richmond Federal Reserve President Jeffrey Lacker just a few weeks ago. Lacker admitted to leaking market-sensitive information to the hedge fund advisor Medley Global.[9] Federal officials investigating the leak had informed the board of the Richmond Federal Reserve that they were interested in speaking with Lacker about his role in the leak as early as May 2015, yet the Richmond Fed's board enthusiastically and unanimously recommended Lacker's re-appointment to a five-year term at the end of 2015.[10] All Reserve Bank presidents are FOMC participants with access to market-sensitive information and influence over important decisions affecting the economy. Yet as the Lacker incident demonstrates, Reserve Bank presidents are private officials accountable only to oversight and *pro forma* re-appointment by their corporate boards.

The Financial CHOICE Act's apparent lesson from the Lacker scandal is that Reserve Bank presidents should be given more power, while Fed policymakers' overall discretion to consider labor market data like the quits rate, involuntary part-time work, and wage growth should be limited. This is the wrong lesson to take. The Federal Reserve can and has made helpful interventions in the economy, and Reserve Bank presidents can contribute to this by bringing insights about labor market conditions in their region to FOMC meetings. Instead, at least one Reserve Bank president has just admitted to essentially the opposite: bringing insights from FOMC meetings to the financial services industry. Currently, the process for selecting Reserve Bank presidents is an opaque and publicly exclusive process, and the individuals chosen have not demonstrated sufficient independence from the financial sector they are supposed to oversee and regulate. Until and unless Reserve Bank presidents are made more publicly representative and accountable, they must not be given a larger role in setting monetary policy.

The *status quo* of the Federal Reserve should not persist. Governance should become more transparent and representative and policy should in turn weigh the economic interests of low and middle-wage workers more highly. But the reforms proposed in the Financial CHOICE Act go in precisely the wrong direction. We urge you to oppose them.

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[7] Jonathan Spicer and Ann Saphir, *Efforts to replace Fed hawks Plosser, Fisher pick up speed* (October 30, 2014), http://www.reuters.com/article/us-usa-fed-plosser-fisher-idUSKBN0IJ26X20141030

[8] Christopher Condon, *Not far to look: New Fed President Searched, Found Himself* (June 3, 2015), http://www.bloomberg.com/news/articles/2015-06-03/not-far-to-look-fed-s-newest-president-searched-found-himself

[9] Jeff Cox, *Richmond Fed President Lacker says he was involved with Medley leak, announced resignation* (April 4, 2017), http://www.cnbc.com/2017/04/04/richmond-fed-president-lacker-says-he-was-source-of-medley-leak-announces-immediate-resignation.html

[10] Chris Condon, *Lacker's Exit Leaves Mystery at Fed Over 2016 Reappoinment* (April 6, 2017), https://www.bloomberg.com/news/articles/2017-04-06/lacker-s-exit-from-fed-leaves-mystery-over-2016-reappointment

Thank you for your consideration. For more information, please contact Fed Up's Campaign Manager Jordan Haedtler at jhaedtler@populardemocracy.org.

Sincerely,

Center for Popular Democracy

# Corporate Governance

*CorpGov.net: improving accountability through democratic corporate governance since 1995*

Chairman Jeb Hensarling
Financial Services Committee
2129 Rayburn HOB
Washington, DC 20515

Financial CHOICE Act – Oppose Unless Amended

April 23, 2017

Dear Chairman Huizenga:

This is to request amendments to the draft Financial CHOICE Act ("Act"). I agree with the stated intent of growing the economy from Main Street up, instead of Washington down. However, as currently written, several provisions will have the exact opposite impact. Freedom is tied to risk and responsibility. Maintaining it requires investment, hard work and the ability of investors to hold their agents accountable. Silencing their directives and recommendations will only lead to further dependency on government.

I am a shareholder advocate at many of the 100 companies where I own stock. As the publisher of Corporate Governance (CorpGov.net) for over twenty years, I have been an important contributor to the movement to facilitate a dialog between shareholders and their companies. As a result, CEOs typically no longer handpick their directors, the majority of whom are now independent. At most large corporations, uncontested directors now need to win a majority vote or resign. Free markets can play their crucial role because shareholders demanded bylaws that allow them to hold special meetings to remove directors or merge with another firm. Most of the largest firms now have proxy access, allowing groups of substantial long-term shareholders to better hold directors accountable. Such measures make companies more accountable and more profitable.

**Corporations: Important Mediating Structures in our Commercial Republic**

A health society depends on important mediating structures, such as family, schools, religious institutions, neighborhoods and businesses - especially corporations. Our founders established the United States as a commercial republic, with business forming a firmer foundation than military, aristocracy or religion.

Corporations are important mediating structures between the individual and the absolute power of the state. They depend on investments, respect for law and benefit from peaceful trade. Corporations teach cooperation, the value of diverse perspectives, prudence and attention to detail. They generate the vast majority of America's wealth. Congress should be strengthening the ability of corporations to act as mediating structures in fostering civic virtue, not attacking the very foundations of corporate governance by creating democratic-free zones.

Prior to the founding of out great nation, corporations were instruments of privilege through tightly controlled monopolistic charters issued by self-serving monarchs. The United States reinvented the corporation. No longer dependent on special privileges granted by the state, survival and growth depended on meeting the needs of customers through governing principles agreed upon by investors. By 1800 we already had more corporations than all of Europe.

In recent decades, fewer and fewer individuals own stock directly (around 30% of stock is still held by individuals). Retail shareholders are so alienated that 90% do not vote their proxies. They have been told over and over that if they don't like anything about how their companies operate, they should leave governance to the experts, remain silent, or should sell their shares. That is like telling a homeowner to move away from an otherwise desirable community because they want a stop sign at the end of their block.

Several provisions of the Financial CHOICE Act serve to reinforce this problematic state of disengagement by shareholders. Congress should be enacting measures that encourage share ownership and participation in corporate governance, instead taking rights from shareholders that allow them to hold their agents accountable.

**Problematic Provisions**

SEC. 844 of the Act would drastically alter the shareholder proposal rules. The Act would require shareholder proponents to hold one percent of the issuer's voting securities, instead of the current threshold of $2,000. The holding period would be increased from one year to three years. Additionally, the thresholds for resubmitting proposals would be raised and the common practice of having an agent submit proposals on behalf of a shareholder would be prohibited.

SEC. 845 of the Act would prohibit the SEC from requiring the use of a universal proxy, prohibiting the ability of shareholders to split their votes between the proxy sent by the current board and the proxy sent by a challenger as they can do if they attend the meeting in person.

**Historical Perspective on Shareholder Proposals**

Shareholder proposals have been allowed at annual meetings since colonel times. When the process was formalized by Securities and Exchange Commission (SEC) regulation in 1942 as Rule X-14A-7, there were no minimum share requirements, no limits on the number of proposals a shareholder could raise and no subject matter limits. When the SEC enforced the rule (*SEC v. Transamerica Corp.*, 1947) the court concluded issuer-specific limitations interfered with the intent of Congress that shareholder voting rights operate as a check on the abuse of power by corporate management and that Rule X-14A-7 was consistent with that intention.

There has been a long history of proxy proposal usage by retail shareholders. Beginning in the 1930s John and Lewis Gilbert, for example, embarked on a lifelong crusade to make corporate governance more democratic and to encourage participation by shareholders. Over almost seventy years, they filed hundreds of proposals, responsible for over half of all proposals introduced by retail shareholders, on topics such as eliminating staggered boards, requiring directors to own stock and limiting executive pay.

**My Own Proxy Proposals**

During the last five years, 132 of my proposals have been voted on. Most received substantial support in the 30-50% range. Well over 20% received a majority vote. See Exhibit 1.

"Losing" a proposal does not mean having no impact. For example, my proposal at Reeds Inc. last year was defeated but negotiations resulted in four of five directors being named for replacement prior to the annual meeting in 2016. While the founder retained his position as the CEO, the new board appointed another director as chairman. Share price increased 69% during the period of our negotiations and the company is now addressing its challenges.

Most of my proposals are aimed at making the board more autonomous in its dealings with management. While many boards have served primarily to sound out management decisions, I seek a body of effective oversight and strategic deliberation – in touch with its shareholders, customers and the needs of society.

The democratization of corporate governance does not impose political constraints in opposition to economic performance; on the contrary, the need for democratization stems from increasing corporate complexity and contributes to corporate performance.

**Impact of Proposed Changes in SEC. 844**

Requiring shareholders to hold 1% of a company's stock for three years would virtually eliminate shareholder proposals.

At most large and mid-sized companies, the only shareholders remaining eligible would be the largest, mostly indexed funds, such as Vanguard, BlackRock, Fidelity and State Street. None of these funds have ever filed a shareholder proposal. Three reasons for this inactivity come to mind:

1. These funds frequently run company retirement programs. Research indicates they vote against management less frequently when they have such contracts. (*Proxy Voting Conflicts: Asset Manager Conflicts of Interest in the Energy and Utility Industries*, 50/50 Climate Project, 4/16/2017 at https://5050climate.org/news/largest-fund-managers-face-conflicts-interest-voting-proxies/) Since conflicts of interest reduce voting against management for fear of losing contracts, we can assume filing proposals would have an even greater chance of reducing the likelihood of contract renewal.
2. Since they are primarily indexed, these funds compete largely based on cost. Although the cost is relatively small, filing proposals does require time and money. Any benefit derived goes equally to competitors holding a similar amount of stock, while all expenses are borne solely by proponents. Filing proposals would put such funds at a competitive disadvantage.
3. These funds hold such a relatively high percentage of stock in most companies that they might be able get the type of changes typically sought through shareholder proposals by simply expressing their desires to company management. Therefore, they have no need to file proposals.

Using mid-cap H&R Block, Inc. as an example, Exhibit 2 shows that only 22 institutional shareholders owned 1% or more of the company's shares at the end of 2016. Exhibit 3 shows that only 9 meet the draft requirement of holding those shares continuously for three years. None of those 9 institutional shareholders has ever filed a proxy proposal.

*Corporate Governance and Equity Prices* by Paul Gompers of Harvard and Andrew Metrick of the University of Pennsylvania's Wharton School found that "firms with stronger shareholder rights had higher firm value, higher profits, higher sales growth, lower capital expenditures, and fewer corporate acquisitions." Investors who bought firms with the strongest democratic rights and sold those with the weakest rights "would have earned abnormal returns of 8.5 percent per year during the sample period." (Available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=278920)

Shareholder proposals have driven most of the rights evaluated by Gompers and Metrick. Since boards can adopt such rights without shareholder proposals but typically do not, we must conclude that boards typically prefer weak shareholder rights. The amendments suggested in SEC. 844 would likely lead to a substantial erosion of existing shareholder rights, lower returns, and a substantial drag on the entire economy.

Congress should be strengthening shareholder rights, not weakening them. Aside from serving to increase accountability, proposals often serve as an "early warning" system. Had companies listened, we might have avoided the 2008 financial collapse, since proposals concerning predatory subprime lending and the securitization of such subprime loans were introduced in 2000. Proposals beginning in 2003 asked securitizers to police their loan pools. See letter to the SEC from Paul M. Neuhauser dated 10/2/2007 available at https://www.sec.gov/comments/s7-16-07/s71607-476.pdf)

Had the board of Wells Fargo's not opposed such a proposal, they could have escaped both losses due to subprime loan practices but also their more recent scandal involving opening unwanted accounts.

> In 2004, Northstar Asset Management raised issues related to Wells' loan sales and asked the bank's board to "conduct a special executive compensation review" because, according to banking regulators at the time, Wells Fargo had "not adjusted compensation policies to discourage abusive sales practices" and did not have adequate audit procedures in place. The board dismissed the request, saying that Wells Fargo's "compensation and commission policies are designed to encourage appropriate sales practices" and that the bank had "comprehensive monitoring and audit procedures." (*Here's How Wells Fargo's Board Of Directors Just Failed Customers*, by Eleanor Bloxham, Fortune, 4/14/2017 at http://fortune.com/2017/04/14/wells-fargo-fake-accounts-2/)

With regard to raising resubmission requirements, changes in voting behavior do not come quickly. Proposals often require years of academic research, consideration, refinement and negotiation before they are widely accepted and proxy voting policies are changed. For example, support for shareholder proposals to declassify boards was regularly below 10% in the 1980s, but grew to over 80% in 2012. If resubmission thresholds of 15% and 30% had been in place, these proposals would have died long before they had the chance to be adopted. Declassified boards are now common practice, with 90% of S&P 500 companies holding annual votes, up from 40% 10 years ago.

With regard to the proposed prohibition against allowing shareholder proposals to be submitted by proxy, that is like denying the right to legal representation in court. Filing proposals is a complex legal process, requiring analysis, coordination and presentation. I typically delegate authority to an agent who helps ensure all legally required paperwork is properly filed and my proposals are properly presented, even if the meeting is held thousands of miles away in a remote location. Corporations frequently appoint outside legal counsel, filing no-action letters with the SEC in hopes of omitting my proposals. I see no reason why corporations should be able to appoint such agents, but shareholders should not.

**Impact of Proposed Changes in SEC. 845**

With regard to universal proxies, proponents of this amendment are driving the push to abandon the rule based on the misconception that activists will use it to drive more contests. However, the universal proxy is not being driven by activists, who will continue to solicit using their own proxy, but by investors who do not want to have to attend the annual meeting to be able to split their votes between two or more proxies.

As SEC Chairman Purcell explained to Congress in 1943, the intent of proxy rules is to replicate the rights that a shareholder would have if she/he actually attended the annual meeting, including the right "to make a proposal; to speak on that proposal at appropriate length; and to have his proposal voted upon." (cited in previously mentioned Neuhauser letter)

This sentiment has been frequently repeated. For example, see the SEC's briefing paper *Roundtable on the Federal Proxy Rules and State Corporations Law*, 5/7/2007 (available at https://www.sec.gov/spotlight/proxyprocess/proxy-briefing050707.htm):

> The proxy system that Congress authorized the SEC to devise was meant to replicate as nearly as possible the opportunity that shareholders would have to exercise their voting rights at a meeting of shareholders, if they were personally present.

Shareholders should be able to vote for the candidates of their own choosing by proxy, without incurring the expense of attending a meeting, which may be thousands of miles away. Instead, proposed amendments contained in SEC. 845 would prohibit the right of shareholders to choose their own representatives.

**Conclusion**

Corporations are among the most important mediating structures between the individual and society. Shareholder engagement in corporate governance has a long history of increasing management accountability and wealth generating capacity. Congress should strengthen the ability of corporations to act as mediating structures in fostering civic virtue, instead of attacking the very foundations of corporate governance by creating democratic-free zones.

Limiting the ability of owners to influence corporate behavior will simply lead to more government regulation, since corporations must be controlled and accountable to someone. I would rather see government regulation as a last resort. Strengthen the ability of shareholders to govern corporations and we can largely hold them accountable with reduced government regulation. I urge you to oppose the proposed amendments contained in draft SEC. 844 and SEC. 845 of the Act and would be happy to discuss these issues with you or your staff at your convenience. Please do not hesitate to call me at 916-869-2402 or jm@corpgov.net.

Sincerely,

J. McRitchie

James McRitchie, Shareholder Advocate
9295 Yorkship Ct.
Elk Grove, CA 95758

Attached: Exhibits 1-3

cc: Randy Hultgren, Illinois, *Vice Chairman*
Peter T. King, New York
Patrick T. McHenry, North Carolina
Sean P. Duffy, Wisconsin
Steve Stivers, Ohio
Ann Wagner, Missouri
Luke Messer, Indiana
Bruce Poliquin, Maine
French Hill, Arkansas
Tom Emmer, Minnesota
Alexander X. Mooney, West Virginia
Thomas MacArthur, New Jersey
Warren Davidson, Ohio
Ted Budd, North Carolina
Trey Hollingsworth, Indiana
Jeb Hensarling, Texas, *ex officio*
Carolyn B. Maloney, New York, *Ranking Member*
Brad Sherman, California
Stephen F. Lynch, Massachusetts
David Scott, Georgia
James A. Himes, Connecticut
Keith Ellison, Minnesota
Bill Foster, Illinois
Gregory W. Meeks, New York
Kyrsten Sinema, Arizona
Juan Vargas, California
Josh Gottheimer, New Jersey
Vicente Gonzalez, Texas
Maxine Waters, California, *ex officio*
Ami Bera, California

**Consumer Federation of America**

April 25, 2017

The Honorable Jeb Hensarling
Chairman
Financial Services Committee
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Maxine Waters
Ranking Member
Financial Services Committee
U.S. House of Representatives
Washington, D.C. 20515

**Re: Oppose the Financial CHOICE Act Discussion Draft**

Dear Chairman Hensarling, Ranking Member Waters, and Members of the Committee:

This week the Committee is scheduled to hold a hearing on the "Financial CHOICE Act" Discussion Draft which purports to offer an alternative approach to reforming the financial system. We are writing on behalf of the Consumer Federation of America (CFA)[1] to urge you to oppose this dangerous and misguided bill. It is by and large a deregulatory wish-list from special interests that repeals many of the significant achievements in the Dodd-Frank Act and other critical laws designed to ensure consumers, investors, and honest market participants are appropriately protected from harm in the marketplace. Without such protections, consumers and investors will be exposed to greater risk of being harmed in concrete ways and the financial system will be exposed to greater risk of instability and crises. This bill will put our financial marketplace in a weaker position than it was before the crisis, making American consumers more vulnerable and more at risk. This bill does not create financial choices for consumers; it creates a financial marketplace of no fair choices. It creates a financial marketplace with higher risk, without a regulator with the authority, resources and independence to minimize risks for consumers. This is not a choice that any consumer would knowingly make.

Congress should not fool itself that the financial crisis, which destroyed trillions of dollars in wealth and wreaked havoc on the financial lives of millions of families, was a random event. As noted by the Financial Crisis Inquiry Commission, widespread failures in financial regulation and rampant predatory lending practices were key drivers of the crisis. The bill appears to completely ignore the lessons learned from this devastating event in our nation's history.

The provisions discussed below are among the sections that raise the most serious concerns. They do not, however, represent all of the concerns that CFA has with this legislation.

[1] Consumer Federation of America (CFA) is a national organization representing approximately 300 organizations at the state, local and national level that conducts public education and policy analysis on behalf of consumers, with a particular focus on low- and moderate-income consumers.

**I. This Discussion Draft would eviscerate the Consumer Financial Protection Bureau and increase the likelihood of rampant abuse in the marketplace by eliminating the majority of the agency's tools to hold financial institutions accountable.**

The Discussion Draft of the Choice Act would weaken the Consumer Financial Protection Bureau's (CFPB's) ability to protect consumers from abusive financial practices. For five years, the CFPB has proven itself to be a transparent, deliberative, and data-driven agency. The CFPB has worked closely with consumers and the financial services industry to develop sensible safeguards against harmful and discriminatory products and practices like abusive payday lending and aggressive debt collection tactics that have harmed consumers and servicemembers. To date, the CFPB has returned $11.8 billion in relief to more than 29 million harmed consumers.[2]

The Discussion Draft would eliminate the CFPB's authority in significant ways:

- In section 736, the Discussion Draft would eradicate the agency's authority to stop unfair, deceptive, and abusive acts and practices. This provision appears to protect companies that cheat their customers. This is critical authority that the CFPB has used, for example, to stop companies such as Wells Fargo from opening sham accounts in customers' names. CFPB enforcement that relies on this authority has returned billions of dollars to consumers. Stripping the agency of this authority would make the CFPB useless to consumers and the marketplace.

- In Section 733, the Discussion Draft would completely gut the CFPB's authority to create competition and sensible safeguards in the payday loan industry, a product market plagued by problems. Over the last several years, the CFPB has produced a voluminous body of research and worked closely with all stakeholders to propose commonsense consumer protections. This provision would thwart this critical work.

- Section 727 of the Discussion draft would eliminate the CFPB's supervisory authority. Much of the toxic mortgage lending that fueled the financial crisis was originated outside of the traditional banking system. While banks were subject to supervision and regular oversight, nonbanks operated in the shadows. Eliminating supervision will recreate an unfair marketplace where nonbanks are not subject to oversight. This supervision is essential to stopping problematic behavior before consumers are harmed. This provision puts consumers at risk.

  Already, the CFPB has engaged in supervisory oversight of payday lenders, student loan servicers, debt collectors, and credit reporting agencies that has yielded major benefits to consumers. The bill would reverse these reforms.

- Section 738 of the Discussion Draft would thwart the implementation of the CFPB's proposed rule on forced arbitration. The CFPB submitted more than 700 pages of its

[2] "https://www.consumerfinance.gov/?gclid=Cj0KEQjwxPbHBRCdxJLF3qen3dYBEiQAMRyxS5edU7b7j7L-qWfSfHo7c_62LB3OPaRMOigg6ueev5caAm4K8P8HAQ. Data updated on 2/28/17.

research findings in a 2015 Report to Congress that analyzed the impact of forced arbitration clauses on consumers and competition. After publishing this report, the CFPB proposed reforms regarding the use of forced arbitration, but the agency did not propose eliminating forced arbitration altogether. The CFPB's approach was grounded in extensive evidence. This provision would block these consumer protective reforms entirely.

- Section 731 of the Discussion Draft would block the public's right to know regarding consumer complaint data received by the CFPB. The agency's consumer complaint database is a model of transparency and accountability. This provision would create insurmountable barriers for the public to access this information.

The Discussion Draft would also weaken the leadership structure of the CFPB. The current structure of the CFPB has successfully led to important work that has increased consumer protection. CFPB's confirmed Director, Richard Cordray, was nominated by the President and confirmed by the Senate. He is fully accountable to Congress and the public and regularly appears before Congressional committees to provide details about the agency's rule-writing, supervision and enforcement strategies. There is no evidence that the changes made by this Discussion Draft would strengthen the CFPB, and we oppose the many provisions in Title VII that weaken the current structure of the Bureau. For example:

- We oppose section 711 of the Discussion Draft which provides that the director of the Consumer Financial Protection Bureau, which will be renamed to the Consumer Law Enforcement Agency, could be fired by the President without cause. This politicizes the Bureau at the expense of consumers.

- We oppose section 712 of the Discussion Draft which empowers the Office of Information and Regulatory Affairs to oversee all consumer protections promulgated by the Bureau, giving further opportunity to politicize rulemaking.

- We oppose section 713 of the Discussion Draft which eliminates the CFPB's independence from the Congressional appropriations process. Investors and taxpayers have suffered from subjecting the Securities and Exchange Commission and the Commodity Futures Trading Commission to the appropriations process, which has left them starved of resources needed to keep pace with rapid changes in our financial markets. Budget constraints have left these agencies out-gunned by the powerful firms they are expected to police, unwilling or unable to pursue an aggressive enforcement program, and years behind on meeting major rulemaking deadlines, all of which puts investors and market stability at risk. Subjecting the CFPB to these beltway antics would give the worst elements of the financial services industry endless opportunities to deny the CFPB the funding to do its job.

- We oppose section 723 which would diminish the CFPB's ability to pay employees at the same rate as other federal financial regulators. This unequivocally makes it harder for the CFPB to hire qualified experts in financial services.

Section 715 of the Discussion Draft also would significantly limit the ability of the CFPB to protect consumers by providing defendants with the ability to move proceedings from the administrative adjudication process of the CFPB to federal court. This will hamstring the CFPB's enforcement authority. In addition, the bill undermines the current organization of the Bureau by duplicating and complicating the structure (section 717), while simultaneously further isolating the Bureau by eliminating the Mandatory Advisory Board, made up of financial services stakeholders, including academics, community banks, credit unions and consumer advocates (section 726).

These sections would eviscerate critical authority that the CFPB has used effectively and that remains necessary to make our financial marketplace effective and fair.

## II. This Discussion Draft would undermine financial regulators' ability to protect the public.

Title VI of the Discussion Draft broadly curtails the regulatory authority of financial regulators. The subtitles include numerous new analytic requirements that will have the result of thwarting agency action and will provide more opportunities for opponents of consumer protection to litigate and enjoin action by agencies. Subtitle B requires the approval from both Houses of Congress of any significant rule without changes. This hurdle would be virtually impossible for agencies to overcome. By design, this subtitle strips away the authority of agencies that Congress created to develop expertise on specific financial matters. Subtitle C contradicts extensive Supreme Court precedent of court deference to the expertise of agencies by undermining the *Chevron doctrine* and permitting judges to substitute their perspectives for agency expertise. These provisions, alone and in combination, will have the effect of stopping critical agency efforts in their tracks.

## III. This Discussion Draft would increase the threat that nonbank financial institutions become too big to fail, that they actually fail, and that their failures wreak havoc on the financial system.

Among other imprudent provisions that are likely to increase financial instability, Title I of the Discussion Draft would repeal the Financial Stability Oversight Council's (FSOC's) authority to designate non-bank financial companies or particular financial activities as systemically important financial institutions (SIFIs) and subject them to heightened oversight and prudential standards. This attack on FSOC's authority is entirely without merit. In exercising its designation authority, the FSOC has undertaken a rigorous, careful, and deliberative process and used this authority judiciously, designating only four financial institutions as SIFIs after determining that their material financial distress or the nature, scope, size, scale, concentration, interconnectedness, or mix of their activities could pose a threat to U.S. financial stability. Furthermore, FSOC has shown a willingness to rescind a SIFI designation when a financial institution no longer poses a threat. The provisions in this bill, however, would effectively allow firms like Lehman Brothers and AIG, companies whose failure during the 2008 financial crisis caused widespread panic and devastating losses throughout the financial system, to operate without sufficient supervision and regulation. In fact, this bill would retroactively repeal the FSOC's current SIFI designations, including that of AIG, which received the largest taxpayer bailout in U.S. history during the financial crisis. Removing this critical oversight function would reopen the possibility of a repeat scenario of 2008.

In addition, Title I of the Discussion Draft would abolish the Office of Financial Research (OFR), which was established in Dodd-Frank to help promote financial stability. OFR helps to inform the FSOC's deliberations by looking across the financial system to measure and analyze risks, perform essential research, and collect and standardize financial data. Abolishing OFR would put a blindfold back on regulators when they should be encouraged to examine all aspects of the financial system that could foster financial instability.

## IV. This Discussion Draft would expose investors to increased harm and financial markets to increased instability.

The Discussion Draft contains an array of provisions that would weaken protections for investors, reduce transparency, and weaken regulatory oversight of our securities markets. Two areas of particular concern are the repeal of the Department of Labor's conflict of interest rule and the assault on investor protections in the name of capital formation. However these do not, by any means, represent all of the anti-investor provisions in this bill.

Section 841 of the Discussion Draft would repeal the Department of Labor's conflict of interest rule, the single most important advance in protection for retail investors and retirement savers in decades. The rule requires financial advisers to act in their customers' best interests when providing retirement investment advice, and it requires financial firms to rein in practices that encourage and reward advice that is not in customers' best interests. Since it was finalized, the rule has spurred pro-investor innovations, such as development of new mutual fund share classes and new fee-based annuities, with the potential to dramatically reduce investor costs even as they reduce harmful conflicts. Developments in the marketplace since the rule was finalized have clearly shown that even the smallest accountholders will retain access to affordable investment advice under the rule, as well as a choice regarding how to pay for that advice.

The Discussion Draft would not only reverse this progress, it would suspend DOL's authority to determine who is a fiduciary under ERISA until at least 60 days after the Securities and Exchange Commission acts to adopt a fiduciary standard for broker-dealers under the securities laws. SEC action to address this problem is far from guaranteed even without the provisions in the bill that impose burdensome new requirements on the SEC before it can act. The DOL would be limited to adopting rules that are substantially identical to any rule adopted by the SEC. That limitation on DOL's authority to define who is a fiduciary under ERISA and what standard should apply would extend to areas where the SEC has no authority or expertise, including with regard to retirement plan fiduciary status and advice regarding non-securities. Before the SEC could engage in rulemaking under the securities laws, it would have to repeat studies it has already conducted and duplicate the extensive economic analysis conducted by the DOL, an analysis that has now been upheld by three separate district courts. In short, the clear intent of this provision of the bill is to preserve the ability of broker-dealers and insurance agents to syphon tens of billions of dollars a year out of the retirement and investment accounts of working families and retirees in order to line their own pockets.

Title IV of the Discussion Draft also includes a host of provisions that, in the name of promoting capital formation, would weaken the very characteristics that once made our securities markets the envy of the world. While some of the provisions included here are harmless, if largely ineffective, others are reckless in the extreme, paving the way for a new wave of securities fraud and abuse that will harm investors and undermine the very capital formation process they are meant to promote. The following are among the most troubling "capital formation" provisions of the Discussion Draft:

- Subtitle P would allow sales of securities of highly speculative start-up companies through **crowdfunding,** based on limited disclosures and with no limits on the amount of the offering, no limits on who can invest or how much they can invest, and no requirement that the sales go through regulated crowdfunding intermediary. This is a recipe for disaster, which will turn the already abuse-prone crowdfunding market into a venue dominated by fraudsters in which capital is diverted from sound companies with genuine prospects for growth and unsophisticated investors suffer devastating financial losses.

- Subtitle M would create a new exemption for **"micro" offerings,** those raising $500,000 or less in a year, subject only to a limit on the number of purchasers and a requirement that those purchasers have a pre-existing relationship with the issuer. The provision, which broadly preempts state oversight authority, doesn't require that investors have the financial sophistication to understand the risks of the offering or the financial wherewithal to withstand potential losses. Nor does it require issuers to notify regulators of the offering, require them to provide even minimal disclosures, impose any limits on the amount individuals can invest, or include any restrictions on secondary sales.

- Subtitle F would make it easier for micro-cap companies to raise additional capital without appropriate regulatory scrutiny by granting them **access to the shelf registration** system designed for use by large, well known issuers. While speedy access to markets enables companies to take advantage of favorable market conditions, it also facilitates several varieties of fraudulent and abusive conduct. These include accounting fraud, market manipulation, and insider trading, all of which have been found to be more common among micro-cap companies and particularly among non-exchange-listed companies.

- Subtitle N would limit **SEC authority to oversee private offerings** under Regulation D, a market which rivals the public markets in size and importance. The SEC would lack even basic authority, under this provision, to limit misleading statements in private fund promotions or collect data necessary to determine how investors are faring and whether the offerings are promoting sustainable capital formation and job growth.

- Subtitle L would allow a new class of **venture exchanges** to offer securities of early stage companies without meeting a host of requirements to ensure either that the markets operate fairly or that issuers meet basic standards appropriate for sales to the general public. Subtitle S would eliminate the requirement that exchanges have **listing standards** comparable to the major national exchanges in order for securities listed on the exchange to qualify for exemption from state oversight. In combination, these provisions threaten to exempt a broad new category of securities from state oversight without any likelihood that federal oversight would fill the gap.

These are merely the most extreme of a group of "capital formation" provisions that, taken together, will destroy the underpinnings of our public securities markets, increase the risk of fraud in our private markets, and raise the cost of capital that investors demand to compensate for those increased risks.

## V. The Discussion Draft's elimination of the Federal Insurance Office halts four years of progress to make the insurance industry more transparent and accountable.

Title XI of the Choice Act Discussion Draft repeals Section 313 of the Dodd-Frank Act, which created the Federal Insurance Office (FIO) and gave it the authority "to monitor the extent to which traditionally underserved communities and consumers, minorities, and low- and moderate-income persons have access to affordable insurance products."[3] Dodd-Frank also gave the FIO the ability to collect data to carry out this mission. In 2016, the Office concluded a two-year process of developing a working definition of affordability for the auto insurance market, with input from a variety of stakeholders, including consumer, civil rights and community groups and the insurance industry.[4] Earlier this year, FIO issued its first "Study on the Affordability of Personal Automobile Insurance," which found that 18.6 million Americans live in ZIP codes where auto insurance is unaffordable. FIO's role of providing relevant data and analysis is extremely important and can be used to improve the economic conditions in struggling communities. Eliminating the Federal Insurance Office and replacing it with a new office that lacks the authority to monitor the insurance market and collect the necessary information to explain these and other affordability challenges, as is proposed here, rolls back four years of progress to improve the transparency and accountability of the insurance market.

## VI. This Discussion Draft would undermine progress on housing finance reform.

Section 352 of the Discussion Draft would repeal the important provision that the Director of the Federal Housing Finance Agency (FHFA) can only be removed "for cause" during his or her term. This would seriously undermine the agency's independence and make it open to political threats to its ability to fully exercise its oversight authority over the housing GSEs and the Federal Home Loan Banks. Taxpayers will benefit from having fully independent leadership of the agency charged with regulating these systemically important institutions. In addition, Section 362 of this bill would require congressional appropriations for all FHFA expenses. Current law finances FHFA operations through assessments on its regulated entities without appropriations approval. This provision will weaken FHFA's oversight ability and constrain its ability to fully discharge its responsibilities in a timely and efficient manner.

This Discussion Draft creates significant exemptions to the CFPB's Qualified Mortgage rule. Section 501 would weaken protections for purchasers of manufactured housing who are already routinely more subject to high-pressure sales tactics and higher costs than other housing

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[3] 31 U.S. Code § 313

[4] 81 Fed. Reg. at 45372 (July 13, 2016)

consumers. The current protections, which are designed to discourage predatory lending by manufactured housing dealers and their affiliated finance companies, provide important consumer protections that should be maintained. Section 516 would exempt any loan held by a depository lender in its portfolio from the basic consumer protections in Title XIV of Dodd-Frank, including the basic requirement that creditors base a loan decision on a reasonable expectation that the consumer can repay the loan. Documented review of the most important factors is essential in this process. This section also would exempt depositories from prohibitions against steering customers into loans if they merely *tell* the consumer that they plan to hold the loan on their balance sheet. Creditors should not be subject to different standards of care or diligence in considering and approving credit decisions based simply on where the loan ultimately will be held. This provision would exempt *any* depository without regard to asset limits from the basic ability to repay requirements that have been so important in reestablishing appropriate alignment of interests between creditors and mortgage applicants.

Section 531 of the Discussion Draft would exempt institutions with less than $10 billion in assets from the escrow requirements for mortgage loans in current law. Failure to properly account for and assure timely payment of required tax and other amounts typically escrowed by mortgage lenders can be very injurious to consumers.

Section 576 of the Discussion Draft would exempt depository institutions originating fewer than 100 closed end or 200 open ended residential mortgage loans from the mortgage data collection and reporting requirements of the Home Mortgage Disclosure Act (HMDA). Current law and pending regulations provide sufficient flexibility for smaller creditors to disclose pertinent information. Section 727 would eliminate the CFPB's authority to examine compliance with HMDA. Without such authority the government would have much less ability to monitor compliance with these reporting requirements, potentially weakening the regime and confidence in the data.

## VII. Conclusion

This Discussion Draft removes critical authority from regulatory agencies and entrusts the nation's financial wellbeing to financial institutions, which have shown time and time again they are incapable of self-monitoring and self-policing. As such, it opens the door to a renewed round of financial crises that have in recent years been the real culprits in slowing growth and harming consumers. This bill is a recipe for disaster that will increase harm to consumers and investors and foster instability in the financial marketplace. We urge you to oppose this Discussion Draft of the Financial CHOICE Act as it offers no choice that any consumer would knowingly make.

Sincerely,

Micah Hauptman

J. Robert Hunter

Micah Hauptman
Financial Services Counsel

J. Robert Hunter, FCAS, MAAA
Director of Insurance

Barbara Roper
Director of Investor Protections

Rachel Weintraub
Legislative Director and General Counsel

Barry Zigas
Director of Housing Policy

April 24, 2017

Honorable Members
House Financial Services Committee
538 Rayburn House Office Building
Washington, D.C.

Dear Honorable Members,

On behalf of the Corporate Reform Coalition, we write to oppose the forthcoming Financial Choice Act and in particular to highlight our concerns with the provision that prohibits the Securities and Exchange Commission from promulgating a rule to provide for proxy access. We also oppose the radical change in ownership requirements for shareholders proposing resolutions that appear on the proxy.

"Proxy access" refers to the ability of long-term shareholders to place a limited number of alternative board candidates on the company's proxy ballot for the company's annual shareowner meeting. As proxy access is typically envisioned, the shareholders must hold a substantial number of shares (often 3 percent of the outstanding shares) and have demonstrated a long-term interest by holding them for a substantial period of time (often three years). Further, the shareholders may only nominate candidates for 20 percent of the total board seats

The fundamental right of shareholders as the owners of a company is their prerogative to participate in the election of directors. Directors oversee executive officers, notably the CEO, who, in turn, oversee the deployment of shareholder capital. Determining the identity of the candidate directors, naturally, should also be the right of shareholders. In practice, however, it is the board itself that selects the candidate directors. And in nearly 100 percent of board elections, there are only as many candidates as there are board positions to fill. As Ann Simpson, Investment Director of the California Public Employee Retirement System, described, [proxy access] "is one of the most important rights for owners of a company. Without effective proxy access, the director election process simply offers little more than a ratification of management's slate of nominees."[1]

Directors who are largely unaccountable to shareholders arguably contribute to poor oversight. Certainly, the number of examples where boards failed to discern long festering problems is legion, from the accounting scandals epitomized by Enron, to the present case of Wells Fargo, where the board was oblivious to more than a decade of client account falsification.[2] According to the Securities and Exchange Commission, many institutional investors "saw a link between the [2008 financial crash] and shareholders' inability to have nominees included in a company's proxy materials."[3]

Proxy access provides a vehicle to introduce modest shareholder accountability into director elections, and in turn create a board that will listen to investor needs as they call for items like more disclosure in areas like corporate political spending.

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[1] Ann Simpson, *Letter to Exxon Mobile Shareholders*, CALPERS (May 11, 2016) https://www.calpers.ca.gov/docs/exxon-mobile-shareowner-letter.pdf

[2] Eleanor Bloxham, *Here's How Wells Fargo's Board Just Failed Customers*, FORTUNE (April 14, 2017) http://fortune.com/2017/04/14/wells-fargo-fake-accounts-2/

[3] Facilitation Shareholder Director Nominations, SECURITIES AND EXCHANGE COMMISSION (November 2010) shareholders' inability to have nominees included in a company's proxy materials.

The support for proxy access spans the investment community:

- **Vanguard:** "We believe that long-term investors may benefit from having proxy access . . . In our view, this improves shareholders' ability to participate in director elections while potentially enhancing boards' accountability and responsiveness to shareholders.[4]

- **Blackrock:** "We believe that long-term shareholders should have the opportunity, when necessary and under reasonable conditions, to nominate individuals to stand for election to the boards of the companies they own and to have those nominees included on the company's proxy card. . . . . [This] can enhance shareholders' ability to participate meaningfully in the director election process, stimulate board attention to shareholder interests, and provide shareholders an effective means of directing that attention where it is lacking." [5]

- **Institutional Shareholder Services:** "Supports proxy access as an important shareholder right." [6]

- **Council of Institutional Investors:** "The Council of Institutional Investors (CII) believes that proxy access is a fundamental right of long-term shareowners. Proxy access—a mechanism that enables shareowners to place their nominees for director on a company's proxy card—gives shareowners a meaningful voice in board elections."[7]

Also supporting proxy access: Colorado Public Employees' Retirement Association; CtW Investment Group; Florida State Board of Administration; International Corporate Governance Network; Connecticut State Treasurer; Ohio Public Employees Retirement System; Pax World; Teamsters; AFL-CIO; California State Teachers' Retirement System; Nathan Cummings Foundation; Pershing Square; Relational Investors; RiskMetrics; Social Investment Forum; State of Wisconsin Investment Board, and Trillium, among others. These organizations supported the SEC's effort to make proxy access a rule. [8]

Already, at least 367 companies, including more than half of the S&P 500 index, have amended their bylaws to allow proxy access.[9] Between January 2015 and October 2016, 95 shareholder proposals calling for proxy access received majority votes.[10] These reforms led to increases in share prices of the firms in aggregate. In fact, a study in 2014 by the CFA Institute found that if all firms adopted the change, this would increase the market value of US firms by as much as $140 billion.[11]

Achieving proxy access through shareholder resolutions, however, is limited by state law; some states provide for such bylaw changes through shareholder resolutions, while others do not. This was one key justification for the Dodd-Frank Section 971, which enabled the SEC to promulgate a proxy access rule.

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[4] Vanguard's Proxy Voting Guidelines, VANGUARD (website visited April 17, 2017) https://about.vanguard.com/vanguard-proxy-voting/voting-guidelines/

[5] Proxy Voting Guidelines for US Securities, BLACKROCK (website visited April 17, 2017) https://www.blackrock.com/corporate/en-br/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf

[6] ISS Summary Proxy Voting Guidelines, ISS (website visited April 18, 2017) https://www.issgovernance.com/file/policy/2016-us-summary-voting-guidelines-23-feb-2016.pdf

[7] Proxy Access, Best Practices, COUNCIL OF INSTITUTIONAL INVESTORS, (website visited April 18, 2017), http://www.cii.org/files/publications/misc/08_05_15_Best%20Practices%20-%20Proxy%20Access.pdf

[8] Facilitation Shareholder Director Nominations, SECURITIES AND EXCHANGE COMMISSION (November 2010) shareholders' inability to have nominees included in a company's proxy materials.

[9] Proxy Access, COUNCIL OF INSTITUTIONAL INVESTORS (website visited April 17, 2017) http://www.cii.org/proxy_access

[10] See shareholder resolution at Schwab, proxy statement (April 2017) https://www.sec.gov/Archives/edgar/data/316709/000119312517103408/d319517ddef14a.htm

[11] Proxy Access in the United States, CFA INSTITUTE (August 2014) http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2014.n9.1

Those who oppose proxy access are not investors but corporate leaders. They do not state that they oppose accountability, but rather disguise their concerns as a wish to maintain collegiality among directors. Investors, however, do not value collegiality as much as functional management well monitored by effective directors.

In a separate provision, the CHOICE act would increase the threshold for submitting shareholder resolutions to 1 percent of a company's outstanding shares. Currently, the rules require a shareholder to hold at least $2,000 worth. In effect, this would eliminate the ability of average Americans to submit shareholder resolutions. At JP Morgan, for example, a shareholder would need to own more than $2 billion worth of stock. At Apple, a shareholder would need to hold more than $7 billion in stock. Only the largest institutional investors could submit a resolution, and none has. We find this proposal preposterous.

In the end, proxy access and shareholder resolutions are about choice, the ability of the owners of a corporation to select among candidates to serve them as management overseers, to propose changes in governance and company policies.. The Financial CHOICE Act poorly reflects its name if it limits this choice. We ask that you oppose this provision as one of the reasons (among many) to oppose the overall bill.

For inquiries, please contact: Lisa Gilbert, lgilbert@citizen.org, Vice President of Legislative Affairs at Public Citizen

Council of Institutional Investors
The voice of corporate governance

Via Hand Delivery

April 24, 2017

The Honorable Jeb Hensarling
Chairman
Committee on Financial Services
United States House of Representatives
Washington, DC 20515

The Honorable Maxine Waters
Ranking Member
Committee on Financial Services
United States House of Representatives
Washington, DC 20515

*Re: Hearing on the Financial CHOICE Act of 2017*[1]

I am writing on behalf of the Council of Institutional Investors (CII), a nonpartisan, nonprofit association of employee benefit plans, foundations and endowments with combined assets under management exceeding $3 trillion. Our member funds include major long-term shareowners with a duty to protect the retirement savings of millions of workers and their families. Our associate members include a range of asset managers with more than $20 trillion in assets under management.[2]

The purpose of this letter is to thank you for holding a hearing on the April 19 discussion draft of the Financial CHOICE Act of 2017 (Act) and to share with you a summary of our initial views. We have organized our comments under three general subject headings: (1) Protect Fundamental Shareholder Rights; (2) Promote Effective Disclosure and Reliable Financial Reporting; and (3) Safeguard the Independence of the U.S. Securities and Exchange Commission (SEC or the Commission).

We would respectfully request that this letter be included in the hearing record.

**1. Protect Fundamental Shareholder Rights**

Shareholder Proposals

CII opposes Section 844 of the Act because it would dramatically restrict the ability of shareowners to file proposals on important governance issues.

[1] Financial CHOICE Act of 2017, H.R. ____, 115th Congress (discussion draft Apr. 19, 2017), *available at* https://financialservices.house.gov/uploadedfiles/choice_2.0_discussion_draft.pdf.
[2] For more information about the Council of Institutional Investors (CII) and our members, please visit CII's website at http://www.cii.org/about_us.

CII and its members have a deep interest in ensuring that Rule 14a-8,[3] the federal rule that governs shareholder proposals, is fair and workable for shareowners and companies.[4] The rule provides an orderly means to mediate differences between managers and owners, and we are mindful that many positive advances in U.S. corporate governance practices simply would not have occurred without a robust shareowner proposal process in place. For example:

- Shareholder proposals were the impetus behind the now standard practice—currently mandated by major U.S. stock exchanges' listing standards—that independent directors constitute at least a majority of the board, and that all the members of the following board committees are independent: audit, compensation, nominating and corporate governance.

- In 1987, an average of 16% of shareholders voted in favor of shareholder proposals to declassify boards of directors so that directors stand for election each year. In 2012, these proposals enjoyed an 81% level of support on average. Ten years ago, less than 40% of S&P 500 companies held annual director elections compared to more than two thirds of these companies today.

- Electing directors in uncontested elections by majority (rather than plurality) vote was considered a radical idea a decade ago when shareholders pressed for it in proposals they filed with numerous companies. Today, 90% of large-cap U.S. companies elect directors by majority vote, largely as a result of robust shareholder support for majority voting proposals.

- A proposal that built momentum even more rapidly and influenced the practices of hundreds of companies in the last few years is the request for proxy access. Resolutions filed by the New York City Comptroller to allow shareholders meeting certain eligibility requirements to nominate directors on the company's proxy ballot achieved majority votes at numerous companies. As a result, since 2015, at least 400 companies have adopted proxy access bylaws.[5]

Section 844 of the Act would radically increase the regulatory hurdles for shareholder proposals. Current rules set a minimum $2,000 ownership requirement.[6] More specifically, Section 844(b) of the Act would require any shareholder wishing to put a proposal on a public company ballot to own at least 1% of the company's stock for a minimum of three years.

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[3] 17 CFR 240.14a-8 - Shareholder proposals, Cornell U. L. School, LII, *available at* https://www.law.cornell.edu/cfr/text/17/240.14a-8 (last viewed Apr. 23, 2017).
[4] *See, e.g.*, Examining the U.S. Proxy Voting System: Is it Working for Everyone, Corporate Governance Roundtable, Hosted by Rep. Scott Garrett, 114th Cong (Nov. 16, 2015) (Statement of Amy Borrus, Interim Executive Director, Council of Institutional Investors), *available at* http://www.cii.org/files/issues_and_advocacy/correspondence/2015/11_16_15_cii_Rep%20_Garrett_roundtable_submission_amy_borrus.pdf.
[5] *See, e.g.*, Ceres Investor Network on Climate Risk and Sustainability, The Business Case for the Current SEC Shareholder Proposal Process 6 (Apr. 2017) (on file with CII).
[6] 17 CFR 240.14a-8(b) Question 2.

Section 844(b) of the Act would require, for example, an investor at Wells Fargo to own approximately $2.6 billion in shares in order to file a single proposal. At Apple, the largest U.S. company by market capitalization, a shareholder would have to own more than $7 billion of stock to file a single proposal. Even our largest public pension fund members rarely hold 1% of a public company.[7] In fact, based on holdings as of December 30, 2016, the only shareholders with eligibility to propose resolutions at Apple would be BlackRock, Vanguard, State Street, FMR, Northern Trust, Bank of New York Mellon, Berkshire Hathaway and T. Rowe Price. To our knowledge, none of these investors has ever presented a shareholder proposal at an annual meeting.

In addition, current rules require a shareholder to re-file a proposal only if it has received at least 3% of the vote on its first submission, 6% on the second and 10% on the third. Section 844(a) of the Act would raise those thresholds to 6%, 15% and 30%, respectively.[8] Those hurdles could also knock out many important governance proposals that, if adopted, could enhance long-term shareowner value. The percentages of proposals since 2000 that are estimated to have fallen below the proposed thresholds are 13.3%, 31.5%, and 50.1%, respectively.[9]

We agree with Anne Sheehan, director of corporate governance at the California State Teachers' Retirement System, the second largest U.S. public pension fund, and a CII member, that the provisions of Section 844 of the Act "would shut down the shareholder proposal process completely."[10] Shutting down shareholder proposals is likely to have unintended consequences, including shareowners more often availing themselves of the blunt instrument of votes against directors, and increased reliance on hedge fund activists to push for needed corporate changes.

<u>Universal Proxies</u>

CII opposes Section 845 of the Act because it appears intended to bar the SEC from issuing a final rule that would allow shareowners to freely vote for those board candidates they favor in a contested election.

The problem that the SEC's October 2016 universal proxy proposal[11] would resolve is a problem that was clearly articulated by the SEC's Investor Advisory Committee in 2013.[12] Namely,

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[7] *See, e.g.*, Letter from Jack Ehnes, Chief Executive Officer, California State Teachers' Retirement System, to The Honorable Maxine Waters, Ranking Member, House Committee on Financial Services 1 (Apr. 20, 2017) ("While 1% may sound like a small amount, even a large investor like the $200 billion CalSTRS fund does not own 1% of publicly traded companies.") (on file with CII).
[8] 17 CFR 240.14a-8(i)(12).
[9] Financial CHOICE Act of 2017, § 844(a).
[10] Andrea Vittorio, Shareholder Advocacy Tool Shut Down in Republican Plan., Bloomberg BNA's Corp. L. & Accountability Rep., Apr. 19, 2017, at 2, *available at* https://www.bna.com/shareholder-advocacy-tool-n57982086844/.
[11] Universal Proxies, Exchange Act Release No. 79,164, Investment Company Act Release No. 32,339 (proposed rule Oct. 26, 2016), *available at* https://www.sec.gov/rules/proposed/2016/34-79164.pdf.
[12] Recommendations of the Investor Advisory Committee Regarding SEC Rulemaking to Explore Universal Proxy Ballots 2 (adopted July 25, 2013) ("shareholders [currently] have no practical ability to 'split their tickets' and vote for a combination of shareholder nominees and management nominees), *available at* https://www.sec.gov/spotlight/investor-advisory-committee-2012/universal-proxy-recommendation-072613.pdf; *see* Letter from Ken Bertsch, Executive Director, Council of Institutional Investors, to Brent J. Fields, Secretary,

investors are currently disenfranchised in a proxy contest, to the extent they vote by proxy, because they have no practical ability to "split their ticket" and vote for the combination of shareowner nominees and management nominees that they believe best serve their economic interests.[13]

That view is reflected in our membership approved policies for director elections which states:

> To facilitate the shareholder voting franchise, the opposing sides engaged in a contested election should utilize a proxy card naming all management-nominees and all shareholder-proponent nominees, providing every nominee equal prominence on the proxy card.[14]

Some opponents of universal proxy cards contend their use would encourage more proxy contests or favor dissidents. We are unaware of any compelling empirical evidence indicating that universal proxies would favor shareowner-proponent board nominees over company-nominees (or the reverse).[15] As concluded in a recent expert analysis of the SEC proposal by attorneys with Fried Frank Harris & Jacobson LLP: "In our view, the universal proxy card mandate, if adopted, would not significantly affect the outcome of proxy contests or activist situations."[16]

We also agree with Keith F. Higgins, former SEC Director of Corporation Finance, who recently commented:

> What I haven't heard is a good answer to this simple question: *Why shouldn't a shareholder who votes by proxy have the same voting options as a shareholder who votes in person? Unless someone comes up with a good answer to that question, I think the Commission should move forward with the proposal*, although I note that a prohibition on doing so may be part of version 2.0 of the Financial CHOICE Act being considered by the House Financial Services

Securities and Exchange Commission 3, 6-40 (Dec. 28, 2016) (Explaining in detail why the "proposal will facilitate the ability of shareholders to fully exercise their franchise by proxy by allowing them to vote for the combination of nominees of their choice"), *available at* http://www.cii.org/files/issues_and_advocacy/correspondence/2016/12_28_16_comment_letter_SEC_universal_proxy.pdf; *see also* Carl Icahn, Statement Regarding SEC Proposal to Require Use of Universal Proxy Cards (Oct. 27, 2016) ("the introduction of the universal proxy card will eliminate needless voter confusion in contested elections, give shareholders greater freedom of choice, and hopefully end some of the gamesmanship employed by incumbent boards to keep shareholder-nominated directors out of the boardroom"), *available at* http://carlicahn.com/statement-regarding-sec-proposal-to-require-use-of-universal-proxy-cards/.

[13] *Id.*

[14] CII Policies, §2.2 Director Elections (updated Sept. 30, 2016), *available at* http://www.cii.org/corp_gov_policies.

[15] *See, e.g.,* Tatyana Shumsky, SEC Weighs Universal Proxy Vote Cards, Wall St. J., Feb. 19, 2016, at 1 (Quoting Michelle Anderson, associate director in the SEC's Division of Corporation Finance, that the universal proxy project is "'not about favoring the company of the dissident'"), *available at* http://blogs.wsj.com/cfo/2016/02/19/sec-weighs-universal-proxy-vote-cards/.

[16] Gail Weinstein et. al., Fried Frank Harris Shriver & Jacobson LLP, Expert Analysis, A Practical Assessment of the 'Universal Proxy Card' Plan, Law360 at 5 (Dec. 14, 2016) (emphasis removed), *available at* https://www.law360.com/articles/871184/a-practical-assessment-of-the-universal-proxy-card-plan.

> Committee. Even though there are only a relatively small number of contested elections each year, *it is a glitch in the system of fair suffrage that should be fixed.*[17]

Say-on-Pay

CII opposes Section 843 of the Act because it would reduce the required frequency of shareholder advisory votes on executive compensation, commonly called say-on-pay votes.

The requirements of Section 951, "Shareholder Vote on Executive Compensation Disclosures," of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), as implemented by the SEC, are generally consistent with CII's membership-approved corporate governance policies. Those policies state:

> All companies should provide annually for advisory shareowner votes on the compensation of senior executives.[18]

While the requirement provides for say-on-pay votes to be held annually, biennially, or triennially, to date over 90% of public companies have opted for annual votes consistent with our policy.[19] Voting trends, investor preferences and results from our member survey indicate that support for annual say-on-pay in 2017 will be at or above that level.[20]

An annual say-on-pay vote is critical to investors, in part, because it provides shareowners with the ability to communicate their views on the most recent payouts stemming from the policies used to administer executive compensation practices. Those payouts may change in unforeseeable and unexpected ways due to a policy's complexity, reliance on forward-looking factors and board discretion.

It is now widely recognized that an annual vote on executive compensation has resulted in a number of ongoing improvements to the process in which corporate boards determine executive pay, including:

- Boards are actively and frequently reaching out to shareowners to solicit their concerns about, and their approval of, executive compensation plans;
- Boards are increasing the proportion of executive compensation linked to company performance, leading to potentially greater alignment between the two; and

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[17] Keith F. Higgins, Keynote Address at the Practicing Law Institute Corporate Governance – A Master Class 2 (Mar. 9, 2017) (emphasis added) (on file with CII).
[18] CII Policies, §5.2
[19] CII, Say-On-Pay Frequency: A Fresh Look 1 (Dec. 2016), *available at* http://www.cii.org/files/publications/misc/12_22_16_SOP_Frequency_Report_Formatted.pdf
[20] *Id.*

- Boards are eliminating executive compensation perks such as club memberships that blur the line between personal and business expenses.[21]

Proxy Research

CII opposes Section 482 of the Act because it would establish an additional federal regulatory superstructure for proxy advisory firms that institutional investors, the primary customer of those firm's research services, do not want or need.

Proxy advisory firms play a vital and necessary role in assisting many pension funds and other institutional investors in carrying out their fiduciary duty to vote proxies. By law, pension fund fiduciaries have a duty to ensure that their proxies are voted in the best long-term interests of plan participants and beneficiaries. Many pension funds and other institutional investors contract with proxy advisory firms to obtain and review their research. But most large holders vote according to their own guidelines and policies.

Last September a letter co-signed by 30 CII members and other organizations expressed concerns about the Act's proxy advisory firm provisions.[22] Those provisions and our specific related concerns remain the following:

> **Require that proxy advisory firms (1) provide companies advance copies of their recommendations and most elements of the research informing their reports, (2) give companies an opportunity to review and lobby the firms to change their recommendations, and (3) establish a heavy-handed "ombudsman" construct to address issues that companies raise.**
>
> This right of pre-review would give companies substantial influence over proxy advisory firms' reports, potentially undermining the objectivity of the firms' recommendations. On a practical level, this right of review would delay pension funds and other institutional investors' receipt of the reports and recommendations for which they have paid.

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[21] See, e.g., Paul Hodgson, Surprise Surprise: Say on Pay Appears to Be Working, Fortune.com, July 8, 2015, available at http://fortune.com/2015/07/08/say-on-pay-ceos/.
[22] *See* Letter from Kenneth A. Bertsch, Executive Director, Council of Institutional Investors et al., to The Honorable Richard C. Shelby, Chairman, Committee on Banking, Housing, and Urban Affairs, United States Senate et al. (Sept. 6, 2016), *available at* http://www.cii.org/files/issues_and_advocacy/correspondence/2016/September%206%20Letter%20to%20Senate%20Banking%20on%20Proxy%20Advisory%20Firms.pdf; Letter from Kenneth A. Bertsch, Executive Director, Council of Institutional Investors et al., to The Honorable Jeb Hensarling, Chairman, House Committee on Financial Services et al. (June 13, 2016) (letter co-signed by 27 CII members and other institutional investors strongly opposing H.R. 5311), *available at* http://www.cii.org/files/issues_and_advocacy/correspondence/2016/06_13_16_FINAL_Letter_on_Proxy_Advisory_Firm_Bill.pdf; *see also* Editorial, Undermining Proxy-Voting Advice, Pensions & Invs., June 27, 2016, at 1 ("A bill pending in Congress would undermine proxy-voting firms and consequently weaken the capability of asset owners and other institutional investors to bring to bear their crucial resources to assist in voting on proxy issues at publicly traded companies") (registration required & on file with CII), *available at* http://www.pionline.com/article/20160627/PRINT/306279998/undermining-proxy-voting-advice.

The requirement that the proxy advisory firms resolve company complaints prior to the voting on the matter would create an incentive for companies subject to criticism to delay publication of reports as long as possible. Pension funds and other institutional investors would have less time to analyze the reports and recommendations in the context of their own customized proxy voting guidelines to arrive at informed voting decisions. Time already is tight, particularly in the highly concentrated spring "proxy season," due to the limited period between company publication of the annual meeting proxy statement and annual meeting dates.

Moreover, the proposed legislation does not appear to contemplate a parallel requirement that dissidents in a proxy fight, or proponents of shareowner proposals, also receive the recommendations and research in advance. This would violate an underlying tenet of U.S. corporate governance that where matters are contested in corporate elections, management and dissident shareowners should operate on an even playing field.

**Require the Securities and Exchange Commission (SEC) to assess the adequacy of proxy advisory firms' "financial and managerial resources."**

The entities that are in the best position to make these types of assessments are the pension funds and other institutional investors that choose to purchase and use the proxy advisory firms' reports and recommendations. In 2014, the SEC staff issued guidance reaffirming that investment advisors have a duty to maintain sufficient oversight of proxy advisory firms and other third-party voting agents. We publicly supported that guidance. We are unaware of any compelling empirical evidence indicating that the guidance is not being followed or that the burdensome federal regulatory scheme contemplated by the proposed legislation is needed.

. . . .

The proposed legislation would appear to result in higher costs for pension plans and other institutional investors – potentially much higher costs if investors seek to maintain current levels of scrutiny and due diligence around proxy voting. Moreover, the proposed legislation is highly likely to limit competition, by reducing the current number of proxy advisory firms in the U.S. market and imposing serious barriers to entry for potential new firms. This would also drive up costs to investors. Given these economic impacts, we are troubled that there appears to be no cost estimate on the provisions of this proposed legislation.[23]

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[23] Letter from Kenneth A. Bertsch, Executive Director, Council of Institutional Investors et al., to The Honorable Richard C. Shelby, Chairman, Committee on Banking, Housing, and Urban Affairs, United States Senate et al. at 8-10 (footnotes omitted).

Our views are consistent with those of former SEC Director of Corporation Finance Keith F. Higgins who recently commented:

> Under this regime, proxy advisory firms would be required to register with the Commission, allow companies to review their reports before issuance, disclose potential conflicts of interest and provide financial reports. Although I don't dismiss concerns about the influence of proxy advisory firms, *I don't think the proposed regulatory regime is the answer*. Part of the problem in the industry is a lack of competition. For example, various sources report that the two largest players, ISS and Glass Lewis, control approximately 97% of the proxy advisory services market. It is unclear how added regulatory burdens will help promote competition. Typically, imposing additional regulation is a costly impediment to new entrants, and in turn, may bolster the incumbents' market position.
>
> *It is interesting that the clients who use proxy advisory reports don't seem to be complaining*. In fact, they often favor the ease, readability, and comparability of the reports.
>
> . . . .
>
> *I don't think placing an additional regulatory support superstructure on proxy advisory firms is the solution.*[24]

**2. Promote Effective Disclosure and Reliable Financial Reporting**

Clawbacks

CII opposes Section 849 of the Act because it would narrow the required scope for clawbacks of unearned compensation from corporate executives to those we had control or authority over the company's financial reporting.

We continue to support the SEC's issuance of a final rule in response to Section 954 of Dodd-Frank entitled, "Recovery of Erroneously Awarded Compensation." The SEC's proposed rule to implement Section 954 is generally consistent with CII's membership approved corporate governance policies.[25] Those policies state:

> The compensation committee should ensure that sufficient and appropriate mechanisms and policies (for example, bonus banks and clawback policies) are in place to recover erroneous bonus and incentive awards paid in cash, stock or any other form of remuneration to current or former executive officers, and to prevent such awards from being paid out in the first instance. Awards can be erroneous

[24] Keith F. Higgins at 2-3.

[25] Listing Standards for Recovery of Erroneously Awarded Compensation, 80 Fed. Reg. 41,144 (proposed rule July 14, 2015), *available at* https://www.federalregister.gov/articles/2015/07/14/2015-16613/listing-standards-for-recovery-of-erroneously-awarded-compensation.

> due to acts or omissions resulting in fraud, financial results that require restatement or some other cause that the committee believes warrants withholding or recovering incentive pay. Incentive-based compensation should be subject to recovery for a period of time of at least three years following discovery of the fraud or cause forming the basis for the recovery. The mechanisms and policies should be publicly disclosed.[26]

Consistent with our policies, we believe the final SEC rule should, as proposed,[27] apply broadly to the compensation of all current or former executive officers whether or not they had control or authority over the company's financial reporting.[28] As we explained in our comment letter to the SEC:

> In our view, establishment of a broad clawback arrangement is an essential element of a meaningful pay for performance philosophy. If executive officers are to be rewarded for "hitting their numbers"—and it turns out they failed to do so—the unearned compensation should generally be recovered notwithstanding the cause of the revision.[29]

We note that if the limitation of Section 849 were adopted, employees such as the former head of community banking at Wells Fargo, Carrie L. Tolstedt, would presumably not fall under the scope the required clawback.[30] Finally, we note that our support for a broad clawback policy appears to be consistent with the "Commonsense Principles of Corporate Governance" recently endorsed by a number of prominent leaders of U.S. public companies, including Mary Barra, General Motors Company; Jamie Dimon, JPMorgan Chase; Jeff Immelt, GE; and Lowell McAdam, Verizon.[31] Those principles state that "companies should maintain clawback policies for both cash and equity compensation" of management.[32]

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[26] § 5.5 Pay for Performance.
[27] *See* 80 Fed. Reg. at 41,153 ("the compensation recovery provisions of Section 10D apply without regard to an executive officer's responsibility for preparing the issuer's financial statements").
[28] Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors, to Brent J. Fields, Secretary, U.S. Securities and Exchange Commission 5 (Aug. 27, 2015), *available at* http://www.cii.org/files/issues_and_advocacy/correspondence/2015/08_27_15_letter_to_SEC_clawbacks.pdf.
[29] *Id.* (footnotes omitted).
[30] Nathan Bomey & Kevin McCoy, Wells Fargo clawing back $75.3 million more from former execs in fake accounts scandal, USA Today, April 10, 2017, at 1 (reporting that "the bank has canceled $47.3 million in additional stock options owed to Carrie Tolstedt, who previously headed the community banking division where the scandal erupted"), *available at* https://www.usatoday.com/story/money/2017/04/10/wells-fargo-compensation-clawback/100276472/.
[31] Commonsense Corporate Governance Principles VII(g) (July 2016), *available at* http://www.governanceprinciples.org/.
[32] *Id.*

Hedging

CII opposes Section 857 of the Act because it would repeal the requirement that public corporations disclose whether their employees and directors can hedge their company's equity compensation.

We continue to support the SEC's issuance of a final rule in response to Section 955 of Dodd-Frank entitled, "Disclosure Regarding Employee and Director Hedging." The SEC's proposed rule to implement Section 955[33] has important implications for CII's long-standing membership approved corporate governance policies on hedging of compensation.[34] Those policies state:

> Compensation committees should prohibit executives and directors hedging (by buying puts and selling calls or employing other risk-minimizing techniques) equity based awards granted as long-term incentive compensation or other stock holdings in the company. And they should strongly discourage other employees from hedging their holdings in company stock.[35]

For those companies that have not yet fully adopted our policy, we believe that a final SEC rule, as proposed, would provide our members and other investors with a more complete understanding regarding the persons permitted to engage in hedging transactions and the types of hedging transactions allowed. Armed with the proposed disclosure, our members and other investors would be in a better position to make more informed investment and voting decisions, including voting decisions on proposals to adopt hedging policies, advisory votes on executive compensation and voting decisions in connection with the election of directors.

We, like the SEC, "are not aware of any reason why information about whether a company has policies affecting the alignment of shareholder interests with those of employees and directors would be less relevant to shareholders of an emerging growth company or a smaller reporting company than to shareholders of any other company."[36] Moreover, we generally agree with the SEC that given its narrow focus, it is unlikely that the proposed disclosure would "impose a significant compliance burden on [those] companies."[37]

Finally, we believe the proposed disclosure also would benefit our members and other investors because the public nature of the required disclosure would result in more public companies adopting our hedging policy and enhancing long-term shareowner value. For all the above reasons, CII generally supports the issuance of a final rule as proposed.[38]

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[33] Disclosure of Hedging by Employees, Officers, and Directors, 80 Fed. Reg. 8486 (proposed Feb. 17, 2015), *available at* https://www.gpo.gov/fdsys/pkg/FR-2015-02-17/pdf/2015-02948.pdf.
[34] § 5.8d Hedging.
[35] *Id.*
[36] 80 Fed. Reg. at 8494.
[37] *Id.*
[38] Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors, to Brent Fields, Secretary, U.S. Securities and Exchange Commission 3 (Apr. 16, 2015), *available at* https://www.sec.gov/comments/s7-01-15/s70115-5.pdf.

Chairman & CEO Structures

CII opposes Section 857(a)(31) of the Act because it would repeal required disclosures of public corporation's Chairman and CEO structures.

We note that the SEC adopted rules in December 2009 that, in effect, implemented the disclosure requirements of Section 972 of Dodd Frank entitled, "Disclosures Regarding Chairman and CEO Structure." CII's membership approved policies generally support appointment of an independent chair. Those policies state:

> The board should be chaired by an independent director. The CEO and chair roles should only be combined in very limited circumstances; in these situations, the board should provide a written statement in the proxy materials discussing why the combined role is in the best interests of shareowners, and it should name a lead independent director who should have approval over information flow to the board, meeting agendas and meeting schedules to ensure a structure that provides an appropriate balance between the powers of the CEO and those of the independent directors.

CII members believe that the board leadership is critical to effective governance. We believe that even those who promote combination of chair and CEO roles generally share that view, and should have no objections to a disclosure requirement providing for clarity around the reasoning behind board leadership structure.

Finally, we note that our support for this disclosure appears to be consistent with the "Commonsense Principles of Corporate Governance" recently endorsed by a number of prominent leaders of U.S. public companies.[39] Those principles state that "board should explain clearly (ordinarily in the company's proxy statement) to shareholders why it has separated or combined the roles."[40]

Internal Controls

CII opposes Sections 441 and 847 of the Act that would further expand the existing exemptions for public corporations from having an external, independent auditor attest to, and report on, management's assessment of internal controls over financial reporting as generally required by Section 404(b) of the Sarbanes-Oxley Act. As explained in a joint letter from CII and the Center for Audit Quality in response to a recent SEC proposal:

> We believe that any amendment that erodes Section 404(b) would substantially impact the quality of financial reporting by public companies to the detriment of investors and our capital markets more generally . . . We believe Section 404(b)

[39] Commonsense Corporate Governance Principles at V(a).
[40] *Id.*

> continues to be significant as it provides investors with reasonable assurance from the independent auditor that a company maintained effective internal control over financial reporting. This assurance is an important driver of confidence in the integrity of financial statements and in the fairness of our capital markets. A Government Accountability Office report found that companies exempted from Section 404(b) experience more financial restatements, as compared to nonexempt companies; and the percentage of exempt companies restating has generally exceeded that of nonexempt companies. According to this report, companies that obtained an auditor attestation generally had fewer financial restatements than those that did not.
>
> Complying with Section 404(b) has a benefit for issuers. Academic research has demonstrated that the cost of capital for companies that voluntarily comply with Section 404(b) is lower than peer companies and has decreased for public companies since enactment of the Sarbanes-Oxley Act, especially for smaller companies.
>
> Lastly, while the cost of compliance with Section 404(b) is often cited as a concern by issuers, an SEC study concluded that such costs have declined by approximately 30% after the PCAOB adopted Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, and the SEC issued management guidance on Section 404(a) in 2007.[41]

Governmental Accounting Standards Board (GASB)

CII opposes Section 857(a)(34) of the Act that repeals an existing market-based accounting support fee for the GASB. As we explained in a recent letter to Chairman Hensarling:

> On behalf of . . . CII, we write to urge you exclude from the Financial CHOICE Act any provision that repeals section 978 of . . . Dodd-Frank . . . that provides a funding mechanism for the . . . GASB.
>
> . . . .
>
> The GASB funding mechanism currently in place provides the GASB with an independent, conflict-free source of funds in order to carry out its important mission of establishing accounting and financial reporting standards for U.S. state and local governments that follow Generally Accepted Accounting Principles (GAAP).

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[41] Letter from Cynthia M. Fornelli, Executive Director, Center for Audit Quality & Jeff Mahoney, General Council, Council of Institutional Investors, to U.S. Securities and Exchange Commission 2-3 (Aug. 30, 2016) (footnotes omitted), *available at* https://www.sec.gov/comments/s7-12-16/s71216-17.pdf.

> The independent and predictable source of funds that GASB receives benefits taxpayers and investors because it is free of the conflicts of interest, real or perceived, that were inherent in GASB's old funding source that required GASB's parent, the Financial Accounting Foundation, to solicit voluntary contributions from the very entities that would be bound by its accounting standards. We should not go back to this practice that undermines investor confidence.
>
> We support the GASB's important work and urge you to exclude any provision in your legislation that repeals GASB's current funding mechanism.[42]

### 3. Safeguard the Independence of the SEC

SEC Rulemaking

CII would amend Sections 311 and 334 of the Act to remove the SEC from the cost-benefit analysis and Congressional review provisions of Title III, Subtitle A and B of the Act, respectively.

As an association of long-term shareowners interested in maximizing share values, we believe it is vital to avoid unnecessary regulatory costs. However, it is not clear to us how the provisions of the Act would improve the cost-effectiveness of the SEC's existing rulemaking process or benefit long-term investors, the capital markets or the overall economy.

We note, for example, that the Act's provisions do not contain any language that would explicitly require the SEC to consider the costs and benefits of a proposal or rule from the perspective of long-term investors. Moreover, as we explained in a recent letter to Speaker Ryan and Minority Leader Pelosi regarding similar cost-benefit provisions of H.R. 78:

> The Commission's rulemaking process is already governed by a number of legal requirements, including those under the federal securities laws, the Administrative Procedure Act, the Paperwork Reduction Act of 1980, the Small Business Regulatory Enforcement Fairness Act of 1996 and the Regulatory Flexibility Act. Moreover, under the federal securities laws, the SEC is generally required to consider whether its rulemakings are in the public interest and will protect investors and promote efficiency, competition and capital formation.
>
> Since the 1980s, the Commission has conducted, to the extent possible, an analysis of the costs and benefits of its proposed rules. The SEC has further enhanced the economic analysis of its rulemaking process in recent years. That process is far more extensive than that of any other federal financial regulator.

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[42] Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors, to The Honorable Jeb Hensarling, Chairman, Committee on Financial Services, U.S. House of Representatives 1-2 (Feb. 9, 2017) (footnotes omitted), *available at* http://www.cii.org/files/issues_and_advocacy/correspondence/2017/February%209,%202017%20GASB.pdf.

> . . . .
>
> The [cost-benefit] provisions . . . would create a false and misleading expectation that the SEC can reasonably measure, combine and compare the balance of all costs and benefits of its proposals consistent with its mandate to protect investors. As explained by Professor Craig M. Lewis, former chief economist and director of the SEC's Division of Economic and Risk Analysis: "[W]ith regard to investor protection, the Commission is often unable to reasonably quantify the related benefits or costs."
>
> [The cost-benefit provisions] . . . would impose upon the SEC a costly, time consuming and incomplete analysis in which the Commission would be hard pressed to determine that the benefits of a proposal or rule "justify the costs of the regulation."[43]

The application of the Act's Congressional review provisions to SEC rulemaking is perhaps even more troubling for long-term investors. On this issue, we generally agree with the following comments of Broc Romanek of the TheCorporateCounsel.net:

> The "Financial Choice Act" is much more than merely repealing big chunks of Dodd-Frank. There are a handful of provisions that would render the SEC's ability to conduct rulemaking much more difficult. But this provision in particular . . . just blows me away:
>
> . . . A joint Congressional resolution to adopt a "major" rule – and even some non-major ones! [Its] goal appears to be neutering the so-called "independent" federal agencies that govern our financial institutions & markets. Talk about putting partisan politics into "independent" agencies. And here I was worried that having Congress involved in the SEC's budget process was too much meddling with a federal agency!
>
> Remember that federal agencies are part of the executive branch of government. Not to mention that members of Congress don't have the expertise, resources or time to understand what the various rules of an agency are. This would be a major windfall for lobbyists who would be able to effectively pay Congress to stop an agency from doing anything. Either the Senate or the House could stop a rulemaking – by simply sitting on their hands. The polar opposite of needing an

[43] Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors, to The Honorable Paul D. Ryan, United States House of Representatives et al. 2-3 (Jan. 11, 2017) (footnotes omitted), *available at* http://www.cii.org/files/issues_and_advocacy/correspondence/2017/01_11_17_letter_house_leadership_HR78.pdf.

> "Act of Congress" to change something. It's brazen & breathtaking – and a whole lot of other things that I can't mention in this family-oriented blog.[44]

We believe the Title III, Subpart A and B provisions, individually, and particularly when combined, would unnecessarily constrain the ability of the SEC to issue any substantive proposals in furtherance of its mission to protect investors—the element of its mission that, in our view, is most critical to maintaining and enhancing a fair and efficient capital market system.

Compensation Structure

CII opposes Section 857(a)(26) of the Act because it would repeal requirements to improve executive pay practices at financial institutions.

We continue to support the issuance of a final rule by the SEC and the federal financial regulators in response to Section 956 of Dodd-Frank titled, "Enhanced Compensation Structure Reporting." As we stated in our comment letter in response to the federal financial regulators proposed rule to implement Section 956,[45] the proposal is "largely consistent with CII's member-approved policies on executive compensation."[46] Those policies support reasonable, appropriately structured pay-for-performance programs that reward executives for sustainable, superior performance over the long-term, consistent with a company's investment horizon.[47] In light of those policies and the experience of the financial crisis,[48] our comment letter concludes:

> [We support] the proposed rule's over-arching requirements that incentive-based compensation arrangements at covered financial institutions 1) appropriately balance risk and reward, and 2) bar arrangements that could encourage inappropriate risks by providing excessive compensation or that could lead to material financial loss. We also support the proposed rule's recognition of the board's important role to oversee incentive-based compensation programs.[49]

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[44] Broc Romanek, Financial CHOICE Act: One Provision Could Destroy the SEC's Rulemaking, TheCorporateCounsel.net Blog (Nov. 17, 2016), *available at* https://www.thecorporatecounsel.net/miscccnet/bio.htm.

[45] Incentive-Based Compensation Arrangements, 81 Fed. Reg. 112 (proposed rule June 10, 2016), *available at* https://www.gpo.gov/fdsys/pkg/FR-2016-06-10/pdf/2016-11788.pdf.

[46] Letter from Glenn Davis, Director of Research, Council of Institutional Investors, to Patrick T. Tierney, Assistant Director, Department of Treasury, Office of the Comptroller of the Currency, Legislative and Regulatory Activities Division et al. 2 (July 15, 2016), *available at* http://www.federalreserve.gov/SECRS/2016/July/20160721/R-1536/R-1536_071516_130346_394428687994_1.pdf.

[47] § 5.1 Introduction.

[48] Investors Working Group, U.S. Financial Regulatory Reform: The Investors' Perspective 22 (July 2009) (concluding that the global financial crisis resulted, in part, from "too many boards approv[ing] executive compensation plans that rewarded excessive risk-taking"), *available at* http://www.cii.org/files/issues_and_advocacy/dodd-frank_act/07_01_09_iwg_report.pdf.

[49] Letter from Glenn Davis at 3.

We believe the issuance of a final rule, as proposed, appropriately preserves a role for incentive-based compensation at financial institutions and places a greater emphasis on risk management and long-term outcomes. The result should be greater stability for the overall market.

Proxy Access

CII opposes Section 857(a)(30) of the Act that would repeal authority of the SEC to issue a proxy access rule.

We believe that proxy access—a mechanism that enables shareowners to place their nominees for director on a company's proxy card—is a fundamental right of long-term shareowners. Proxy access gives shareowners a meaningful voice in board elections. Without effective proxy access, the director election process at many companies simply offers little more than a ratification of management's slate of nominees.

Our member-approved policy on proxy access states, in part:

> Companies should provide access to management proxy materials for a long-term investor or group of long-term investors owning in aggregate at least 3% of a company's voting stock, to nominate less than a majority of the directors. Eligible investors must have owned the stock for at least two years.[50]

We also generally support an approach to proxy access similar to the one that the SEC adopted in 2010 but was later vacated after a court challenge. Now, more than 400 U.S. public companies have adopted proxy access in a form generally consistent with our policy.[51] That includes 11% of the Russell 3000, constituting more than half of the index's total market capitalization, and about half of the S&P 500.[52]

The companies that implemented proxy access are from a variety of industries. They include Intercontinental Exchange (the parent company of the New York Stock Exchange), Apple, United Airlines, CarMax, JPMorgan Chase and Apache.

Relying on private ordering rather than a uniform approach envisaged by the SEC in 2010 has led to myriad versions of proxy access, at greater legal expense than with a uniform rule, and with the potential for various creative provisions that seem aimed at making it difficult for shareowners to use the mechanism.[53] Given the clear growing trend of public companies adopting proxy access, and the increasing complexity and related costs resulting from the current private ordering process, there may soon come a time when companies and their shareowners will favor a more uniform, less costly set of standards and requirements for proxy access. If that

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[50] § 3.2 Access to Proxy.
[51] CII, Proxy Access by Private Ordering (Feb. 2017), *available at* http://www.cii.org/files/publications/misc/02_02_17_proxy_access_private_ordering_final.pdf.
[52] *Id.*
[53] *See id.* at 10.

time should arrive, Section 971 would facilitate the SEC's ability to respond with rule-making in a more cost-effective manner.

Private Equity

CII opposes Section 858 of the Act because it would remove transparency in private equity by requiring the SEC to exempt advisors to private equity funds from registration and reporting.

We continue to agree with the 2009 recommendation of the Investor Working Group that all investment managers of funds available to U.S. investors, including private equity funds, should be required to register with the SEC as investment advisers and be subject to oversight and disclosure requirements.[54] As has been widely reported, the existing registration and reporting requirements for advisers to private equity funds has led "firms such as KKR, Blackstone and Apollo Global Management LLC Group to [pay] . . . tens of millions in fines . . . after SEC examinations uncovered what regulators said were insufficient disclosures of some fee and expense practices to clients."[55] We believe that the Act's provisions to eliminate registration and reporting requirements for advisors to private equity funds would harm the SEC's investor protection efforts, disadvantage fund managers that currently follow best practices, as well as expose long-term investors and all taxpayers to potentially greater financial stability risks.[56]

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Thank you for considering our initial views on the Act. We would be very happy to discuss our perspective on these and other issues with you or your staff at your convenience. I am available at jeff@cii.org or by telephone at (202) 822-0800.

Sincerely,

Jeff Mahoney

Jeffrey P. Mahoney
General Counsel

[54] Investors Working Group at 16 ("All investment advisers and brokers offering investment advice should have to meet uniform registration requirements, regardless of the amount of assets under management, the type of product they offer or the sophistication of investors they serve[] [e]xemptions from registration should not be permitted").
[55] *See, e.g.,* Melissa Mittelman, Private Equity Eyes Tax and Financial Reform in the Trump Era, Bloomberg, Jan. 19, 2017, at 3, *available at* https://www.bloomberg.com/news/articles/2017-01-19/with-close-trump-ties-private-equity-eyes-tax-financial-reform.
[56] *See, e.g.,* Letter from Jeffrey P. Mahoney, General Counsel, Council of Institutional Investors, to The Honorable Paul D. Ryan, Speaker, United States House of Representatives et al. 1-2 (Sept. 7, 2016) (opposing proposed legislation that would roll back transparency and reporting requirements for private equity funds because it would inhibit the ability to monitor systemic risk and protect investors), *available at* www.cii.org/files/issues_and_advocacy/correspondence/2016/Sept%207%202016%20Letter%20to%20Speaker%20regarding%20H%20R%20%205424%20(003).docx%20(final).pdf.

Fair Arbitration Now

April 25, 2017

Chairman Jeb Hensarling
House Financial Services Committee
U.S. House of Representatives
Washington, D.C. 20515

Ranking Member Maxine Waters
House Financial Services Committee
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Hensarling and Ranking Member Waters:

Fair Arbitration Now, a network of more than 70 consumer, labor, legal and community organizations, write to strongly oppose Financial CHOICE Act of 2017. While much of the legislation would undo critical protections instituted in response to the 2008 financial crisis, we specifically oppose provisions – Sections 738 and 857 – aimed at repealing the fundamental rights of everyday consumers and investors. Contrary to its title, H.R. 5983 would deprive ordinary consumers and investors of their choice on how to resolve serious disputes with powerful financial institutions.

For too long, consumers and investors in the marketplace have been restricted by terms in the fine-print contracts of consumer financial services, brokerage and investment advice, and employment contracts that deny them the ability to go to court to challenge misbehavior. Instead, the nonnegotiable corporate contracts require individuals to resolve disputes often on an individual basis, in private arbitration proceedings, which, as a tremendous amount of evidence shows,[1] are set up to favor corporations at the expense of ordinary people.

The Great Recession of 2007-2008 highlighted the harm of financial deregulation and the absence of corporate accountability in the financial system. The resulting recklessness caused significant damage in the form of lost jobs, foreclosures, and massive corporate bailouts, and reverberated throughout the economy for years. Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) to reform the financial system and increase accountability in the markets. Indeed, important provisions in the Dodd-Frank Act recognized that the overall goal of improving corporate behavior depended on the ability of individual homeowners, consumers, investors and whistleblowers to enforce their rights in court when they were harmed by predatory conduct.

[1] See. e.g., Consumer Financial Protection Bureau, *Arbitration Study Report to Congress, pursuant to Dodd-Frank Wall Street Reform and Consumer Protection Act § 1028(a)*, March 2015.

For example, the Dodd-Frank Act prohibited forced arbitration clauses outright in residential mortgages and lines of credit as well as for whistleblower claims under the Sarbanes-Oxley Act of 2002. It ensured that grievances related to these financial sectors could be heard in court. In addition, the statute specifically authorized regulators to examine the market and restrict forced arbitration in the interest of ordinary Americans.

Section 1028 required the Consumer Financial Protection Bureau to study the use of forced arbitration terms in consumer financial products or services and explicitly authorized the bureau by regulation to "prohibit or impose conditions or limitations" on the use of forced arbitration clauses if it finds it in the public interest and for the protection of consumers. Not only is the bureau's authority under this section indisputable, the agency has spent valuable time and resources to fulfill its mission pursuant to this provision. It released a data-driven study that demonstrated widespread use and impact of forced arbitration on the marketplace. The evidence showed that the court system is a critical tool to encourage corporate responsibility and also to reimburse consumers for losses caused by corporate transgressions. The bureau relied on meticulous information gathering and its explicit authority to propose a rule that would restore consumers' ability to band together when they are similarly harmed by financial misconduct. Our organizations strongly support this rulemaking.

Similar to the CFPB's authority, section 921 of the Dodd-Frank Act authorizes the Securities and Exchange Commission to prohibit or limit the use of forced arbitration clauses in contracts that investors enter into with broker-dealers and investment advisors, if doing so is in the public interest and for investors' protection. Forced arbitration is prevalent in the securities sector, forcing investors to surrender their ability to seek redress in court as a condition to receiving brokerage and other financial services. Brokerage firms were responsible for many fraudulent actions that led to or arose from the financial crisis. Ensuring that investors can choose the forum in which to resolve disputes with broker- dealers and investment advisors is critical to deterring future misconduct. The SEC has not exercised its authority under this provision at this time, but it should not be blocked from doing so.

The Dodd-Frank Act permits the SEC and CFPB to provide basic fairness by ensuring that consumers and investors enter arbitration voluntarily, after disputes arise. Voluntariness ensures that one party can't force a secret, biased arbitration process on the other. The agencies alone cannot combat the malfeasance that can run rampant at the hands of insatiable financial institutions. Private enforcement is integral for protecting the integrity of the marketplace.

The recent Wells Fargo scandal demonstrates the very real harm caused by forced arbitration, as well as the danger it poses to our financial system. Reports show that Wells Fargo customers had been trying to sue over fraudulent accounts since at least 2013, but the bank concealed its misconduct from the public and its investors by forcing these claims into secret arbitration. Even now that the bank's widespread fraud has been exposed, Wells Fargo continues to invoke forced arbitration clauses to deny justice to millions of consumers. This behavior is particularly galling, as the bank is relying on arbitration clauses in its customers' legitimate account contracts to block them from seeking redress over fraudulent accounts. The proposed rule from the CFPB to restrict forced arbitration would help prevent exactly this type of misconduct and subsequent denial of justice.

This bill would prevent these federal agencies from acting in the public interest to enact rules that would restore the rights of consumers and investors to hold financial companies accountable. Further, this proposal would undermine the fundamental purpose of Wall Street reform by aiding and abetting reckless corporate behavior like that of Wells Fargo. We urge you to reject this legislation. Thank you for considering our views.

If you have any questions or concerns, please contact Christine Hines, National Association of Consumer Advocates, christine@consumeradvocates.org or Amanda Werner, Americans for Financial Reform and Public Citizen, awerner@ourfinancialsecurity.org.

Sincerely,

Fair Arbitration Now (Organizations that support ending the predatory practice of forced arbitration in consumer and non-bargaining employment contracts: http://www.fairarbitrationnow.org/coalition/).

Friends Fiduciary

ADDING VALUES TO STRONG PERFORMANCE.

DELIVERY VIA ELECTRONIC MAIL

April 25, 2017

Dear Chairman Hensarling and Ranking Member Waters,

I am writing in response to the House Financial Services Committee consideration of legislation that would effectively stop shareholders from engaging corporations through the shareholder proposal process. On behalf of Friends Fiduciary, I am asking you to oppose any attempt to limit the current shareholder proposal rule, as contemplated by Chairman Hensarling in Section 844 of the Discussion Draft of the Financial CHOICE Act.[1] The existing shareholder proposal process under Securities and Exchange Commission rule 14a-8 is well functioning - it should not be changed as proposed in Section 844.

Friends Fiduciary Corporation manages $400 million in assets for more than 360 Quaker meetings, churches and organizations across the country. Our investment philosophy and process is grounded in the beliefs of the Religious Society of Friends (Quakers), among them the testimonies of peace, simplicity, integrity, equality, and justice. We are long term investors and take our responsibility as shareholders seriously. When we engage with companies we own, we seek to witness to the values and beliefs of Quakers as well as to protect and enhance the long-term value of our investments. We file shareholder proposals on crucial environmental, social, and governance issues from a unique position as an outsider stakeholder with a long-term business perspective, and consider our ability to file a crucial aspect of responsibly owning our shares.

While we are deeply concerned about a number of parts of the Discussion Draft of the Financial CHOICE Act and will be sharing those concerns later, for the time being we want to express our concerns on Section 844. Section 844 changes the SEC shareholder proposal by (1) changing the holding requirement to 1% ownership over a three year period (vs. 1% or $2000 for one year) to submit a proposal; (2) dramatically increasing resubmission thresholds to unreasonable levels; and (3) prohibiting proposal by a proxy other than the shareholder.

As investors, we are adamantly opposed to these recommendations that would interfere with shareholder rights. For over 45 years the shareholder proposal process has served as a cost effective way for corporate management and boards to gain a better understanding

[1] https://financialservices.house.gov/uploadedfiles/choice_2.0_discussion_draft.pdf

of shareholder priorities and concerns. For an overview of some of the issues considered in shareholder proposals this year, I refer you to the ICCR Proxy Book.

Below are several benefits of the current shareholder proposal rule:

- **Facilitates communication between shareholders and companies.** It provides shareholders of all types and sizes, from large pension funds to individual investors, an opportunity to communicate directly with corporate boards and management on issues of importance. Resolutions that are not withdrawn can be voted on by all holders of voting stock – giving the board and management input far beyond that of the shareholder(s) who initially filed the resolution.

- **Shareholder value and financial performance.** Over the years, the shareholder proposal process has contributed to many reforms that protect and enhance shareholder value, both at specific companies and in many cases to the benefit of the entire corporate and shareholder community. A 2015 study found that successful shareholder engagements can generate cumulative excess returns of +7.1%.[2] In another example, a 2012 and 2014 Credit Suisse Research Report "Gender Diversity and Corporate Performance", links board diversity – an issue that has been raised through dozens of shareholder proposals – to better stock market and financial performance (higher return on equity, lower leverage, and higher price/book ratios).[3]

- **Protects shareholder rights.** The right to file a proposal is part of the bundle of rights that an investor acquires when acquiring shares. Radically curtailing those rights and taking away this process through which investors can bring concerns to management's attention would undermine investor confidence in the stability of our arrangement of rights associated with share ownership. All trustees and fiduciaries have a duty to monitor risk, many extend that duty to filing proposals when necessary to probe risks and potential weaknesses, as well as improve performance.

It is clear that Section 844 is an overreach, representing radical and dramatic interference with an important shareholder right:

- 1% ownership over a three year period to submit a proposal: This would require an investor in Wells Fargo to own $2.5 billion in shares in order to file a proposal. Only 11 investors have held those shares long enough: Berkshire Hathaway, Vanguard, State Street, BlackRock, Fidelity, Capital Research & Management, Wellington, JPMorgan, Dodge & Cox, Northern Trust, and State Street. Those investors do not file shareholder proposals at all, let alone shareholder proposals that have been filed at Wells Fargo on matters such as customer fraud, independent board chairman, proxy access, and irregularities in mortgage

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[2] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2154724

[3] https://www.credit-suisse.com/us/en/articles/articles/news-and-expertise/2015/06/en/diveristy-on-board.html

practices. The language in the discussion draft effectively kills any ability of shareholders to file proposals on these important issues. Improvements in business are driven by the marketplace of ideas, and minority shareholders are also important stakeholders.

- Increase resubmission thresholds consistent with previous SEC proposal: This would mean resubmission thresholds of 6% (year 1, from 3%); 15% (year 2, from 6%); and 30% (year 3, from 10%). From 2007 through 2009 only about 17 percent of the proposals that came to a vote achieved the support of 30 percent of the shares voted, and from 2010 onwards, this has been approximately 30 percent of proposals filed.[4] This amendment would negatively impact shareholder re-filing of proposals on new and emerging issues. Change does not come quickly to large and complex corporations and ideas often require years of consideration before they are accepted. Take for example the issue of declassified boards where directors stand for election each year – support of shareholder proposals on this issue was regularly below 10% in 1987 and below 30% for many years, but eventually grew to 81% in 2012. With 15% and 30% resubmission thresholds these proposals would have died long before they had the chance to be adopted. Declassified boards are now common practice, with two-thirds of S&P 500 companies holding annual votes, up from 40% 10 years ago.

- Prohibit proposal by a proxy other than the shareholder: Investors have a fundamental right to empower their representatives to act on their behalf and the proxy is a basic mechanism for well-functioning corporate governance.

To learn more about this issue, I refer you to a letter from organizations representing $65 trillion in opposition to these proposals and an in-depth briefing document. I am happy to speak about this at your convenience and can provide additional details on the impact of shareholder proposals. I urge you to oppose this attempt to limit shareholder rights.

Sincerely,

Jeffery W. Perkins
Executive Director

cc: Jason Powell, Legislative Director
Kyle Jackson, Deputy Chief of Staff, Legislative Director
Katelynn Bradley, Senior Counsel, House Committee on Financial Services

[4] Report on US Sustainable, Responsible and Impact Investing Trends, 2016 - http://www.ussif.org/trends

**Rezaeerod, Paniz**

| | |
|---|---|
| **From:** | Jennie Kristel <jkristel61@hotmail.com> |
| **Sent:** | Wednesday, April 26, 2017 6:05 AM |
| **To:** | Bradley, Katelynn; Erickson, Kristofor |
| **Subject:** | Don't Legislate Against Shareholder Democracy |

Dear Ranking Member Waters
I am writing in response to a section of the discussion draft Financial CHOICE Act that the House Financial Services Committee is currently considering. Section 844 would effectively eliminate fundamental rights of investors to file shareholder proposals. I urge you to defend the rights of investors by opposing inclusion of section 844 in the Choice Act, or otherwise ensuring that it does not modify or limit the Securities and Exchange Commission's shareholder proposal rule, SEC Rule 14a-8.
My investment advisor has advised me that the legislation being considered by Congress would fundamentally impair my rights as an investor. In particular, the legislation would interfere with the ability of my investment advisors and mutual funds to implement my investment goals, by eliminating the ability to engage with directors, managers and other shareholders through the shareholder proposal process.
Section 844 would effectively eliminate the ability of most shareholders to file proposals for the annual corporate ballot. This is a fundamental right, especially for minority shareholders who need to make their voices heard, especially when the management is ignoring significant governance failures or environmental or social risks. The proposed language would effectively shut me out, as the ability to file a shareholder proposal rule go from being a right common to all shareholders, to one only available to the wealthiest 1% of investors. would also prevent my financial advisors and representatives from filing proposals on my behalf.
Such legislation would upset 70 years of SEC rulemaking and deliberations that have shaped this well-functioning corporate governance process. To undermine these rights of shareholder democracy under legislation that purports to promote "Financial Choice" would be a special travesty.
You should know that it is not so easy for a shareholder to file a proposal. For instance, the SEC's extensive rules already block proposals that would micromanage a company, as well as proposals promoting a personal grievance.
The ultimate test of any proposal support in the marketplace of ideas, as reflected by the corporate ballot. If my ideas persuade other investors to vote in favor, that is a perfect test of whether the idea merits continued attention and debate. Congress should not enact provisions making it harder to *resubmit* a proposal either. The existing thresholds are working well.
The quality of ideas in shareholder proposals, and their ultimate contribution to value, does not correlate with the size of the stock positions held by proponents. Experience shows that in the absence of the right to file a shareholder proposal, minority shareholders may be ignored, and companies will act as if they are "too big to listen."
As a shareholder, I am a long-term owner of the holdings in my portfolio. If Congress alters investors' limited rights, it will undermine confidence in the stability of our rights as shareholders, and therefore discourage investment.
I would be pleased to discuss this issue at your convenience. I urge you to oppose any attempt to legislatively alter the SEC's shareholder proposal rule (Rule 14a-8).

ncerely,

Jennie Kristel

*Please be advised that the confidentiality of this communication cannot be guaranteed since it is transmitted electronically.*

,ennie Kristel, MA, REAT, RMT APTT
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**The Leadership Conference on Civil and Human Rights**

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The Leadership Conference

April 25, 2017

**Oppose the "Financial CHOICE Act of 2017"**

Dear Financial Services Committee Member:

On behalf of The Leadership Conference on Civil and Human Rights, a coalition of more than 200 national advocacy organizations, we write to express our strong opposition to the "Financial CHOICE Act of 2017." This bill is nothing more than a repackaging of the Committee's efforts over the past six years to deregulate the financial services industry, enable payday lending and other predatory services, and unlearn the lessons of the 2008 financial crisis.

The Leadership Conference sees no need to catalogue all the reasons why this is such a profoundly misguided bill. We have weighed in on many of its pieces as they have come up in standalone legislation in recent years – particularly this committee's efforts to undercut many of the pro-consumer rules and policies issued by the Consumer Financial Protection Bureau (CFPB) and to undermine the independence of the CFPB itself. In the five years since the CFPB opened its doors, it has worked tirelessly to put an end to the "anything goes" mortgage lending that marked the previous decade, racial discrimination in auto lending markups, sneaky credit card add-ons, and many other deceptive and abusive practices, while also promoting consumer education and the growth of more inclusive financial technology. Our position on any effort to roll back this progress is the same, regardless of whether it is done piecemeal or lumped into one comprehensive bill.

It speaks volumes that not a single industry representative is scheduled to appear in this week's hearing to defend, in an open forum, the provisions in this bill. The planned markup of this bill in less than a week after the hearing is also telling. We can understand if the Committee is rushing the process to avoid public scrutiny: the markup last fall of a largely identical bill came only five days after the CFPB's biggest success story to date, in which it concluded a years-long investigation into fraudulent consumer account practices by one of the nation's largest banks and collected $100 million in fines for the CFPB Civil Penalty Fund. Yet if this Committee is so concerned with political optics, perhaps it could show an interest in more financial services oversight and enforcement, not less.

We urge you to reject this bill. If you have any questions, please contact either of us or Senior Counsel Rob Randhava at (202) 466-3311.

Sincerely,

Wade Henderson
President & CEO

Nancy Zirkin
Executive Vice President

NACA

National Association of Consumer Advocates

April 25, 2017

U.S. House of Representatives
Financial Services Committee
Washington, DC 20515

Chairman Jeb Hensarling, Ranking Member Maxine Waters, and Committee Members:

The National Association of Consumer Advocates (NACA) is a nonprofit association whose members are private and public sector attorneys, legal services attorneys, law professors, and law students committed to representing consumers' interests. NACA is actively engaged in promoting a fair and open marketplace that forcefully protects the rights of consumers, particularly those of modest means. For the hearing scheduled on April 26, 2017 to discuss legislation titled "Financial CHOICE Act of 2017," we write to urge you to reject this dreadful proposal.

The legislation, broad in breadth and scope, unabashedly seeks to dismantle the Dodd-Frank Wall Street Reform and Consumer Protection Act, the law passed to remedy flaws in the U.S. economic system that led to the 2008 Great Depression and the loss of homes, jobs, businesses and economic security for millions of Americans. In particular, you must reject the dangerous sections of the bill that aim to sabotage the work and mission of the Consumer Financial Protection Bureau (CFPB).

Since it opened its doors six years ago, the CFPB has utilized its powers and authority to bring about fairness in a marketplace that had been almost toppled during the financial crisis by sheer recklessness and greed by financial institutions, lack of oversight from public officials, and subsequent lack of accountability for the harm it all caused. The CFPB's efforts have included rigorous collection and analysis of data about financial products, services and practices; supervision and examination of financial services providers and their systemic conduct; clear guidelines and standards formalizing appropriate protections for consumers; and enforcement actions against financial institutions engaged in practices that deceive, cheat or rip off their customers.

The bureau has identified and addressed some of the worst unfair, abusive and deceptive practices in debt collection, credit reporting, student loans, payday loans, back accounts, and other products and services. Its work has resulted in billions of dollars returned to consumers and consequential changes and improvements to industry practices. Yet, the proposal brought before this committee would upend the far-reaching progress that has resulted from the Dodd-Frank reforms. The financial marketplace will quickly return to a dark period when consumers were significantly more vulnerable to predatory financial schemes and institutions were shielded from being held responsible for their destructive actions.

Among others, NACA strongly objects to provisions in the proposal that would:

• Eliminate the CFPB's authority to issue a rule on the use of forced arbitration in consumer financial services contracts. [Sec. 738]
• Eliminate the authority of the Securities and Exchange Commission to issue a rule to prohibit brokers and financial advisors from using forced arbitration clauses in contracts with investor-customers. [Sec. 857]
• Weaken CFPB's complaint database and prevent publication of consumer complaints against financial institutions.
• Remove the CFPB's authority to tackle unfair, deceptive, or abusive acts and practices in the marketplace. [Sec. 736]
• Interfere with the CFPB and other federal regulators' funding by making them subject to the congressional appropriations process. [Sec. 713]
• Remove the CFPB's authority to curb the worst practices in payday lending. [Sec. 733]
• Eliminate CFPB guidance to stop discrimination in auto lending. [Sec. 734]
• Eliminate the CFPB's supervisory authority to properly monitor financial institutions' conduct and systemic practices that ultimately have a profound impact on the economy and consumers' financial welfare. [Sec. 727]
• Obstruct the CFPB's ability to enforce critical consumer protection laws. [e.g. Sec. 715]
• Obstruct the CFPB's ability to consider and issue appropriate rules and standards for the financial marketplace. [Sec. 313, 717 et al]
• Rename the CFPB to the "Consumer Law Enforcement Agency," directly attacking the main purpose for which the agency was created: consumer protection. [Sec. 711]

For the above reasons, we urge you to reject this bill. Thank you for considering our views. For more information, please contact me at Christine@consumeradvocates.org or (202) 452-1989.

Sincerely,

Christine Hines
Legislative Director
National Association of Consumer Advocates

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April 26, 2017

Representative
Committee on Financial Services
U.S. House of Representatives
Washington, DC 20515

Re: CHOICE Act of 2017 (oppose)

Dear Representative,

The National Consumer Law Center, on behalf of its low income clients, writes to express our strong opposition to the "Financial CHOICE Act of 2017." This bill is more accurately titled the "Wrong CHOICE Act." The bill appears to have been written by a team of lawbreakers and predatory lenders putting together their wish list of how to undo consumer protections. Even by the standards of other anti-consumer protection legislation, this bill is breathtaking in its assault on ordinary Americans, responsible companies who want a level playing field, and safeguards for the economy as a whole.

In this letter, we will touch briefly on many (but not all) of the provisions that directly attack consumer protections and the Consumer Financial Protection Bureau. We join in the letter by Americans for Financial Reform in opposing other provisions that gut the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, thus exposing consumers, investors and the economy to far greater risk of abuses, instability and another financial crisis.

The financial crisis of 2008 cost from $6 to $14 trillion in lost economic output alone.[1] That enormous figure underestimates the full toll on millions of families who lost their jobs or homes due to the crisis.[2] Lax regulation and oversight led to the financial crisis, and the bill would undo essential reforms adopted to prevent shoddy financial practices from returning. Indeed, the bill would weaken regulatory powers that long pre-date Dodd-Frank, making financial regulation significantly weaker than it was even in the years leading up to the 2008 crisis.

[1] United States Government Accountability Office, "Financial Regulatory Reform: Financial Crisis Losses and The Potential Impact of the Dodd-Frank Act", GAO 13-180, January 2013. Luttrell, David, Tyler Atkinson and Harvey Rosenblum, "How Bad Was It? The Costs and Consequences of the 2007-2009 Financial Crisis and Its Aftermath", Federal Reserve Bank of Dallas Staff Paper No, 20, July, 2013.

[2] Americans for Financial Reform, "Costs of the Crisis," Briefing Paper, Updated July 2015.

Any claim that the Dodd-Frank Act and overregulation are harming our economy is baseless.[3] Commercial bank loan growth has been almost 6 percent over the past three years, well above the historical average of 4 percent.[4] Community banks are doing well, with faster loan growth than larger banks.[5] Wall Street has also thrived since the passage of the Dodd-Frank Act.

The risk of harm from deregulation far outweighs any purported benefits. Below we briefly address some of the more alarming provisions of the CHOICE Act.

***The CHOICE Act Eviscerates the Consumer Financial Protection Bureau's Ability to Protect Consumers and Stop Abusive Financial Practices.***

The bill makes numerous changes that eliminate core powers of the CFPB. Currently, the CFPB appropriate has a range of different tools that it can use to uncover and address problems in financial services. The bill would make it much harder for the CFPB to spot problems in the first place or to address them appropriately. The legislation:

**Eliminates the CFPB's Supervision and Enforcement Authority for Large Banks.**[6] Problems in the mortgage market were quite apparent before the financial crisis. But bank regulators without a focus on consumer protection ignored those warning signs because bank profits were doing well. The bill would end the CFPB's ability to examine or enforce the law against large banks and return that authority to agencies that failed to use it effectively in the past.[7] Problems continue today. Just one example is the recent internal report by the OCC on its dramatic failures in examining Wells Fargo in the many years before the CFPB and the Los

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[3] Americans for Financial Reform, *Dodd-Frank And Economic Growth*, Fact Sheet, January 2017. Available at http://ourfinancialsecurity.org/wp-content/uploads/2017/01/Dodd-Frank-and-Economic-Growth-Final.pdf

[4] Americans for Financial Reform analysis of total loans and leases in bank credit, deflated using Implicit Price Deflator for Gross Domestic Product. Long run average calculated using all data available since 1973. Source Federal Reserve Board Release H.8, Assets and Liabilities of Commercial Banks In The United States. Available at https://fred.stlouisfed.org/series/TOTLL; GDP deflator U.S. Bureau of Economic Analysis. Available at https://fred.stlouisfed.org/series/GDPDEF/

[5] Federal Deposit Insurance Commission, "Quarterly Banking Profile", Various Dates, https://www.fdic.gov/bank/analytical/qbp/.

[6] Section 727(a)(5) & 727(a)(6) of Discussion Draft of Financial CHOICE Act of 2017 ("Discussion Draft"), https://financialservices.house.gov/uploadedfiles/choice_2.0_discussion_draft.pdf.

[7] *See, e.g.,* Testimony of Lauren Saunders, National Consumer Law Center, On behalf Americans for Financial Reform et al. Before the Subcommittee on Monetary Policy, Committee on Financial Services, U.S. House of Representatives, Hearing on Regulatory Restructuring: Safeguarding Consumer Protection and the Role of the Federal Reserve (July 16, 2009), https://www.nclc.org/images/pdf/regulatory_reform/testimony-safeguarding-cons-protection.pdf.

Angeles City Attorney took action against the bank for opening some 2 million fake accounts.[8]

**Blocks CFPB Supervision of Large and Growing Nonbanks and Others that Cause New Problems.**[9] The bill freezes the CFPB's authority to examine nonbank financial companies to those it currently examines. This provision has two harmful impacts. First, a credit reporting agency, debt collector, student loan servicer, remittance provider, or auto lender that is small today but grows in size will never be examined, even if its similarly sized competitors are subject to supervision. Second, the CFPB will not be able to identify new markets that need closer supervision, such as the debt settlement market – long a hotbed of fraud – or the installment loan market, which is growing in importance and presents many new problems. Examination is a critical tool that enables the CFPB to identify and address problems before they rise to the point that an enforcement action is warranted.

**Repeals CFPB Authority To Stop Unfair, Deceptive, and Abusive Acts and Practices (UDAAP).**[10] The bill eliminates the ban on *abusive* acts and practices. The CFPB has used that authority to stop firms from targeting 9/11 heroes and depriving them of millions of dollars in compensation funds for their injuries,[11] to prohibit Wells Fargo from opening fake accounts in their customers' names,[12] to stop lenders from making false threats in debt collection[13] or pushing people into new loans they cannot afford to repay,[14] and to require refunds to consumers tricked into paying for worthless credit card add-on services and fake protections.[15]

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[8] Office of the Comptroller of the Currency, "Lessons Learned: Review of Supervision of Sales Practices at Wells Fargo," Enterprise Governance Supervision, April 19, 2017. Available at https://www.occ.gov/publications/publications-by-type/other-publications-reports/pub-wells-fargo-supervision-lessons-learned-41917.pdf.

[9] Section 727(a)(4), Discussion Draft.

[10] Section 736, Discussion Draft.

[11] CFPB, Press Release, "CFPB and New York Attorney General Sue RD Legal for Scamming 9/11 Heroes Out of Millions of Dollars in Compensation Funds" (Feb. 7, 2017), https://www.consumerfinance.gov/about-us/newsroom/cfpb-and-new-york-attorney-general-sue-rd-legal-scamming-911-heroes-out-millions-dollars-compensation-funds/.

[12] Summary and legal documents available at https://www.consumerfinance.gov/about-us/newsroom/consumer-financial-protection-bureau-fines-wells-fargo-100-million-widespread-illegal-practice-secretly-opening-unauthorized-accounts/

[13] *See, e.g.,* summary and legal documents available at https://www.consumerfinance.gov/about-us/newsroom/cfpb-orders-navy-federal-credit-union-pay-285-million-improper-debt-collection-actions/.

[14] CFPB, Press Release, "CFPB Takes Action Against ACE Cash Express for Pushing Payday Borrowers Into Cycle of Debt" (July 10, 2014), https://www.consumerfinance.gov/about-us/newsroom/cfpb-takes-action-against-ace-cash-express-for-pushing-payday-borrowers-into-cycle-of-debt/.

[15] Summaries and legal documents available at https://www.consumerfinance.gov/about-us/newsroom/cfpb-orders-bank-of-america-to-pay-727-million-in-consumer-relief-for-illegal-credit-card-practices/; https://www.consumerfinance.gov/about-us/newsroom/cfpb-orders-citibank-to-pay-700-million-in-consumer-relief-for-illegal-credit-card-practices/; https://www.consumerfinance.gov/about-us/newsroom/cfpb-orders-chase-and-jpmorgan-chase-to-pay-309-million-refund-for-illegal-credit-card-practices/.

The bill strips the CFPB of the power to take enforcement actions against unfair or deceptive practices or to write rules to define or prevent those practices. UDAAP authority is especially important to address new problems that are not addressed in older regulations.[16] No agency would have the authority to write rules to give banks clarity on what practices are unfair or deceptive, and that is largely true for nonbanks as well, as the FTC has unworkable rulewriting powers.[17] This would leave important areas of consumer protection, such as first-party debt collection by non-banks (i.e., collection by payday lenders and other creditors themselves), without comprehensive and uniform rules.

**Ends the CFPB's independence.** The bill would end the CFPB's status as an independent agency, allowing the President to fire the Director without cause,[18] making the CFPB hesitant to protect consumers from powerful interests. It would also specifically require CFPB rules – unlike the rules of the other independent banking agencies – to be reviewed by non-experts in the White House, directly politicizing consumer financial protection.[19]

**Gives politicians more control through appropriations.** The CFPB's funding would be subject to the appropriations process,[20]increasing lobbyist power by giving Congress the ability to threaten funding or to attach policy riders if their donors are unhappy.

**Creates new bureaucracy and eliminates useful functions.** The bill would create a new, unnecessary, duplicative bureaucracy within the agency,[21] while eliminating the CFPB's market monitoring functions that allow it to gather information and base its actions on responsible data collection.[22] The bill would also threaten the advisory boards that help the Bureau's work be informed by consumer advocates, academics, community banks, and credit unions.[23]

**Slashes CFPB employee salaries below those of all other federal financial regulators**.[24] This

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[16] Carolyn Carter, NCLC, Consumer Protection in the States: A 50-State Report on Unfair and Deceptive Acts and Practices Statutes (Feb. 2009), https://www.nclc.org/images/pdf/udap/report_50_states.pdf.

[17] For a description of the requirements that apply to the FTC and their effects, see AFR Letter Opposing HR 5112, May 20, 2016. Available at http://ourfinancialsecurity.org/wp-content/uploads/2016/05/OppoLetterHR5112-5-12-16-1.pdf.

[18] Section 711(a)(1)(D), Discussion Draft.

[19] Section 712, Discussion Draft.

[20] Section 713, Discussion Draft.

[21] Section 717, Discussion Draft (establishing an Office of Economic Analysis). For a detailed discussion of these harmful provisions, see Letter to Congress: AFR Opposes H.R. 5211, Legislation to Weaken the CFPB (June 21, 2016), http://ourfinancialsecurity.org/2016/06/letter-congress-afr-opposes-hr-5211-legislation-weaken-cfpb/.

[22] Section 724, Discussion Draft.

[23] Section 726, Discussion Draft.

[24] Section 723, Discussion Draft.

would undermine the agency's capacity to attract and retain highly-qualified financial professionals and give consumer protection a second class status.

**Eliminates both enforcement and rulewriting jurisdiction over payday and title loans and expands usurious lending.**[25] One of the most predatory financial markets would be completely outside the CFPB's authority. To make matters worse, the bill makes it easier for lenders to use rent-a-bank arrangements to make 300% APR loans that evade state interest rate caps.[26]

**Blocks a rule on forced arbitration clauses.**[27] Wells Fargo has been using forced arbitration clauses with class action bans to stop a court from addressing all of the harm of the 2 million fake accounts it created. The CFPB would be barred from finalizing a rule that would provide access to justice for victims of widespread wrongdoing.

**Keeps the public in the dark about consumer complaints.**[28] The CFPB could not reveal information about the complaints it has received, eliminating an important public resource for understanding and avoiding consumer abuses.

**Undermines enforcement of anti-discrimination laws:**

- The bill seeks to stall the CFPB's enforcement of anti-discrimination laws in the auto industry, thereby allowing racial discrimination in auto lending to go unchecked.[29]
- The bill would scale back data collection under the Home Mortgage Database Act, weakening a critical tool to fight redlining.[30]
- The bill would abandon the effort required by Dodd-Frank to learn more about small business lending through systematic data collection,[31] undermining enforcement of the Equal Credit Opportunity Act and missing a badly needed opportunity to better understand the small business lending market and help small businesses access credit.

These provisions would leave the CFPB powerless to protect consumers.

[25] Section 733, Discussion Draft.

[26] Section 581, Discussion Draft.

[27] Section 738, Discussion Draft. *See also* Letter to Congress: Reject Proposals That Interfere with CPFB's Authority on Mandatory Arbitration (May 19, 2016) (AFR and 70 organizations), http://ourfinancialsecurity.org/2016/05/letter-congress-2-2/.

[28] Section 725, Discussion Draft.

[29] Section 734, Discussion Draft. *See also* Letter to Congress: AFR, 65 Organizations Urge Congress to Stand Against Discriminatory Auto Lending and Reject HR 1737 (Nov. 16, 2015), http://ourfinancialsecurity.org/2015/11/letter-to-congress-afr-65-organizations-urge-congress-to-stand-against-discriminatory-auto-lending-and-reject-hr-1737/.

[30] Section 576, Discussion Draft.

[31] Section 561, Discussion Draft.

***The CHOICE Act Makes it More Difficult for Any Financial Regulator to Protect the Public.***

The CHOICE Act contains a set of drastic new bureaucratic analytic, legislative, and legal requirements for financial regulatory agencies that would add thousands of pages and months if not years to agency rulemakings, interpretations or even guidances. The bill would make it much easier for abusive industries to tie actions up in court and block them from ever going into effect. The new roadblocks to action include:

- Regulators complete dozens of additional analyses prior to issuing any new regulation, guidance, or interpretation. Required analyses include broad, vague, impossible and subjective mandates such as measuring all "direct and indirect" costs and benefits of a regulation and assessing "all available alternatives" to a regulation. The adequacy of any of these analyses could be challenged in court.[32]

- Congress must approve any major regulation, guidance or interpretation, or any rule for which measured quantitative benefits did not exceed measured quantitative costs.[33] This would vastly increase the delay and complication of regulatory action.

- Overturning longstanding precedent, courts need not defer to experts in regulatory agencies. Instead, judges with only legal training could second guess technical issues that an agency spent years studying with experts and extensive public input.[34]

These requirements would effectively halt any new rulemaking, interpretation, or guidance that was opposed by financial interests with the resources to mount a lawsuit or to lobby Congress.

***The CHOICE Act Eliminates Protections Against Unaffordable Mortgage Lending***

The CHOICE Act would deem most mortgages held in bank portfolios – including those originated by the largest Wall Street banks – to be "Qualified Mortgages" without requiring those loans to comply with the ability to repay protections adopted after the financial crisis, thus denying homeowners meaningful recourse.[35] This provision is based on the false premise that portfolio loans are inherently safe. Washington Mutual and Wachovia—two large regional banks—failed because of the significant losses in mortgage loans held in their own portfolios. The bill would further weaken protections against hidden fees and other traps by changing the calculation for determining Qualified Mortgage status and high-cost loan protections, making it

[32] Subtitle A of Title III, Discussion Draft; additional analytic requirements for banking agencies are included in Subtitle J of Title V, Discussion Draft.

[33] Subtitle B of Title III, Discussion Draft; Section 312(b)(4) in Subtitle A of Title III of Discussion Draft

[34] Subtitle C of Title III, Discussion Draft.

[35] Section 516, Discussion Draft. For a detailed discussion of this provision, see Letter to Congress: Oppose HR 1210, the "Portfolio Lending and Mortgage Access Act," July 27, 2015. Available at http://ourfinancialsecurity.org/wp-content/uploads/2015/07/Oppose-HR-1210-Barr-Portfolio-with-sign-ons-final-7.27.15.pdf.

easier for predatory mortgage loans to be made.[36] The bill also would subject vulnerable homeowners with higher-priced mortgages to deceptive mortgage marketing by allowing many lenders to exclude escrow payments from any loan held in portfolio for three years.[37]

Separately, the bill would also eliminate a wide range of consumer protections for home buyers who borrow to purchase manufactured housing, including by permitting higher interest rates in this market before basic consumer protections applied.[38] These loans are generally made to lower income people, and there is a record of both past and recent abuses in this market.[39]

The bill would also eliminate the independence of the Federal Housing Finance Agency, giving the White House direct control over the conservatorships of Fannie Mae and Freddie Mac, which finance nearly half of the home mortgages in the United States.

* * *

Overall, the Wrong CHOICE Act would take us back to the days when predatory lenders wreaked havoc on American families and destroyed our economy. The bill puts the interests of Wall Street banks and financial wrongdoers ahead of the American public. We urge you to reject this bill in its entirety.

Sincerely,

Lauren K. Saunders
Associate Director

[36] Section 506, Discussion Draft. For a detailed discussion of this provision, see Letter to Congress: Oppose HR 685, March 18, 2015. Available at http://ourfinancialsecurity.org/wp-content/uploads/2015/04/CRL-Oppose-H.R.-685-Mortgage-Choice-Act-3.18.15.pdf

[37] Section 531, Discussion Draft.

[38] Sections 501 & 502, Discussion Draft. For a detailed discussion of these provisions, see Joint Letter: AFR Joins 15 Organizations in Supporting Low Income Families, Opposing HR 650 (Feb. 26, 2015), http://ourfinancialsecurity.org/2015/02/joint-letter-afr-joins-15-organizations-in-supporting-low-income-families-opposing-hr-650/.

[39] Baker, Mike and Daniel Wagner, "The Mobile-Home Trap: How A Warren Buffet Empire Preys on the Poor," Seattle Times / Center for Public Integrity, April 2, 2015. Available at http://www.seattletimes.com/business/real-estate/the-mobile-home-trap-how-a-warren-buffett-empire-preys-on-the-poor/.

NEW YORK CITY COMPTROLLER
**SCOTT M. STRINGER**

# Statement of New York City Comptroller Scott M. Stringer on the April 19th Discussion Draft of the Financial CHOICE Act of 2017 (Act)

**New York, NY, April 25, 2017 –** As Comptroller for the City of New York, I am the chief investment advisor and custodian of assets of the five New York City Pension Funds (NYC Pension Funds) and a trustee of four of them.

The NYC Pension Funds are long-term shareowners of more than 3,000 U.S. public companies and are the fourth largest public pension system in the United States, with $170 billion in assets under management. Our funds have likely filed more than 1,000 shareholder proposals, almost certainly more than any other institutional investor in the world, with a record dating back 30 years.

Section 844 of the draft Act includes provisions that would dramatically change the shareholder proposal process, and block the ability of the NYC Pension Funds to submit shareholder proposals. Currently, under the U.S. Securities and Exchange Commission (SEC) Rule 14a-8, shareowners who own 1% or $2,000 worth of outstanding shares for at least one year can submit a single proposal to be included in a public company's proxy statement. Section 844(b) of the draft Act would eliminate the $2,000 threshold and require investors to hold a minimum of 1% of the issuer's voting securities over a three- year holding period.

The NYC Pension Funds have a proud record of engaging our portfolio companies on a broad range of environmental, social, and corporate governance issues, and thereby working to enhance long-term shareowner value, often through shareowner proposals. Despite being among the largest pension investors in the world, we rarely hold more than 0.5% of any individual company, and most often hold less. As a result, the Act, if enacted, would effectively prevent our funds entirely from participating in the shareholder proposal process.

Shareholder proposals have been an important tool for the NYC Pension Funds to prompt constructive engagement on specific concerns that benefit the investing public, both financially and socially. A few of our most recent and most impactful efforts directly resulting from our shareholder proposals include the following:

In 2014, we launched the Boardroom Accountability Project—an effort to enact proxy access on a company-by-company basis in the U.S. market. At the time, just a handful of U.S. companies had proxy access bylaws, which allow shareowners to nominate one or more directors to a company's board of directors, and require the company to list those nominees on the company's proxy voting card. Today more than 400 companies, including 58% of the S&P 500, have proxy access bylaws. A July 2015 study by economic researchers at the SEC analyzed the public launch of the Boardroom Accountability Project and found a 0.5% average increase in shareowner value at the targeted firms. The findings were consistent with the 2014 CFA Institute study that found that proxy access on a market-wide basis has the potential to raise U.S. market capitalization by as much as 1%, or $140 billion.

The NYC Pension Funds for many years have fought for strong policies to enable boards to claw back compensation from senior executives responsible for egregious misconduct that causes financial or reputational harm to their companies. In 2013, we successfully negotiated this enhancement to Wells Fargo's clawback policy. The policy then enabled the Wells Fargo board of directors to announce in September 2016 that it would recoup $41 million from CEO John Stumpf and $19 million from former Senior Vice President Carrie Tolstedt in order to hold them financially accountable for the credit card scandal which cost 5,300 lower-level employees their jobs and cost Wells Fargo $185 million in fines and penalties.

Our shareholder proposals have encouraged many companies to adopt anti-discrimination practices, including stepping up board diversity and disclosing data on work force composition by race and gender. Studies have found that board and workforce diversity enhances financial returns. The NYC Pension Funds were early and vocal proponents of corporate policies against workplace discrimination based on sexual orientation or gender identity. Now, almost 90% of Fortune 500 companies prohibit discrimination based on sexual orientation, and two-thirds prohibit discrimination based on gender identity.

Our diversity focus has recently expanded to include gender pay equity. We filed proposals at major insurance and health care companies—two industries that have the highest adjusted gender pay gaps in the nation—to disclose information on how they address gender pay equity. In response:

- AIG released information on how it reviews employee salaries and has worked to ensure women and men are compensated equally;
- Aflac committed to disclosing its female to male salary ratio, opportunities for advancement, and details on board oversight of compensation and benefits in its next Corporate Social Responsibility report;
- Allstate committed to publish a diversity report discussing its annual compensation review process, gender pay equity adjustment policies, opportunities for advancement, and details on board oversight of diversity efforts; and
- Anthem and UnitedHealth Group agreed to conduct additional analyses on gender pay equity.

The following are among other policies advocated over the years in our shareholder proposals that now have wide acceptance:

- Substantial independent majorities on boards of directors
- Enhanced standards of independence for members of company audit and compensation committees
- Independent nominating committees
- Annual election of all directors
- Majority vote standards in election of directors
- Annual sustainability reporting
- Shareholder advisory votes on executive compensation
- Emphasis on performance-based awards in executive compensation; and
- Shareholder votes to ratify auditors

All of the above achievements and many more were made possible because of the NYC Pension Funds' long standing right and ability to file shareholder proposals—a right and ability that would be pointlessly eviscerated by the passage of the Act.

Should the Financial Services Committee desire greater details about the impact of the draft Act on the work of the New York City Comptroller's Office and the NYC Pension Funds, please reach out to Michael Garland in our Office at mgarlan@comptroller.nyc.gov or (212) 669-2517.

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nia

April 24, 2017

Representative Maxine Waters
℅ Jason Powell
jason.powell@mail.house.gov

RE: **Letter from Nia Impact Advisors to Congressional Finance Services Committee re: Proposed Financial CHOICE Act**

Dear Representative Waters,

I am writing in response to the discussion draft legislation that the House Financial Services Committee will consider during the April 26 hearing on the Financial Choice Act. The bill contains legislative provisions (Section 844) effectively eliminating fundamental rights of investors to file shareholder proposals. As a committee member, I am asking your help to defend the rights of investors by opposing any attempt to modify or limit the Securities and Exchange Commission's shareholder proposal rule, SEC Rule 14a-8.

Nia Impact Advisors, LLC is a women owned and operated Registered Investment Adviser based in Oakland, California. We assist our clients in investing in alignment with their values. We are activist investors, investing in companies with diversity in leadership. We vote our proxies and actively engage with each of our companies encouraging them to diversify their boards of directors and management teams.

The effect of the proposed legislation, would be to eliminate effective power of minority shareholders to engage with companies and fellow investors on essential matters of corporate governance and risk management.

The proposed legislation would:

<u>1 Alter the threshold for filing proposals so that only the very wealthiest investors could file proposals.</u> To file a proposal one would be required to hold 1% of shares over a three year period. In contrast the longstanding current and well functioning rule allows shareholders holding $2,000 for one year. While updating this threshold to account for inflation could be reasonable, this proposal appears intent on essentially eliminating this fundamental shareholder right. Smaller shareholders would be cut out of this process entirely, even though they have been among the most important filers in the process. Depending on the size of the company, the holdings required by the proposed threshold would be in the millions or even billions of dollars, cutting out all but the largest shareholders from access to corporate democracy.

While the largest pension funds and mutual funds typically have little difficulty getting a hearing with most companies, the shareholder proposal rule was created to support the ownership interests of all shareholders. The process gives us an essential tool to engage with boards and management on risk and governance concerns, and then if necessary, to spur debate among shareholders.

The quality of ideas in shareholder proposals, and their ultimate contribution to value, does not correlate with the size of the stock positions held by proponents. Experience shows that in the absence of the right to file a shareholder proposal, most shareholders may be ignored, and companies will act as if they are "too big to listen."

2 Alter the resubmission threshold for proposals. Current rules require that for a proposal to be resubmitted a subsequent year it must receive at least 3% support on its first year voted, 6% of the second, and 10% on the third. The proposal would raise these to 6%, 15%, and 30%, respectively. Yet support growing to 10% over 3 years is already proven to be a significant show of investor interest. For emerging issues and risks, the existing thresholds represent a significant growth in investor interest to merit continued discussion and disclosure on an issue.

In recent years, we have seen how directors and executives can become insular, engage in self-dealing or fraud, or simply fail to see risks and opportunities for profitability emerging outside of the board room. Ongoing deliberation and input from investors has been crucial to educating shareholders and boards over time and eventually arriving at effective governance and closer attention to social and environmental risks. These improve companies' financial performance.

3 Prohibit filing on behalf of another person. Currently it is common practice and well-functioning for investment advisors and issue experts to file proposals on behalf of Asset Owners. The legislation seeks to eliminate this traditional practice, undermining a right of state law to appoint an agent on one's behalf.

The shareholder proposal rule allows us to authorize our financial advisors and other issue experts to defend our interests by representing us in raising risk and governance issues and suggesting needed innovations and reforms at companies in our portfolio. Moreover, we count on the expertise of our advisors and experts to navigate the complex rules of the SEC. As asset owners, our right to file such proposals exists under state law. The provision to prevent "filing by proxy" apparently attempts to preempt this existing state law right, and is inappropriate. The proposed changes through the Financial Choice Act would eliminate our ability to do have our voice heard.

Please oppose these radical changes. The proposal process is working and does not need fixes.

The legislation would upset 70 years of SEC rulemaking and deliberations on this important and well-functioning corporate democracy process. This existing balance of rights and responsibilities in our investments supports a relationship of trust between capital providers and corporations. Stripping away shareholder rights as proposed by Chairman Hensarling would undermine that relationship. If Congress proves willing to alter rights associated with share ownership, it could undermine investor confidence in the inviolate rights of share ownership and discourage capital investment.

I urge you to oppose section 844 in Chairman Hensarling's proposed Financial Choice Act discussion draft that attempts to limit shareholders' property rights.

Sincerely,

Kristin Hull

Kristin Hull, PhD
*Founder, CEO & Portfolio Manager*
Nia Impact Advisors, LLC
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www.niaimpactadvisors.com

NORTHSTAR ASSET MANAGEMENT | Progressive Wealth Management Since 1990

April 24, 2017

Office of Congressman Stephen Lynch
One Harbor St
Suite 304
Boston, MA 02210

Via email: jaclyn.cahan@mail.house.gov

Dear Representative Lynch:

I am writing in response to aspects of the discussion draft legislation that the House Financial Services Committee will consider during the April 26 hearing on the **Financial Choice Act**. I am concerned about multiple aspects of the bill that would affect our work as investors and fiduciaries, but I am writing to draw your attention to the provisions of **Section 844**, which would effectively eliminate fundamental rights of investors to file shareholder proposals. As a committee member, I am urging you to defend the rights of investors by **opposing any attempt to modify or limit the Securities and Exchange Commission's shareholder proposal rule, SEC Rule 14a-8.**

My firm, NorthStar Asset Management, Inc., is a Boston-based socially responsible investment firm. We manage assets of high net worth individuals and families as well as nonprofit organizations with the common goal of values-aligned investing. Clients join our firm because of our in-depth social screening policy, but also because we actively file shareholder resolutions. It is the fiduciary duty of our firm to engage with corporations on behalf of our clients regarding issues and social concerns that matter to our clients. We invest in high quality government bonds and community loan funds, but our primary investments are publicly-traded domestic and international equities.

Research has shown that company managers unchecked by shareholder input leads to poor performance over the long-term.[1] It is our responsibility to our clients, who often own only a few thousand dollars each in a particular company, to engage companies via the shareholder proposal process in order to protect their investments.

[1] "The Effects of Dual-class Ownership on Ordinary Shareholders." Knowledge@Wharton. 30 June 2004. <http://knowledge.wharton.upenn.edu/article/the-effects-of-dual-class-ownership-on-ordinary-shareholders/>

The effect of the proposed **Financial Choice Act** would be to eliminate the ability of shareholders, including our clients, to engage with companies and fellow investors on essential matters of corporate governance and risk management. The proposed legislation would:

**1. Alter the threshold for filing proposals to an impossible level so that only the very wealthiest investors could file proposals.** Should the legislation pass, in order to file a proposal, one would be required to hold 1% of shares over a three year period. In contrast, the longstanding current and well-functioning rule allows shareholders holding $2,000 for one year to file shareholder proposals. While updating this threshold to account for inflation could be reasonable, the draft legislation eliminates this fundamental shareholder right.

Smaller shareholders, whether individuals or institutional investors, would be cut out of this process entirely, even though they have been among the most important filers in the process. Depending on the size of the company, the holdings required by the proposed threshold would be in the millions or even billions of dollars, cutting out all but the largest shareholders from access to corporate democracy.

The shareholder proposal rule was created to support the ownership interests of all shareholders. The process gives us an essential tool to engage with boards and management on risk and governance concerns, and then if necessary, to spur debate among shareholders.

The quality of ideas in shareholder proposals, and their ultimate contribution to shareholder value, does not correlate with the size of the stock positions held by proponents. Experience shows that in the absence of the right to file a shareholder proposal, most shareholders may be ignored, and companies will act as if they are "too big to listen."

**2. Alter the resubmission threshold for proposals.** Current rules require that for a proposal to be resubmitted a subsequent year it must receive at least 3% support on its first year voted, 6% of the second, and 10% for each subsequent year. The draft legislation would raise these to 6%, 15%, and 30%, respectively. Yet support growing to 10% over 3 years is already proven to be a significant show of investor interest. For emerging issues and risks, the existing thresholds represent a significant growth in investor interest to merit continued discussion and disclosure on an issue.

In recent years, we have seen how directors and executives can become insular, engage in self-dealing or fraud, or simply fail to see risks and opportunities for profitability emerging outside of the board room. Ongoing deliberation and input from investors has been crucial to educating shareholders and boards over time and eventually arriving at effective governance and closer attention to social and environmental risks. These improve companies' financial performance.

**3. Prohibit filing on behalf of another person.** Currently it is common practice and well-functioning for investment advisors to file proposals on behalf of their clients. The legislation seeks to eliminate this traditional practice, undermining a right of state law to appoint an agent on one's behalf.

The shareholder proposal rule allows us to work on behalf of our clients to defend their interests by aiding them in raising risk and governance issues at their companies, and to suggest needed innovations and reforms. Moreover, our firm is often asked by our clients to file proposals on their behalf. They count on our expertise to navigate the complex rules of the SEC. As investment advisors, we act as agents for our clients in filing proposals. Our right to file such proposals exists under state law. The provision to prevent "filing by proxy" apparently attempts to preempt this existing state law right, and is inappropriate. The proposed changes through the Financial Choice Act would eliminate our ability to do so.

Investment advisors, trustees and fiduciaries have a duty to monitor risk; many of us extend that duty to filing proposals, when needed, to improve performance or manage those risks. Our risk controls also often prevent us from owning too great a stake in any single company, which, again, would mean that with the proposed changes, most shareholders with appropriate risk controls would lose any real potential for engagement, which the proposal process enables.

Please oppose these radical changes. The proposal process is working and does not need fixes.

The legislation would upset 70 years of SEC rulemaking and deliberations on this important and well-functioning corporate democracy process. This existing balance of rights and responsibilities in our investments supports a relationship of trust between capital providers and corporations. Stripping away shareholder rights as proposed by Chairman Hensarling would undermine that relationship. If Congress proves willing to alter rights associated with share ownership, it could undermine investor confidence in the inviolate rights of share ownership and discourage capital investment.

I have attached a background document on this issue for your convenience, and I would be glad to assist you or your staff further in preparing for Wednesday's hearing. In any event, **I urge you to oppose section 844 in Chairman Hensarling's proposed Financial Choice Act** discussion draft that attempts to limit shareholders' property rights.

Feel free to contact me via email at jgoodridge@northstarasset.com and/or my staff member Mari Schwartzer at mschwartzer@northstarasset.com.

Sincerely,

Julie N.W. Goodridge
CEO
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**Discussion Draft – Financial CHOICE Act of 2017**
**Section 844: Shareholder Proposals**

**Our Position**
While we have serious concerns about many elements of the Financial CHOICE discussion draft circulated by House Financial Services Chairman Jeb Hensarling and supported by corporate advocates such as the Business Roundtable and the U.S. Chamber of Commerce – this background memo focuses on our opposition to the proposals contained within Section 844, which relate to shareholder proposals. This memo provides (I) a short description of the shareholder proposal process and its history, (II) a description of current law, (III) a description of the proposed changes, and (IV) a discussion of why the proposed changes are bad policy and should be rejected by Congress.

**I. Brief Background on Shareholder Proposals**
In the aftermath of the Great Depression, Congress tasked the SEC with creating a system to protect investors by balancing the interests of those who own financial stakes in a publicly listed company (shareholders) and those who run the business. Part of the answer was a system where shareholders could file recommendations (also referred to as "proposals" or "resolutions") relevant to the company to be published on the company's annual proxy statement, for a vote by all its shareholders.

**II. Current Law**
The shareholder proposal process, set forth in SEC Rule 14a-8, specifies certain parameters around which shareholders can file resolutions:

1. In order to be eligible to submit a proposal, an investor must have continuously held at least $2,000 in market value, or 1% (whichever is lower), of the company's securities for at least one year by the date he or she submits a proposal. Investors must continue to hold those securities through the date of the annual meeting where proposals usually receive a vote.

2. In order for investors to resubmit the same proposal in successive years, their proposal must garner an increasing percentage of affirmative votes. In year 1 the threshold is 3%, in year two it is 6%, and year three it is 10%.

3. In addition, pursuant to state law of agency and contracts, of agency, shareholders often authorize investment advisors or experts to file shareholder resolutions on their behalf.

**III. Proposed Changes to Current Law in Financial CHOICE Act of 2017**
This bill would change existing law to:

1. Require a 1% ownership (of total market capitalization) over a three-year period in order to be eligible to submit a proposal.

2. Increase resubmission thresholds to 6% of the vote in year 1 (from 3%); 15% in year 2 (from 6%); and 30% in year 3 (from 10%).

3. Prohibit the submission of proposals on behalf of a shareholder (what the bill refers to as "filing by proxy")

**IV. Why the Proposed Changes Are Bad Policy and Should Be Rejected**
Section 844 of the Financial CHOICE Act of 2017 is a clear overreach, representing radical and dramatic interference with important shareholder rights:

1. *1% ownership requirement over a three-year period:* This would require, for example, an investor in Wells Fargo to own $2.5 billion in shares in order to file a proposal. Only 11 investors have held those shares long enough: Berkshire Hathaway, Vanguard, BlackRock, Fidelity, Capital Research & Management, Wellington, JPMorgan, Dodge & Cox, Northern Trust, and State Street. Those investors do not file shareholder proposals at all, let alone shareholder proposals that have been filed at Wells Fargo on matters such as customer fraud, independent board chairman, proxy access, and irregularities in mortgage practices. The language in the discussion draft effectively kills any ability of shareholders to file proposals on these important issues. Improvements in business are driven by the marketplace of ideas, and minority shareholders are also important stakeholders.

2. *Increase resubmission thresholds*: This would mean resubmission thresholds of 6% (year 1, from 3%); 15% (year 2, from 6%); and 30% (year 3, from 10%). From 2007 through 2009 only about 17 percent of the proposals that came to a vote achieved the support of 30 percent of the shares voted, and from 2010 onwards, this has been approximately 30 percent of proposals filed.[1] This amendment would negatively impact shareholder re-filing of proposals on new and emerging issues. Change does not come quickly to large and complex corporations, and ideas often require years of consideration before they are accepted. Take for example the issue of declassified boards where directors stand for election each year - support of shareholder proposals on this issue was regularly below 10% in 1987 and below 30% for many years, but eventually grew to 81% in 2012. With 15% and 30% resubmission thresholds these proposals would have died long before they had the chance to be adopted. Declassified boards are now common practice, with two-thirds of S&P 500 companies holding annual votes, up from 40% 10 years ago.

3. *Prohibit proposal by a proxy other than the shareholder:* Investors have a fundamental right under state law to empower their representatives to act

[1] Report on US Sustainable, Responsible and Impact Investing Trends, 2017 - http://www.ussif.org/trends

on their behalf. Interference with these rights undermines this well functioning mechanism of corporate governance and investor relationships with corporate governance experts and financial advisor.

To learn more about this issue, please see a letter from organizations representing $65 trillion in opposition to these proposals and an in-depth briefing document.

**Additional Background**
The SEC has clear rules that allow companies to exclude improper shareholder resolutions, for instance, if they micromanage the company, address an immaterial portion of the company's operations, or violate state law. The staff of the SEC considers the arguments put forth by companies on the SEC guidelines that seek to exclude shareholder proposals based on the rules by issuing "no-action letters."

This system has worked well to balance interests and make sure that both company directors and investors don't go too far afield pursuing their own interests to the detriment of the other. Over the years it has helped shape corporate boards as independent, diverse, and elected annually, and safeguard against emerging risks – such as throughout supply chains and those posed by climate.

The process represents a cost effective way for corporate management and boards of directors to gain a better understanding of shareholder priorities and concerns and to benefit from those insights on critical and emerging risks and opportunities. The process has proven to be valuable to numerous companies and has given shareholders an important voice, consistent with the American tradition democratic governance and market based solutions.

**These resolutions are not a burden on the business community.** Most companies have never received a shareholder resolution and fewer than 1,000 resolutions are filed in an average year. After withdrawal of resolutions based on positive agreements (an average 25% of the resolutions submitted) or the SEC allowing a resolution to be omitted, there are closer to an average of 600 resolutions on environmental, social and governance issues going to a vote.

For example, in 2016 there were 382 social and environmental resolutions filed but only 203 went to a vote (USSIF 2016 Trends Report).

Sponsors of such resolutions range from individuals, to state and city pension funds, to foundations, investment firms, and mutual funds, trade union funds, religious investors – a broad cross-section of investors. **Pension funds and investment managers are, at least in part, motivated by their fiduciary duty to protect investors' interests.**

Finally, many investors do not exercise the right to file resolutions but do vote their proxies conscientiously. Thus the shareholder resolution becomes a platform for investors to communicate with a company by voting for or against a resolution.

Examples of mainstream mutual funds and investment managers voting stock include State Street, Northern Trust, Morgan Stanley, Goldman Sachs and John Hancock.

Eliminating the right to file resolutions takes away the opportunity for investors, large and small, to register a position with the company.

And finally there is ample evidence that the filing of shareholder resolutions has resulted in meaningful changes in company policies and practices.

Shareholder resolutions:

- Stimulated changes in governance, such as annual election of Directors, access to the proxy, majority vote for Directors;
- Since 2009, close to 100 companies have agreed to publish Sustainability Reports for investors in response to shareholder resolutions;
- Numerous companies have broadened their search for diversity on their Board and added women or people of color in response to shareowner engagements. Dozens of companies have committed to increasing diversity on the board of directors, thereby moving towards gender equity in the boardroom and encouraging companies to "open the pipeline" for woman and minorities to be promoted within companies;
- Over 150 companies are committed to disclosure and Board oversight of political spending in response to shareowner petition;
- Hundreds of companies have disclosed information and confirmed plans for reducing their Greenhouse Gas emissions in response to shareholder dialogue and resolutions.

Shareholder Proposals as Consumer Protection

The shareholder proposal process is relevant to most Americans because most Americans own stock in their savings, or indirectly benefit from their growth in their pensions. Over 55% of Americans directly own stocks – many of those are in 401K and retirement plans. That number was at 62% in 2008 (Gallup Poll, from 2015).[2]

A Goldman Sachs Report from 2013 found that "households directly own 38 percent of the US equity market. However, the total effective household ownership is closer to 80 percent when combined with indirect ownership in the form of mutual funds (20 percent), pension funds (16 percent), and insurance policy holdings (7 percent).[3]

[2] http://www.gallup.com/poll/182816/little-change-percentage-americans-invested-market.aspx

[3] http://www.businessinsider.com/chart-stock-market-ownership-2013-3

The Honorable Jeb Hensarling
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April 25, 2017

Sent via email for PRI Managing Director Fiona Reynolds (nathan.fabian@unpri.org)

Dear Mr Chairman Hensarling, Mr Vice Chairman McHenry and Ranking Member Waters,

I'm writing on behalf of the Principles for Responsible Investment (PRI), the world's leading responsible investment initiative, in advance of the April 26 hearing of the Financial Choice Act.

The PRI was launched in New York in 2006, and now supports more than 1,700 investors globally with over US$$62 trillion in assets under management. The United States is the PRI's largest market with almost 300 signatories.

The PRI has strong concerns that multiple aspects of the Financial Choice Act would significantly weaken the role institutional investors play in the corporate governance of US companies, jeopardise long-term value-creation. In particular, we strongly recommend opposing any attempt to modify or limit the Securities and Exchange Commission's shareholder proposal rule, SEC Rule 14a-8.

In December 2016, the Department of Labor clarified its Interpretive Bulletin from October 2008 (29 CFR 2509.08-1) applicable to ERISA fiduciaries (the "Shareholder Rights Bulletin")[1]. On shareholder activism, the clarification stated:

[1] https://www.dol.gov/sites/default/files/ebsa/2016-31515.pdf

> *"... where the responsible fiduciary concludes that there is a reasonable expectation that such monitoring or communication with [company] management, by the plan alone or together with other shareholders, will enhance the economic value of the plan's investment in the corporation, after taking into account the costs involved."*
>
> *"Such a reasonable expectation may exist ... where plan investments in corporate stock are held as long-term investments ..."*

The PRI welcomed the clarification, which is consistent with other peer markets.

In January 2017, the Investor Stewardship Group[2] launched an initiative focused on investor stewardship and corporate governance. Signatories include JPMorgan Asset Management, Blackrock and Vanguard, as well as international investors such as HSBC asset management and Legal & General investment management[3]. This follows the UK, Japan and Hong Kong, among others, which have formalised stewardship codes. The UK's Financial Reporting Council recently introduced "tiering" to enable stewardship to be a tool of competitive differentiation among asset managers. A number of US investors are Tier 1 signatories, including State Street Global Advisors and Goldman Sachs Asset Management[4].

Shareholders play a critical role in corporate governance. Enhanced shareholder engagement has led to changes in board election practices, executive compensation and, in some instances, corporate strategy. To be an effective shareholder, this includes the ability to file resolutions, as well as exercise voting rights.

Engagement helps shareholders to make informed voting decisions about investee companies. It has moved from the margins to the mainstream and is now a year-round activity, not one simply precipitated by an AGM or corporate crisis. Engagement is an instrument for creating long-term value and is central to the prudent oversight of investee companies.

The effect of the proposed legislation, would be to significantly weaken the ability of shareholders, including our signatories, to engage with companies and fellow investors on corporate governance and risk management.

The proposed legislation would:

- Alter the threshold for filing proposals to 1% of shares over a three-year period. Depending on the size of the company, the holdings required by the proposed threshold would be millions, or even billions of dollars, excluding all but the largest shareholders.

- Alter the resubmission threshold for proposals. For emerging issues and risks, the existing thresholds represent a significant growth in investor interest to merit continued discussion and disclosure on an issue.

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[2] https://www.isgframework.org/stewardship-principles/
[3] https://www.isgframework.org/signatories-and-endorsers/
[4] https://www.frc.org.uk/Our-Work/Corporate-Governance-Reporting/Corporate-governance/UK-Stewardship-Code/UK-Stewardship-Code-statements/Asset-Managers.aspx

- Prohibit filing on behalf of another person. Currently it is common practice and effective for investment advisors to file proposals on behalf of their clients.

The proposed changes are inconsistent with peer markets. For example:

In Canada:

- The federal statute Canada Business Corporations Act (2001), requires shareholders to individually or collectively account for the lesser of 1% of the total number of voting shares or CAD$2,000-worth of voting shares for a minimum of six months prior to the date of submission to file a resolution. These thresholds are consistent with provincial legislation in British Columbia, Alberta, and Quebec. In other provinces, the only requirement is for shareholders to have voting rights.

- There are also efforts to improve proxy access, specifically around the influence on director nomination process. However, this is counter to the Financial Choice Act's intention to curb proxy access by prohibiting filing by proxy.

- Consistent with the current wording of Rule 14a-8, proposals may be resubmitted if they receive a 3% vote in year one, 6% in year two, and 10% in year three, in line with the current US rules. Raising them to the proposed thresholds is therefore out of line with international standards.

In UK:

- In the UK, shareholders of a public company can require it to circulate a resolution to be voted on at its AGM where such a request is made by either shareholders representing at least 5% of the total voting rights or 100 shareholders who have a right to vote on the resolution and hold shares of at least GB£100 per shareholder.

- Prime Minister Theresa May recently published a corporate governance green paper which encourages companies to engage with their shareholders. As mentioned earlier, regulators in the UK, Japan and Hong Kong have also introduced stewardship codes. The UK guidance recommends investors consider: "submitting resolutions and speaking at General Meetings".[5]

The PRI recommends the act is withdrawn.

Sincerely,

[5] https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Stewardship-Code-September-2012.pdf

Fiona Reynolds
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PUBLIC CITIZEN

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April 25, 2017

Honorable Member
House Committee on Financial Services
United States House of Representatives

***RE: Oppose the Financial CHOICE Act***

Dear Honorable Committee Member,

On behalf of more than 400,000 members and supporters of Public Citizen, we offer the following comments on Chair Jeb Hensarling's Financial CHOICE Act. This measure is a 593-page license for the financial sector to endanger the system and abuse consumers. Not only does it eliminate many of the reforms Congress adopted to respond to the Wall Street crash of 2008, it would render financial policing agencies even weaker than before this calamity.

It eliminates the Volcker Rule prohibition on using taxpayer-backed funds for speculation. It eliminates most of the reforms on banker pay, ignoring the glaring compensation incentives for excessive risk-taking.

The bill hobbles the new Consumer Financial Protection Bureau. It removes its powers to enable consumers to use the courts when scammed by predatory lenders, instead allowing firms to force them into unworkable, mandatory arbitration.

The bill also sprawls into the securities markets with measures that reduce safeguards for investors when firms attempt to raise capital. Shareholder rights to bring resolutions before annual meetings are stripped, as is the ability of shareholders to nominate directors that would be listed on the ballot with company-proposed directors.

Chair Hensarling does include one modest step forward in the bill. He includes a provision which would require greater bank capital requirements for the largest institutions. Whereas the bill envisions assets greater than liabilities of 10 percent, some of the losses reported by the Federal Reserve leading to the financial crash approached 20 percent of assets. This argues for a leverage ratio of 20 percent.

This bill is divorced from reality. It is a fact that the financial crisis caused enormous harm, draining more than $12 trillion from the economy, where millions lost their homes, the jobs and their savings. [1] This tragedy demanded reform. It is also a fact that since passage and then partial implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010, the economy has mainly recovered. Unemployment is half its post-crash peak, and loan-making has recovered.[2] The CHOICE Act claims that neither fact is true.

There are more than 200 provisions in this massive bill that Public Citizen opposes. To list these provisions is essentially to reprint the sections of the bill. What follows are simply a few of the more dangerous provisions, not an exclusive listing of our concerns.

**Systemic Risk and "Too Big to Fail"**

Following the Lehman bankruptcy on September 15, 2008, credit markets froze as this interconnected firm ceased its payments to a sprawling network of creditors. Washington reversed course with the other failing financial institutions and bailed them out so they could meet their debt payments, as the institutions were considered "too big to fail" (TBTF). The 2010 Wall Street Reform Act was an initial attempt to mitigate TBTF, both when firms become insolvent, and ideally, to reduce the practices that lead to insolvency. The CHOICE Act irresponsibly eliminates many of these safeguards.

Section 151 of the bill prohibits the Financial Stability Oversight Council from designating any non-bank financial institution as systemically important. The biggest bailout went to AIG, an insurance company, following the firm's unmonitored issuance of bond insurance known as credit default swaps. Violating the first maxim of insurance, the purchasers of these swaps need not own the underlying bond, meaning that the failure of one bond could trigger payments many times the size of the bond. This section also eliminates the Office of Financial Research, a team that specifically looks at potential problems such as AIG that are not daily supervised by federal agencies.

Section 111 eliminates the Federal Deposit Insurance Corp.'s ability to address a major failure through what's known as "orderly liquidation authority." The Lehman bankruptcy demonstrated that a court could not efficiently and expertly prevent contagious damage to other firms. Instead, orderly liquidation provides a means for experienced bank specialists to sustain the core functions of credit-making while the institution is resolved.

Section 901 repeals the Volcker Rule, the important provision which limits the ability of banks to use taxpayer-backed deposits for speculation. Some of the largest losses during the financial crash took place in what's called the "trading book," which is where securities are held. According to

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[1] United States Government Accountability Office, "Financial Regulatory Reform: Financial Crisis Losses and The Potential Impact of the Dodd-Frank Act", GAO 13-180, January, 2013.
Luttrell, David, Tyler Atkinson and Harvey Rosenblum, "How Bad Was It? The Costs and Consequences of the 2007-2009 Financial Crisis and Its Aftermath", Federal Reserve Bank of Dallas Staff Paper No, 20, July, 2013.
[2] Kate Berry, *Four myths in the battle over Dodd-Frank,* AMERICAN BANKER (March 10, 2017) https://www.americanbanker.com/news/four-myths-in-the-battle-over-dodd-frank.

Basel Committee on Banking Supervision, "Since the financial crisis began in mid-2007, the majority of losses and most of the build-up of leverage occurred in the trading book. Losses in many banks' trading books during the financial crisis have been significantly higher than the minimum capital requirements."[3] Many assets were connected to bad loans packaged in securities such as collateralized debt obligations. Even after the crash, JP Morgan reported a $6 billion loss from speculation in derivatives. Instead of repealing it, the Volcker Rule should be improved by eliminating market-making as a permission for federally insured banks and their affiliates.

Section 857 contains 40 separate repeals of Wall Street Reform provisions, many of which are intended to address out-of-control banker compensation. Even as taxpayers bailed out banks, bankers collected substantial bonuses. One reason that Wall Street crashed the economy are the misplaced incentives that meant excessive risk-taking could lead to increases in personal fortune; and the inevitable losses were not balanced by personal loss. The 10 senior executives of Bear Stearns and Lehman Brothers were paid a collective $1.4 billion in eight the years leading to the crash (2000-2008). That's an average of $140 million each.[4] Among the provisions repealed is an important directive that compensation be restructured so that it does not motivate "inappropriate risk-taking." Also repealed is a provision that requires that compensation hedging be disclosed. Hedging defeats the role of bonuses, which are supposed to be based on performance. Also repealed is a simple disclosure of the CEO's pay as a multiple of the median-paid employee. This measure can help investors understand better if CEO pay is excessive and may contribute to employee demoralization and loss of productivity. Section 849 sharply reduces the claw back provisions meaning that even senior Wells Fargo officers would not face compulsory claw backs.

**Regulatory hurdles**

In addition to eviscerating Wall Street reform, the CHOICE Act would disable regulatory response to evolving problems, leaving the public even more vulnerable to financial mayhem than before the financial crash of 2008.

Title III establishes new, unworkable rules that will stifle oversight and rulemaking. First, subtitle A of Title III contains new analytic requirements a financial regulatory agency must complete before any rulemaking, any one of which could be material for a lawsuit by Wall Street interests seeking to block new rules. Then, Subtitle B requires an affirmative vote by both houses of Congress of any significant new financial regulation. Where Congress fails to act, which has been the norm in the last 6 years, there could be no new rules. Subtitle C overturns Supreme Court precedents whereby courts defer to experts in regulatory agencies when deciding anti-regulation lawsuits. Instead, courts would be required to judge "de novo" claims involving the justification for and technical details of the regulation, reversing the precedent of more than three decades under the *Chevron* doctrine. This means that in any lawsuit claiming that a regulatory action was unjustified, the judge would be encouraged to substitute his or her views for that of the regulatory agency's expertise.

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[3] *Reducing procyclicality arising from the bank capital framework*, JOINT FSF-BCBS WORKING GROUP ON BANK CAPITAL ISSUES (2009)

[4] Bebchuk, L., Cohen, A., Spamann, *H. The Wages of Failure: Executive Compensation at Bear Stearns and Lehman* 2000–2008. YALE JOURNAL ON REGULATION 27, 257–282

Finally, Subtitle E politicizes financial supervision by making the budgets of the FDIC, the Comptroller of the Currency, and the Federal Reserve (except monetary policy functions) subject to congressional appropriations. This paves the way for financial firms with influence in the legislative process to interfere with what should be impartial supervision and rule-making. The Securities and Exchange Commission is already subject to such appropriations, which is one reason that the agency has failed to complete mandatory rule-making and ignored petitions for other important reforms, such as the investor demanded rulemaking to require corporate disclosure of their political spending.

**Consumer Protection**

Reckless, often predatory mortgage loan-making led to a housing bubble whose rupture caused the great recession. When housing prices fell, many borrowers found themselves "underwater," with mortgage obligations greater than the value of their homes. In response to this and other abuses, Congress created the Consumer Financial Protection Bureau (CFPB). Unlike the banking agencies, which guard the soundness (often measured as profitability) of the banks, the CFPB was designed to focus exclusively on financial firm treatment of consumers. To date, that's led to some $12 billion in restitution for more than 28 million customers.

Title VII appears to be designed by the very industry that the CFPB polices. Under Section 711, the President could remove the director at will. Currently, the director can only be removed for malfeasance, misconduct or neglect of duty. The current president, who has not divested his many business interests, is highly dependent on credit. This provision would allow the president to provide relief to favored lenders.

This title further subjects the CFPB budget to the appropriations process, subjecting its policies to congressional politicization.

Section 738 prohibits the CFPB from restricting mandatory arbitration. Many consumer contracts contain clauses that prohibit a customer who discovers an unlawful charge from joining with other, similarly aggrieved citizens to file in court. Instead, they must submit to arbitration, an absurd option especially where the claim may be smaller than the arbitration fee. Mandatory arbitration serves as an invitation for firms to abuse customers because there is no real recourse.

Section 736 repeals the ability of the CFPB to address practices that it finds unfair, deceptive or abusive.

Section 733 eliminates the CFPB's ability to oversee payday lending, one of the most abusive arenas, where many borrowers find themselves in a debt trap with unconscionable interest rate payment obligations.

Section 735 repeals limits on debit card fees charged by banks with more than $10 billion in assets. The law requires the fee to be limited to the reasonable cost of the transaction. Repeal of this regulation would allow the nation's largest banks to charge retailers and customers an additional

$6 – $8 billion per year in card fees. The current law followed a careful study by the Federal Reserve.

Section 725 eliminates the popular consumer complaint data base. This data base has allowed consumers both to register complaints, allowing the CFPB to respond to specific problems, and also lets consumers educate themselves about problem service providers.

**Securities Markets**

Beyond gutting Wall Street reform, the bill cuts safeguards in other arenas.

Section 841 effectively nullifies a new rule from the Department of Labor (DOL) that requires Wall Street agents to put their client interests ahead of their own interest in commissions. Unsuspecting customers are often steered into inferior investment products that pay the broker more. The Hensarling measure requires that any DOL rule must be substantially similar to one adopted by the Securities and Exchange Commission (SEC). The SEC hasn't acted on the issue.

Section 844 effectively eliminates the ability of average shareholders of publicly traded companies to submit resolutions for a vote at annual meetings. These resolutions have led to important reforms over the years, such as requiring the chair of the board to be someone other than the CEO. The Hensarling bill would require shareholders to hold 1% of the company in order to submit a resolution. At JP Morgan, this would require a holding of more than $2 billion.

Section 857 also prohibits the SEC from adopting a rule whereby shareholders could nominate director for corporate boards that would appear on the ballot. Perhaps one of the most glaring problems in corporate governance is the fact that boards are insulated, and there are only as many candidates as there are board seats. Even though many large corporations have as much influence on the nation as a city, there are no true elections for these boards, even for their shareholders.

Even as the proposal terminates many shareholder rights, it proposes to expand the powers of business to raise funds in the capital markets with fewer investor safeguards. Section 847 allows firms with as much as $500 million worth of shareholder capital to escape basic financial accountability provided under the Sarbanes-Oxley Act of 2002, such as the CEO attestation that the books are sound. Section 421 lets firms that are selling securities to promote the stock in the guise of investment research. This harkens to the days of the "dot.com" bubble when investment firms knowingly promoted internet firms in so-called analyst reports that the analyst privately believed where unworthy. Section 452 allows private placement investments that should only be advertised to sophisticated investors to be marketed at non-profit organizations, including places of worship.

**Conclusion**

America deserves true Wall Street reform. Public Citizen has outlined a blueprint to address the TBTF problem in our publication *Too Big.*[5] We believe that real capital standards, where a major bank's assets are 20 percent greater than liabilities, are sorely needed. We also believe that the Glass-Steagall separation of commercial and investment banking should be restored, as provided in Rep. Michael Capuano's (D-Mass) measure, shortly to be reintroduced. And we believe the largest banks should be broken up.

Consumers deserve protection from predatory lenders. Investors need protection from unscrupulous Wall Street brokers.

The CHOICE act is a profoundly cynical exercise that will only please Wall Street, not Main Street, the greater economy, and the nation.

For questions, please contact Bartlett Naylor at bnaylor@citizen.org, or 202.580.5626

Sincerely,

Public Citizen

[5] Bartlett Naylor, *TOO Big*, PUBLIC CITIZEN (June 2016) http://www.citizen.org/documents/TooBig.pdf

# SANFORD J. LEWIS, ATTORNEY

April 25, 2017

The Honorable Jeb Hensarling
Chairman
Committee on Financial Services
United States House of Representatives
Washington, DC 20515

The Honorable Maxine Waters
Ranking Member
Committee on Financial Services
United States House of Representatives
Washington, DC 20515

*Re: April 26 Hearing on Discussion Draft of the Financial CHOICE Act of 2017 – Section 844 – Shareholder Proposals*

Dear Representatives Hensarling and Waters,

I am writing regarding Section 844 of the discussion draft of the Financial Choice Act under consideration for the Financial Services Committee hearing of April 26, 2017. I am a lawyer who represents investors who file proposals under the Securities and Exchange Commission (SEC) shareholder proposal rule, Rule 14a-8. My clients include pension funds, investment firms and individual investors but opinions stated here are my own.

**Important Background: Rule 14a-8 was Created to Protect Rights of Individual Investors**

The apparent impetus for these amendments to the shareholder proposal rule come from critics who assert that that "individual investors" are abusing the rule, which the critics believe should instead be reserved for larger, longer-term investors. It is important, therefore, at the outset of discussion of this provision to recognize that the SEC's shareholder proposal rule arose to ensure the ability of individual investors to engage in oversight and deliberation on important issues of corporate risk and governance.

Today we take for granted the rituals of the corporate annual meeting, including the proxy statement on which shareholders vote on an array of issues. In contrast, in the early 20th Century it was unclear whether a shareholder had to appear at a corporate meeting to vote in person or whether they could appoint an agent — a "proxy" — to vote on their behalf.

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State law was eventually clarified, so that investors could appoint a proxy to vote on their behalf at the meeting. This led to corporations established the corporate proxy statement, including allowing investors to authorize management to vote on their behalf. Such authorizations have sometimes been abused, as shareholders have found themselves unwittingly approving self-dealing by management, exorbitant executive compensation and other decisions authorized against shareholders' interests. Fortunately, a body of rules has evolved to provide balance by empowering investors to also engage in the governance process. Corporate governance pioneers John and Lewis Gilbert were individual investors who, beginning in the 1930s, put forth proposals to protect investors and improve transparency ranging from demanding proper auditing, post-meeting reports to shareholders, and convenient locations for shareholder meetings to increased director accountability and limits on executive compensation.

However, these pioneers faced a practical problem. Under state law a shareholder can submit a proposal on the floor of a meeting, however, given the heightened role of proxy voting, a proposal would be unlikely to receive sufficient votes if voting were limited to those in attendance.

The Gilberts fought for and won an SEC rule requiring clear notice by companies to all security holders regarding proposals that shareholders intend to bring up at the meeting. The resulting shareholder proposal rule became a bedrock element of corporate democracy.[1] The federal rule, by providing for prepublication of shareholder proposals to all investors, created a real and practical opportunity for an individual investor to offer and win support for his or her proposals.

Over time, the rule has also become a critical corporate governance tool for large institutional investors including mutual funds and pension funds and mission driven investors including foundations and religious investors, as well as the individual investors who were the original intended beneficiaries of the rule.

**Investment Backed Expectations**

A complex web of client relationships, contractual, institutional and fiduciary arrangements, disclosure obligations, negotiation rituals and investor expectations has been constructed around the rule. Many investors undertake cooperative dialogue and engagement with companies, and win important company reforms, built on the shareholder proposal process. Many clients choose investment advisors based in part on the advisor's commitment to an active investment and engagement strategy, which includes the filing of proposals on an individual shareholder's behalf.

With this background in mind, I will turn to proposed Section 844 of the Financial Choice Act.

**The Filing Threshold**

Financial Choice Act discussion draft Section 844 (b) effectively eviscerates the existing rule and negates its purpose, and undermines critical, investment-backed

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[1] The SEC proxy rule was put to its first legal test in the courts in a proposal brought by John Gilbert at

expectations of shareholders by elevating holding amounts and time periods from the current $2000 for one year to requiring 1% of shares held for three years. .

As demonstrated above, the shareholder proposal rule was established by the SEC to make it possible for individual investors to participate in corporate governance matters that impact all investors on a more level playing field with management and larger shareholders. The proposed threshold would bar all current filers of proposals, effectively negating the rule entirely.

In contrast with the unworkable provisions of the discussion draft, the SEC has the ability to increase the filing threshold in accordance with the rate of inflation. The last time the filing threshold was increased by the SEC was 1998, when it was increased from the $1,000 level set in 1983, to $2,000 based on inflation. There is no need or propriety in increasing the holding period; in the context of the investing marketplace, a one-year holding period represents a reasonable compromise between providing adequate investor flexibility while ensuring a sufficiently long-term stake.

**Filing by Agents - Interfering with State Law Of Agency**

The proposed Section 844 (c) would eliminate the right of shareholders to rely on agents, lawyers and experts to file proposals on their behalf. Throughout the investing marketplace, investors necessarily rely on agents to effectuate their intentions as investors. The ability to appoint an agent is a matter of state law; as such, it would be an inappropriate encroachment on state law to eliminate investors' ability to appoint an agent, such as an advisor, lawyer or expert to file proposals on their behalf.

**Resubmission Thresholds**

The current resubmissions thresholds have proven effective as allowing an ongoing deliberation and education process on issues raised by a shareholder proposal. Support for many proposals evolves along with an issue. The existing 3%, 6% and 10% thresholds have proven appropriate measures of shareowner support. They have allowed numerous proposals on issues such as say-on pay-and sustainability to grow in support over time.

**Shareholder Proposals, Rights and Responsibilities**

The federally established right to publish shareholder proposals on the corporate proxy has evolved into an important element of value in the bundle of rights associated with share ownership. Given the investment-backed expectations associated with these rights, it is inappropriate for Congress to make the kinds of changes proposed by the legislation.

Trustees, advisors and investment managers typically have a fiduciary obligation to monitor risk associated with their portfolios, as well as contractual obligations to shareholder clients to engage in active management of portfolio companies including filing shareholder proposals when necessary.

The shareholder proposal process is part of an integrated set of rights and responsibilities that investors and management owe to one another -- the form of social contract between management and providers of capital. Under this arrangement, shareholders dedicate attention, energy, and resources, together with board and management, in ensuring the success of their companies. To the extent that legislation upsets this balanced relationship embodied in the set of rules and interpretations created by the SEC and the courts, it would undermine the collaborative relationship of trust between capital providers and capital recipients. This is not an area where Congress should be involved; a misstep could undermine support for the capital markets.

Thank you for the opportunity to comment. I would be glad to provide the Committee with additional information.

Respectfully Submitted,

Sanford Lewis

Sisters of Mercy Hermanas de la Misericordia

April 25, 2017

The Honorable Maxine Waters and
House Committee on Financial Services (Minority)
U.S. House of Representatives
Washington, DC

Dear Representative Waters and Committee Members on Financial Services:

We are writing in response to the House Financial Services Committee's consideration of legislation that would effectively stop shareholders from engaging corporations through the shareholder proposal process. We ask that you oppose any attempt to limit the current shareholder proposal rule, as contemplated by Chairman Jeb Hensarling (R. Texas) in Section 844 of the Discussion Draft of the Financial CHOICE Act.[1] A hearing by the House Financial Services Committee is scheduled for April 26. As a committee member, we urge you to defend the rights of investors by opposing any attempt to limit the existing shareholder proposal process under Securities and Exchange Commission rule 14a-8.

For almost 175 years, the **Sisters of Mercy of the Americas** have served communities in the United States in health care, education and social service ministries. This deep commitment to caring for others has extended to the sisters' role as long-term investors in many companies through their investment program, **Mercy Investment Services**. The **Sisters of Mercy** consider not only the financial returns of their investments, but also believe that demonstrated corporate responsibility in matters of the environment, social and governance concerns fosters long-term business success. In addition to investing in companies, the **Sisters of Mercy** have invested in communities for more than four decades to bring access to health care, housing and jobs.

While we are deeply concerned about several parts of the Discussion Draft of the Financial CHOICE Act, we want to express our concerns on Section 844, which would change the current SEC shareholder proposal process by (1) increasing the holding requirement to submit a proposal to 1% ownership over a three-year period (vs. the current law of $2000 for one year); (2) dramatically increasing resolution resubmission thresholds; and (3) prohibiting proposal by a proxy other than the shareholder.

As an investor, we oppose these recommendations that would interfere with shareholder rights. The shareholder proposal rule was created to support the ownership interests of <u>all</u> shareholders. For more than 45 years, the shareholder proposal process has served as a cost-effective way for corporate management and boards to hear and address shareholder concerns on issues of sustainability, corporate governance, and risk. Smaller shareholders, whether individuals or institutional investors, would be cut out of this process entirely, even though they, like the Sisters of Mercy, have been among the most important and active participants in the process. Depending on the size of the company, the holdings required by the

[1] https://financialservices.house.gov/uploadedfiles/choice_2.0_discussion_draft.pdf

8380 Colesville Road, #300, Silver Spring, MD 20910 t 301.587.0423 f 301.587.0533 w sistersofmercy.org

proposed threshold would be in the millions or even billions of dollars, cutting out all but the largest shareholders from access to corporate democracy.

The quality of ideas in shareholder proposals, and their ultimate contribution to value, does not correlate with the size of the stock positions held by shareholders. Experience shows that in the absence of the right to file a shareholder proposal, most shareholders may be ignored, and companies will act as if they are "too big to listen." For an overview of some of the issues considered in shareholder proposals this year, we refer you to the ICCR Proxy Book.

Several benefits of the current shareholder proposal rule include:

- ✓ **Facilitates communication between shareholders and companies:** It provides shareholders of all types and sizes, from large pension funds to individual investors, an opportunity to communicate directly with corporate boards and management on issues of importance.
- ✓ **Shareholder value and financial performance:** Over the years, the shareholder proposal process has contributed to many reforms that protect and enhance shareholder value, both at specific companies and in many cases to the benefit of the entire corporate and shareholder community. A 2015 study found that successful shareholder engagements can generate cumulative excess returns of +7.1%.[2] In another example, a 2012 and 2014 Credit Suisse Research Report "Gender Diversity and Corporate Performance" links board diversity – an issue that has been raised through dozens of shareholder proposals – to better stock market and financial performance.[3]
- ✓ **Protects shareholder rights:** The right to file a proposal is part of the bundle of rights that an investor receives when acquiring shares. Radically curtailing those rights and taking away this process through which investors can bring concerns to management's attention would undermine investor confidence in the stability of share ownership.

The changes proposed in Section 844 represent a radical and dramatic interference with important shareholder rights:

- ✓ **1% ownership over a three-year period to submit a proposal:** For example, this would require an investor in Apple to own $7 billion in shares, or at Wells Fargo to own $2.5 billion in shares, to file a proposal. Shareholder proposals have been filed at Wells Fargo on matters such as customer fraud, independent board chairman, and irregularities in mortgage practices. Improvements in business are driven by the marketplace of ideas, and minority shareholders are also important stakeholders.
- ✓ **Increase resubmission thresholds consistent with previous SEC proposal:** Current rules require that for a proposal to be resubmitted, it must receive at least 3% support on its first year voted, 6% on the second, and 10% on the third. The proposal would raise these to 6%, 15%, and 30%, respectively. Yet support growing to 10% over three years is already proven to be a significant show of investor interest. This amendment would negatively impact shareholder refiling of proposals on new and emerging issues. Change does not come quickly to large and complex corporations, and ideas often require years of consideration before they are accepted.
- ✓ **Prohibit proposal by a proxy other than the shareholder:** Investors have a fundamental right to empower their representatives to act on their behalf, and the proxy is a basic mechanism for well-functioning corporate governance.

The legislation would upset more than 45 years of SEC rulemaking and deliberations on this important and well-functioning corporate democracy process. This existing balance of rights and responsibilities in our investments supports a relationship of trust between capital providers and corporations. Stripping away shareholder rights as proposed by Chairman Hensarling would undermine that relationship. To learn more

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[2] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2154724

[3] https://www.credit-suisse.com/us/en/articles/articles/news-and-expertise/2015/06/en/diveristy-on-board.html

about this issue, we refer you to a letter from organizations, representing $65 trillion of investments, opposing these proposals.

We are happy to speak about this at your convenience and can provide additional details on the impact of shareholder proposals. We urge you to oppose this attempt to limit shareholder rights.

Sincerely,

Patricia McDermott, RSM

Sister Patricia McDermott RSM
President
Sisters of Mercy of the Americas

Trinity Health

April 25, 2017

Representative David Trott
1722 Longworth HOB
9 Independence Ave. SE
Washington, D.C. 20515

Via Email: Bridget Dobyan, bridget.dobyan@mail.house.gov

Dear Congressman Trott,

I am writing in response to the House Financial Services Committee's consideration of legislation that would effectively stop shareholders from engaging corporations through the shareholder proposal process. I ask that you oppose any attempt to limit the current shareholder proposal rule, as contemplated by Chairman Jeb Hensarling (R. Texas) in Section 844 of the Discussion Draft of the Financial CHOICE Act.[1] A hearing by the House Financial Services Committee is scheduled for Wednesday, April 26. As a committee member, we urge you to defend the rights of investors by opposing any attempt to limit the existing shareholder proposal process under Securities and Exchange Commission rule 14a-8.

Trinity Health is one of the largest multi-institutional Catholic health care delivery systems in the nation, serving diverse communities that include more than 30 million people across 22 states. Trinity Health includes 93 hospitals, as well as 120 continuing care locations that include PACE, senior living facilities, and home care and hospice services. Our continuing care programs provide nearly 2.5 million visits annually. Committed to those who are poor and underserved, Trinity Health returns almost $1 billion to our communities annually in the form of charity care and other community benefit programs. We have 35 teaching hospitals with Graduate Medical Education (GME) programs providing training for 2,080 residents and fellows in 184 specialty and subspecialty programs. We employ approximately 97,000 full-time employees, including more than 5,300 employed physicians, and have more than 15,000 physicians and advanced practice professionals committed to 22 Clinically Integrated Networks that are accountable for 1.3 million lives across the country.

Trinity Health is headquartered in Livonia staffing 4000 individuals. We are the parent of St. Mary Mercy Livonia, also part of your Congressional district, which employs 2,545 colleagues. As a Catholic Health Ministry we believe investment decisions can provide

[1] https://financialservices.house.gov/uploadedfiles/choice_2.0_discussion_draft.pdf

economic prosperity, embrace environmental stewardship and enhance social responsibility. One of the ways Trinity Health lives out its mission to be a compassionate and transforming healing presence is through the Shareholder Advocacy Program. We use our voice as shareowners to engage with corporations to improve corporate decision-making on a number of issues that reflect our mission and core values.

While we are deeply concerned about several parts of the Discussion Draft of the Financial CHOICE Act, we want to express our concerns on Section 844, which would change the current SEC shareholder proposal process by (1) increasing the holding requirement to submit a proposal to 1% ownership over a three-year period (vs. the current law of $2000 for one year); (2) dramatically increasing resolution resubmission thresholds; and (3) prohibiting proposal by a proxy other than the shareholder.

As an investor, we oppose these recommendations that would interfere with shareholder rights. The shareholder proposal rule was created to support the ownership interests of all shareholders. For more than 45 years, the shareholder proposal process has served as a cost-effective way for corporate management and boards to hear and address shareholder concerns on issues of sustainability, corporate governance, and risk. Smaller shareholders, whether individuals or institutional investors, would be cut out of this process entirely, even though they, like the congregations of Catholic sisters who founded Trinity Health, have been among the most important and active participants in the process. Depending on the size of the company, the holdings required by the proposed threshold would be in the millions or even billions of dollars, cutting out all but the largest shareholders from access to corporate democracy.

The quality of ideas in shareholder proposals, and their ultimate contribution to value, do not correlate with the size of the stock positions held by shareholders. Experience shows that in the absence of the right to file a shareholder proposal, most shareholders may be ignored, and companies will act as if they are "too big to listen." In 2010, Trinity Health filed a proposal at Tyson Foods, asking the company to phase out the routine use of animal feeds containing antibiotics that are important to human health and to implement animal-raising practices that do not require the routine use of antibiotics. The SEC agreed that this issue is a significant policy issue and allowed the resolution to remain on the proxy. The proposal led to ongoing shareholder dialogue with the company and this past February, Tyson Foods announced it would stop using antibiotics with its chickens by June 2017.

Several benefits of the current shareholder proposal rule include:

- ✓ **Facilitates communication between shareholders and companies:** It provides shareholders of all types and sizes, from large pension funds to individual investors, an opportunity to communicate directly with corporate boards and management on issues of importance.
- ✓ **Shareholder value and financial performance:** Over the years, the shareholder proposal process has contributed to many reforms that protect and enhance shareholder value, both at specific companies and in many cases to the benefit of the entire corporate and shareholder community. A 2015 study found that successful

shareholder engagements can generate cumulative excess returns of +7.1%.[2] In another example, a 2012 and 2014 Credit Suisse Research Report "Gender Diversity and Corporate Performance" links board diversity – an issue that has been raised through dozens of shareholder proposals – to better stock market and financial performance.[3]

✓ **Protects shareholder rights:** The right to file a proposal is part of the bundle of rights that an investor receives when acquiring shares. Radically curtailing those rights and taking away this process through which investors can bring concerns to management's attention would undermine investor confidence in the stability of share ownership.

The changes proposed in Section 844 represent a radical and dramatic interference with important shareholder rights:

✓ **1% ownership over a three-year period to submit a proposal:** For example, an investor in Wells Fargo would need to own $2.5 billion in shares to file a proposal. Only 11 investors have held those shares long enough: Berkshire Hathaway, Vanguard, State Street, BlackRock, Fidelity, Capital Research & Management, Wellington, JPMorgan, Dodge & Cox, Northern Trust, and State Street. Those investors have not filed shareholder proposals at all, let alone shareholder proposals that have been filed at Wells Fargo on matters such as customer fraud, independent board chairman, and irregularities in mortgage practices. Improvements in business are driven by the marketplace of ideas, and minority shareholders are also important stakeholders that raise these issues.

✓ **Increase resubmission thresholds consistent with previous SEC proposal:** Current rules require that for a proposal to be resubmitted, it must receive at least 3% support on its first year voted, 6% on the second, and 10% on the third. The proposal would raise these to 6%, 15%, and 30%, respectively. Yet support growing to 10% over three years is already proven to be a significant show of investor interest. This amendment would negatively impact shareholder refiling of proposals on new and emerging issues. Change does not come quickly to large and complex corporations, and ideas often require years of consideration before they are accepted.

✓ **Prohibit proposal by a proxy other than the shareholder:** Investors have a fundamental right to empower their representatives to act on their behalf, and the proxy is a basic mechanism for well-functioning corporate governance.

The legislation would upset more than 45 years of SEC rulemaking and deliberations on this important and well-functioning corporate democracy process. This existing balance of rights and responsibilities in our investments supports a relationship of trust between

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[2] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2154724

[3] https://www.credit-suisse.com/us/en/articles/articles/news-and-expertise/2015/06/en/diveristy-on-board.html

capital providers and corporations. Stripping away shareholder rights as proposed by Chairman Hensarling would undermine that relationship. To learn more about this issue, I refer you to a letter from organizations, representing $65 trillion of investments, opposing these proposals.

I am happy to speak about this at your convenience and can provide additional details on the impact of shareholder proposals. I urge you to oppose this attempt to limit shareholder rights.

Sincerely,

Tonya K Wells

Tonya Wells
Vice President, Public Policy & Federal Advocacy

CC: Rebekah Goshen, Rebekah.Goshorn@mail.house.gov
Kevin Edgar, Kevin.Edgar@mail.house.gov
Katelynn Bradley, Katelynn.Bradley@mail.house.gov
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Tri-State Coalition
for Responsible Investment

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Dear Chairman Hensarling and Ranking Member Waters:

On behalf of the Tri-State Coalition for Responsible Investment, I am writing about the attempt to limit the shareholder proposal rule, as currently anticipated in Section 844 of the Discussion Draft of the Financial CHOICE Act.[1] The existing shareholder proposal process under Securities and Exchange Commission rule 14a-8 is well functioning - it should not be changed as proposed in Section 844. Please oppose this section of the bill and any further attempts to limit the shareholder proposal process that would silence the voices of nearly all shareholders, especially minority shareholders.

The Tri-State Coalition is comprised of 40 Catholic institutional investors in the New York, New Jersey, and Connecticut area who use their shareholder power to engage with corporations in their investment portfolios to address risks related to environmental and human rights concerns. Coalition members filed or co-filed at least 28 shareholder resolutions in the past year, with proposal topics ranging from water stewardship, financial practices, to business planning to address the risks of climate change. Many member resolutions were filed for a second year, and the proposed changes to the voting thresholds for re-filing would have prevented these proposals from making it to the proxy in the subsequent years. Faith-based investors have historically played an influential role as shareholder advocates and it is important that religious institutional investors do not lose their ability to file resolutions due to the proposed holding requirements.

While we are deeply concerned about a number of provisions in the Discussion Draft of the Financial CHOICE Act and will be sharing those concerns later, for the time being we want to express our concerns on Section 844. Section 844 changes the SEC shareholder proposal by (1) changing the holding requirement to 1% ownership over a three year period (vs. 1% or $2000 for one year) to submit a proposal; (2) dramatically increasing resubmission thresholds to unreasonable levels; and (3) prohibiting proposal by a proxy other than the shareholder.

As an investor, I am adamantly opposed to these recommendations that would interfere with shareholder rights. For over 45 years the shareholder proposal process has served as a cost effective way for corporate management and boards to gain a better understanding of shareholder priorities and concerns. For an overview of some of the issues considered in shareholder proposals this year, I refer you to the ICCR Proxy Book.

[1] https://financialservices.house.gov/uploadedfiles/choice_2.0_discussion_draft.pdf

Below are several benefits of the current shareholder proposal rule:

- **Facilitates communication between shareholders and companies.** It provides shareholders of all types and sizes, from large pension funds to individual investors, an opportunity to communicate directly with corporate boards and management on issues of importance. Resolutions that are not withdrawn can be voted on by all holders of voting stock – giving the board and management input far beyond that of the shareholder(s) who initially filed the resolution.

- **Shareholder value and financial performance.** Over the years, the shareholder proposal process has contributed to many reforms that protect and enhance shareholder value, both at specific companies and in many cases to the benefit of the entire corporate and shareholder community. A 2015 study found that successful shareholder engagements can generate cumulative excess returns of +7.1%.[2] In another example, a 2012 and 2014 Credit Suisse Research Report "Gender Diversity and Corporate Performance", links board diversity – an issue that has been raised through dozens of shareholder proposals – to better stock market and financial performance (higher return on equity, lower leverage, and higher price/book ratios).[3]

- **Protects shareholder rights.** The right to file a proposal is part of the bundle of rights that an investor acquires when acquiring shares. Radically curtailing those rights and taking away this process through which investors can bring concerns to management's attention would undermine investor confidence in the stability of our arrangement of rights associated with share ownership. All trustees and fiduciaries have a duty to monitor risk, many extend that duty to filing proposals when necessary to probe risks and potential weaknesses, as well as improve performance.

It is clear that Section 844 is an overreach, representing radical and dramatic interference with an important shareholder right:

- **Requirement of 1% ownership over a three year period to submit a proposal:** This would require an investor in Wells Fargo to own $2.5 billion in shares in order to file a proposal. A coalition of faith based investors who have a resolution on the proxy next week at Wells Fargo on the recent ethics scandal would all be excluded from filing if this were the filing requirement. Improvements in business are driven by the marketplace of ideas, and minority shareholders are also important stakeholders.

- **Increase resubmission thresholds consistent with previous SEC proposal:** This would mean resubmission thresholds of 6% (year 1, from 3%); 15% (year 2, from 6%); and 30% (year 3, from 10%). From 2007 through 2009 only

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[2] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2154724

[3] https://www.credit-suisse.com/us/en/articles/articles/news-and-expertise/2015/06/en/diveristy-on-board.html

about 17 percent of the proposals that came to a vote achieved the support of 30 percent of the shares voted, and from 2010 onwards, this has been approximately 30 percent of proposals filed.[4] Filings on new issues often require education of the shareholder community and consideration of emerging risks, and this germination process would be stymied by these proposed resubmission thresholds.

- **Prohibit proposal by a proxy other than the shareholder**: Investors have a fundamental right to empower their representatives to act on their behalf and the proxy is a basic mechanism for well-functioning corporate governance. The current language appears to be vague in defining which proxies would be prohibited, but this requirement would be burdensome, if not impractical.

To learn more about this issue, I refer you to a letter from organizations representing $65 trillion in opposition to these proposals and an in-depth briefing document. I urge you to oppose this attempt to limit shareholder rights.

I would be grateful for the opportunity to have a brief call with you about this issue and to have you raise these concerns at next Wednesday's hearing on the bill.

Sincerely,

Mary Beth Gallagher
Executive Director
Tri-State Coalition for Responsible Investment
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[4] Report on US Sustainable, Responsible and Impact Investing Trends, 2016 - http://www.ussif.org/trends

Jack Ehnes
*Chief Executive Officer*

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April 20, 2017

The Honorable Maxine Waters
Ranking Member, House Committee on Financial Services
4340 Thomas P. O'Neill, Jr. Federal Office Building
Washington, DC 20515

RE: The Financial CHOICE Act

Dear Ranking Member Waters:

CalSTRS was established more than 100 years ago to provide retirement benefits for California's public school teachers and is the largest educator-only pension fund in the world. The CalSTRS portfolio is currently valued at approximately $202 billion, which we carefully invest, as patient capital with a long-term investment horizon, to meet the retirement needs of more than 900,000 plan participants and their families. [1]

As the CEO of CalSTRS, I am writing in response to reports that the Financial Services Committee will be holding a hearing on a revised Financial CHOICE Act (the CHOICE Act 2.0 or revised CHOICE Act) on April 26. I want to preemptively highlight specific provisions of the discussion draft of the bill posted on April 19. We acknowledge that the primary goal of the revised CHOICE Act is financial deregulation, but there are several provisions that CalSTRS is deeply concerned about beyond financial deregulation. We want to focus our letter on those revisions we find most alarming to ensure they are not lost amongst the rhetoric of financial deregulation. We respectfully request that our letter be entered in to the public record when the revised bill is considered by the Committee.

**<u>Shareholder Proposal Process</u>**

The discussion draft includes a provision to dramatically change the shareholder proposal process. Currently under the Securities and Exchange Commission's (SEC) Rule 14a-8, shareholders who own 1 percent or $2,000 worth of outstanding shares for at least one year can submit a proposal to be included on the company's proxy statement. The CHOICE Act 2.0 would eliminate the $2,000 threshold and require investors to own a minimum of 1 percent of the issuer's voting securities over a three year period. While 1 percent may sound like a small amount, even a large investor like the $200 billion CalSTRS fund does not own 1 percent of publicly traded companies. In fact, 1 percent of Apple Inc., the largest U.S. company by market capitalization, would equate to more than $7 billion worth of stock. If enacted, we believe these changes would effectively prevent investors, like CalSTRS from participating in the shareholder proposal process. The current shareholder proposal process allows shareholders, even small investors, the ability to communicate their concerns to public

[1] California State Teachers' Retirement System Current Investment Portfolio as of February 28, 2017. http://www.calstrs.com/current-investment-portfolio and At-a-Glance http://www.calstrs.com/glance.

The Honorable Maxine Waters
April 20, 2017
Page 2

companies and, in fact, has had a significant and positive impact on corporate policies and practices on a wide range of issues. As a fund that has filed more than 300 proposals over the past five years, this provision would have a chilling impact on company/shareholder relations.

**Universal Proxy Ballot**

In October of 2016, the SEC voted to propose amendments to the proxy rules that would require parties in a contested election to use universal proxy cards that would include the names of all board of director nominees. Subsequently, a public comment period opened, and CalSTRS submitted comments supporting the proposed rule. [2] At present if a shareholder wants to vote for candidates on different proxy cards, we have to travel to the shareholder meeting. Not only does the current practice disenfranchise shareholders, it creates a different process for voting in contested elections, a mechanism designed solely to protect incumbent directors. This proposal would give shareholders the ability to vote by proxy for their preferred combination of board candidates and would replicate how shareholders can vote in person at the shareholder meeting. The CHOICE Act 2.0 eliminates the SEC's ability to enact a universal proxy rule. Voting for director nominees is a fundamental right, and as a long-term investor, CalSTRS supports the ability to choose among the best suited candidates to represent their interests inside the boardroom.

**Sarbanes-Oxley Act Sec. 404 (b) Exemptions**

Section 404(b) of the Sarbanes-Oxley Act required companies to have an outside auditor attest to a company's internal financial controls. Following the scandals at Enron and WorldCom, investors welcomed the protection this would provide. Section 989G of Dodd-Frank allowed a permanent exemption for those companies whose market capitalization was less than $75 million. A new provision in the revised CHOICE Act would raise this exemption to companies with market capitalizations of $500 million or $1 billion in assets for banks. There are approximately 680 companies currently in the Russell 2000 Index with market capitalizations less than $500 million. Under this proposed legislation, investors in these 680 companies, including CalSTRS, would not have the protection of an outside auditor's oversight of the company's financial statements. While we appreciate that the cost of compliance is often cited as a concern by small issuers, we believe it is a necessary cost for receiving investments from the public markets and an important source for risk mitigation.

We respectfully ask that our views be entered into the record. We plan to provide more detailed comments once we have reviewed the discussion draft in its entirety and would be happy to discuss our perspective on these issues with you or your staff at your convenience. Thank you for your consideration.

Sincerely,

Jack Ehnes

Jack Ehnes
Chief Executive Officer

[2] https://www.sec.gov/comments/s7-24-16/s72416-1471415-130426.pdf.

U.S. PIRG
Standing Up
To Powerful Interests

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www.uspirg.org (202) 546-9707
info@uspirg.org

25 April 2017

**OPPOSE FINANCIAL CHOICE ACT, GUTS CFPB, ROLLS BACK WALL STREET REFORM, REPEALS DURBIN AMENDMENT**
**"Wrong Choice Act" Leaves Consumers, Depositors, Small Investors, Taxpayers and Economy At Risk of Another 2008 Collapse**

Dear Representative,

On behalf of U.S. PIRG, which serves as the non-partisan, non-profit association of state Public Interest Research Groups nationwide, we write to express our strong opposition to the "Financial Choice Act" and to urge you to oppose this bill. This legislation would be better dubbed "Wall Street's Choice Act", or the "Wrong Choice Act" or even the "Cruel Choice Act."

Have proponents and supporters of the bill forgotten that this September, we will have the 9$^{th}$ anniversary of the second-most extraordinary financial collapse in our nation's history? Both collapses were driven by Wall Street greed and risk-taking. Millions lost homes, millions lost jobs, and millions more lost trillions in retirement income. Ordinary taxpayers were forced to step in and bail out Wall Street before Congress, nearly two years later and after careful study and debate, in 2010, finally enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act to protect the rest of us. Now, the Financial Services Committee, according to widely-circulated news reports, appears ready to send this dangerous reversal of those critical protections to the floor next month after just one hearing, tomorrow.

The bill, if enacted, would have a devastating effect on the capacity of regulators to protect the public interest and defend consumers and investors from future Wall Street wrongdoing and the economy from financial risks created by too-big-to-fail financial institutions. It sends the wrong signal to the financial sector that unfettered risk-taking – much of it with other people's money -- is in vogue again.

It would expose consumers, investors, and the public to greatly heightened risk of abuse in their regular dealings with the financial system, and our entire economy to a far greater risk of instability and crisis.

This nearly 600-page bill – significantly amended from version 1.0 and, again, apparently to be the subject of only one committee hearing -- is a radical piece of legislation. Not only does it eliminate numerous major elements of the Dodd-Frank protections passed in the wake of the disastrous financial crisis of 2008, it would also weaken regulatory powers that long pre-date Dodd-Frank. If this bill passed, it would make financial regulation significantly weaker than it was even in the years leading up to the 2008 crisis.

Proponents of the bill claim that certain portions of the bill would somehow improve financial protections. This claim is deeply misleading. In fact, the so-called protections in the bill are in many cases simply more disguised deregulation. For example, the bill exempts banks that meet a ten percent leverage capital ratio from a broad range of risk controls that have been part of bank regulation since the 1950s if not before. While an increase in leverage capital would be a positive development, banks which took advantage of this provision could still pose major risks to the financial system – and the legislation would strip regulators of their ability to address those increased risks.

This legislation is crammed with deregulatory gifts that would facilitate abuses by financial institutions across the board, including giant mega-banks who want to return to the excessive borrowing and risky practices that led to the financial crisis; private equity and hedge funds who want to manipulate the rules to enrich their executives while harming workers and investors; mortgage lenders who want to undo the safeguards against the kind of unaffordable loans that drove the financial crisis, storefront payday and car title lenders pushing products that trap consumers in a cycle of ever increasing debt, and more.

**Among other changes, this Wall Street's CHOICE Act would eviscerate the highly-successful CFPB, which in just under six years of service has returned nearly $12 billion to 29 million victims of financial chicanery, by firms ranging from Wall Street banks to usurious payday lenders and fly-by-night debt collectors:**

- The bill completely strips the powers of the Consumer Financial Protection Bureau to stop unfair, deceptive, and abusive practices in consumer markets or to regularly examine banks and financial companies to determine whether they are breaking the law, returning to the regulatory patchwork that failed before the crisis and the CFPB was created to solve.
- The bill destroys the Bureau's independence by eliminating its independent funding, moving it under the executive branch and subjecting its director to political manipulation by allowing removal for any reason, including no reason. The bill also rejects over 150 years of national policy that bank regulators and the financial system should be insulated from the highly-politicized appropriations process by not only eliminating CFPB's independent funding, but also that of other bank regulators, including the FDIC, OCC and FRB, as well.

- The bill makes the Bureau's highly successful statutory Offices of Financial Empowerment, Older Americans, Service Member Affairs and its Office of the Student Loan Ombudsman all "optional," so a future director could simply eliminate them.
- The bill eliminates the CFPB's Public Consumer Complaint Database, which would only benefit companies that don't want to improve their customer service and don't want to be transparent about their business.
- The bill eliminates the CFPB's Congressionally-granted authority to ban or regulate arbitration in consumer contracts, which serves corporate wrongdoer Wells Fargo well, as it has been using an arbitration shield to defend itself against its fake-account scandal.
- Incredibly, despite that abusive high-cost small dollar lending is one of the largest financial problems consumers -- especially working class families -- face, the bill simply removes any authority of the CFPB to regulate or issue enforcement actions against small-dollar lenders.

**Of course, the bill also takes aim at critical Dodd-Frank safety and soundness and investor protections:**

- Creates unprecedented barriers to regulatory action that would effectively give large financial institutions power to overturn or avoid government oversight.
- Eliminates critical elements of regulatory reforms passed since the crisis, including restrictions on unaffordable mortgage lending, the Volcker Rule ban on banks engaging in hedge-fund like speculation, restrictions on excessive Wall Street bonuses, and more.
- Increases the ability of "too big to fail" financial institutions to hold up taxpayers for a bailout by threatening economic disaster if they failed.
- Weakens investor protection and oversight of the capital markets, including repealing crucial new fiduciary protections that save tens of billions a year for retirement investors.
- We concur with and associate ourselves with the additional detailed concerns described in a much longer letter from Americans for Financial Reform.

**The bill also wrongly repeals the Durbin amendment.** That wise provision helps limit the impact of anti-competitive "swipe fees" on merchants and their customers. If anything, the Durbin amendment should be expanded to credit, as well as debit, cards. All consumers, including cash customers, pay more at the store and more at the pump due to the Visa-Mastercard duopoly's market power and the unfair conditions imposed on merchants to accept their cards.

Opponents of financial regulation have not presented convincing evidence that any significant deregulatory measures are needed, let alone the radical assault on financial oversight contained in this bill. In contrast to the lack of evidence for negative effects of post-crisis measures to improve financial regulation, we know exactly how disastrous failures of financial oversight can be. Non-partisan sources such as the Federal Reserve Bank of Dallas and the Government

Accounting Office have estimated that the financial crisis cost from $6 to $14 trillion in lost economic output alone.[1]

This does not incorporate the full human cost of millions of jobs lost and the millions of families who lost their homes due to foreclosure.[2] Extensive research also shows that the negative economic impacts of such major financial crises drag on for years, slowing recovery from recession, and leaving tens of millions of families across the country struggling with economic pain and uncertainty.[3] Meanwhile, apart from any crisis, left unchecked exploitation of consumers and investors costs everyday people tens of billions of dollars a year in their ordinary interactions with the financial system.

It is profoundly foolish to eliminate safeguards against the catastrophic consequences of a financial crisis. It is also wrong to place such severe restrictions on the ability of regulators to protect the public from exploitation in their everyday interactions with the financial system. We urge you to reject this radical and destructive legislation.

This is by no means a comprehensive description of the many dangerous provisions of the so-called Financial Choice Act. We will continue to evaluate it if it moves forward in the legislative process.

Please contact me at 202-461-3821 (d) or at edm@pirg.org if you or your staff have any questions.

Sincerely,

Edmund Mierzwinski

Edmund Mierzwinski
Consumer Program Director
U.S. PIRG

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[1] United States Government Accountability Office, "Financial Regulatory Reform: Financial Crisis Losses and The Potential Impact of the Dodd-Frank Act", GAO 13-180, January, 2013. Luttrell, David, Tyler Atkinson and Harvey Rosenblum, "How Bad Was It? The Costs and Consequences of the 2007-2009 Financial Crisis and Its Aftermath", Federal Reserve Bank of Dallas Staff Paper No, 20, July, 2013.
[2] Americans for Financial Reform, "Costs of the Crisis", Briefing Paper, Updated July 2015.
[3] Reinhart, Carmen and Kenneth Rogoff, "Recovery From Financial Crises: Evidence From 100 Episodes", American Economic Review, Volume 104, No.5, 2014.

Walden Asset Management
*Advancing sustainable business practices since 1975*

April 21, 2017

Congressman Stephen Lynch
2268 Rayburn House Office Building
Washington, DC 20515

Dear Congressman Lynch,

I write to urge your leadership in strongly opposing the section of the proposed Financial Choice Act that would eliminate the ability of shareholders to file resolutions with companies in which they own shares.

While we have deep concerns about a number of aspects of the proposed Act, we wish to bring this specific issue to your attention.

Walden Asset Management, a division of Boston Trust & Investment Management is based in Boston. Walden serves clients deeply concerned about environmental, social and governance (ESG) issues who have asked us to integrate these ESG issues into investment decisions for their portfolio and in our discussions and engagements with companies in which we invest. Our company as a whole manages approximately $8 billion for clients.

Walden Asset Management has filed shareholder resolutions with companies for decades. We believe it is an important part of our fiduciary duty to our clients.

Further, it is our experience that companies often find shareowner input constructive and useful as they make decisions. We seek a discussion with a company before filing a resolution.

We utilize a resolution filed alone, or with others, as a tool if the engagement has not been successful. Often the resolution prompts a review by the company leading to positive and constructive changes in policy and practices and the resolution is withdrawn in light of an agreement.

As you can see, our firm has been a long term and we believe an effective shareholder advocate with companies.

The proposed Financial Choice Act literally would destroy our rights and the right of virtually all other investors to sponsor resolutions.

A Division of Boston Trust & Investment Management Company
One Beacon Street Boston, Massachusetts 02108 617.726.7250 Fax: 617.227.2690

We write to urge your leadership as a Member of the House Financial Service Committee in opposing this section of the proposed Financial Choice Act.

We enclose a Fact Sheet which includes lists to other resources describing our concerns in more detail.

We look forward to discussing this matter with your staff.

Sincerely,

Timothy Smith
Senior Vice President
Director of Shareowner Engagement

Cc: Jaclyn Cahan, Staffer (jaclyn.cahan@mail.house.gov)
Kevin Ryan, Chief of Staff (kevin.ryan@mail.house.gov)
Bruce Fernandez, Legislative Director (bruce.fernandez@mail.house.gov)

**- The Proposed Financial CHOICE Act of 2017**
**Section 844: Shareholder Proposals**

**Our Position**
While we have serious concerns about many elements of the Financial CHOICE discussion draft circulated by House Financial Services Chairman Jeb Henserling and supported by corporate advocates such as the Business Roundtable and the U.S. Chamber of Commerce – this background memo focuses on our opposition to the proposals contained within Section 844, which relate to shareholder proposals. This memo provides (I) a short description of the shareholder proposal process and its history, (II) a description of current law, (III) a description of the proposed changes, and (IV) a discussion of why the proposed changes are bad policy and should be rejected by Congress.

**I. Brief Background on Shareholder Proposals**
In the aftermath of the Great Depression, Congress tasked the SEC with creating a system to protect investors by balancing the interests of those who own financial stakes in a publicly listed company (shareholders) and those who run the business. Part of the answer was a system where shareholders could formally introduce "proposals" or "resolutions" relevant to the company, to be published in the proxy for a vote by all its shareholders.

**II. Current Law**
The shareholder proposal process, set forth in SEC Rule 14a-8, specifies certain parameters around which shareholders can file resolutions:

1. In order to be eligible to submit a proposal, an investor must have continuously held at least $2,000 in market value, or 1% (whichever is lower), of the company's securities for at least one year by the date he or she submits a proposal. Investors must continue to hold those securities through the date of the annual meeting where proposals usually receive vote.

2. In order for investors to resubmit the same proposal in successive years, their proposal must garner an increasing percentage of affirmative votes. In year 1 the threshold is 3%, in year two it is 6%, and year three it is 10%.

3. Finally, the resolution process allows shareowners to authorize a representative or investment firm to file shareholder resolutions on their behalf.

**III. Proposed Changes to Current Law in Financial CHOICE Act of 2017**
This bill would change existing law to:

1. Require a 1% ownership (of total market capitalization) over a three-year period in order to be eligible to submit a proposal.

2. Increase resubmission thresholds to 6% of the vote in year 1 (from 3%); 15% in year 2 (from 6%); and 30% in year 3 (from 10%).

3. Prohibit the submission of proposals by a representative other than the shareholder. (what the bill refers to as "filing by proxy")

**IV. Why the Proposed Changes Are Bad Policy and Should Be Rejected**
Section 844 of the Financial CHOICE Act of 2017 is a clear overreach, representing radical and dramatic interference with important shareholder rights:

1. *1% ownership requirement over a three-year period:* One example makes the point. This would require an investor in Wells Fargo to own $2.5 billion in shares in order to file a proposal. At the moment only 11 investors have held those shares long enough: Berkshire Hathaway, Vanguard, State Street, BlackRock, Fidelity, Capital Research & Management, Wellington, JPMorgan, Dodge & Cox, Northern Trust, and State Street. Those investors do not file shareholder proposals at all, let alone shareholder proposals that have been filed at Wells Fargo on matters such as customer fraud, independent board chairman, proxy access, and irregularities in mortgage practices. The language in the discussion draft effectively kills the ability of shareholders to file proposals on these important issues.

2. *Increase resubmission thresholds*: This would mean resubmission thresholds of 6% (year 1, from 3%); 15% (year 2, from 6%); and 30% (year 3, from 10%). From 2007 through 2009 only about 17 percent of the proposals that came to a vote achieved the support of 30 percent of the shares voted, and from 2010 onwards, this has been approximately 30 percent of proposals filed.[1] This amendment would negatively impact shareholder re-filing of proposals on new and emerging issues. Change does not come quickly to large and complex corporations and ideas often require years of consideration before they are accepted. Take for example the issue of declassified boards where directors stand for election each year – support of shareholder proposals on this issue was regularly below 10% in 1987 and below 30% for many years, but eventually grew to 81% in 2012. With 15% and 30% resubmission thresholds these proposals would have died long before they had the chance to be adopted. Declassified boards are now common practice, with two-thirds of S&P 500 companies holding annual votes, up from 40% 10 years ago.

3. *Prohibit proposal by a proxy other than the shareholder:* Investors have a fundamental right under state law to empower a representative to act on their behalf.

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[1] Report on US Sustainable, Responsible and Impact Investing Trends, 2017 - http://www.ussif.org/trends

Thus a law firm or investment manager or legally authorized representative could not act on your behalf

To learn more about this issue, please see a letter from organizations representing $65 trillion in opposition to these proposals and an in-depth briefing document.

**Additional Background**
Eligible shareholders meeting the criteria described above cannot bring any random proposal up for a vote. The SEC has developed clear rules that allow companies to try and exclude certain shareholder resolutions that are not appropriate e.g. if they micromanage the company. The staff of the SEC considers the arguments put forth by companies that seek to exclude shareholder proposals based on the rules by issuing "no-action letters" from the SEC Staff.

This system has worked well to balance interests and make sure that both company directors and investors don't go too far afield pursuing their own interests to the detriment of the other. Over the years the resolution process has helped shape corporate boards as independent, diverse, and elected annually, and helped safeguard against emerging risks - such as throughout supply chains and those posed by climate.

The process represents a cost effective way for corporate management and boards of directors to gain an understanding of shareholder priorities and concerns and to benefit from those insights on critical and emerging risks and opportunities. The process has proven to be valuable to numerous companies and has given shareholders an important voice.

These resolutions are not a burden on the business community. Most companies have never received a shareholder resolution and there are under 1,000 resolutions filed in an average year. After withdrawal of resolutions based on positive agreements (an average 25% of the resolutions submitted) or the SEC allowing a resolution to be omitted, there are closer to an average of 600 resolutions on environmental, social and governance issues going to a vote.

For example, in 2016 there were 382 social and environmental resolutions filed but only 203 went to a vote (USSIF 2016 Trends Report)

And sponsors of such resolutions range from individuals, to state and city pension funds, to foundations, investment firms and mutual funds, trade union funds, religious investors - a broad cross-section of investors.

And for example, pension funds and investment managers are motivated by their fiduciary duty to protect investor's interests.

Finally, many investors do not exercise the right to file resolutions but do vote their proxies conscientiously. Thus the resolution becomes a platform for investors to communicate with a company by voting for or against a resolution. Examples of mainstream mutual funds and investment managers voting their proxies include State Street, Northern Trust, Morgan Stanley, Goldman Sachs and John Hancock.

Many issues are now gaining votes of over 50% and other issues regularly get votes in the 30-50% range.

Eliminating the right to file resolutions takes away the opportunity for investors, large and small, to register their opinion with the company.

And finally there is ample evidence that the filing of shareholder resolutions has resulted in meaningful changes in company policies and practices.

Shareholder resolutions -

- Stimulated changes in governance, e.g. annual election of Directors, access to the proxy, majority vote for Directors;
- Since 2009 close to 100 companies have agreed to publish Sustainability Reports for investors in response to shareholder resolutions;
- Numerous companies have broadened their search for diversity on their Board and added women or people of color in response to shareowner engagements;
- Over 150 companies are committed to disclosure and Board oversight of political spending in response to shareowner petition;
- Hundreds of companies have disclosed information and confirmed plans for reducing their Greenhouse Gas emissions in response to shareholder dialogue and resolutions.

In short, there is a very clear record of the shareholder resolution process resulting in meaningful and positive changes with companies.

# Zevin Asset Management, LLC

PIONEERS IN SOCIALLY RESPONSIBLE INVESTING

April 25, 2017

*VIA E-MAIL*

Representative Stephen Lynch
United States House of Representatives
2268 Rayburn HOB
Washington, DC 20515
(via Legislative Counsel Jaclyn Cahan, jaclyn.cahan@mail.house.gov)

**RE: Protecting investor rights by opposing Section 844 of the proposed Financial Choice Act & any changes to SEC Rule 14a-8**

Dear Representative Lynch,

This message responds to the discussion draft legislation that the House Financial Services Committee will consider during the April 26 hearing on the Financial Choice Act. I am concerned about multiple aspects of the bill that would affect my firm's work as a responsible investor, but I write today to draw your specific attention to the provisions of Section 844, effectively eliminating fundamental rights of investors to file shareholder proposals. I urge you to oppose those provisions and, as a committee member, to defend the rights of investors by opposing any attempt to modify or limit the Securities and Exchange Commission's shareholder proposal rule, SEC Rule 14a-8.

I write on behalf of Zevin Asset Management, a socially responsible investment manager — based in the heart of Boston — which integrates financial and environmental, social, and governance (ESG) research in managing investment portfolios for our clients. We manage approximately $600 million in assets for a wide range of individual and institutional clients.

Our clients engage our firm to protect and grow their capital and also to work with companies in their portfolios to improve those companies' approach to material ESG issues. That work — called shareholder advocacy or investor engagement — is essential for socially responsible investors who seek to decrease the long-term risk profile of their investment portfolios and, in the process, create a positive social impact.

On behalf of our clients, we routinely meet with company executives to suggest management changes and improvements in the way those firms address ESG risks

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and opportunities. Usually, Zevin Asset Management and our peer socially responsible investment firms make positive progress through direct dialogue and collaborative meetings with management. However, when company managers choose to ignore investors' concerns or refuse to make reasonable changes in the interests of shareholders and other stakeholders, we frequently find it necessary to file shareholder proposals.

The decision to file a shareholder proposal is not taken lightly. Indeed, proposing a resolution for an up-or-down vote by a company's shareholder base sends a strong signal to management about the importance of material environmental, social, and governance issues. When those proposals win support from fellow investors (even less than a majority), companies are often convinced to reckon with the underlying issue. In this way, the shareholder proposal process channels and amplifies legitimate investor concerns, empowers shareholders to learn about and support issues raised by other investors, and serves as a critical check against the inertia and groupthink that can develop among the executives and largest investors of publicly traded companies.

The effect of the proposed legislation, would be to cripple the healthy process of communication and risk identification that I have described above. This would silence our clients and take away a key investment risk management tool.

Specifically, the proposed legislation would damage shareholders' rights by:

1. <u>Altering the threshold for filing proposals to an impossible level so that only the very wealthiest investors could file proposals</u>. To file a proposal one would be required to hold 1 percent of shares over a three year period. In contrast, the longstanding current and well functioning rule allows shareholders holding $2,000 for one year. While updating this threshold to account for inflation could be reasonable, the proposal at hand eliminates this fundamental shareholder right. Smaller shareholders, whether individuals or institutional investors, would be cut out of the shareholder proposal process entirely, even though they have been among the most important filers in the process. Depending on the size of the company, the holdings required by the proposed threshold would be in the millions or even billions of dollars, cutting out all but the largest shareholders from access to corporate democracy.

   The shareholder proposal rule was created to support the ownership interests of <u>all</u> shareholders. As I have described, the shareholder proposal process gives us an essential tool to engage with boards and management on risk and governance concerns, and then if necessary, to spur debate among investors. In the absence of the right to file a proposal, most shareholders may be ignored, and companies will act as if they are "too big to listen."

2. Altering the resubmission threshold for proposals. Current rules require that for a proposal to be resubmitted a subsequent year, it must receive at least 3 percent support on its first year voted, 6 percent in the second year, and 10 percent in the third year. The legislative proposal would raise these thresholds to 6 percent, 15 percent, and 30 percent, respectively. Yet, support growing to 10 percent over 3 years is already proven to be a significant show of investor interest. For emerging issues and risks, the existing thresholds represent a significant growth in investor interest to merit continued discussion and disclosure on an issue. The proposed change would substantially undermine important discussions of emerging risks and opportunities.

3. Prohibiting filing proposals on behalf of another person. Currently it is common and well-functioning practice for investment advisors like our firm to file proposals on behalf of their clients. The proposed legislation mistakenly seeks to eliminate this traditional practice, undermining a right of state law to appoint an agent on one's behalf.

   The SEC's shareholder proposal rule allows us to work on behalf of our clients to defend their interests by aiding them in raising risk and governance issues at their portfolio companies, and to suggest needed innovations and reforms. Moreover, clients often ask our firm to file proposals on their behalf. They count on our expertise to navigate the complex rules of the SEC. As investment advisors, we act as agents for our clients in filing proposals — a right that exists under state law. The provision in the proposed legislation seeking to prevent "filing by proxy" apparently attempts to preempt this existing state law right, and is inappropriate. The proposed changes through the Financial Choice Act would eliminate our ability to carry out these tasks as an agent of our clients and thus endanger our ability to perform our fiduciary obligations to each of our clients.

We urge you to oppose the radical changes embedded in the proposed legislation. The shareholder proposal process is working and does not need any purported fixes.

The proposed legislation would upset 70 years of SEC rulemaking and deliberations on this important and well-functioning corporate democracy process. The existing balance of rights and responsibilities in our investments supports a relationship of trust between capital providers and corporations. Stripping away shareholder rights as proposed by Chairman Hensarling would undermine that relationship. Indeed, radically altering the rights associated with share ownership could ultimately undermine investor confidence.

I would be glad to speak with your staff and answer any questions as you prepare for Wednesday's hearing, including providing additional briefing materials and questions to ask during the hearing. In any event, I urge you to oppose section 844 in Chairman Hensarling's proposed Financial Choice Act discussion draft that attempts to limit shareholders' property rights.

Sincerely,

Pat Miguel Tomaino
*Associate Director of Socially Responsible Investing*
Zevin Asset Management, LLC
617-742-6666
Pat@zevin.com

CC:

Rep. Jeb Hensarling
Chairman, Financial Services Committee
United States House of Representatives
2129 Rayburn HOB
Washington, DC 20515
(via staff members Kyle Jackson, kyle.jackson@mail.house.gov, Rebekah Goshorn, Rebekah.Goshorn@mail.house.gov, and Kevin Edgar, Kevin.Edgar@mail.house.gov)

Rep. Maxine Waters
Ranking Member, Financial Services Committee
United States House of Representatives
2221 Rayburn House Office Building
Washington, DC 20515
(via staff members Jason Powell, jason.powell@mail.house.gov, Kris Erickson Kristofor.Erickson@mail.house.gov, and Katelynn Bradley, Katelynn.Bradley@mail.house.gov)

**WRITTEN STATEMENT OF MIKE ROTHMAN**

**PRESIDENT, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.**

**AND**

**MINNESOTA COMMISSIONER OF COMMERCE**

**BEFORE THE**

**U.S. HOUSE COMMITTEE ON FINANCIAL SERVICES**

**"A Legislative Proposal to Create Hope and Opportunity for Investors, Consumers, and Entrepreneurs"**

**April 26, 2017**

**WASHINGTON, DC**

## I. Introduction

Good morning Chairman Hensarling, Ranking Member Waters, and Members of the Committee. On behalf of the North American Securities Administrators Association, Inc. ("NASAA"), I am pleased to submit this statement for inclusion in the record of the April 26, 2017, hearing entitled "A Legislative Proposal to Create Hope and Opportunity for Investors, Consumers, and Entrepreneurs," which will examine recently released "discussion draft" legislation entitled "The Financial CHOICE Act of 2017" ("Financial Choice Act" or "bill").

NASAA was organized in 1919, and its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico and the U.S. Virgin Islands. In the United States, state securities regulators have protected Main Street investors for the past 100 years, longer than any other securities regulator. State securities regulators are responsible for administering state securities laws that both serve to protect your constituents from fraud while also providing regulatory frameworks through which businesses can raise capital.

State securities regulators enforce state securities laws by investigating suspected investment fraud, and, where warranted, pursuing enforcement actions that may result in fines, restitution to investors and, in some instances, jail time. Keeping the bad actors out of the markets serves not only the interests of investors, but the businesses that rely on markets to raise money. State securities regulators also ensure honest financial markets by licensing registrants—both firms and investment professionals—and conducting ongoing compliance inspections and examinations.

In addition to serving as "cops on the beat," state securities regulators serve as the primary regulators of many small and local securities offerings. As such, state securities regulators regularly provide important information to local businesses seeking investment capital. Moreover, state securities regulators, acting within NASAA, have a long history of working closely with the U.S. Securities and Exchange Commission ("SEC" or "Commission") to effect greater uniformity in federal-state securities matters.

Finally, both independently and within the framework of NASAA, state securities regulators have consistently provided Congress and other federal policymakers with timely, pertinent information, gleaned from our experiences, which may be relevant to federal policymaking activities. During the approximately two years between the onset of the Financial Crisis in August 2008, and the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") in July 2010, NASAA provided extensive commentary to Congress on financial regulatory reform legislation, including through testimony and more than a dozen letters addressing legislative proposals under the jurisdiction of the Financial Services Committee. Further, in January 2010, NASAA delivered detailed testimony to the U.S. Financial Crisis Inquiry Commission regarding the perspective of state securities regulators on the Crisis, and since 2011, NASAA's membership and staff have actively participated in the activities of the Financial Stability Oversight Council ("FSOC"), as well as several federal advisory committees and similar working groups.

## II. NASAA's Perspective on the Financial Choice Act of 2017

Congress enacted the Dodd-Frank Act in July 2010, in response to the financial crisis of 2008-2009, to strengthen our financial system and better protect the millions of hard-working Americans who rely on their investments for a secure retirement. The Dodd-Frank Act was crafted to promote stronger investor protection and provide more effective oversight to help prevent another economic crisis. Passage of the Act was central to the restoration of the confidence of Main Street investors in our capital markets. In addition to provisions designed to strengthen our financial system, the Dodd-Frank Act addressed a number of critical issues affecting retail investors, such as incorporating disqualification provisions to prevent securities law violators from conducting securities offerings under SEC Regulation D, Rule 506; strengthening the accredited investor standard; increasing state regulatory oversight of investment advisers; providing for a means to enact a fiduciary duty for broker-dealers; providing authority to prohibit or limit the use of mandatory pre-dispute arbitration contracts by broker-dealers in customer agreements, among many other important reforms.

The reforms and investor protection provisions in the Dodd-Frank Act were born of necessity: trust in the market needed to be restored if our system of capital formation was to thrive. The financial crisis had underscored that the existing securities regulatory landscape required an overhaul. By passing the Dodd-Frank legislation into law, Congress signaled the beginning of a new era of financial market oversight and investor protection, including reforms intended to better empower state securities regulators to protect citizens from fraud and abuse.

As is true of any major legislation, the Dodd-Frank Act requires improvements and updates; however, the Financial Choice Act does not improve nor build upon the modernized financial regulatory framework that Congress crafted in response to the lessons of and weaknesses exposed by the Financial Crisis. Rather, the bill is predominantly backward-looking and deregulatory in nature. By attempting to eviscerate so many of the critically important reforms summarized above—weakening oversight of private securities markets and reforms; watering down provisions intended to expand fiduciary obligations to investment professionals; lowering standards for securities sold to the investing public; diluting rules that keep "bad actors" out of our securities markets, among many others—the legislation blithely aims to sweep away in one stroke scores of essential protections and modernizations to our financial regulatory architecture that were literally decades in the making.

In sum, state securities regulators are deeply concerned that, if enacted in its current form, the Financial Choice Act would dramatically change regulatory policies in the wrong direction, weakening the important reforms and protections put in place in response to the financial crisis, and exposing investors and the securities markets to significant, unnecessary and new risks.

## III. Provisions Affecting Investors and Securities Markets

The legislation and policy changes embodied in the Financial Choice Act are far too vast to address comprehensively in my statement today. Indeed, so numerous and extensive are the revisions contemplated by the bill that I will not be able to fully or comprehensively address even those of the bill's provisions that are of direct interest to NASAA and state securities regulators. I will use the remainder of this statement to highlight for the Committee several provisions that NASAA considers to be of utmost interest and importance, and to furnish some analysis of the impact of the provisions. In certain cases, where NASAA has previously commented on a particular provision, I will simply note this fact in my statement and provide appropriate citations so that the Committee may easily access the relevant commentary for the record.

### A. Provisions Relating to Enforcement & Regulatory Authority

The Financial Choice Act would make it more difficult for state securities regulators and other regulatory and law enforcement agencies to police U.S. securities and other financial markets to protect investors from fraudulent and abusive practices. NASAA appreciates that the bill does include some provisions that stand to enhance the ability of the SEC to impose meaningful civil penalties for certain violations of securities laws. However, when viewed in their totality, it is clearly evident that the changes contemplated by the bill would significantly undermine and compromise regulators' ability to effectively enforce financial laws and regulations.

***Section 391. Joint Investigations and Enforcement Actions***

Section 391 is overbroad and misguided in including State authorities as part of efforts to minimize duplication of enforcement efforts; therefore, the reference to "State authorities" should be removed. Section 391 seeks to require federal agencies, including the SEC, to implement policies to (1) minimize duplication between federal and state authorities in bringing enforcement actions; (2) determine when joint investigations and enforcement actions are appropriate; and (3) designate a process to establish a lead agency for joint investigations and enforcement actions. Section 391's reference to "State authorities" is both unnecessary in light of the existing voluntary collaboration, described below, as well as wholly unworkable because of Supreme Court case law that delineates state and federal authority in law enforcement.

In the realm of securities regulation, state and federal securities regulators currently collaborate on a voluntary basis, usually at the regional level, with common goals of sharing information and leveraging resources efficiently. Collaboration includes ongoing informal quarterly or monthly meetings at the state or regional levels; regulators working on investigations and enforcement cases when the nature of the case or warrants collaboration;[1] and other initiatives, such as Memorandums of Understanding ("MOUs"). Recently, in conjunction with new rules to facilitate intrastate crowdfunding offerings and regional offerings taking effect, the SEC and NASAA signed an information-sharing MOU.[2] The agreement is intended to facilitate the sharing of information to ensure that the new exemptions are indeed serving their intended purposes of facilitating access to capital for small businesses. Such collaborative efforts are long-standing. For example, from 2011 to 2013, the SEC and state securities regulators worked closely to facilitate and streamline the process by which 2,100 investment advisers transitioned, pursuant to the Dodd-Frank Act, from federal to state oversight.[3]

This current system of voluntary collaboration ensures that resources are focused on productive collaboration, rather than working through federal bureaucratic processes and red-tape before the actual work can begin. Furthermore, voluntary collaboration can be based on the needs of a situation and take geography into account. Not every state has a federal securities regulatory presence, but every state has a state securities regulator, ensuring a boots-on-the-ground approach wherever a bad actor may be perpetrating fraud. Voluntary collaboration ensures that the jurisdictional reach of federal and state securities regulators remains unhindered and that harmful conduct is addressed in a direct and efficient manner without the need to work through federal bureaucratic obstacles.

NASAA has great concerns about hampering this voluntary state-federal collaborative framework through Section 391 as written, which could result in the SEC's Washington bureaucracy being imposed at the state and regional level. In addition to being inefficient, Section 391's inclusion of "State authorities" is opposite to the Supreme Court's holding in *Printz v. United States*, which upholds the separation between federal and state authority. Specifically, in *Printz*, the Court held that the federal government could not compel state law enforcement offices to participate in a federal handgun regulation program.[4] Therefore, the SEC would be unable to impose its policies and procedures on state securities regulators. The current voluntary collaboration between state and federal securities regulators is far preferable to applying Section

[1] This type of collaboration generally requires formalizing the relationship through access letters and other joint memoranda.

[2] *See* "SEC, NASAA Sign Info-Sharing Agreement for Crowdfunding and Other Offerings." Press Release. Feb. 17, 2017, *Available at* https://www.sec.gov/news/pressrelease/2017-50.html.

[3] For additional information see NASAA report entitled "A Successful Collaboration to Enhance Investor Protection," *Available at* http://www.nasaa.org/23169/ia-switch-report/.

[4] *Printz v. United States*, 521 U.S. 898, 935 (1997).

391 to state securities regulators. Striking references to "State authorities" is necessary to improve Section 391.

***Section 827. Elimination of Automatic Disqualifications***

Section 827 should be stricken because it would undo important investor protection reforms. Section 926 of the Dodd-Frank Act took a necessary first step toward reducing risks for investors in private offerings by requiring the SEC to issue rulemaking to exclude bad actors from utilizing the Regulation D, Rule 506 exemption ("Rule 506"). These unregistered private offerings naturally have become a favorite vehicle for unscrupulous promoters, who use the Rule 506 exemption to fly under the radar. As required by the Dodd-Frank Act, the SEC in 2013 adopted rules prohibiting bad actors from relying on the Rule 506 exemption.[5]

In contrast to the sound policy of Dodd-Frank Section 926, the Financial Choice Act's Section 827 is baffling and misguided in its attempt to prohibit the SEC from automatically disqualifying from registration or from using a registration exemption bad actors; namely, a universe of persons the bill expressly defines to include persons "having been convicted of any felony or misdemeanor or made the subject of any judicial or administrative order...[or]...having been suspended or expelled from membership in, or suspended or barred from association with a member of a registered national securities exchange."[6] The effect of this provision would be to undermine the "bad-actor" disqualifications currently applicable to Rule 506 and other securities offerings.

This provision runs contrary to sound public policy and plain common sense. If enacted, this provision would create procedural burdens to necessary disqualifications, allowing bad actors to continue to rely on exemptions, registrations, and activities that led to those bad acts.

There is simply no valid basis for tying the hands of the SEC or any other securities law-enforcement agency in the manner contemplated by this provision.

***Section 823. Private Parties Authorized to Compel the SEC to Seek Sanctions by Filing Civil Action***

Section 823 was introduced in the 114th Congress as H.R. 3798, the Due Process Restoration Act of 2015. As NASAA commented previously,[7] this provision seeks to broadly undermine the efficacy of the federal securities law enforcement framework by providing all respondents in SEC enforcement cases with the right to have their case removed out of the SEC's administrative authority to a federal district court and. The right to remove would apply not only to unregulated respondents, but to entities directly regulated by the SEC, such as brokerage firms, investment advisers, investment companies, and persons associated with such entities. The provision would create a similar right of removal for persons who are subject to an SEC cease and desist order. Finally, for cases that remain within the purview of an SEC Administrative

[5] *See* Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, SEC Release No. 33-9414, 78 Fed. Reg. 44729 (July 24, 2013).
[6] Sec. 827 (P. 448).
[7] *See* Letter from Judith Shaw, Maine Securities Administrator and NASAA President, to the Hon. Jeb Hensarling, Chairman, House Committee on Financial Services and the Hon. Maxine Waters, Ranking Member, House Committee on Financial Services, dated Mar. 2, 2016 *available at* nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2013/10/NASAA-Letter-Re-3-2-16-HFSC-FC-Markup-March-2-2016.pdf.

Law Judge, the provision would raise the burden of proof from the "preponderance of the evidence" standard to a higher bar at the "clear and convincing evidence" level.[8]

The SEC has possessed the authority to seek civil monetary penalties in enforcement actions since Congress enacted the Securities Remedies and Penny Stock Reform Act of 1990.[9] In 2010, as part of the Dodd-Frank Act, Congress granted the SEC broader authority to impose civil monetary penalties in administrative proceedings. Section 929P of Dodd-Frank, amended Section 8A of the Securities Act, Section 21B(a) of the Securities Exchange Act, Section 9(d)(1) of the Investment Company Act, and Section 203(i)(1) of the Investment Advisers Act to permit the imposition of civil monetary penalties in administrative proceedings, in addition to the cease-and-desist orders previously available to the SEC.

The authority to pursue remedies for alleged violations of federal securities laws in an administrative proceeding is an important tool in the SEC's arsenal and furthers the agency's mission to protect investors. The likely impact of Section 823 on the SEC's ability to effectively police wrongdoing would be significant and would likely not only reduce the overall number of enforcement actions pursued by the SEC but the deterrent effect that comes with an effective enforcement program. Further, because SEC enforcement actions brought as administrative proceedings often conclude more rapidly than those brought in federal district court, and because they consume fewer federal resources than enforcement actions brought in the federal courts, the bill would serve to make future SEC enforcement actions significantly costlier to the SEC and the government.

Again, there is no valid basis for tying the hands of the SEC or any other securities law enforcement agency in the manner contemplated by this provision.

***Section 820. Advisory Committee on Commission's Enforcement Policies and Practices***

NASAA is troubled by Section 820 of the bill, which provides for the establishment of an "advisory committee on the Commission's enforcement policies and practices." State securities regulators know first-hand the importance of strong enforcement programs free of influence from the regulated entities subject to their oversight. As envisioned by the bill, the Advisory Committee would conduct analysis and make recommendations on the Commission's policies and practices, which will include direction regarding the appropriate blend of regulation, publicity, and formal enforcement actions, criteria for the selection and disposition of actions, and the suitability and effectiveness of sanctions imposed by Commission proceedings. This Advisory Committee would include up to seven members, including a Chair, each designated by the SEC Chairman.

As proposed, this new Advisory Committee has the potential to hinder and unduly limit the Commission's ability to investigate and pursue securities fraud and other misconduct. It would compromise the independence of the Commission's staff and could, over time, serve to institutionalize a degree of "regulatory capture" through the appointment to the Committee of members with perspectives and allegiances that do not fully align with the mandate of the SEC.

***Subtitle A—SEC Penalties Modernization***

[8] The SEC has traditionally applied a "preponderance of the evidence" standard to administrative enforcement actions.
[9] Initially, the SEC's authority to seek such penalties in administrative proceeding was limited to regulated entities or persons associated with a regulated entity—brokerage firms, investment advisers and investment companies. In order to obtain monetary penalties against other persons, the SEC was required to pursue a civil action in federal district court.

Federal securities laws limit the amount of civil penalties that the SEC can impose on an institution or individual. NASAA supports provisions included in the Financial Choice Act that would update and strengthen the SEC's authority to impose civil penalties for securities law violations, including by directly linking such penalties to the scope of harm and associated investor losses, increasing the statutory limits on monetary penalties, and increasing the cap for repeat securities law violators.

***Subtitle R—Senior Safe***

Subtitle R is comprised of bipartisan legislation introduced and passed by the House during 114th Congress as the Senior$afe Act.[10] The Senior$afe Act consists of several essential features that improve protections for persons aged 65 and older from financial exploitation by increasing the likelihood it will be identified by financial services professionals and reported to state securities regulators and other appropriate governmental authorities who can help stop it. Specifically, the Senior$afe Act promotes and encourages financial services professionals, who are positioned to identify and report "red flags" of potential exploitation, to report suspected elder financial exploitation. The provision would incentivize financial services employees to report any suspected exploitation by making them immune from any civil or administrative liability arising from such a report, provided that they exercised due care, and that they make these reports in good faith. Second, in order to better assure that financial services employees have the knowledge and training they require to identify "red flags" associated with financial exploitation, the bill would require that, as a condition of receiving immunity, financial institutions train certain personnel regarding the identification and reporting of senior financial exploitation.

NASAA has supported the Senior$afe Act since its introduction in 2015, and we continue to strongly support its passage.

## B. Provisions Relating to Capital Formation

The Financial Choice Act incorporates more than a dozen distinct legislative proposals pertaining to capital formation, including numerous proposals that resemble legislation considered by the Committee earlier this year and during the 114th and 113th Congress. NASAA has commented extensively on many of these past proposals, so I will focus my statement on what we view as some of the more significant proposals. However, to the extent that NASAA has previously commented on a proposal that is not addressed in my statement, I would strongly encourage interested members of the Committee to review the relevant information, as it appears on NASAA's website and in the Committee's own records.[11]

***Subtitle N—Private Placement Improvement***

The Private Placement Improvement provision in Section 466 of the bill would prohibit the SEC from adopting proposed rules to implement common sense reforms for Regulation D, Rule 506 offerings. As NASAA has testified on several prior occasions, state securities regulators oppose any action by Congress to further diminish the ability of the SEC to address investor protection concerns associated with these offerings or gather quantitative and qualitative data in the private marketplace.

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[10] The Senior Safe Act of 2016 (H.R. 4538) passed the House of Representatives by voice vote on July 05, 2016. (H. Rept. 114-659).

[11] NASAA testified to the House Financial Services Committee and its subcommittees regarding legislative proposals aimed at facilitating capital formation on three occasions during the 113th and 114th Congress, including on April 14, 2016, May 1, 2014, and October 23, 2013. During the same period, NASAA submitted numerous statements and comment letters addressing legislation relating to "capital formation" under consideration by the Committee. Copies of all such testimony, statements, and comment letters may be accessed on NASAA's website at nasaa.org.

Title II of the Jumpstart Our Business Startups Act of 2012 ("JOBS Act") repealed the long-established prohibition on general solicitation and advertising of securities offered under Rule 506. When the SEC adopted rules to implement Title II, on July 10, 2013, it also voted to propose rules that could improve the transparency and mitigate the risk to ordinary investors who participate in Rule 506 offerings, including a requirement to pre-file the "Form D" notice when issuers intend to advertise such offerings to the general public. The SEC's proposal would also impose meaningful penalties on issuers who fail to file a Form D.[12] Section 466 would effectively prohibit the Commission from adopting these modest proposals.

Proponents have opposed a Form D filing requirement prior to conducting a Rule 506 offering, and again upon the completion of the offering, arguing that multiple filings would impose an onerous compliance burden. Form D, however, is a short form, capturing basic information about the issuer (e.g., business address, officers, directors, business type, etc.).. The amount of information required on the Form D relative to the information contained in an issuer's private placement memorandum or offering document is minimal yet vital to regulators and potential investors. These additional, modest filing requirements are particularly important in understanding the $1 trillion market in unregistered Regulation D, Rule 506 securities.

State securities regulators, pursuant to their antifraud authority, are the de facto primary regulators of offerings conducted under Regulation D, Rule 506. Fraudulent offerings involving Rule 506 offerings are routinely among the most frequently reported by state securities regulators. We believe it would be a mistake for Congress to weaken the few existing investor protections in Rule 506, and we urge the Committee to reject Subtitle N.

***Subtitle L—Main Street Growth***

The Main Street Growth provision would amend the Securities Exchange Act to provide a framework for a national securities exchange to elect to be treated as a "venture exchange," which the bill would define as a "market place or facilities for bringing together purchasers and sellers of venture securities." The venture exchange, as currently envisioned, would function in parallel with traditional public markets for companies under $2 billion in value. The bill would also create a new class of security—a venture security—that would be listed and traded only on venture exchanges. These venture securities would be exempt from a significant number of regulatory requirements, and presumably subject to significantly diminished listing standards.[13]

The securities listed on the venture exchange could include securities not presently listed on a national exchange, and transacted only on an over-the-counter ("OTC") basis, as well as securities listed on a national securities exchange as an "emerging growth company." One of the most notable common features of these types of securities, however, is that they are prone to illiquidity. To manufacture additional liquidity for such securities, this provision would exempt them when listed on a venture exchange from various reporting and disclosure requirements, and would establish new trading rules specifically for securities on venture exchanges, including rules that would allow higher tic-sizes.

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[12] Amendments to Regulation D, Form D and Rule 156, SEC Release Nos. 33-9416, 34-69960, IC-30595. 78 Fed. Reg. 44806. (2013, July 24). Retrieved from gpo.gov/fdsys/pkg/FR-2013-07-24/html/2013-16884.htm.

[13] Under Subtitle L, securities listed on a venture exchange would be exempt from SEC Regulations ATS and NMS, Decimalization, Sarbanes-Oxley, and State Blue Sky laws.

NASAA has previously questioned the need for new legislation to establish a new venture exchange.[14] Current law allows for the creation of new exchanges, including exchanges targeted to smaller companies. Today, there are many national exchanges registered with the SEC that operate with varied listing requirements. In addition to traditional national exchanges, various alternative marketplaces exist, such as the OTCQX, OTCQB, and OTC Pink. It is not clear why, or if, new legislation or regulatory relief would be necessary to foster the creation of such an exchange in light of existing exchanges.

Further, it is far from certain that any venture exchange will be created, or succeed, with the enactment of this provision. Venture exchanges have existed in the past and have fared poorly. Over the past 80 years, more than 20 regional stock exchanges have gone out of business or merged with other exchanges to stay afloat. While state securities regulators do not oppose the establishment of a new venture exchange provided there are sufficient safeguards for investors, serious questions remain about the challenges to making such exchanges a successful proposition in the United States. Moreover, to the extent any securities traded on such an exchange would receive federal covered status, the exchange must have rigorous listing standards to provide protections ordinarily afforded under state Blue Sky laws.

To the extent Congress proceeds with legislation that would prescribe the establishment and structure of a U.S. venture exchange, NASAA recommends that Congress proceed in a manner that allows for adequate attention to several critical and specific considerations, summarized below.[15]

First, retail investors will be a primary source of capital for a venture exchange, which immediately raises investor protection concerns. A venture exchange likely will significantly rely on retail investors, including passive and "self-directed" retail investors, to support a market for the securities traded on the exchange, because many institutional investors simply do not invest in smaller and more speculative issues such as those that would likely be listed on a venture exchange.[16] Indeed, while it is unclear how venture exchanges would augment the many tools already available to provide capital to businesses, it is readily evident that establishing such exchanges could pose significant risks to investors. The central features of the proposed venture exchange—newer, untested companies, reduced disclosure, limited liquidity, and comparatively high rates of failure or bankruptcy and investment loss—sharply contrast with the robust disclosure and transparency regime that define America's modern and efficient capital markets.

Second, appropriate listing standards will be essential to a successful venture exchange. To be successful, a U.S. venture exchange will need to attract and sustain interest from issuers, retail investors, brokers, analysts, and other market participants, as well as some institutional capital. Sustained interest

[14] *See* Written Statement of William Beatty, NASAA President and Washington Securities Division Director, delivered to the Subcommittee on Securities, Insurance and Investment of the Senate Committee on Banking, Housing and Urban Affairs, "Venture Exchanges and Small-Cap Companies," Mar. 10, 2015, *available at* www.nasaa.org/34863/venture-exchanges-and-small-cap-companies.

[15] Unfortunately, only one hearing on the topic of venture exchanges has been held by the House Financial Services Committee in recent years—a subcommittee hearing in early 2015—and that hearing focused on a number of bills, one of which related to a venture exchange. The Committee needs to further explore the many challenges to establishing a venture exchange. While additional study could be helpful and even decisive in assuring the long-term prospects of a venture exchange effort, the Committee is advancing a concept that has not been fully analyzed and explored.

[16] There may be a variety of reasons that institutional investors tend not to invest in smaller issues such as those likely to be listed on a venture exchange. Some obstacles, such as potential illiquidity and lack of research coverage, may be attenuated by a venture exchange with robust listing standards. Other obstacles seem likely to persist, particularly as they relate to the size of the issues themselves. For example, the low market capitalization of the issues listed on a venture exchange may make it difficult for institutional investors to invest in them profitably, or to buy them in the ordinary course of their business activities without pushing the stock price up appreciably.

will require robust listing and disclosure standards to facilitate brokers recommending investments in securities traded on a venture exchange. When recommending investments to retail clients, brokers rely on disclosures to meet their suitability responsibilities. A venture exchange without reliable disclosure and governance requirements will face additional challenges as brokers could be unable to meet their suitability responsibilities to their clients. Similarly, inadequate listing standards will impose a major barrier to investments of assets from individual retirement accounts ("IRAs") and other tax-deferred retirement accounts, which may become subject to the fiduciary standard later this year.

In NASAA's view, among the flaws of this provision is a lack of listing standards. At the very least, the legislation must be amended to require listing standards governing reporting, auditing, accounting, due diligence, management, and corporate governance. As a general principle, the listing standards of a successful venture exchange should be as rigorous as possible without compromising the ability of the exchange to scale its requirements to reasonably reduce costs and attract listings. In addition, there should be a mechanism to remove companies that fall below the listing standards.[17] Finding the appropriate balance is challenging but absolutely crucial in establishing a venture exchange.

In any effort to develop legislation to establish a new venture exchange, Congress should account for the lessons learned from other venture exchange efforts in the United States and elsewhere. There is theoretical potential for a venture exchange to play a useful function in our capital markets, but there are also many valid questions about why, how, and whether such exchanges might succeed in the United States. Congress should study these questions more closely prior to passing legislation establishing such an exchange. In particular, Congress should examine reasons for the demise of the American Stock Exchange Emerging Company Marketplace ("ECM"), as well as the lessons learned from NASDAQ's efforts to establish a new venture exchange in 2011. Congress also should examine the international experience with venture exchanges, including notably Canada's TSX Venture Exchange, and the Alternative Investment Market ("AIM") in the United Kingdom. As former SEC Commissioner Luis Aguilar has noted, there is considerable evidence that these and other international venture exchanges are continuously plagued by low liquidity, and at times high volatility.[18] In NASAA's view, Congress should strive to understand the underlying causes of such problems prior to establishing similar exchanges in the United States.

Finally, and perhaps most importantly, venture exchanges have the potential to be very risky for certain investors. No matter how effective the regulatory scheme for a venture exchange, securities that trade on such proposed exchanges will be significantly riskier investments than securities issued by public companies traded on a major national exchange. Congress should thoroughly examine all issues NASAA and other commenters have raised regarding venture exchanges prior to advancing this or any similar legislation.

***Subtitle S—National Securities Exchange Regulatory Parity***

The National Securities Exchange Regulatory Parity provision would amend Section 18 of the Securities Act of 1933 to allow the SEC to recognize any exchange of any size or quality as a "national

[17] Shell or non-operating companies, for example, are often a mechanism for fraud. Indeed, since 2012, the SEC has suspended trading of more than 800 microcap stocks. Press Release, SEC, SEC Suspends Trading in 128 Dormant Shell Companies to Put Them Out of Reach of Microcap Fraudsters (March 2, 2015), available at https://www.sec.gov/news/pressrelease/2015-44.html.
[18] Remarks of Commissioner Luis Aguilar, Meeting of the SEC Advisory Committee on Small and Emerging Companies, Mar. 4, 2015, *available at* sec.gov/news/statement/need-for-greater-secondary-market-liquidity-for-small-businesses.html.

securities exchange." All securities listed on such exchanges would be covered securities and not subject to state registration laws.

NASAA strongly opposes this proposal, which threatens the core tenets of modern securities market regulation. Under existing law, a listing on a national securities exchange affords such securities covered security status such that state registration requirements are preempted.[19] A balance was struck regarding the level of rigorousness in listing standards that would afford such covered security status and preemption of state law in 1996, with the enactment of the National Securities Markets Improvement Act ("NSMIA"). The benchmark for preemption established by Congress under NSMIA is that an exchange must have rigorous listing standards comparable to those of the major national stock exchanges, such as the New York Stock Exchange ("NYSE"), or have "substantially similar" listing standards, as the SEC may determine by rule. The rationale is that investors purchasing securities listed on an exchange that has sufficiently rigorous listing standards do not require the added protection afforded by Blue Sky registration.[20] This bill would upend the balance struck in NSMIA and remove vital investor protections afforded by state securities laws that would otherwise be applicable.

Given the number and variety of exchanges currently in existence, it is not clear why this provision is necessary.[21] Further, current law allows the creation of exchanges with varied listing requirements, including alternative marketplaces.[22] By removing the statutory references to recognized national securities exchanges like the NYSE, and the attendant requirement that all national securities exchanges with covered security status maintain meaningful listing standards that are substantially similar to such major exchanges, this language undercuts the distinction between national exchanges with rigorous listing standards and all other exchanges, including local or regional exchanges with no regard to the applicable listing standards. It also creates confusion with alternative trading systems, a secondary trading platform.[23] Ultimately, this provision will create adverse marketplace confusion and impact the quality of securities listed on recognized national exchanges.

***Subtitle M—Micro-Offering Safe Harbor***

The Micro-Offering Safe Harbor provision seeks to amend Section 4 of the Securities Act to create a new exemption from registration for an offering that meets the following three criteria: (1) each purchaser has a substantive pre-existing relationship with an officer or director of the issuer, or with a shareholder holding 10 percent or more of the issuer's shares; (2) there are no more than 35 purchasers of securities from the issuer in reliance on this exemption during the preceding 12 months; and (3) the aggregate amount raised by the issuer during the 12-month period preceding the transaction, including in reliance on this exemption, does not exceed $500,000. The bill also preempts state regulation of these proposed securities offerings, and does not prohibit general solicitation, disqualify bad-actors, limit offering amounts (for instance, to unaccredited investors), or permit any notice filings to state and federal regulators.

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[19] Exchanges with less stringent listing standards (e.g., the Miami International Securities Exchange) do not provide "covered" status.
[20] *See* Section 18(b)(1)(A)-(B)) of the Securities Act of 1933 and Rule 146.
[21] There are currently 19 national securities exchanges registered with the SEC, and ten recently approved securities exchange applications. *See* sec.gov/divisions/marketreg/mrexchanges.shtml.
[22] Various alternative marketplaces currently exist, such as the OTCQX, OTCQB, and OTC Pink. In fact, OTC Markets refers to the OTCQB as "The Venture Marketplace."
[23] If an entity is conducting secondary trading and meets the criteria of a national securities exchange, they must register under Section 6 of the Securities Exchange Act of 1934. An entity that does not meet the criteria of a national securities exchange, depending on their activities and trading volume, may alternatively register as a broker-dealer and comply with Regulation ATS.

This new exemption would create an overly broad federal exemption that would allow public solicitation and sales to any investor regardless of sophistication or financial wherewithal, subject only to the requirement that there be a previously existing relationship—a standard that is not difficult to establish. We also question why an issuer would need to engage in public solicitation if it had a previously existing relationship. Further, the practical necessity of the proposed exemption remains unclear—just as basic questions about what issuers it would serve remain unanswered. In fact, there are already several provisions at the state and federal level that small, microcap issuers can rely upon for limited offerings.[24] Congress should consider the relationship between this new proposed exemption and the popular, existing exemption—Rule 506(b)—that allows an issuer to sell its securities to up to 35 non-accredited, sophisticated, investors.[25]

This proposed exemption would preempt state authority to register or review securities offering that are by their nature local, state-based offerings. Without effective regulatory oversight, provisions such as this one will not succeed. Preemption of state review and registration for this type of small localized offering would serve only to handcuff the very regulators best positioned to oversee these smaller, local offerings. In short, there is no valid public policy basis for Congress to prevent state officials and their constituents from making decisions about the purely local or regional issuers that would likely rely on this provision.

***Subtitle P—Fix Crowdfunding***

Subtitle P of the Financial Choice Act would enact a wholesale revision of Title III of the 2012 JOBS Act, which took effect less than a year ago, on May 16, 2016. State securities regulators appreciate Congress's continued interest in federal crowdfunding but believe that Congress should wait until the framework has matured and there is a sufficient record in place before making changes to the crowdfunding law. This is particularly important given the significant overhaul contemplated in this section of the Financial Choice Act.

It is still too early to determine what changes are needed to improve or "fix" federal crowdfunding as there is limited available data. Moreover, enacting a wholesale replacement of federal crowdfunding runs contrary to the work entailed by Congress in drafting Title III of the JOBS Act, and extensive SEC rulemaking to implement Title III. The final federal crowdfunding provisions represent a balance struck by Congress to encourage small business capital formation while also protecting investors.

State securities regulators agree that small businesses are important to job growth and to the continued improvement of the overall economy. In fact, as of today, 33 states plus the District of Columbia have passed state-based crowdfunding laws and other limited offering exemptions. Numerous small businesses rely on those laws to raise money and further their business objectives. Nevertheless, state securities regulators have concerns with proposed Subtitle P. First, it removes individual and aggregate investment caps. As NASAA commented during Congressional consideration of the JOBS Act, one of the fundamental tenets of securities law is to require securities sellers to disclose sufficient information to investors to protect and allow them to make informed decisions. Post-sale antifraud remedies provide little

[24] For example, an issuer can raise funds under Rule 504, Section 3(a)(11) of the Securities Act of 1933 ("1933 Act") and its safe harbor Rule 147, and Section 4(a)(2) of the 1933 Act. Most states also have de minimus offering exemptions, allowing issuers to raise money with a limited number of purchasers through self-executing exemptions with little or no notice filing requirements. Finally, amendments recently finalized by the SEC to Rules 147 and 504 will significantly increase the utility of those exemptions. Small issuers can similarly rely on federal crowdfunding rules and Regulation A.

[25] Under 506(b), however, the non-accredited investors must nevertheless be sophisticated, must receive a disclosure document containing certain information, and cannot be solicited via general solicitation.

comfort to an investor who has lost a significant sum of money that is unrecoverable. In the case of federal crowdfunding, investors are largely unaccredited and many are unsophisticated or first-time investors. Given that most U.S. households have a relatively modest amount of savings, eliminating the cap can expose many more American families to potentially crippling financial harm. Similarly, no cap on the aggregate investment amount makes this provision inconsistent with the expressed rationale for the crowdfunding exemption. A company wanting to raise large sums of investment capital must do so consistent with the laws applicable to such an endeavor, including the registration and filing requirements.

Subtitle P also would allow an issuer to conduct federal crowdfunding without a registered intermediary (an important gateway protection when unsophisticated investors are being solicited), and removes a significant amount of the currently existing regulatory requirements on intermediaries and issuers that protect investors. For example, it removes the requirement that an intermediary protect the privacy of information collected or that an issuer provide a description of its financial condition including certain tax returns and other financial statements. It removes many required disclosures to investors and ongoing reporting to the SEC, and removes all liability for material misstatements and omissions. It also fails to prohibit directors, officers, or partners of an intermediary from having a financial interest in an issuer. Finally, this language amends the current federal crowdfunding regime by prohibiting a state from imposing any fees under authority reserved to the states. While states argued that their registration and review authority should not be preempted under Title III of the JOBS Act, Congress reserved to the states their full enforcement authority, including the imposition of fines or related fees, and the authority to require notice filings and fees. Any attempt to prevent states from collecting fees or imposing fines for improper conduct is misguided, and restricting a state's enforcement authority completely undermines the deterrence that comes with such authority.

This rewritten federal crowdfunding bill will further delay the maturation of this new marketplace, and implement worrisome and dangerous provisions that strip the carefully considered Title III of many of its investor protections. The bill prevents state securities regulators from ensuring that investors do not lose significant and unrecoverable savings. If Congress is poised to enact policies intended to strengthen the economy, this provision will have precisely the opposite effect.

***Subtitle H—Small Business Credit Availability***

As NASAA has testified extensively in the past,[26] Subtitle H would relax portfolio strictures, leverage limits, and other regulations for business development companies ("BDCs"). BDCs are regulated, closed-end investment firms that invest in small, developing or financially troubled companies. Although governed by the Investment Company Act of 1940 ("ICA"), BDCs are unique in that they enjoy a number of important exemptions from the ICA. For instance, BDCs are permitted to use more leverage than a traditional mutual fund—up to and including a 1-to-1 debt-to equity ratio, and BDCs can engage in affiliate transactions with portfolio companies. BDC managers also have access to "permanent capital" that is not subject to shareholder redemption. In exchange for such regulatory latitude, BDCs must adhere to certain portfolio strictures not applicable to other registered funds. Most prominently, BDCs are required to maintain an asset coverage ratio of 200%, at least 70% of which must be in certain "eligible" investments. In addition, under Section 12(d)(3) of the ICA, a BDC generally cannot acquire securities issued by a broker-dealer, an underwriter or an investment adviser of an investment company, or a registered investment adviser, except under limited circumstances.

[26] *See* Letter from Judith Shaw, Maine Securities Administrator and NASAA President, to the Hon. Jeb Hensarling, Chairman, House Committee on Financial Services and the Hon. Maxine Waters, Ranking Member, House Committee on Financial Services, dated Nov. 2, 2015 available at http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2013/10/NASAA-Letter-to-HFSC-Regarding-November-3-2015-Markup.pdf

Subtitle H would alter the restrictions currently imposed on BDCs. It would allow BDCs to invest in investment advisers and an "eligible portfolio company" that includes a list of enumerated investment companies, other than a private equity company or hedge fund, thus resulting in a diversion of BDC funds from the companies that BDCs were intended to benefit. NASAA appreciates that language in the provision permits the SEC to address potential conflicts of interest with investment advisers, but remains concerned about such conflicts. For example, if an advisory firm were among a BDC's portfolio of companies, an incentive could exist for the investment adviser to recommend, or even push, clients toward investments in the BDC or its other portfolio companies. Such conflicts of interest could be even more troublesome in the context of an investment adviser's discretionary or "managed" accounts, where the adviser is delegated authority to make investment decisions on behalf of the client. These inherent conflicts could interfere with an investment adviser's fiduciary obligations to its clients and the BDC as a shareholder. Finally, such conflicts may allow a BDC to access the advisory firm's pool of capital to shore up an underperforming portfolio company. No such conflicts of interest exist now, and NASAA urges Congress not to enact legislation that would create such conflicts as it considers reforms to BDC portfolio strictures.

The proposed language also would have an adverse impact on BDC transparency and increase the risk to retail investors. It would redefine an eligible portfolio company as almost any type of investment company, other than a private equity company or hedge fund, and provides that a BDC may invest up to 50% of its "total assets" (20% more than currently allowed) in any type of eligible or non-eligible company. Because BDCs are frequently "blind pool" offerings, retail investors may only receive broad, vague disclosures about the underlying investment portfolio. It is these retail investors who would bear the loss if the BDC invested in riskier products such as payday lenders and installment programs, REITS, or other structured products.

Finally, NASAA continues to question the rationale for further expanding the leverage limits applicable to BDCs. Excessive leverage comes with increased risk as was the case with many of the largest financial institutions that had to be bailed out by the federal government during the financial crisis. Adjusting the leverage limits applicable to BDCs has inherent potential to put retail investors at significantly increased risk. If Congress ultimately concludes that a modest adjustment to BDC asset coverage ratios for well-established BDCs is in order, it should carefully consider the increased risks that such changes could create for retail investors, and examine what, if any, steps can be taken to mitigate such risks.

***Subtitle T—Private Company Flexibility and Growth***

Section 12(g) of the Securities Exchange Act of 1934 was enacted to ensure that as companies grew and became more complex, so would their disclosures to investors, such that ultimately companies could not avoid becoming public reporting companies once their assets and shareholder base reached a certain threshold. Already creative shareholder recording methods (such as "beneficial" shareholders relying on brokers, banks and other intermediaries) allow companies to avoid mandatory reporting. The JOBS Act increased the shareholder threshold from securities "held of record" by 500 persons, to securities "held of record" by either 2,000 persons, or 500 persons who are not accredited investors. That law also exempted crowdfunding investors and for purposes of the shareholder threshold calculation as well as securities held by shareholders under employee compensation plans. This provision of the JOBS Act is often overlooked but has played a role in the expansion of the private markets to the detriment of the public IPO markets.

Further increasing this threshold under Subtitle T (both for Section 12(g) registration and deregistration) would allow even more private companies to avoid public reporting and rely on existing exemptions from registration (i.e., Rule 506 of Regulation D, Regulation A, crowdfunding) when issuing shares. Subtitle T also removes the 500 non-accredited investor threshold, thus allowing a company to have up to 2,000 non-accredited investors who do not have the benefits of a public reporting company. These benefits include enhanced transparency (e.g., publishing quarterly reports, holding shareholder meetings, etc.), allowing retail investors to participate in the economy and grow their wealth, and permitting investors to freely trade their shares.

***Subtitle U—Small Company Capital Formation Enhancements***

Subtitle U, "JOBS Act-Related Exemption" would increase the aggregate offering limit under Regulation A+ (Section 3(b)(2) of the Securities Act) from $50 million to $75 million and automatically adjust this amount for inflation every 2 years.[27] As with federal crowdfunding, Regulation A+ has not been effective for a sufficient amount of time to make decisions regarding needed adjustments. The Commission adopted final rules on March 25, 2015, and the rules became effective June 19, 2015. It has been less than two years since the rules took effect, and the Commission is still evaluating their effectiveness and considering whether revisions are necessary or prudent. NASAA questions the reasoning behind further increasing the aggregate offering amount and recommends that Congress make those determinations after the market has matured and there is a sufficient regulatory record in place.

***Section 860. Definition of Accredited Investor***

NASAA opposes the provisions in Section 860 that would codify the existing income and net worth standards of the accredited investor definition and direct the SEC to establish new untested means for persons to qualify as accredited investors. Such categories would include natural persons who are licensed or registered as a broker-dealer or investment adviser, and natural persons who the SEC determines, by regulation, have "demonstrable education or job experience to qualify such person as having professional knowledge of a subject related to a particular investment."

As the Government Accountability Office and others have discussed, dollar thresholds have never been an accurate proxy for investor sophistication.[28] Congress should refrain from embedding such flawed metrics, and new untested criteria, into our nation's securities laws. Further, on December 18, 2015, the SEC issued a Dodd-Frank Act mandated report on the definition of accredited investor, making recommendations on potential changes.[29] Congress should allow the SEC to review those findings and any staff recommendations, prior to taking steps to codify additional changes to the accredited investor definition.

***Sec. 401. Registration exemption for merger and acquisition brokers***

Section 401 of the Financial Choice Act would establish an exemption from registration requirements under federal securities laws for persons serving as brokers in certain merger and acquisition

[27] Prior to the enactment of the JOBS Act, the offering cap for Regulation A was $5,000,000. The increase of the offering cap to $50,000,000 represents a 900% increase in the cap. Raising the cap to $75,000,000 would represent a 1400% increase from the initial $5,000,000 cap.

[28] United States Government Accountability Office Report. "Alternative Criteria for Qualifying As An Accredited Investor Should Be Considered." GAO-13-640. (July, 2013).

[29] Section 413(b)(2)(A) of the Dodd-Frank Act directs the SEC to review the accredited investor definition as it relates to natural persons every four years to determine whether the definition should be modified or adjusted for the protection of investors, in the public interest and in light of the economy. The first report is available at sec.gov/corpfin/reportspubs/special-studies/review-definitionof-accredited-investor-12-18-2015.pdf. NASAA submitted a detailed comment letter in response to this recommendation on May 25, 2016, which is available at http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2011/07/NASAA-Accredited-Investor-Comment-Letter-05252016.pdf.

deals ("M&A brokers"). State securities administrators share Congress's interest in establishing a more streamlined regulatory framework for persons serving as brokers in M&A deals that involve the transfer of securities, subject to certain conditions, including (1) the disqualification from the exemption of any broker or associated person who is a bad actor, or subject to suspension or revocation of registration; and (2) the inapplicability of the exemption to any M&A transaction where one party or more is a shell company. NASAA supported legislation identical to Section 401 when it was passed by the House as a provision of a broader legislative package in 2016[30] and continues to support the provision. We also note the federal exemption established by Section 401 closely mirrors a recently adopted NASAA Model Rule which exempts M&A brokers from state securities registration pursuant to certain conditions.[31]

***Other Capital Formation Sections***

NASAA continues to have questions about additional provisions that impact the capital markets and securities regime.[32]

## C. Other Provisions of Significant Concern

In addition to the provisions addressed above, NASAA is concerned with the following provisions in the Financial Choice Act.

***Section 841—Retail Investor Protection Act***

NASAA strongly opposes Section 841 of the Financial Choice Act. This provision would, among other things, invalidate the rule recently adopted by the U.S. Department of Labor ("DOL") until after the SEC issues its own final rule relating to standards of conduct for brokers and dealers, and effectively prevent the DOL from undertaking any future rulemaking regarding the conduct of brokers and dealers in the management of retirement accounts. Section 841 also would impose additional regulatory, analytical, and economic analysis requirements on the SEC prior to any rulemaking. These provisions would only create significant obstacles to any future SEC rulemaking aimed at raising the standards of conduct applicable to broker-dealers.

While the DOL's fiduciary rule remains distinct from any SEC rulemaking pursuant to Section 913 of the Dodd-Frank Act, NASAA continues to advocate on multiple initiatives to raise the standard of care for the benefit of investors.[33] With Americans living longer and, in many instances, with fewer funds

[30] *See* Letter from Judith Shaw, Maine Securities Administrator and NASAA President, to the Hon. Bill Huizenga, dated Feb. 3, 2016 available at http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2013/10/NASAA-Letter-on-Huizenga-Amendment-to-H-R-1675.pdf

[31] On September 29, 2016, NASAA adopted a Model Rule Exempting Certain Merger & Acquisition Brokers from Registration. The NASAA Model Rule is available at http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2011/07/MA-Broker-ModelRule-adopted-Sept.-29-2015.pdf

[32] For example, NASAA questions: (a) whether additional investor protections should be included in Subtitle K - Helping Angels Lead Our Startups; (b) the removal of important investor protections in Subtitle G - Enhancing the RAISE Act - which has already been enacted into law; (c) unnecessary delay of enactment of XBRL in Subtitle C - Small Company Disclosure Simplification; (d) substantially increasing the Rule 701 thresholds from a bill that already passed the House in this Congress in Subtitle B - Encouraging Employee Ownership; and (e) expanding the qualifying investor limitation for a qualifying venture capital fund in Subtitle O- Supporting America's Innovators; among other provisions.

[33] *See* Letter from Mike Rothman, Minnesota Commerce Commissioner and NASAA President, to U.S. Department of Labor, dated March 16, 2017 available at http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2017/03/20170316-Comment-Letter-to-DOL-re-Rule-Delay.pdf

available for retirement, it is absolutely essential that fundamental legal protections for the assets they do have are in place in the form of fiduciary laws—such as the Employee Retirement Income Security Act of 1974 and the Investment Advisers Act of 1940. Further, any nullification of the DOL's fiduciary rule or any attempt to thwart meaningful rulemaking by the SEC would be a profound disservice to investors.

***Section 857—Repeal of Authority to Restrict or Prohibit Mandatory Arbitration***

Section 857 of the Financial Choice Act would repeal Section 921 of the Dodd-Frank Act, which was enacted in direct response to Congressional concern that mandatory pre-dispute arbitration agreements were unfair to investors.[34] The provision gives the SEC explicit rulemaking authority to prohibit, condition or limit the use of mandatory pre-dispute arbitration agreements if it finds that doing so is in the public interest and for the protection of investors.

NASAA has long been concerned with the widespread use of mandatory pre-dispute arbitration clauses in customer contracts used by broker-dealers and, more recently, investment advisers as well.[35] Investors must have a choice of forum when it comes to resolving disputes with their investment professionals. Investor confidence in fair and equitable recourse is critical to the stability of the securities markets and long-term investments by retail investors. As NASAA and others have previously noted, participation by "mom and pop" investors in our capital markets, and, by extension, job growth, is directly tied to their level of trust in having a reasonable avenue to seek recovery if they are victimized by securities fraud or other unethical conduct.

While the SEC has not taken action to limit mandatory pre-dispute arbitration pursuant to its authority under Section 921, this does nothing to alter the fact that the recent proliferation in the use of such contracts by investment professionals is fundamentally harmful to many investors. We urge Congress to retain this important authority and remove this language from the bill.

***Section 858—Exemption of and Reporting by Private Equity Fund Advisers & Section 859 – Records and Reports of Private Funds***

Sections 858 and 859 of the Financial Choice Act would unnecessarily weaken oversight of advisers to private-equity funds, including by repealing important provisions in the Dodd-Frank Act that require the registration and reporting of advisers to such funds. As recent SEC examinations have revealed, the scrutiny of advisers to private funds is important to the protection of investors in such funds, including limited partners, and even certain state pension funds. The registration of private fund advisers has brought much needed transparency to a significant segment of the markets.[36]

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[34] Congress considered the following concerns about the arbitration process: "high upfront costs; limited access to documents and other key information; limited knowledge upon which to base the choice of arbitrator; the absence of a requirement that arbitrators follow the law or issue written decisions; and extremely limited grounds for appeal." *See* Senate Committee on Banking, Housing, and Urban Affairs on S. 3217, S. Rep. No. 111-176, at 110.

[35] *See* Letter from Secretary William F. Galvin of the Commonwealth of Massachusetts to SEC Chair Elisse B. Walter and SEC Commissioners Tory A. Paredes, Luis A. Aguilar, and Daniel M. Gallagher, dated Feb. 12, 2013, *available at* http://sec.state.ma.us/sct/sctarbitration/arbitration-letter.pdf (citing a Massachusetts Securities Division survey to 710 state registered Massachusetts investment advisers, which indicated that of the more than 50% of surveys received, nearly half of the investment advisers included a binding pre-dispute arbitration clause in their advisory contracts).

[36] *See* Prepared remarks of Andrew J. Bowden, Director, Office of Compliance Inspections and Examinations, SEC, Private Equity International (PEI), Private Fund Compliance Forum 2014, New York, NY. (May 6, 2014), *available at* https://www.sec.gov/news/speech/2014--spch05062014ab.html.

NASAA strongly urges Congress to refrain from repealing provisions of the Dodd-Frank Act that provide appropriate and overdue scrutiny of advisers to private funds.

***Section 332—Congressional Approval Procedure for Major Rules***

Section 332 of the Financial Choice Act would require Congress to pass, and the President to sign, a joint resolution of approval for all major rules published in the Federal Register.[37] This radical provision would upend decades of federal administrative law practices dating back to the 1930s. Its potential to dramatically and adversely impact the ability of regulatory agencies to take actions to implement laws intended to protect the investing public is self-evident. NASAA strongly opposes requiring affirmative Congressional and Presidential approval of regulations, and we similarly oppose any attempt to impose debilitating, unreasonable and unrealistic hurdles on independent agencies engaged in rulemaking.

***Section 341—Scope of Judicial Review of Agency Action***

Section 341 would undo nearly two centuries of Supreme Court precedent in which the Court has affirmed that deference to federal agencies is a good jurisprudential practice. The Court's 1984 *Chevron* decision is the most widely recognized case in this regard.[38] But *Chevron* was merely a logical consequence of Court precedents dating as far back as 1827.[39] Deference to federal agencies is good policy because federal agencies, much like a rudder on a ship, provide an inherently stabilizing force to the development of administrative law. Upending the longstanding tradition of agency deference would inevitably result in greater policy discontinuities, to the detriment of American businesses and families.

The conclusion that deference to administrative agencies is ultimately good for the American people is reinforced by the fact that states roundly accept this practice. State legislatures and state courts defer to state administrative agencies on the interpretation of state laws and rules which those agencies administer not because they have to—*Chevron*, of course, does not bind the states—but because they have considered this issue and concluded that deference works. It would be a mistake for the federal government to abort this principle.

***Section 811—Duties of SEC Investor Advocate***

NASAA strongly opposes provisions in the Financial Choice Act that would weaken the independence and influence of the SEC's Office of the Investor Advocate. Specifically, Section 811 would restrict the SEC Investor Advocate's authority to express views regarding legislation introduced in Congress, except in regard to a legislative change proposed by the Investor Advocate, and also would require the Investor Advocate to consult and coordinate activities and recommendations with unrelated SEC advisory committees. In NASAA's view, such requirements are unnecessary and would undermine the ability of the Investor Advocate to speak as an independent voice for the interests of retail investors.

***Section 831—Complaint and Burden of Proof Requirements for Certain Actions for Breach of Fiduciary Duty***

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[37] Section 334 of the Financial Choice Act defines the term major rule as any rule or interim final rule that the Office of Management and Budget find has resulted in or is likely to result in (A) an annual effect on the economy of $100 million or more; (B) a major increase in costs or prices for consumers, individual industries, Federal, State or local government agencies; or significant adverse effects on competition, employment, investment, productivity or innovation.

[38] *Chevron v. Nat'l Resources Def. Council*, 467 U.S. 837 (1984).

[39] *Edwards' Lessee v. Darby*, 25 U.S. 206 (1827).

Section 36(b) of the Investment Company Act (ICA) provides mutual fund investors with a cause of action against mutual fund investment advisers that charge investors excessive advisory fees. Section 36(b) is the only private cause of action in the ICA. In 2010, the Supreme Court adopted the so-called *Gartenberg* test as the proper standard for Section 36(b) claims.[40] This test poses a significant hurdle to plaintiffs, who must show that an adviser charged a fee "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining."[41]

Section 831 would place two additional burdens on investors by elevating the pleading standard and burden of proof in Section 36(b) claims. This would make it nearly impossible for investors to succeed in 36(b) cases. First, raising the pleading standard will put investors in a Catch-22: they will be required to plead specific facts that show an adviser's fee was excessive yet they will have no ability at this stage of litigation to discover these facts through subpoenas for documents or testimony. Second, elevating the burden of proof in Section 36(b) claims from a preponderance to clear and convincing evidence standard would put a nearly insurmountable hurdle in investors' way if they even could successfully plead their claims. Indeed, Section 831 would tip the scales of justice in Section 36(b) disputes strongly in favor of investment advisers, to the detriment of average American retail investors.

## IV. Conclusion

In conclusion, NASAA's message to Congress is simple and clear: Please continue your commitment to protecting investors and do not undermine the important and overdue reforms implemented in the wake of the financial crisis, either directly through legislative repeals, or indirectly through a lack of appropriate funding or delayed execution. The financial crisis that struck our country is not some distant memory in the minds of hard-working Americans. The distress that comes with the loss of retirement savings built up over many years is devastating. It is, therefore, incumbent upon members of Congress and regulators to demonstrate an unwavering commitment to Main Street investors and continue to take the steps necessary to protect them. Their confidence in knowing that the "cops are on the beat" is integral to the success and integrity of our nation's markets. NASAA looks forward to working cooperatively with the Committee, as well as all members of Congress and fellow regulators, to ensure Americans continue to benefit from effective regulation, strong investor protection, and robust and transparent capital markets.

Thank you again for the opportunity to provide this statement for the hearing record, and for your consideration of NASAA's views on the Financial Choice Act.

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[40] *Jones v. Harris Assoc.*, 559 U.S. 335 (2010).
[41] *Id.* at 344.