

WRITTEN TESTIMONY

OF

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BEFORE THE

**COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES**

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EXECUTIVE SUMMARY

- Sound regulatory implementation of the Dodd-Frank Act is vital to economic growth and maintaining America's competitiveness. President Obama should not leave the financial system behind in his new initiatives in these areas.
- The rulemaking process is a massive undertaking in which over 200 new rules are being implemented in one year, completely revamping the regulation of our financial system. This is too fast a timetable to do the job correctly. It does not permit adequate public input and is devoid of meaningful cost-benefit analysis.

Recommendations for Dodd-Frank Regulatory Implementation

1. Congress should urge the President to require OMB to comment on the adequacy of cost-benefit analysis of the independent financial agencies in promulgating new rules, *e.g.*, the CFTC, FDIC, Federal Reserve, and SEC. Congress should require by statute that all these agencies engage in cost-benefit analysis.
2. Congress should encourage the financial agencies to report on progress toward meeting statutory deadlines and permit the missing of deadlines if truly justified.
3. Congress should encourage the financial agencies to make proposed and issued rules available to the public promptly.
4. Congress should give the financial agencies the resources they legitimately need to implement Dodd-Frank.

¹ Biography available at <http://www.law.harvard.edu/faculty/directory/index.html?id=63>.

Needed Changes in the Dodd-Frank Act

1. Do not require the Federal Reserve to get advance Treasury Secretary approval for emergency lending.
2. Narrowly define “proprietary trading” under the Volcker Rule to include only “trading activities set up with segregated capital and separate teams of personnel that do not interact with customer businesses or rely on customer deposits.”
3. The Congress, not the Federal Reserve, should fund the activities of the Bureau of Consumer Financial Protection and should urge the President to promptly nominate a director of the new agency.
4. Fundamental structural reform of the regulatory system is needed, beyond the creation of the Financial Stability Oversight Council.
5. The ban on the use by the government of credit ratings in formulating regulations should be somewhat relaxed by providing that the government cannot unduly rely on such ratings.

* * *

Thank you, Chairman Bachus, Ranking Member Frank, and members of the Committee for permitting me to testify before you today on promoting economic recovery and job creation. I am testifying today in my own capacity and do not purport to represent the views of the Committee on Capital Markets Regulation, although much of my testimony is based on the Committee’s past reports and statements.

I will focus my remarks on the process of the regulatory implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank),² as well as some proposals for legislative improvements. These rules will have a profound long-term impact on our financial system, which is crucial to the U.S. economy. President Obama has recently shifted his focus to American competitiveness and the increasing burden of the regulatory system. Financial regulations and regulators should not be exempt from these concerns. Competitiveness of our

² Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 [hereinafter “Dodd-Frank Act”].

financial system has long been a concern of the Committee on Capital Regulation, indeed spurring its creation in 2005. Rushed regulation devoid of public input and sound cost-benefit analysis will harm the competitiveness of the U.S. financial markets and will in turn be a drag on our economy.

As the Committee knows, the unprecedented scope and pace of agency rulemakings implementing Dodd-Frank has created unique challenges for businesses and regulators. The Securities and Exchange Commission (SEC), Federal Deposit Insurance Corporation (FDIC), Commodity Futures Trading Commission (CFTC), Board of Governors of the Federal Reserve System (Federal Reserve), and the new Financial Stability Oversight Council (FSOC) are collectively responsible for at least 230 rulemakings.³ Many more are likely to follow from those and other agencies. The scope of these rulemakings is vast and encompasses almost a complete revision of the regulation of the financial system. President Obama, keenly aware of the danger of poorly formulated rules to economic growth, moved improvements in the regulatory process near the top of his agenda last week.⁴ I applaud him for doing so.

This is a particularly opportune time to consider the regulatory process because last week we also crossed the six-month anniversary of the Dodd-Frank Act. This puts us halfway to the one-year deadline this July, by which time the regulatory agencies must finalize the majority of important rules implementing the Act. In revising our regulatory structure, the most important objective should be to get the rules right, not to act quickly. While a prolonged process may result in some uncertainty for our economy, bad rules will result in more serious and permanent damage. Let me be clear: I am not urging delay to avoid or unnecessarily defer regulation; I am simply advocating taking the time we need to get it right.

³ Sec. Industry & Fin. Mkts. Ass'n, *Regulatory Action Database*, <http://www.sifma.org/members/dodd-frank.aspx>.

⁴ See Barack Obama, *Toward a 21st-Century Regulatory System*, WALL ST. J., Jan. 18, 2011, at A17.

I will begin by detailing needed improvements in the regulatory process and then turn to some more substantive issues that would require revisions of the Act.

I. The Dodd-Frank Implementation Process

The Committee on Capital Markets Regulation recently examined how the financial agencies are handling the daunting task of writing these rules to implement the Dodd-Frank Act. In its December 15 letter to you and your counterparts on the Senate Committee on Banking, Housing, and Urban Affairs, it detailed how “the current rulemaking process is sacrificing quality and fairness for apparent speed.”⁵ The current rulemaking process is undoubtedly rushed, and even the most interested and sophisticated parties, including the trade associations, are finding it very difficult to keep up and offer meaningful input.

As the Committee’s letter explained, speed can kill.⁶ This push for speed can be traced, in large part, back to Secretary of the Treasury Geithner’s promise in August 2010 to change the “glacial pace” of rulemaking.⁷ This was done to blunt charges that a slow pace of implementation would create economic uncertainty and impede economic recovery. At that time, Glenn Hubbard and I wrote an op-ed in the Wall Street Journal urging federal agencies not to sacrifice the requirement for deliberative and rational regulatory implementation in search of speed.⁸ Since our

⁵ Letter from the Comm. on Capital Mkts. Reg. to Christopher Dodd, Chairman, Richard Shelby, Ranking Member, S. Comm. on Banking, Hous. & Urban Affairs and Barney Frank, Chairman, Spencer Bachus, Ranking Member, H. Comm. on Fin. Servs. 1 (Dec. 15, 2010), http://www.capmksreg.org/pdfs/2010.12.15_Rulemaking_Timeline_Letter.pdf [hereinafter “CCMR Dec. 15, 2010 Letter”].

⁶ *See id.* at 4.

⁷ Timothy F. Geithner, *Rebuilding the American Financial System*, Address at New York University Stern School of Business (Aug. 2, 2010), transcript available at <http://www.treasury.gov/press-center/press-releases/Pages/tg808.aspx> (“First, we have an obligation of speed. We will move as quickly as possible to bring clarity to the new rules of finance. The rule writing process traditionally has moved at a frustrating, glacial pace. We must change that.” (internal paragraph break omitted)).

⁸ Glenn Hubbard & Hal S. Scott, *Geithner’s Hollow ‘Speed’ Pledge to Business*, WALL ST. J., Aug. 5, 2010.

call, and those of others, particularly after the November elections, the pace has slowed down somewhat but not nearly enough.

Our nation’s rulemaking process, as codified in the Administrative Procedure Act (APA), is founded on the principles of transparency and responsiveness to the views of the public. Historically, the SEC, CFTC, FDIC, and Federal Reserve have all respected this process. In 2005 and 2006, the SEC issued on average fewer than ten new substantive rules. It must now issue approximately 100 rules, 60 of them by this July. Meanwhile, the CFTC, which issued a total of 11 substantive rulemakings in 2005 and 2006 combined, must now issue nearly 40 by July.

Table 1: Average annual rate of rulemaking (rules per year)⁹

Agency	Pre-Dodd-Frank (2005–2006)	Post-Dodd-Frank
SEC	9.5	59
CFTC	5.5	37
FDIC	8	6
Federal Reserve	4.5	17

Agencies are abandoning their responsible, deliberative rulemaking processes in favor of a faster process. A random sample of rulemakings by the SEC, CFTC, FDIC, and Federal Reserve from 2005 and 2006 revealed that during that time those agencies provided more than 60 days on average for public comment on proposed rules. They often left the comment period open for as long as 90 or 120 days for major rulemakings. In contrast, in the first three months since the passage of the Dodd-Frank Act, these same agencies and the new Financial Stability Oversight Council (FSOC) gave, on average, just over 30 days for comment.¹⁰ The average comment period for all rulemaking since the Dodd-Frank Act was passed is now about 45 days (the pace having

⁹ Includes only formal, notice-and-comment rulemaking. Does not include technical amendments or interim final rules.

¹⁰ CCMR Dec. 15, 2010 Letter, *supra* note 5, at 3.

slowed somewhat in recent months), but this is still not enough time, especially since these agencies issued nearly 50 proposed rules in the last two months of 2010, nearly 40 of which came in November. Further, some of the most significant rules have very short comment periods. For example, one of the most important tasks FSOC has is to determine which “systemically important” nonbank financial companies should be subject to enhanced supervision by the Federal Reserve.¹¹ Yet FSOC provided only 30 days to comment on both the advance notice of proposed rulemaking and the proposed rule itself.¹² The latter was even subject to review by Executive Order 12866, which states that in most cases the comment period should be “not less than 60 days.”¹³ Indeed, President Obama recently reaffirmed the long-standing presidential policy that in order to “afford the public a meaningful opportunity to comment,” the comment period “should generally be at least 60 days.”¹⁴

The statutory requirement and historical practice of allowing all interested parties to provide input during the rulemaking process is made only more important when, as now, agencies are considering complex and critical policies like those in the Dodd-Frank Act. The rules regulators are drafting will dramatically reshape entire industries; the affected people, companies, and industry groups need extra time to process these fundamental changes. Instead they are getting less time.

¹¹ See Dodd-Frank Act § 113(a)(1).

¹² See Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 75 Fed. Reg. 61,653, 61,653 (Oct. 6, 2010); *Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies*, FSOC, RIN 4030-AA30.

¹³ Exec. Order No. 12,866, § 6(a)(1), 58 Fed. Reg. 51,735, (Oct. 4, 1993). See *Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies*, FSOC, RIN 4030-AA30 (“It has been determined that this regulation is a significant regulatory action as defined in section 3 of Executive Order 12866 (‘Regulatory Planning and Review’) and it has been reviewed by the Office of Management and Budget.”).

¹⁴ Exec. Order No. 13,563, § 2(b), 76 Fed. Reg. 3,821 (Jan. 21, 2011); see also Exec. Order No. 12,866, § 6(a), 58 Fed. Reg. 51,735, (Oct. 4, 1993).

The present lack of coordination among agencies also contributes to making the process unwieldy. In many instances Dodd-Frank requires agencies to coordinate rulemaking, sometimes even requiring the promulgation of joint rules. A total of 43 rulemaking provisions involve two or more agencies, 25 of which involve three or more.¹⁵ Unfortunately, the progress thus far does not bode well for this process. Dodd-Frank requires joint rulemaking among several agencies in the field of securitization, yet the SEC and the FDIC have each already released proposed or final rules, which conflict with each other, in advance of the joint process.¹⁶ Such conflicts are, in part, a reflection of different agency views on substance. But they are also a result of a process in which the promulgation of rules lacks overall consistency and direction. This is a legacy of our continuing fragmented regulatory structure.

An inadequate process will also make successful challenges in federal court more likely. The APA forbids rulemaking practices that are “arbitrary and capricious”; a rushed and uncoordinated process is, unfortunately, very likely to live up to that standard. The short time limits permitted by the statute are no excuse. The D.C. Circuit has stated that even if the Congress “vest[s] broad rulemaking authority in an agency...[and] charge[s] the agency with swiftly and effectively implementing a national policy,...the agency remains bound by the APA’s notice and comment requirements.”¹⁷ Rules that are likely to be overturned in court only add to uncertainty and make the speed of implementation nothing more than an illusion.

¹⁵ See Curtis W. Copeland, Cong. Research Serv., R41472, *Rulemaking Requirements and Authorities in the Dodd-Frank Wall Street Reform and Consumer Protection Act* 7 (Nov. 3, 2010),

¹⁶ See Dodd-Frank Act § 941(b); compare *Asset-Backed Securities*, 75 Fed. Reg. 23,328 (May 3, 2010) (SEC) with *Treatment by the Federal Deposit Insurance Corporation as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection With a Securitization or Participation After September 30, 2010*, 75 Fed. Reg. 60,287 (Sept. 30, 2010) (FDIC).

¹⁷ *Chamber of Commerce of U.S. v. SEC*, 443 F.3d 890, 899 (D.C. Cir. 2006).

Some agencies have statutory responsibilities to engage in some form of cost-benefit analysis. The CFTC is required to “consider the costs and benefits” of its rules, and the SEC is generally required to consider whether its rules “will promote efficiency, competition, and capital formation.”¹⁸ Similarly, FSOC is required to conduct cost-benefit analysis when completing some of its studies.¹⁹ The Executive Order the President issued last week reaffirms the importance of cost-benefit analysis in rulemaking.²⁰ But doing proper analysis takes both data and time. The present pace of rulemaking makes it extremely difficult for the regulators to do such analysis. In a recent release proposing rules on reporting requirements for swap transactions, the CFTC devoted one paragraph to examining costs and two paragraphs to benefits.²¹ Moreover, rather than quantify the costs for a typical transaction or examine the tradeoffs for each required data element, the CFTC took a qualitative and holistic approach and concluded *ipse dixit* that “the additional cost imposed by the [rules]...would be minimal.”²² One must bear in mind that regulators do not have a particularly impressive historical record of sound cost-benefit analysis, even when they take more time. When implementing the last significant piece of financial legislation, the Sarbanes-Oxley Act of 2002, the SEC dramatically underestimated the cost of Section 404 requirements for internal controls.²³ The SEC originally estimated that internal costs (exclusive of audit fees) would average \$91,000 per company.²⁴ Subsequent studies have shown that the true cost is on the order

¹⁸ 7 U.S.C. § 19(a) (CFTC); 15 U.S.C. § 78c(f) (SEC); *see also* 15 U.S.C. § 78w(a)(2) (SEC required to consider burden on competition).

¹⁹ Dodd-Frank Act §§ 115(c)(1), 123(a)(1).

²⁰ Exec. Order No. 13,563, § 2(b), 76 Fed. Reg. 3,821 (Jan. 21, 2011).

²¹ *See* Reporting, Recordkeeping, and Daily Trading Records Requirements for Swap Dealers and Major Swap Participants, 75 Fed. Reg. 76,666, 76,673 (proposed Dec. 9, 2010).

²² *See id.*

²³ *See* 15 U.S.C. § 7262.

²⁴ *See* Management’s Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports of Companies That Are Not Accelerated Filers, 70 Fed. Reg. 56,825 (proposed Sept. 29, 2005). Note that this estimate covered only § 404(a), not § 404(b).

of \$3.5 million per company—more than 35 times the SEC’s estimate.²⁵ In a rushed environment, where not even rudimentary data is collected, the results will be worse.

To be sure, the deadlines imposed by the Congress in the Dodd-Frank legislation are part of the problem. The overambitious timeframe is evident when compared with past practice. Before the Dodd-Frank Act, in 2005 and 2006, the SEC took an average of 524 days between proposing and finalizing a rule. For the rules it has proposed so far, it has an average of only about 200 days before the Dodd-Frank Act requires final rules. Although the CFTC now has more time to finalize its rules than it typically takes (it has 238 days, compared to its 109-day historical average), it has never before been tasked with writing so many complex rules.²⁶

Table 2: Average number of days between proposed rule and final rule

Agency	Pre-Dodd-Frank (2005–2006)	Post-Dodd-Frank²⁷
SEC	524	206
CFTC	109	230
FDIC	154	248
Federal Reserve	596	229

The implementation of the Dodd-Frank Act is daunting. But this is no excuse for abandoning the traditional practices of sound rulemaking. Slowing things down admittedly will create some uncertainty, but the economic damage will be less than if bad rules are adopted. The 112th Congress can take some very important steps toward ensuring more responsible rulemaking in this area.

Let me turn to some specific recommendations.

²⁵ See COMM. ON CAPITAL MKTS. REG., INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 1, 126 (Nov. 30, 2006), [hereinafter “CCMR Interim Report”].

²⁶ CCMR Dec. 15, 2010 Letter, *supra* note 9, at 4.

²⁷ Calculated using the number of days between the proposed rule and the statutory deadline.

Recommendation 1: Extend OMB Review to the Independent Agencies

For the last 30 years, a period spanning nearly five presidents, a series of executive orders has added additional requirements to the rulemaking process to the skeletal requirements of the APA. The current system, under the 1993 Executive Order 12866, generally requires governmental agencies to conduct cost-benefit analysis, leave comment periods open for at least 60 days, and submit proposed rules for review by the Office of Information and Regulatory Affairs (OIRA) within the Office of Management and Budget.²⁸ President Obama recently reaffirmed these principles in a new executive order.²⁹

Many financial regulators, however, escape these requirements. The “independent regulatory agenc[ies]” are exempt under both the 1993 Order and the President’s new Order.³⁰ The list of these independent agencies includes the Federal Reserve, CFTC, FDIC, and SEC.³¹ Cass Sunstein, presently the Administrator of OIRA, has long called for expanding the Executive Order to subject proposed rules of the independent agencies to OIRA review, and therefore a requirement to engage in cost-benefit analysis.³² This approach may go too far because it impinges on the independence of the “independent agencies” created by Congress and conceivably could raise constitutional issues.³³

A more moderate approach that avoids issues of separation of powers would be for OIRA to file comments with the agency, with respect to important rulemakings (as determined by OIRA)

²⁸ See Exec. Order No. 12,866, § 6(a), 58 Fed. Reg. 51,735 (Oct. 4, 1993).

²⁹ Exec. Order No. 13,563, § 2(b), 76 Fed. Reg. 3,821 (Jan. 21, 2011); 44 U.S.C. § 3502(5).

³⁰ See Exec. Order No. 12,866, § 6(a), 58 Fed. Reg. 51,735 (Oct. 4, 1993); Exec. Order No. 13,563, § 2(b), 76 Fed. Reg. 3,821 (Jan. 21, 2011); 44 U.S.C. § 3502(5).

³¹ See *id.*

³² See Robert W. Hahn & Cass R. Sunstein, *A New Executive Order for Improving Federal Regulation? Deeper and Wider Cost-Benefit Analysis*, 150 U. PA. L. REV. 1489, 1531–37 (2002); see also Richard H. Pildes & Cass R. Sunstein, *Reinventing the Regulatory State*, 62 U. CHI. L. REV. 1 (1995).

³³ See Hahn & Sunstein, *id.*, 150 U. PA. L. REV. at 1531–37; Pildes & Sunstein, *id.*, 62 U. CHI. L. REV. at 24–33; see also Elena Kagan, *Presidential Administration*, 114 HARV. L. REV. 2245, 2319–31 (2001).

on the adequacy of whatever cost-benefit analysis the agency is required to do under statute or decides to do on its own. The agency would be free to incorporate or disregard OIRA's comments as it sees fit, although the final rules would still be subject to review in court and ignoring OIRA comments would obviously be taken into account in deciding whether the agency action was "arbitrary" or "capricious."³⁴

This approach assumes that the agencies are required to engage in some form of cost-benefit analysis. Some agencies, such as the CFTC, are already required to do so. This requirement should be extended and strengthened so that all of the financial regulators (including FSOC) are required to determine whether the costs of its rules exceed the benefits. President Obama cannot expect to avoid harm to the economy through ill-advised regulation as a whole unless financial regulation is included.

Recommendation 2: Encourage Agencies to Report on Deadlines

This Congress should also encourage agencies to report on their progress toward statutory deadlines. Such reporting would make it easier to determine when more time is required. Indeed, the CFTC has already missed a statutory deadline to set position limits on some commodities,³⁵ and the Financial Crisis Inquiry Commission announced that it will not issue its report on the financial crisis to the President and Congress before its statutory deadline.³⁶

³⁴ 5 U.S.C. § 706(2)(A); CCMR Interim Report at 60–63 (noting that "because OMB and OIRA are offices of the White House, [review by those offices] would bring an "independent" agency under the political influence, if not control, of the Executive Branch").

³⁵ See Charles Abbott & Tom Doggett, *CFTC Admits Will Miss Deadline on Position Limits*, Reuters (Dec. 15, 2010), <http://www.reuters.com/article/idUSTRE6BE4OX20101215>; see also Dodd-Frank Act § 737(a)(4) (requiring rules on some position limits within 180 days).

³⁶ See Exec. Order No. 13,563, § 2(b), 76 Fed. Reg. 3,821 (Jan. 21, 2011).

The ability of agencies to meet statutory deadlines has always been stretched during times of increased rulemaking. As the Fifth Circuit Court of Appeals noted, agencies do not always “regard the statutory deadline[s] as sacrosanct.”³⁷ For example, during the implementation of the SOX, the SEC missed at least two statutory deadlines.³⁸ Such a reporting system should acknowledge that Congress will tolerate delays in implementation where such delays are justified.

Recommendation 3: Prompt Availability of Proposed and Issued Rules

President Obama’s new executive order from last week highlighted the importance of the internet in the regulatory process, particularly for public input.³⁹ Yet it can typically take days, and sometimes weeks, for agencies to make available the full text of proposed and even final rules. Although agencies frequently issue press releases and summaries of the rules, interested parties need access to the full rules in order to understand their full contours. The full text of regulations should be posted immediately to the agencies’ own websites and should be posted to regulations.gov as soon as possible.

Recommendation 4: Agencies Need Adequate Resources

It is unwise to cut the budgets of the financial regulatory agencies in an attempt to control or derail the regulatory reforms prompted by Dodd-Frank. Tightening the purse strings will not stop the rulemaking process; it will only make it worse. Independent agencies deprived of funds will not stop writing rules—they will only do a worse job or shift resources from other important

³⁷ U.S. Steel Corp. v. U.S. Environmental Protection, 595 F.2d 207, 213 (5th Cir. 1979); see also Jacob E. Gersen & Anne Joseph O’Connell, *Deadlines in Administrative Law*, 156 U. PENN. L. REV. 923, 954 (2008) (discussing missed deadlines).

³⁸ See, e.g., Improper Influence on Conduct of Audits, 68 Fed. Reg. 31,820, 31,820 (May 28, 2003) (issuing final rule two months after statutory deadline); Strengthening the Commission’s Requirements Regarding Auditor Independence, 68 Fed. Reg. 6,006 (Feb. 5, 2003) (announcing final rule after statutory deadline had passed that would not become effective for over two months).

³⁹ See Exec. Order No. 13,563, § 2(b), 76 Fed. Reg. 3,821 (Jan. 21, 2011).

areas such as enforcement. As the Committee on Capital Markets Regulation said in its December letter to Congress, “bad rules [will] interfere with the proper functioning of the financial system for years to come.”⁴⁰ I agree with some members of Congress that there are major problems with the implementation of Dodd-Frank, but they should be fixed through legislation and oversight, not through withholding funds in the appropriations process. Starving the agencies of necessary funds risks making a bad situation worse.

II. Substantive Issues with the Dodd-Frank Act

I would also like to take this opportunity to highlight five areas of the Dodd-Frank Act itself that deserve your attention.

A. Requiring the Federal Reserve to Get Treasury Secretary Approval for Emergency Lending

Section 1101 of the Dodd-Frank Act provides that the Federal Reserve may establish an emergency lending facility only with “the prior approval of the Secretary of the Treasury.”⁴¹ As the Committee on Capital Markets Regulation argued in its June 2010 letter to Congress, this approach “imposes unnecessary procedural hurdles on the Federal Reserve, potentially hampering its ability to act decisively in a crisis.”⁴² The Federal Reserve, not the Secretary of the Treasury, is the proper decision-making body for emergency lending, assuming such lending is adequately collateralized, a result Dodd-Frank makes more likely because any lending facility must ensure “that the security for emergency loans is sufficient to protect taxpayers from losses,” may not be

⁴⁰ CCMR Dec.15, 2010 Letter at 5.

⁴¹ Dodd-Frank Act § 1101(a)(6)(B)(iv).

⁴² Letter from the Comm. on Capital Mkts. Reg. to Christopher Dodd, Chairman, Richard Shelby, Ranking Member, S. Comm. on Banking, Hous. & Urban Affairs, Barney Frank, Chairman, Spencer Bachus, Ranking Member, H. Comm. on Fin. Servs. 6 (June 14, 2010), http://www.capmksreg.org/pdfs/2010.06.14_CCMR_Reconciliation_Letter.pdf.

used to lend to insolvent borrowers, must have “broad-based eligibility,” and is subject to audits by the Comptroller General of the United States.⁴³

Not only does the Federal Reserve have the expertise for making such decisions, but as we saw in the crisis, it is also uniquely capable of acting with the speed and decisiveness that is required in any emergency. Although it may be proper and prudent to require the Federal Reserve’s general procedures for administering such facilities to be approved by the Secretary of the Treasury, it is unwise to require, as the Dodd-Frank Act currently does, approval of the facility itself. Federal Reserve lending may be demonized as a bailout; if done properly however, it is a well-collateralized loan. Nonetheless, Treasury Secretaries, particularly in the anti-bailout environment following our crisis, may be reluctant to approve needed lending facilities for fear of political consequences. This is why we need to rely on independent agencies to make what may be necessary but unpopular decisions. Lender of last resort authority is a key power of independent central banks.

B. The Definition of “Proprietary Trading” under the Volcker Rule

The Volcker Rule, as enacted in § 619 of the Dodd-Frank Act, prohibits any bank from “engag[ing] in proprietary trading.”⁴⁴ In testimony I delivered last year to the Senate Committee on Banking, Housing, and Urban Affairs, I showed how restrictions on proprietary trading are both over- and under-inclusive. They are over-inclusive because not all banks engaged in proprietary trading contribute to systemic risk, and under-inclusive because some non-banks engaged in proprietary trading may contribute to systemic risk.⁴⁵ In addition, such rules risk

⁴³ Dodd-Frank Act §§ 1101(a)(6), 1102(a).

⁴⁴ *Id.* § 619.

⁴⁵ *Implications of the ‘Volcker Rules’ For Financial Stability: Hearing Before the S. Comm. on Banking, Housing, & Urban Affairs*, 111th Cong. 2, 5 (Feb. 4, 2010) (statement of Hal S. Scott).

making our banks uncompetitive internationally, a result the President seeks to avoid. Again, the financial system cannot be left outside the concern of competitiveness. Further, proprietary trading was not a cause of our financial crisis, and can make banks more safe and sound by diversifying their activities beyond risky lending.

The term “proprietary trading” in section 619 is ambiguous. That is why the FSOC has called for input on further defining the term through the rulemaking process, but has yet to give any specific guidance on a proper definition.⁴⁶ The Act defines “proprietary trading” as follows:

engaging as a principal for the trading account of the banking entity or nonbank financial company supervised by the Board in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that the [regulators] determine.⁴⁷

The implementation of the Dodd-Frank Act would be greatly improved if, through rule or amendment, the term “proprietary trading” is defined narrowly and the various exceptions defined broadly. The definition should be limited to “trading activities set up with segregated capital and separate teams of personnel that do not interact with customer businesses or rely on customer deposits.”⁴⁸

⁴⁶ See Public Input for the Study Regarding the Implementation of the Prohibitions on Proprietary Trading and Certain Relationships With Hedge Funds and Private Equity Funds, 75 Fed. Reg. 61,758, 61,759, § 4(v) (Oct. 6, 2010).

⁴⁷ Dodd-Frank Act § 619(h)(4).

⁴⁸ See Comm. On Capital Mkts. Reg., comment to Financial Stability Oversight Council Advance Notice of Proposed Rulemaking, *Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies*, 75 Fed. Reg. 61,653 (filed Nov. 5, 2010).

C. Funding and Management of the Bureau of Consumer Financial Protection

Under the Dodd-Frank Act, the newly created Bureau of Consumer Financial Protection (Bureau) is funded from the profits of the Federal Reserve.⁴⁹ The Bureau receives whatever amount its Director determines is “reasonably necessary to carry out [its] authorities,” subject to a cap of about \$550 million.⁵⁰

Funding the Bureau through Fed profits, particularly without any review of the justification for the money claimed, is problematic because it sets a bad precedent for appropriating Federal Reserve profits to particular budgetary needs. Budgetary determinations should be made through the normal appropriation process, where justification is required.

In addition, the Bureau is in need of a permanent Director. Professor Elizabeth Warren, a wonderful colleague of mine, is doing an admirable job in helping to set up the Bureau. But the Bureau needs a real Director, properly appointed by the President and confirmed by the Senate as required by Dodd-Frank, whether it be her or someone else.⁵¹ Dodd-Frank allows the Secretary of the Treasury to perform some functions of the Bureau before a Director has been confirmed, a power which Secretary Geithner has delegated to Warren in her role as Special Advisor to the Secretary.⁵² That interim authority is limited, however. It presently includes establishing the Bureau, hiring its employees, and working with other regulators.⁵³ On the “designated transfer

⁴⁹ See Dodd-Frank Act § 1017(a)(1).

⁵⁰ *Id.* § 1017(a); *Annual Report, 2009, Board of Governors of the Federal Reserve System* at 475, 491. Note that this cap, which increases slightly for fiscal years 2012 and 2013 and is adjusted for inflation thereafter, does not include the additional appropriations through fiscal year 2014 provided by § 1017(e).

⁵¹ See Dodd-Frank Act § 1011(b)(2).

⁵² See *Id.* § 1066(a). Letter from Eric M. Thorson, Inspector General, Department of the Treasury, and Elizabeth A. Coleman, Inspector General, Board of Governors of the Federal Reserve System, to Hon. Spencer Bachus, Chairman, Committee on Financial Services, and Hon. Judy Biggert, Chairman, Committee on Financial Services, Subcommittee on Insurance, Housing, and Community Opportunity, OIG-CA-11-004, FRB OIG 2011-01 Enclosure at 2 (Jan. 10, 2011) [hereinafter “OIG Letter”].

⁵³ OIG Letter at 4-5. Note that § 1066(b) also permits the Treasury to provide additional “administrative services.”

date,”⁵⁴ currently set for July 21, 2011,⁵⁵ many of the Bureau’s substantive powers and responsibilities will begin. The Inspectors General for both the Treasury and the Federal Reserve have concluded that after this date, the powers of the Secretary of the Treasury, or his delegate, are limited to the Bureau’s functions under subtitle F of Title X of the Act, which generally encompass the existing authorities of *other* regulators that will be transferred to the Bureau.⁵⁶ The Inspectors General have concluded that only a Senate-confirmed Director may exercise the *new* authorities that the other subtitles of the title establish, including the new powers to prohibit unfair, deceptive, or abusive practices and to control disclosures about consumer financial products.⁵⁷

The Bureau needs to have a head that is capable of executing the full powers of the office. It will not get off to a good start if, when it becomes a functional agency, its head is operating with one hand tied behind his or her back.

D. Structural Reform Beyond the Financial Stability Oversight Council

In 2009, the Committee on Capital Markets Regulation called for the reorganization of the U.S. regulatory structure, calling it “an outmoded, overlapping sectoral model.”⁵⁸ The Dodd-Frank Act has not rectified the problem. Although it eliminated the Office of Thrift Supervision,⁵⁹ it created the Bureau of Consumer Financial Protection, the Federal Insurance Office, and the FSOC.⁶⁰ I urge this Congress to make real structural reform a top priority. Regulation of the U.S.

⁵⁴ Dodd-Frank Act § 1062.

⁵⁵ Designated Transfer Date, 75 Fed. Reg. 57,252, 57,253 (Sept. 20, 2010).

⁵⁶ OIG Letter at 5-6.

⁵⁷ *Id.* at 6–7; *see* Dodd-Frank Act §§ 1066(a) (“The Secretary is authorized to perform the functions of the Bureau under this subtitle until the Director of the Bureau is confirmed by the Senate.”), 1031 (“prohibiting unfair, deceptive, or abusive acts or practices”), 1032 (disclosures).

⁵⁸ COMM. ON CAPITAL MKTS. REG., THE GLOBAL FINANCIAL CRISIS: A PLAN FOR REGULATORY REFORM 1, 203 (May 2009) [hereinafter “CCMR May 2009 Report”].

⁵⁹ *See* Dodd-Frank Act § 312(b).

⁶⁰ *See id.* §§ 111(a) (FSOC), 502 (FIO), 1011(a) (CFPB).

financial system should be concentrated in no more than three federal regulatory bodies, as the Committee has recommended.⁶¹

Although the FSOC has been tasked with some oversight and coordination roles, and may represent a transition toward real reform, it is not a real solution to our fragmented regulatory structure. First, it has little direct supervisory authority—authority remains dispersed among the other agencies. For example, although it has the authority to designate nonbank financial institutions as systemically important, Dodd-Frank places enhanced supervisory authority in the hands of the Federal Reserve.⁶² It can make recommendations to the Federal Reserve, but cannot force it to act.⁶³ Similarly, it can resolve some disputes among agencies, but its recommendations are generally nonbinding.⁶⁴ In addition, the two-thirds supermajority vote for many of its actions may be difficult to achieve. More generally, it is hard to run anything in a timely and important way by committee.

E. Credit Ratings

The Dodd-Frank Act requires federal agencies to purge from regulations “any reference to or requirement of reliance on credit ratings.”⁶⁵ Yet the Act provides no solution as to what should replace reliance on these ratings beyond calling for “uniform standards of creditworthiness for use by each such agency.”⁶⁶ Many important regulations like capital requirements and those of the Investment Company Act rely heavily on credit ratings.

⁶¹ CCMR May 2009 Report at 203.

⁶² See Dodd-Frank Act § 113.

⁶³ See *id.* § 115.

⁶⁴ See *id.* § 119.

⁶⁵ *Id.* § 939A(b).

⁶⁶ *Id.*

This problem requires immediate action by Congress. In the short term, the Act should be amended to allow the use of credit ratings but forbid “undue reliance” on them. Although this approach may still give too much influence to the ratings agencies, it will give the regulators more flexibility and discretion than an absolute prohibition while the regulators, Congress, and the public determine how to replace credit ratings.


In the longer term, the Congress can explore alternatives. One alternative might be to create a Credit Assessment Panel composed of not only rating agencies, but also other expert firms, like PIMCO and BlackRock, that already provide credit analysis to private financial firms. Each member of the Panel would evaluate creditworthiness using its own proprietary methodology but would provide credit assessments in a standardized format. The government could then use each firm’s contribution in forming a composite assessment. The government itself would be prohibited from devising its own ratings; it would have to rely exclusively on the input from the Panel. The Panel members would have to be compensated, a major challenge of this approach. In principle, beneficiaries could be charged a fee. This is only an idea to explore; I am not now advocating its adoption.

Thank you and I look forward to your questions.

**United States House of Representatives
Committee on Financial Services**

“TRUTH IN TESTIMONY” DISCLOSURE FORM

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

1. Name:	2. Organization or organizations you are representing:
Hal Scott	Harvard Law School
3. Business Address and telephone number: [REDACTED]	
4. Have <u>you</u> received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	5. Have any of the <u>organizations you are representing</u> received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?
<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No	<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.	
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