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"The Dodd-Frank Wall Street Reform and Consumer Protection Act: 2 Years Later"
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Good morning Chairman Stabenow, Ranking Member Roberts and members of the Committee. Thank you for the invitation to Better Markets to testify today.

Better Markets is a nonprofit, nonpartisan organization that promotes the public interest in the domestic and global capital and commodity markets. It advocates for transparency, oversight, and accountability with the goal of a stronger, safer financial system that is less prone to crisis and failure, thereby eliminating or minimizing the need for more taxpayer funded bailouts. Better Markets has filed almost 100 comment letters in the U.S. rulemaking process related to implementing the financial reform law and has had dozens of meetings with regulators. Our website, www.bettermarkets.com, includes information on these and the many other activities of Better Markets.

My name is Dennis Kelleher and I am the President and CEO of Better Markets. Prior to that, I was a senior staffer in the Senate. Prior to the Senate, I was a litigation partner at Skadden, Arps, Slate, Meagher & Flom, where I specialized in securities and financial markets in the U.S. and Europe. Prior to obtaining degrees at Brandeis University and Harvard Law School, I enlisted in the U.S. Air Force while in high school and served four years active duty as a crash-rescue firefighter. I grew up in central Massachusetts.

INTRODUCTION

The Dodd-Frank Wall Street Reform and Consumer Protection Act was passed two years ago in response to the financial collapse and economic crisis that began in 2007, reached a peak in 2008-2009, and is still being felt throughout our country today. It was the worst financial collapse since the Stock Market Crash of 1929; it almost caused a second Great Depression; it cost U.S. taxpayers and the government trillions of dollars and those costs continue to increase; and, it has produced the worst economy since the Great Depression of the 1930s.

While this is the second anniversary of the passage of the financial reform law, it is critical to remember those facts and events. It is also critical to remember that it has been almost four years since the collapse of Lehman Brothers and the peak of the financial crisis, and that the American people remain largely as unprotected today from another devastating financial crisis as they were four years ago. That context is essential to understand the financial reform law, which was passed to prevent another crisis and protect the American people, taxpayers, Treasury, financial system, and economy.

That is why the Dodd-Frank financial reform law is more properly understood as **the Wall Street re-regulation law**.

The too big to fail banks of Wall Street and the financial industry were able to cause the financial collapse and economic crisis largely because they used their economic power to gain political, academic, media and other influence that enabled them to tear down the many laws, rules, and regulations put in place during the Great Depression of the 1930s to protect the American people from Wall Street's recklessness and greed. It must be remembered that, after those laws, rules and regulations were put in place, our country did not have a financial or economic crisis on that scale for more than 70 years.

It must also be remembered that, even with all those many laws, rules and regulations – a truly unprecedented degree of government regulation of Wall Street and the U.S. capital markets – still:

- our country prospered;
- we built the largest and most broad-based middle class in the history of the world; and
- Wall Street, our financial industry, our nonfinancial businesses and our economy all thrived.

By 2000, virtually all of those protections were torn down and the too big to fail financial institutions of Wall Street were not just de-regulated, but almost entirely un-regulated. The results are clear: after 70 years of regulation that protected the American people, our financial system and our economy, it took just 7 years for Wall Street's unregulated investment, trading and other activities to cause what almost became a second Great Depression.

Those actions by Wall Street required the U.S. government to spend, lend, guarantee, pledge, assume, or otherwise use trillions of dollars to save Wall Street from itself and to prevent the crisis from becoming even worse. Every single major bank, all of the other too big to fail financial institutions, and all the systemically significant entities like money market funds, would have collapsed and been bankrupt but for the actions of the U.S. government and the taxpayer dollars used to bail them out and put them back on the road to profitability. Thus,

- JP Morgan Chase;
- Goldman Sachs;
- Morgan Stanley;
- Merrill Lynch;
- Bank of America;
- AIG;
- Citigroup; and
- all of the other financial institutions and entities that were bailed out, directly or indirectly;

are only in business today because they were all saved by the U.S. government and the American taxpayer.

But, those bailouts were only part of the costs of that crisis. The economic wreckage caused by the too big to fail banks and financial institutions and activities of Wall Street have touched every corner of our country, resulting in:

- high and persistent unemployment and under-employment;
- historically high foreclosures and underwater homeowners;
- slow-to-no economic growth;
- business failures;
- untold wealth destruction;
- widespread and growing poverty; and
- so many other costs that continue to mount, including, increasingly, a loss of belief in the American Dream.

Just one measure of these costs reveals how deep and overwhelming the crisis has been and continues to be on our country: the Federal Reserve Board recently released a study that shows that **the net worth of the median family declined 38.8% in just three years, from 2007-2010, wiping out almost two decades of hard work and prosperity – that was due entirely to the financial crisis.**

This financial and economic calamity has proved yet again that, other than war, nothing devastates a country more than the economic ruin that follows a financial crisis such as the one that began in 2007. (Better Markets tracks the cost of the crisis on its website: www.bettermarkets.com.)

The Dodd-Frank financial reform law was passed two years ago to prevent that from ever happening again. It was necessary to protect the American people, taxpayers and Treasury from the too big to fail banks on Wall Street and to eliminate or minimize the need for any future bailouts. The law is designed to do that largely by re-regulating Wall Street and systemically significant institutions and activities. After all, the financial crisis and the costs it created arose from the de-regulation and non-regulation of Wall Street. In stark contrast, the country prospered after Wall Street was comprehensively regulated for the 70 or so years after the Great Depression.

Any attempted genuine evaluation of the Dodd-Frank financial reform and Wall Street re-regulation law, or parts of it, must take these facts into account.

And, of course, any attempt to really understand the financial reform law and its impact would require considering the law as a whole and not just picking a couple of discrete parts, taken out of context, and discussing them as if they were either representative of the entire law or somehow could be properly understood as isolated standalone provisions. Thus, understanding how each provision and section relates to the entirety of financial reform and how they relate to preventing another financial collapse and economic crisis are essential to evaluating the law.

My testimony will, therefore, first review the financial collapse and economic crisis, the deregulation of the financial industry and what it has cost and continues to cost the American people. Then I will discuss the re-regulation of the financial industry and the need to shift costs from society back to the industry so that incentives and costs are properly aligned to reduce reckless behavior and the need for bailouts. Unsurprisingly, this re-regulation has caused industry to complain about its costs, but history proves that such complaints have little merit and that the industry and the country can thrive when Wall Street is properly regulated. This is true for the industry's latest attack on financial reform – an attempt to impose a burdensome cost-benefit analysis on every rule – but that tactic is also without merit, as discussed below. I will then discuss some of the derivatives reforms in Title VII. Lastly, I will address the indefensible underfunding of the CFTC. Here is an overview of the points discussed below:

- Financial reform was necessitated by the largest financial and economic collapse since the Stock Market Crash of 1929 and the Great Depression of the 1930s, and it was enacted to prevent a second Great Depression.

- The benefits of avoiding another financial crisis are enormous, totaling trillions of dollars, measured not just in terms of the current crisis but also in light of a potentially worse financial disaster that may befall our country if reform is not fully implemented.

- Effective financial reform that protects the American people requires the re-regulation of the financial industry and that will result in shifting costs back to the industry from society where it was shifted when the industry was de-regulated.

- Industry always complains about the alleged costs and disruption of regulation, but history proves that they are without merit

- The latest attack on financial reform and re-regulating Wall Street is the claim that no rule passed to implement the law protecting the American people can cost industry too much, which ignores how much Wall Street has cost America.

- Derivatives played a key role in the precipitating and transmitting the financial crisis and collapse; derivatives regulation is an essential part of the comprehensive financial reform and to protecting the American taxpayer from again having to bail out the financial industry.

- The Volcker Rule.

- Cross-Border application of derivatives protections.

- International harmonization.

- The CFTC is the only police force on the derivatives beat and it needs substantially more funding to protect the American people properly.

Financial reform was necessitated by the largest financial and economic collapse since the Stock Market Crash of 1929 and the Great Depression of the 1930s, and it was enacted to prevent a second Great Depression

As the aftershocks of the Lehman Brothers bankruptcy shook the world in September of 2008, the U.S. and global financial system seized up and nearly collapsed. Only massive, multi-trillion dollar interventions by the U.S. government and international institutions prevented that calamity in the fall of 2008 and the spring of 2009. Making matters worse, as the **financial system** was unraveling, the U.S. and global **economies** were also grinding to a halt. That too required multi-trillion dollar governmental actions to prevent a second Great Depression.

The wave of bailouts, buyouts, and other rescue efforts that were undertaken to support the nation's leading financial institutions revealed the depth of the unfolding crisis. In the days and weeks after the Lehman bankruptcy, the U.S. government nationalized Fannie Mae and Freddie Mac, and then effectively nationalized AIG and Citigroup through bailouts totaling hundreds of billions of dollars. To prevent their inevitable bankruptcies, investment banks Goldman Sachs and Morgan Stanley were allowed to quickly convert into bank holding companies, thereby receiving full access to the federal safety net. Bank of America acquired investment bank Merrill Lynch, and Wells Fargo acquired Wachovia (derailing Citigroup's attempt to buy Wachovia only days before). The nation's largest savings and loan association, Washington Mutual, failed, was seized by regulators, and was ultimately sold to JP Morgan Chase at a bargain basement price (similar to the bargain price JP Morgan paid for Bear Stearns in March 2008).

Throughout this time, the U.S. government was creating innumerable rescue programs to prevent any financial institution or sector of the financial industry (including the $3.8 trillion money market fund industry) from collapsing. The much ballyhooed $700 billion TARP program was but one of the countless emergency measures adopted during this time.[1] And, it must be remembered that the U.S. government also assisted foreign banks and financial institutions throughout the world, not just those in the U.S. The pace and scale of

[1] In what appears to be yet another attempt to minimize and understate the depth and cost of the crisis, some talk misleadingly as if TARP was the only government rescue program and some even claim that TARP will make money. That is not accurate. TARP is currently projected to cost at least $60 billion. However, even if all the money TARP lent was paid back, that doesn't mean it would have "made" money. The meritless claim that has been made by people who know better is that if TARP (or any one of the other bailout programs) takes in one penny more than it lent (or the other programs spent, pledged, guaranteed, or otherwise used), then it made money. That is simply misleading propaganda. The only proper way to evaluate any of these programs is what any return was or should have been on a **risk adjusted basis**. By that measure, not only have none of the government bailouts "made" money; they have all cost taxpayers and the government hundreds of billions if not trillions of dollars (above and beyond all the other costs).

deteriorating events was unprecedented, as the contagion from the liquidity and solvency crises spread rapidly to every corner of the financial system and the globe.

But even those unprecedented actions, programs, and interventions – representing trillions of dollars – were not sufficient to stop the multiple crises from spiraling out of control, as almost every financial indicator continued to deteriorate and to do so at an accelerating pace into 2009. Indeed, as late as February 2009, **more than five months after the Lehman bankruptcy**, the financial systems and economies of the U.S. and the global community were still declining rapidly, with no bottom in sight. Policymakers were facing a very dark and dangerous abyss and **the possibility of a second Great Depression was a very real and increasingly likely prospect**.

In response, the U.S. government took additional unprecedented actions. For example, on February 23, 2009, it announced that the full faith and credit of the United States would stand behind **the entire financial system, which was thus effectively nationalized**, as set forth in this dramatic policy statement:

> A strong, resilient financial system is necessary to facilitate a broad and sustainable economic recovery. The U.S. government stands firmly behind the banking system during this period of financial strain to ensure it will be able to perform its key function of providing credit to households and businesses. The government will ensure that banks have the capital and liquidity they need to provide the credit necessary to restore economic growth. Moreover, we reiterate our determination to preserve the viability of systemically important financial institutions so that they are able to meet their commitments.

Joint Statement by the Treasury, FDIC, OCC, OTS, and the Federal Reserve (Feb. 23, 2009) (full statement available at
http://www.federalreserve.gov/newsevents/press/bcreg/20090223a.htm).

That historic step was followed by others, and trillions of additional government dollars were spent, lent, pledged, guaranteed, or otherwise used in an all-out effort to prevent a second Great Depression. We now know that those actions somehow worked, that the financial system did not entirely collapse, and that a second Great Depression was avoided. Having lost 54 percent of its value since its October 9, 2007 high, we also now know – with the benefit of hindsight – that the stock market hit its lowest point on March 9, 2009 and that the precipitous and uncontrolled decline of the financial markets and the economy stopped sometime in the March-April 2009 period.

However, and most important, **<u>even to this day no one knows</u>** exactly why or how complete disaster was averted. No one knows which policy, program, intervention, action, or expenditure – or what combination or order of those measures – arrested the downward spiral.

Nevertheless, the need to prevent such a calamity from ever happening again is overwhelmingly and indisputably clear: Not only did the financial collapse and economic crisis cost many trillions of dollars, it also caused vast, unquantifiable, and still-ongoing human suffering, from skyrocketing unemployment, millions of home foreclosures, widespread poverty, and enormous wealth destruction, to foregone retirements, obliterated college funds, and, for many, the lost American Dream. This proved yet again that, other than war, nothing devastates a country more than the economic ruin that follows a financial crisis such as the one that began in 2008.

That is why comprehensive financial reform and the re-regulation of Wall Street was essential. The Dodd-Frank law is intended to protect the American people, taxpayers, and the U.S. Treasury from ever again having to suffer through and pay for another financial collapse and economic crisis. Above all, it is intended to prevent a second Great Depression from afflicting the United States. That dire outcome was avoided, but just barely and through a measure of good luck. The American people may not be so fortunate next time and, most importantly, they should not have to depend on luck. They should have the benefit of laws, reforms, rules, and regulations to protect them, and they should be able to count on their elected representatives and regulators to fulfill their duties and ensure that those safeguards are put in place.

That is what Dodd-Frank financial reform law is all about and how it should be evaluated.

<u>The benefits of avoiding another financial crisis are enormous, totaling trillions of dollars, measured not just in terms of the current crisis but also in light of a potentially worse financial disaster that may befall our country if reform is not fully implemented</u>

It cannot be legitimately denied that the value of a stronger and more comprehensive regulatory system is huge. It includes the benefits of sparing our economy and our society the devastating consequences that another financial collapse and economic crisis would bring in the form of both monetary losses and human suffering.

A reasonable starting point for determining the cost of a future crisis is the cost of the recent financial collapse and ongoing economic crisis. The impact of that crisis is staggering. Better Markets has a detailed analysis of the costs of the crisis on its website (www.bettermarkets.com), but here are some snapshots of the financial devastation it caused:

- Gross domestic product ("GDP") has fallen dramatically and it is not expected to return to normal levels until at least 2018. At that time, the cumulative shortfall in GDP relative to potential GDP is expected to reach **$5.7 trillion**.

- The unemployment rate skyrocketed to 10.1 percent in October of 2009, representing **15.4 million workers**, many of whom have become members of the permanently unemployed.

- Government expenditures, including corporate bailouts, special lending facilities, unemployment benefits, and the economic stimulus package are well in excess of a trillion dollars. The value of the government's total commitment of support, provided through some 50 separate programs, is estimated at **$23.7 trillion**.

- The national debt will increase by **$8 trillion** as of 2018 as a result of the crisis, due to the combined effects of government expenditures and reduced revenues.

- The stock market fell by more than 50 percent in just 18 months, from October 2007 until March of 2009, representing **$11 trillion** in evaporated wealth.

- From 2007 to 2010 median family income **fell 7.7 percent**, from $49,600 to $45,800.

- Over those same three years, median family net worth **fell 38.8 percent**, which totals **more than $7 trillion**, "**erasing almost two decades of accumulated prosperity**." (From peak in July 2007 to trough in January 2009, households lost **$19 trillion** in wealth, according to the Fed (adjusted to 2011 dollars)).

- Home values have declined 33 percent since the crisis began, representing **$7 trillion** in lost value.

- Over **11 million** homeowners own homes worth less than their mortgages, or about 22.8 percent of all residential properties with a mortgage.

- A total of **at least 3.6 million** homes—and by some accounts **5 million—**have been lost to foreclosure since the crisis began, with millions of additional foreclosures to come.

- The number of families falling below the poverty line has climbed steadily since 2007, rising from 12.5 to 15.1 percent, representing over **46 million** individuals deemed poor.

- The **human anguish** caused by the crisis has been enormous and incalculable, encompassing all of the psychological and physical health effects that come with unemployment, poverty, homelessness, delayed retirements, abandoned college educations, increased crime rates, and lost healthcare.

- Maybe worst of all, the faith of the American people in **The American Dream**, where the U.S. is the land of opportunity, everyone gets a fair shot, and the next generation will have it better than the last, is dropping at an alarming rate, which could undermine the spirit of our country.

It is impossible at this point to quantify all of the consequences of the still-unfolding economic crisis. Moreover, the actual costs of another crisis are almost certain to be far greater than what we have witnessed since 2007. This is attributable to the fact that our fiscal and monetary capacities to institute remedial measures and to absorb the costs of a future crisis have now become so depleted. With the annual budget deficit now exceeding 1.2 trillion dollars, the Treasury will have far fewer fiscal tools at its disposal with which to manage another financial crisis. This vulnerability will persist for years to come, until something approximating a full recovery has been achieved, and no one is expecting that for a very long time.

From 2007 to 2010, the U.S. government responded to the financial and economic crisis by implementing trillions of dollars in emergency measures to prevent a precipitous slide into a second Great Depression. To create a more lasting safeguard against another financial crisis, the comprehensive reforms in the Dodd-Frank law were passed. Those reforms promise an enormous **collective benefit --** avoiding the costs of what would likely be a second Great Depression -- but only if they are implemented on a **collective basis**.

Therefore, as legislators evaluate the law, as regulators promulgate rules under the law, and as courts review those rules, they must consider the entire set of reforms enacted and the benefits that those reforms can provide as a single, coherent collection. If the cohesive framework envisioned in the financial reform and Wall Street re-regulation law is not understood and evaluated this way, then the public, the markets, and the economy as a whole will once again be vulnerable to another financial catastrophe.

<u>Effective financial reform that protects the American people requires the re-regulation of the financial industry and that will result in shifting costs back to the industry from society where it was shifted when the industry was de-regulated</u>

Over a three-year period beginning in 2007 and culminating in the passage of the financial reform and Wall Street re-regulation law on July 21, 2010, the U.S. government witnessed the financial and economic destruction caused by the crisis, implemented emergency measures to contain it, and then made the judgment that comprehensive reforms were essential to protect investors, taxpayers, the Treasury, the financial system, and the economy from another financial crisis. That will necessarily result in the industry assuming their proper regulatory costs and burdens, which is necessary to prevent those costs from being shifted to taxpayers and society. Those burdens include initial and ongoing compliance costs as well as the elimination of extremely profitable lines of business.

Those consequences were well known, but nevertheless intentionally imposed to **re-regulate the recently de-regulated financial industry**, thus closing regulatory gaps and strengthening existing requirements for the benefit of investors, the public, and the entire economy.

The financial industry was very significantly regulated after the Stock Market Crash of 1929 and during the Great Depression. Those regulations protected the public, investors, taxpayers, the financial system, and the economy for seven decades. It was no accident that they prevented a repeat of the Crash of 1929 and the Great Depression for more than 70 years. However, those regulatory protections were removed, primarily during the 1990s, reaching a peak in 1999 with the passage of the Gramm-Leach-Bliley Act of 1999 and in 2000 with the passage of the Commodities Futures Modernization Act.

Thus after seventy years of heavy regulation, it took just seven years after de-regulation for the financial industry to engage in the high risk trading and reckless investments that nearly collapsed the financial system and almost ushered in a second Great Depression. While the costs are still being counted and incurred, the U.S. government had to spend, lend, pledge, guarantee, insure, or otherwise use trillions of dollars to prevent the full collapse of the financial system and halt the economic crisis.

The primary motivations in passing the Dodd-Frank financial reform and Wall Street re-regulation law were to prevent such a financial collapse and economic crisis from ever happening again, and to avoid a second Great Depression. In many respects, the reforms in the Dodd-Frank law re-regulate the financial industry as it had been regulated beginning in the 1930s. **This re-imposition of regulation also means shifting the substantial costs of risky behavior and predatory practices from the public back onto the industry**—or, as economists would say, forcing the industry to assume the costs of the externalities that they imposed on society when they were deregulated.

Title VII illustrates this legislative resolve. It establishes a broad range of regulatory requirements in the previously unregulated swaps markets. For example, Title VII requires, among other things:

- Registration of market participants to ensure their fitness;
- Recordkeeping and reporting to enable regulators to oversee market activities;
- Exchange trading, central clearing, and public disclosure of transaction information to protect investors, reduce risk, increase transparency, price competition, and a level playing field;
- Business conduct standards and prohibitions against conflicts of interest to prevent fraud, abuse, and unfair economic advantage;
- Position limits, capital, collateral, and margin requirements to mitigate risk;
- Chief compliance officers to foster compliance from within the industry and to complement regulatory oversight; and
- Enforcement provisions to induce compliance with all of the requirements.

There is no genuine dispute that these measures are necessary to bring integrity and stability to the derivatives markets. And it is equally clear that these reforms would be impossible to implement without imposing significant compliance costs on market participants, who will be required to pay filing fees, hire new staff, upgrade and maintain information technologies, and alter their business procedures. These reforms are also impossible without eliminating or scaling back profits derived from abusive or highly risky conduct.

Thus, the Dodd-Frank financial reform law and the regulations promulgated thereunder must necessarily (1) prohibit some activities, including fraudulent transactions and those based upon conflicts of interest; (2) curtail other behaviors, including excessive speculation; (3) force the reallocation of funds to other uses, such as capital and margin; and (4) increase transparency and competition through pre- and post-trade reporting, thus reducing profit margins.

Further illustrating this approach, the Dodd-Frank law imposes a broad set of regulatory reforms on bank holding companies and nonbank financial institutions, with the focus on systemically important institutions. They will pay necessary compliance costs from new requirements relating to registration, reporting, recordkeeping, public disclosures, risk committees, examinations, fees, and capital and leverage requirements, among other enhanced supervisory prudential standards. Key provisions of the statute will also eliminate some immensely profitable trading activities. Most notable is the "Volcker Rule," which prohibits insured depository institutions, bank holding companies, and certain nonbank companies from almost all proprietary trading and all but *de minimis* investment in hedge funds. These bans on highly profitable activities will effectively eliminate billions of dollars in annual revenue for the largest banks. But, they are necessary to protect the American people, taxpayers and Treasury from Wall Street.

The Dodd-Frank financial reform law imposes new requirements in many other sectors of the financial industry as well. Title IV establishes registration and reporting obligations for private fund advisers; Title IX enhances the regulation of securities firms, rating agencies, and securitizers; Title X creates an entirely new regulatory body for consumer financial products and services; and Title XIV extensively reforms mortgage lending and increases regulation of mortgage loan originators.

Given that the ongoing costs of the last financial collapse and economic crisis have exceeded trillions of dollars, the enormous collective benefits of the financial reform and Wall Street re-regulation law far exceed the costs and lost profits that industry will have to absorb as the price for protecting the American people, taxpayers, Treasury, and economy.

<u>Industry always complains about the alleged costs and disruption of regulation, but history proves that they are without merit</u>

Critics argue that the costs of the Dodd-Frank financial reform and Wall Street re-regulation law are or will be excessive and that they will cripple the financial industry and even stifle economic recovery from the financial crisis. However, using the past 100 years as a guide, there is no basis for the claim that the essential reforms, even on the scale required by the Dodd-Frank financial reform law, will produce these consequences.

Since the emergence of financial market regulation, the financial services industry has argued that new regulatory requirements will have a devastating impact by imposing unbearable compliance costs. Yet Wall Street has always absorbed the cost of those new regulations and has consistently remained one of the most profitable sectors in our economy. For example, a century ago, when securities regulation first emerged at the state level, Wall Street railed against it as an "unwarranted" and "revolutionary" attack upon legitimate business that would cause nothing but harm. However, in the years following this early appearance of financial regulation, banks and their profits grew handsomely.

Subsequently, when the federal securities laws were adopted in the midst of the Great Depression, Wall Street staunchly opposed them, claiming that they would slow economic recovery by impeding the capital formation process and discouraging the issuance of new securities – virtually identical arguments that industry is making today. However, in the years after the enactment of the federal securities laws, the nation's securities markets flourished and became what has often been described as the envy of the world. The same pattern has been repeated with each new effort to strengthen financial regulation, including deposit insurance, the Glass-Steagall Act, mutual fund reform, and the national market initiatives of the mid-1970s.

The lesson to be learned from this history is that when faced with new regulations, members of the regulated industry routinely argue that the costs and burdens are too heavy—but then they invariably adapt and thrive. Opponents of reform under the Dodd-Frank law are following this familiar pattern, and their attempts to minimize regulation by invoking the costs and burdens must be similarly discounted.

Equally unfounded is the claim heard from opponents of regulatory reform that regulation is stifling overall economic growth and preventing a robust recovery from the financial crisis. This claim is unsupported, often just repeated as a self-evident proposition. In fact, the slow pace of economic recovery is not attributable to regulation but instead to rampant unemployment and lack of consumer demand following the worst financial crisis since the Great Depression. We need more financial regulation, not less, to ensure that the economy recovers and that we never again experience such a profound and long lasting financial disaster.

"Economists who have studied the matter say that there is little evidence that regulations cause massive job loss in the economy, and that rolling them back would not lead to a boom in job creation." In fact, the Bureau of Labor Statistics continuously surveys the private sector to understand the reasons for layoffs. Data for 2010 shows that only 0.2 percent of the people who lost their jobs in layoffs were let go because of government regulation. By comparison, 30 percent were let go because of a drop in business demand.

In survey after survey, business owners consistently say that their reluctance to hire employees and expand production arises from uncertainty about consumer demand for products and services, not concern over regulation. One policy analyst recently canvassed numerous sources on the impact of financial regulation, ranging from the Bureau of Labor Statistics, the Wall Street Journal, the McClatchy Newspapers, and business trade data. The surveys and data collected from these organizations debunk the myth that either existing regulation or uncertainty about future regulation over financial services is responsible for the current economic stagnation. For example, a Wall Street Journal survey of business economists found that "[t]he main reason U.S. companies are reluctant to step up hiring is scant demand, rather than uncertainty over government policies."

Even as additional and essential regulations are being adopted, corporate America is actually faring well. Regulation is clearly not interfering with corporate profits, cash reserves, or executive compensation. Corporate profits are at record levels, representing over 10 percent of GDP after tax, and executive compensation has nearly regained its pre-recession levels, with a reported remarkable 27 percent increase in median pay in 2010. That level of compensation remained steady and even increased somewhat in 2011, with the top 100 CEOs receiving a total of $2.1 billion in compensation.

The stagnant consumer demand holding back economic growth was a direct result of the financial collapse and economic crisis, which were a direct result of **too little** regulation. In the years leading up to the crisis, huge sectors of our financial markets (such as swaps) were completely unregulated, and other sectors (such as mortgage-backed securities) were poorly regulated.

The resulting costs of the crisis are enormous and lasting. As set forth in summary fashion above and in detail on our website (www.bettermarkets.com), they include unemployment of tens of millions of Americans, a massive drop in GDP, a huge decline in home values, and decimated retirement accounts. These costs, inflicted by the financial collapse caused by Wall Street, are what brought our economy to a standstill, not excessive regulation. Regulated, transparent markets with less fraud and reckless conduct will restore confidence in our markets and banks. That will in turn help economic growth and confidence.

Moreover, industry's claims that financial reform will reduce market liquidity, capital formation, and credit availability, and thereby hamper economic growth and job creation, simply disregard the fact that the financial crisis did more damage to those concerns than any rule or reform possibly could. In September 2008, there was no market liquidity, capital formation or credit availability and, since then, there has been little economic growth and even less job creation. That is due to the Wall Street created financial collapse and economic crisis. The financial reform and Wall Street re-regulation law was passed and is designed to prevent that from ever happening again.

The latest attack on financial reform and re-regulating Wall Street is the claim that no rule passed to implement the law protecting the American people can cost industry too much, which ignores how much Wall Street has cost America

Having failed to prevent the passage of a comprehensive financial reform law, the financial industry is redoubling its efforts to make sure the law is never implemented as intended. What that means is that they are trying to prevent the protection of the American people, taxpayer, Treasury, and economy from suffering **again** as a result of their unregulated conduct and activities.

Their latest weapon to kill or weaken financial reform is to claim that every rule and regulation passed to implement the Dodd-Frank financial reform and Wall Street re-regulation law must be subjected to exhaustive "cost-benefit analysis," which is a seductively innocent sounding phrase. Indeed, it is an activity that on its face seems sensible and appealing. After all, assessing and weighing the costs and benefits of taking an action appears on the surface to be reasonable. However, in the context of regulation generally and financial regulation in particular, that thinking is simply wrong and it will likely kill financial reform, as the too big to fail banks on Wall Street and their allies have intended all along.

Moreover, it is a ridiculous argument: the very industry that caused the financial collapse, economic crisis, and trillions of dollars in costs – many that continue to this day – now claims that it cannot be re-regulated to prevent it from causing yet another crisis **if** the costs it must bear are too great. That is irrational. The American people, taxpayer, Treasury, and economy have to be protected from Wall Street; Wall Street doesn't have to be protected from regulation. In fact, Wall Street must be re-regulated because when it is deregulated and unregulated it causes financial collapse, economic crisis, and trillions of dollars in costs – all of which the American taxpayers have to pay.

Nonetheless, the industry is making this argument in the regulatory process and in lawsuits filed to prevent Wall Street from being re-regulated. For example, the International Swaps and Derivatives Association (ISDA) and the Securities Industry and Financial Markets Association (SIFMA) have sued the CFTC over what is referred to as its "position limits" rule claiming, among other things, that the CFTC did not conduct the proper cost-benefit analysis. Better Markets filed a brief opposing that argument and detailing why it is without merit. More recently, the Chamber of Commerce and the Investment Company Institute (ICI) have sued the CFTC over re-establishing a registration requirement for investment companies acting as commodity pool operators. Better Markets also filed a brief in this case detailing why industry's claims are without merit.[2]

In addition, Better Markets has just completed a report that it will be issuing shortly entitled "Setting the Record Straight on Cost-Benefit Analysis and Financial Reform at the SEC." Many of the arguments applicable to the SEC are also applicable to the CFTC. The Report comprehensively reviews these cost-benefit claims and demonstrates that these arguments are without merit and must be rejected. I will just mention but a few of the reasons why this latest attack on financial reform must be rejected.

First, cost-benefit analysis generally assumes that all or most of the material costs and benefits of a regulation are quantifiable and comparable. In reality, **costs** are much easier to identify and calculate than **benefits**, which are often as much qualitative as quantitative. For example, if the SEC adopts a rule that prevents fraud and manipulation in the securities markets, how can the enormous benefit to investors and to society of an honest, un-manipulated market be calculated? Indeed, financial markets can serve their fundamental purpose as a capital-raising mechanism **only** if investors have confidence in those markets, believing them to be fair and free of fraud and manipulation (at least to some tolerable level). How can the benefit of that confidence and that willingness to participate be quantified? In

[2] *See* Brief of Better Markets, Inc. as Amicus Curiae in Support of Defendant Commodity Futures Trading Commission, Inv. Co. Institute v. CFTC, No. 1:12-cv-00612 (BAH) (D.D.C. 2012) (filed June 29, 2012), *available at* http://bettermarkets.com/sites/default/files/ICI%20v.%20CFTC%20-%20Amicus%20Brief%20of%20Better%20Markets%20June%2025,%202012.pdf; Corrected Brief of Better Markets, Inc. as *Amicus Curiae* in Support of Defendant Commodity Futures Trading Commission, Int'l Swaps and Derivatives Ass'n v. CFTC, No. 11-cv-2146 (RLW) (D.D.C. 2011) (filed May 1, 2012), *available at* http://bettermarkets.com/sites/default/files/Amicus%20Brief%20CFTC%204-30-12.pdf.

sharp contrast, companies that must hire new staff and buy information technology to fulfill their compliance obligations know exactly how to quantify those costs. Thus, a cost-benefit analysis almost always favors industry and overweighs its costs. Conversely, no matter how much society, investors, and others benefit, those benefits are often amorphous and difficult to quantify.[3]

This problem is especially pronounced in connection with the rulemaking arising from the Dodd-Frank Act. Currently, the process is centered on each individual rule being proposed and then finalized by each agency. However, the Dodd-Frank Act was not passed by the Legislative and Executive Branches with this narrow focus in mind. The law was passed as a comprehensive and integrated whole designed and intended to prevent another financial collapse and economic crisis. In fact, it was passed to prevent a second Great Depression. Avoiding that calamity—if indeed it can be avoided in the future—will be the historic accomplishment of the Dodd-Frank Act, but how is that enormous benefit quantified? Such questions illustrate the fundamental flaw in applying cost-benefit analysis to the process of regulatory reform (and they also explain why the Legislative and Executive Branches decided not to impose such a condition on the implementation of financial reform).

Second, with regulation, even if the costs are higher than the benefits by some measure, a society often decides that the benefits in the long run still outweigh the costs. For example, if predatory and subprime lending had been stopped in the early 2000s (as a number of State Attorneys General tried to do before being thwarted by federal banking regulators[4]), many if not all of the ingredients of the crisis might not have materialized. How would that benefit be quantified? And, if the 3.6 million home foreclosures since 2008 could have been avoided, how would a regulation that provided such a benefit be measured? It would have to include not only the economic costs averted—including a massive decline in household wealth, losses sustained by lenders, hollowed-out communities, and others—but also the incalculable human suffering that could have been avoided as well.

This imbalance in cost-benefit analysis is starkly illustrated in the auto safety context. Ford's decision regarding exploding gas tanks in Pintos may be the best example: Ford calculated that it would cost $137 million to correct a fatal design defect, but just $50 million to pay the claims of the estimated 180 people killed and 180 people injured from that defect.[5] From one point of view, this cost-benefit analysis may make perfect economic sense: Spend

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[3] Financial regulation provides many examples of the distorted nature of cost-benefit analysis, and preventing market manipulation is only one of them. For example, the same point applies to measuring the benefit to society of bringing transparency and regulation to the shadow banking system, including in particular the $700 trillion derivatives market. The benefit of that transparency is enormous, but also impossible to quantify with any degree of accuracy. Pricing that benefit is even more challenging under the currently fragmented rulemaking process, where the impact of each rule is viewed in isolation rather than as part of a coherent collection of reforms. *See, e.g.,* ZOLTAN POZSAR ET AL., SHADOW BANKING, FED. RESERVE BANK OF NEW YORK, STAFF REPORT NO. 458, (July 2010, revised Feb. 2012), *available at* http://www.newyorkfed.org/research/staff_reports/sr458.pdf.

[4] Eliot Spitzer, *Predatory Lenders' Partner in Crime*, Washington Post, Feb. 14 2008, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2008/02/13/AR2008021302783.html.

[5] *See* DOUGLAS BIRSCH & JOHN H. FIELDER, THE FORD PINTO CASE: A STUDY IN APPLIED ETHICS, BUSINESS, AND TECHNOLOGY 51-52 (State Univ. of N.Y. Press, 1994).

$137 million to save 180 lives and prevent another 180 injuries, or spend $87 million **less** by just paying for the deaths and injuries. However, it also serves as a perfect illustration of the deficiencies of cost-benefit analysis from the perspective of society rather than an individual corporation or industry: It ignores unquantifiable human consequences as well as the moral component in regulatory decision-making.

Third, it is often assumed that the people advocating for cost-benefit analysis are doing so in good faith, with an open mind, and for the purpose of genuinely determining the most appropriate outcome, considering all relevant factors in context. That, however, is often not true, and it is decidedly not what is happening in the debate over financial reform. Almost all of the **proponents** for what they call "cost-benefit analysis" in financial regulation are **opponents** of financial reform (either expressly or in fact). The two perspectives go hand-in-hand. For example, Senator Richard Shelby, who voted against the Dodd-Frank Act, has introduced a bill that would impose an extraordinarily burdensome standard of cost-benefit analysis on federal regulators.[6] In announcing the bill, Senator Shelby was clearly focused on a much larger target, as he proclaimed that "American job creators are under siege from the Dodd-Frank Act."[7] It is thus clear that cost-benefit analysis is the Trojan Horse in the battle over financial reform:

> But the string of court challenges, and Shelby's bill, are not really about cost-benefit analysis at all in the narrow sense. The standard they seek to enforce would be impossible to meet. As Geithner observed, **the unstated aim is to beat back federal regulation.**[8]

Finally, too often cost-benefit analysis is portrayed as the only acceptable form of economic analysis applicable to rulemaking. That is simply not the case. Cost-benefit analysis is too often inflexible, incomplete, inappropriate, and difficult to apply. But, that does not mean that **no** economic analysis can or should be performed by regulators. Indeed, as detailed below, Congress picks from a full spectrum of economic analysis options, from none whatsoever on one end, to a highly detailed and prescriptive cost-benefit analysis on the other. The Legislative and Executive Branches, working together in enacting and implementing laws, choose the level of analysis that they believe is appropriate for particular regulations and in light of particular objectives. For financial regulation, they have determined that a minimal economic analysis should apply, which prioritizes the public interest and the protection of investors, rather than an exhaustive cost-benefit analysis, which would interfere with the achievement of those policy goals.

Thus, cost-benefit analysis is not merely a neutral methodology that involves the mechanistic weighing of agreed upon costs and benefits. Instead, its use involves significant policy choices, implications, and outcomes. Indeed, although seemingly innocuous, cost-

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[6] Financial Regulatory Responsibility Act of 2011, S. 1615, 112th Cong. (introduced Sept. 22, 2011).

[7] Press Release, *Shelby Introduces Financial Regulatory Responsibility* Act (Sept. 22, 2011), *available at* http://shelby.senate.gov/public/index.cfm/newsreleases?ID=df5330c4-80f7-479b-b6a3-c0b8e7d138be.

[8] John Kemp, *The Trojan Horse of cost-benefit analysis*, REUTERS, Jan. 3, 2012, http://blogs.reuters.com/great-debate/2012/01/03/the-trojan-horse-of-cost-benefit-analysis/.

benefit analysis has become a battlefield, where the war over financial reform is being waged. Following the "Executive Summary" below, the body of this Report analyzes that ongoing war, the SEC's very limited duty to consider the economic impact of its rules, and the appropriate holistic analysis actually required by the law.

Derivatives played a key role in the precipitating and transmitting the financial crisis and collapse; derivatives regulation is an essential part of the comprehensive financial reform aimed at protecting the American taxpayer from again having to bail out the financial industry

No one can deny that the unregulated and nontransparent derivatives markets, conducted almost entirely over the counter, were a central cause of the financial collapse and economic crisis that begin in the U.S. in 2007. As the ongoing Eurozone crisis shows, allowing major financial institutions to engage in derivatives activities of unknown amounts – with unseen risks, often even to the institutions themselves as well as the regulators and the public – can cause the entire financial system to collapse. As Warren Buffett has aptly noted, derivatives are "financial weapons of mass destruction."

They must be regulated and transparent. They must be moved from the dark over-the-counter markets to exchanges, ideally, or to clearing houses and execution facilities, at a minimum. Collateral and margin must be required, counterparty concentration must be limited, and trade reporting must convey meaningful information in real time. In addition, the product and entity definitions for "swaps" and "dealers" that trigger these new regulatory requirements must be broad and without loopholes. Further, rules implementing business conduct standards must be strong so that conflicts of interest and other abuses that destroy the integrity of the marketplace – and kill investor confidence in the markets – are limited to the maximum possible extent. Better Markets has commented on many facets of this new regulatory structure, which will now, for the first time, finally come into effect after the CFTC's and the SEC's recent passage of final rules on a further definition of "swap."

These reforms are going to cost money, but, contrary to self-interested claims, **they will not cost more** money than the current system. Currently, these costs are hidden, embedded, or shifted to society. The costs of risky, unregulated derivatives trading became apparent to everyone in the Fall of 2008, but those costs were shifted to society rather than borne by financial market participants. The financial reform and Wall Street re-regulation law shifts those costs back to the market participants, which is where they belong and which will reduce risky conduct the likelihood of future crises and bailouts.

End Users

The new requirements relating to margin in swap transactions perfectly illustrate the need to reallocate the costs of regulation – and the ability to do so without stifling the market. Many financial firms fought against this new approach. They claimed forcing derivatives to trade in the light of day on open exchanges would increase costs for commercial end users who rely on derivatives to manage their risks. What they didn't mention is that the supposedly "new" costs that end users would face from margin requirements (a transparent risk-management tool that Congress rightly determined should become the new norm) had really existed all along, but had simply always been embedded in the spreads they paid in the dark markets where end users had no way to determine what they were being charged or the ability to comparison shop regarding price or features.

For example, a business that uses an interest rate swap to trade a fixed rate for a floating rate might now have to put up initial margin of, say, 5% of the total value of the swap. This is to ensure that there is at least some cash on hand to cover losses in case interest rates move sharply against them. Previously, they may not have had to pay this 5% margin charge. But you can be sure they would have paid it elsewhere, embedded in the overall price of the swap, or in the spreads that the market offered them. In the past, the derivatives desk at a large dealer would simply have estimated the credit risk posed by a firm, and calculated a buffer that they would then add to the price of the swap.[9] This would be invisible to the end user, and also to regulators, but it was there nevertheless. Indeed, any trader who tried to avoid this step would have been fired on the spot. The problem was, this cost was entirely opaque, and there was no obligation on the part of the dealer to actually set the extra cash aside as a risk management buffer. Instead, it would just be treated as regular income and either used for other trading, or to pay bonuses.[10]

The new regime requires this hidden cost to be made explicit, and for the cash to be set aside as a genuine buffer against losses. This has been confusing to some end users, largely because some in the financial industry have misleadingly characterized this as a completely new cost. The analyses presented to end users by self-interested derivatives dealers not only ignored the previously embedded costs, but also assumed that all derivatives would now be subject to a uniformly high level of initial margin, with no netting. Thus, from a set of false assertions, they arrived at the entirely misleading conclusion that mandatory clearing would be costly to end users, when in fact it is quite the opposite. By bringing trading out into the open and requiring proper risk management, mandatory clearing greatly reduces the risk of another financial crisis.[11] The benefit of that reduced risk is, of course, enormous.

Moreover, transparency will enable end users to determine what they are being charged and for what. This will enable comparison shopping and, almost certainly, engender competition among providers. Of course, the big dealer banks that currently control the opaque over-the-counter markets do not want such transparency or competition.

Importantly, the financial reform law did recognize that there are some situations in which it might be advantageous for a commercial firm, such as a manufacturer, to trade a derivative off-exchange. Consequently, the law carved out a narrow exemption from the clearing mandate. The exemption applies to all bona fide end users, as well as small banks and financial institutions. It relieves them of the need to clear swaps and report them in real time.

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[9] *See* Better Markets Comment Letter "End User Exception to Mandatory Clearing of Swaps", February 22, 2011, *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27992&SearchText=better%20markets.

[10] *See* Better Markets Comment Letter General Regulations and Derivatives Clearing Organizations, February 11, 2011, *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27682&SearchText=, *see also* Mello, A. and Parsons, J., "Margins, Liquidity and the Cost of Hedging", May 2012, *available at* www.web.mit.edu/ceepr/www/publications/workingpapers/2012-005.pdf.

[11] *See* Better Markets Comment Letter "Trading Documentation and Margining Requirements under Section 4s of the CEA", November 4, 2011, *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=49931&SearchText=better%20markets.

Instead, whenever a commercial firm uses a swap to hedge its commercial risks, it will now be able to employ a simple check-the-box form, which will allow reporting with the minimum of burden. Margin payments will not be required, and end users will be free to negotiate their own bilateral risk-mitigation methods, as in the past.

Thus, end users are not subject to most of the new derivatives regulations that are designed to reduce systemic risk. At the same time, they will benefit hugely from the requirements placed on large financial swap dealers and participants. These large banks, hedge funds, and other traders are now required to clear their swaps, with adequate margin and full transparency. They are also required to employ business conduct standards in their dealings with end users. The combination of the Swap Dealer/Major Swap Participant rules and the End User Exception rule ensures that end users will be safer in the derivatives marketplace without being subjected to any burdensome regulations.

Bone fide commercial end users have a very strong interest in this process because they will be hurt the most if big financial firms and dealer banks are allowed to sneak into this narrow exception by claiming they are commercial end users when they are not. If they are allowed to do that, bone fide commercial end users will be hurt the most and not just because there will be less transparency and greater systemic risk. This will also almost certainly raise prices for bone fide commercial end users and enable manipulation of the markets to the detriment of end users. That is why the law has a narrow exception: to protect genuine end users, not big dealer banks and other financial players trying to hide behind bone fide commercial end users.

The Volcker Rule

The Volcker Rule prohibiting most proprietary trading and all but *de minimis* investments in hedge funds by banks that benefit from the federal financial safety net or are otherwise systemically significant is an essential reform. It effectively applies to only the biggest too big to fail banks because they are really the only ones that engage in any substantial proprietary trading or hedge fund investments. Moreover, while some continue to deny it, proprietary trading by those systemically significant financial institutions played a key role in the financial collapse and economic crisis.[12]

Proprietary trading is fundamentally no more than wild speculating by making huge leveraged bets with the banks' money for the purpose of hitting the jackpot and reaping an enormous windfall. Thus, this type of very high risk trading offers vast and fast wealth to those working for these too big to fail institutions. However, if those bets go wrong, as they did in 2007 and 2008, they can lose massive amounts of money very quickly and drag down

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[12] All these issues and more are addressed in four comment letters filed by Better Markets in response to the proposed Volcker Rule: November 5, 2010, *available at* http://www.regulations.gov/#!documentDetail;D=FSOC-2010-0002-1363; February 13, 2012, *available at* http://www.federalreserve.gov/SECRS/2012/March/20120309/R-1432/R-1432_021312_105537_519233431691_1.pdf; *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=57403&SearchText=; and June 19, 2012, *available at* http://www.sec.gov/comments/s7-41-11/s74111-594.pdf. The letters are referred to in the text by date.

an entire bank, which then has to be bailed out so it doesn't take down the entire financial system.

However, the law also carefully carves out certain permitted, socially desirable activities such as market making and risk-mitigating hedging. To avoid the big banks from disguising improper proprietary trading as a permitted activity (which they are highly incentivized to do given the gigantic bonus potential), the permitted activities are carefully defined. For example, permissible market making must be "designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties." The permitted activity of "risk-mitigating hedging" is also very carefully defined in the statute. Most of the industry's so-called concerns and objections to these definitions appear to be no more than attempts to create loopholes in the definitions of permitted activities so that they can continue their high-risk, but lucrative, proprietary trading.

Reinforcing the ban on proprietary trading and ensuring that the permitted activities don't become such loopholes, the Volcker Rule also prohibits, among other things, any "transaction, class of transactions or activity … if the transaction, class of transactions or activity … would result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies …."

Thus, the recently reported trading by JP Morgan Chase's Chief Investment Office (CIO) in London (the so-called "London whale") almost certainly would have violated the letter and not just the spirit of the law and proposed Volcker Rule. First, given the enormous net gains (reportedly 25% of the bank's net income for 2010) and losses (now reported to be approaching $9 billion) arising from this trading activity, it cannot properly be described as "hedging." And, given the swings in net profits and losses, it cannot properly be characterized as "**risk-mitigating** hedging," which is the definition of the permitted activity. Moreover, it has been widely reported that JP Morgan's CEO personally transformed the CIO from a low-risk hedging operation into a "profit seeking" operation; real "risk-mitigating hedging" does not generate net profits, which is what the CEO reportedly structured and staffed the CIO operations to create. (While losses and profits may be generated, they should be largely offsetting, resulting in little net profit or loss.)

Moreover, the JP Morgan CIO's trading certainly involved "high-risk assets" and "high-risk trading strategies," which are also expressly prohibited by the law. This is proved not only by the net profits and losses generated, but also by the fact that the CIO had to wager vast amounts of money to create those profits and losses, reportedly involving hundreds of billions of dollars. The CIO had, by the CEO's admissions, more than $350 billion under its control and much of that was apparently bet by the "London Whale" seeking to make a big splash and get a huge bonus, if not other rewards. Proving the high-risk nature of these assets and trading strategies, they apparently involved relatively illiquid securities because the bank couldn't exit the investments in any reasonable period of time to minimize its losses.

As if all that wasn't enough to demonstrate beyond a doubt that JP Morgan's trading violated the law and rule, it is also the case – as the CEO himself has admitted – that those very high risks were unknown to the bank; the bank's CEO, CFO, and other executives; and risk and operational management.[13] The narrow permitted activity of "risk-mitigating hedging" cannot, by definition, occur by accident, which is why the proposed rule has detailed procedures to establish that such hedging is in fact risk mitigating and in fact bone fide (although, as set forth in Better Markets February 13, 2012 comment letter, those procedures need to be strengthened).

Thus, the incentives to engage in this high risk behavior are enormous and must be addressed directly, which Better Markets did in its comment letters by focusing on compensation. Moreover, we addressed with specificity the industry's complaints regarding their claim that the rule will reduce their ability to act as market makers for corporate bonds, i.e., the alleged liquidity concerns. In this regard, it is noteworthy that the industry did not provide information or data on their own purported inventories to show (rather than merely claim) how the proposed rule would impact liquidity.

They do rely on a paper by the consulting firm of Oliver Wyman. Given that the paper was purchased by SIFMA on behalf of the industry, it is no surprise that it agrees with SIFMA's and the industry's position on the Volcker Rule. Like their arguments, however, the paper is deeply flawed. Better Markets addressed these flaws in its comment letters (specifically in the April 16, 2012 and June 19, 2012 comment letters), but I will briefly address the primary flaw here: Oliver Wyman, without explanations or basis (and contrary to basic economics), assumed that there would be no new entrants into the business of market making if the biggest too big to fail banks stopped making markets as a result of the Volcker Rule (which itself is a highly dubious assumption because market making is an expressly permitted activity).

Specifically, the Oliver Wyman paper stated that "[w]e do not directly analyze a wide range of potential knock-on effects, including… [t]he potential replacement of some proportion of intermediation currently provided by Volcker-affected dealers by dealers not so affected." As set forth in our comments letters of February 13, 2012, April 30, 2012 and June 19, 2012 (referenced and cited above), there is, however, a great deal of historical and contemporary evidence that entry is the normal market response to profit opportunities like this, including recently in the corporate bond markets.

This should come as no surprise to anyone. After all, the big dealer banks are not nonprofit organizations and do not make markets for free. They do it to make money and because there is money to be made. If they don't make that money, other market participants will move into the business to reap the profits.

Frankly, most of the industry's other objections simply don't stand up under the most minimal scrutiny either. For example, they claim that it is almost impossible to distinguish between proprietary trading and market making or hedging. This is simply baseless. Such activities have been going on for decades if not centuries or more and there has not been any

[13] Moreover, JP Morgan's CEO also, without detail or explanation, claimed that the London Whale trade "morphed" into something he "couldn't defend." It is hard to conclude that statement is anything other than an attempt to mislead because a trade or trades – as he well knows – do not "morph." They are not living organisms. People structure trades, put trades on, take them off, change them, and are supposed to authorize, supervise, and monitor them. Someone or some collection of people did all of that, even if it wasn't with the knowledge or consent of the CEO, CFO, or others.

evidence of widespread confusion over those activities……….until the Volcker rule banning proprietary trading was proposed.

Wall Street has some of the highest paid people in the world and many claim that they are the smartest people in the world, but all of a sudden they can't tell the difference between activities that have been distinguishable for years, decades and more? These are self-interested complaints that seek to get the law and the rules re-written in a way that would allow the biggest banks to continue their wildly lucrative proprietary trading by a different name (which is what JP Morgan Chase and its CEO were apparently trying to do with the London CIO operations). While that would increase Wall Street's profits, it would yet again risk a raid on taxpayer's pockets and it must not be allowed.

<u>Cross-Border application of derivatives protections</u>

One obvious lesson of the financial crisis is that we had to establish comprehensive regulation over the previously unregulated swaps market to create transparency, mitigate risk, and protect market participants from predatory behavior. If implemented in the right way, Title VII of the Dodd-Frank Act will do just that.

Less obvious but equally vital is ensuring that this regulatory framework applies to cross-border transactions that have an effect on U.S. markets and financial institutions – and ultimately U.S. taxpayers. It is no exaggeration to say that without taking this critical step, the entire regime put in place to protect taxpayers, the Treasury, financial system, and our economy from unregulated swaps markets will become largely meaningless. If given the opportunity, the financial industry will devise whatever corporate structures are necessary – including heavy reliance on foreign entities – to facilitate swap transactions without any compliance with Title VII. This must not be allowed to happen.

The sheer volume of overseas swaps activity by large U.S. banks is enormous, representing in some cases half of their swaps-derived revenue. We also know that such cross-border activity poses very real risks to U.S. institutions and markets, since a risk that infects one affiliate within a family of corporate entities can quickly spread throughout the organization and jeopardize the entire group.

Before, during, and since the financial crisis, we have seen case after case of foreign swaps activity causing massive losses to U.S. banks and even destabilizing our entire financial system:

- Ten years before the financial crisis, Long –Term Capital Management, based in Connecticut, nearly collapsed as a result of losses in a trillion-dollar swaps portfolio ran by a Cayman Islands affiliate;

- During the crisis, the epic failure of AIG was triggered when its subsidiary operating in London and routing trades though a French bank sustained huge losses on its portfolio of credit default swaps, requiring an $182 billion bailout by the U.S. taxpayers;

- And just two months ago, JP Morgan served up a fresh reminder that global trading activity directly affects domestic banks: JPMorgan's "Chief Investment Office," based on London, has sustained multi-billion dollar losses on swaps transactions, and the actual extent of the damage to the bank is still being calculated.

Mindful of the need to expand swaps regulation beyond just U.S. borders, Congress included not one but **two layers** of protection in the Dodd-Frank Act. The statute applies the Title VII provisions to activities outside the United States that "**have a direct and significant connection with activities in, or effect on, commerce of the United States**," as well as foreign activities that "**contravene such rules . . . as are necessary or appropriate to prevent the evasion of any provision of this Act**."

The CFTC has just released interpretive guidance to clarify the way the law will be applied to cross-border swaps transactions. Better Markets will be commenting on the proposal in the rulemaking process greater detail, but it is clear that the guidance must answer four especially important questions:

- Is the definition of "U.S. Person" sufficiently broad to ensure that all foreign branch offices, subsidiaries, and other affiliates of U.S. institutions are subjected to all the provisions of the law, regardless of the location or the nature of their counterparties?

- Are the registration criteria for non-U.S. Persons acting as dealers and major swap participants sufficiently strong and comprehensive?

- Will the "entity level" and "transaction level" requirements be applied to foreign transactions in a way that addresses all of the risks and abuses that may eventually affect U.S. financial institutions and markets?

- And, is the test for allowing non-U.S. dealers and major swap participants to satisfy Dodd-Frank Act requirements through "substituted compliance" sufficiently reliable to ensure that foreign regulatory regimes are truly comparable in form, substance and enforcement, and remain so?

On these issues, we see some encouraging provisions in the interpretive guidance, but we also have some concerns that we intend to raise with the CFTC. Unless the application of the law to foreign swaps activity with a nexus to the United States is truly robust, much of what the financial reform law sought to achieve by regulating derivatives will fail.

And, just as U.S. taxpayers had to put up $182 billion to bail out AIG from its London based swap activities, U.S. taxpayers will be on the hook again. That simply cannot be allowed.

<u>International Harmonization</u>

Even more challenging than regulating cross-border swap activity is harmonizing the standards that multiple foreign jurisdictions and international regulatory bodies might apply to financial market regulation. The goal is certainly worthwhile as a general proposition, and it takes on special importance in light of the CFTC's interpretive guidance on the regulation of cross-border swap transactions under the U.S. financial reform law. If done right, harmonization could (and should) enhance the CFTC's ability to make comparability determinations that respect principles of comity and regulatory efficiency, without compromising the overriding goals of investor and market protection.

It is critical, however, that any comparability determination ensure that foreign and international laws and regulations are in fact comparable in substance and enforcement and not just in form. Claimed international harmonization simply cannot be used as cover for a race-to-the-global-regulatory-bottom, where the U.S. lowers its standards or accepts weak, porous, or easy-to-evade laws and regulations in other countries.

The American people have already suffered from U.S. authorities being too accepting of foreign and international promises and agreements that look terrific on the books, but provide no protection in substance. False comfort is no comfort at all and should be summarily rejected. International comity and cooperation cannot be more important than enforcing the law, preventing too big to fail banks from evading U.S. law, and allowing risk to be shifted – again – back to U.S. taxpayers and the Treasury.

The statutory foundations for harmonization are in place, as Section 752(a) of the Dodd-Frank law requires the SEC and CFTC (and also the prudential regulators) to "consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards with respect to the regulation … of swaps, security-based swaps, swap entities, and security-based swap entities" in order to "promote effective and consistent global regulation of swaps and security-based swaps." Most importantly, the law says that should be done only "as appropriate" and that means only if it in fact protects the U.S. national interests in preventing another financial collapse and economic crisis.

Thus, the law does not require international harmonization as an end in itself. The purpose is to "promote effective and consistent global regulation of swaps and security-based swaps." The key words are "**effective** and consistent" regulation. That is what the law requires and that is what regulators are mandated to achieve.

It is encouraging that the crucial first steps are already underway: taking stock of the current state of international regulation, initiating dialogue with international authorities, and entering MOUs that provide the broad templates for building consensus for "effective and consistent" financial regulation worldwide. For example—

- In accordance with Section 719(c) of the Dodd-Frank Act, the SEC and CFTC have completed and issued a joint study on international harmonization of swaps and SBS regulation. The report was released in January 2012 (www.sec.gov/news/studies/2012/sec-cftc-intlswapreg.pdf), and it lists the major market participants in each geographic area, the major contracts (including trading volumes, clearing volumes, and notional values), the methods for clearing swaps, and the systems used for setting margin.

- IOSCO has issued a report on central clearing requirements (https://www.iosco.org/library/pubdocs/pdf/IOSCOPD374.pdf).

- Various memoranda of understanding have been entered with foreign regulators (http://www.cftc.gov/international/memorandaofunderstanding/index.htm).

- CPSS (part of BIS) and IOSCO have issued a report on principles for financial market infrastructures (i.e. clearing, settlement, payment) (http://www.iss-mag.com/news-bytes/cpss-iosco-issue-new-standards-for-financial-ma).

- Regular "technical dialogues" are underway with regulators in Europe, Japan, Hong Kong, Singapore, and Canada.

- Perhaps most important, in 2009, the G20 nations agreed that: (i) OTC derivatives contracts should be reported to trade repositories; (ii) all standardized OTC derivatives contracts should be cleared through central counterparties and traded on exchanges or electronic trading platforms, where appropriate, by the end of 2012; and (iii) non-centrally cleared contracts should be subject to higher capital requirements.

However, notwithstanding these laudable goals and positive early steps, the process of harmonization must be approached with two exceedingly important caveats in mind.

First, as observed in the CFTC's recent interpretative guidance on the regulation of cross-border swaps transactions,

> "In line with the G20 commitment, much progress has been made to coordinate and harmonize international reform efforts, **but the pace of reform varies among jurisdictions and disparities in regulations remain due to differences in cultures, legal and political traditions, and financial systems."**

Thus, the U.S. must be patient and persistent with a complex international process. However, it must not and cannot subordinate enforcing its laws, promulgating its regulations, and protecting its people to that process. Indeed, that process may ultimately achieve imperfect results in other countries, but the U.S. cannot allow those outcomes here. The American people have suffered too much already.

As the effort to achieve harmonization moves forward, the financial regulators in the United States, including the CFTC and the SEC, must not waiver in their commitment to strong, clear, and rigorously enforced standards across the entire spectrum of financial regulation—from capital and margin requirements to antifraud provisions. Any deviation from this guiding principle would be counterproductive in fact and unacceptable in principle. Moreover, it would violate U.S. law.

As a practical matter, the argument that diluting our own regulatory standards to more closely parallel weaker standards in foreign jurisdictions has never been supported by any evidence, and this approach is neither necessary nor desirable. The argument in favor of such concessions tends to be yet another example of the financial industry's perpetual cry that good regulation is bad for business, but that simply has not been substantiated and it is not true. On the contrary, high regulatory standards foster confidence in financial markets, leading to more, rather than less robust participation.

Self-interested industry participants claiming that a robust and effective U.S. financial reform system will hurt competition, business, growth, and employment have no basis for their unsupported assertions. As set forth above, when Wall Street and the financial industry was most regulated, our country and that very industry enjoyed the greatest prosperity. And, history shows that when the financial industry is least regulated, it quickly engages in reckless behavior, causing financial and economic crises that inflict enormous damage to the very interests they claim to promote through de-regulation.

Harmonization should be pursued earnestly and in good faith, but not at the expense of what the law requires: protecting our financial markets, investors, and the American people from another devastating financial and economic crisis that has so gravely damaged our country and our people.

<u>The CFTC is the only police force on the derivatives beat and it needs substantially more funding to protect the American people properly</u>

Financial regulators are the Wall Street policemen. If the regulators are not funded, they won't have the personnel or technology to pass, implement, and enforce the laws, which are essential to protect investors and our capital markets. Without regulators – and adequately funded regulators – another major financial crisis is virtually certain.

Unfortunately, one of the key tactics of the opponents of financial reform is to deprive the financial regulators of the funding they need to carry out their new responsibilities. To make matters worse, once they have successfully prevented the agencies from having adequate resources to do their job, opponents then attack them for failing to do their job.

Those agencies – and most notably the CFTC – must be provided with significantly greater funding so that they can acquire the human resources and information technologies that are indispensable to effective oversight of our increasingly complex and data-driven financial markets. This is especially important now that the CFTC has primary responsibility for ensuring that derivatives do not – again – become weapons of financial destruction and blow up the American taxpayer and treasury.

Added to the CFTC's traditional responsibilities for regulating markets with about $40 trillion of notional value, they are now also responsible for markets with more than $300 trillion in notional value. They need a budget commensurate with the duty of policing markets with more than $340 trillion in notional value.

Consider the challenges facing the CFTC. In the decade leading up to passage of the Dodd-Frank Act, the CFTC faced a steadily increasing strain on its budget. From 2000 to 2009, the futures markets expanded dramatically, with the number of actively traded futures and options contracts increasing six-fold, and the dollar volume of trading in futures and options increasing four-fold. Yet the CFTC's resources failed to keep pace with that market expansion, as its staff actually contracted and its budget barely doubled in size over that ten-year period.

Now, as a result of the Dodd-Frank Act, the CFTC is facing an extraordinary challenge. In addition to its current oversight duties, the agency must now regulate a swaps marketplace that is eight times the size of the futures and options market—representing a domestic notional value of over $300 trillion. This new responsibility has already put the agency under enormous strain as it has struggled to propose and finalize dozens of complex rules under Title VII of the Dodd-Frank Act. Going forward, the CFTC will have the responsibility for—

- Overseeing the registration over 200 new market participants, ranging from swap dealers to swap execution facilities and swap data repositories;

- Reviewing new swap "products" under the provisions of Dodd-Frank that mandate clearing and exchange trading of designated swaps;

- Examining each market participant with sufficient thoroughness and frequency to ensure that each entity remains in compliance with the Title VII requirements;

- Collecting, sorting, and analyzing a tremendous wave of new data on swap transactions;

- Investigating and taking enforcement action against all market participants that violate the law – tasks that are essential if the new regulatory regime for swaps is to have any meaning.

All of these new challenges for the CFTC, added to its already significant responsibilities over futures and options, will require major increases in funding for the agency. And yet, for fiscal year 2012-2013, the Agriculture Subcommittee of the House Appropriations Committee actually **cut** the CFTC's budget by $25 million—more than 10%.

This funding level is clearly indefensible—indeed inexcusable. In reality, it represents another assault on regulatory reform. Having failed to prevent passage of the Dodd-Frank Act and derail the CFTC's rulemaking effort, opponents of reform seek to prevent regulators from implementing and enforcing the law by starving the CFTC of the funding it plainly needs. This tactic is not only unfair, it is profoundly unwise: Unless the CFTC and the other financial regulators have sufficient resources to regulate and oversee the swaps market effectively, our markets will remain far too vulnerable to the risky and abusive behaviors that spawned the last crisis and threaten a new one.