Reforming the Financial System So It Works for the Rest of the System

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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

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[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

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[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."