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REGULATING FINANCIAL MARKETS BEGETS INNOVATION WHICH BEGETS MORE REGULATION IN AN ENDLESS CYCLE

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The *Dodd-Frank Wall Street Reform and Consumer Protection Act* which passed the U.S. Senate last week and was signed this week by President Obama is massive in length and detail: 2,319 pages, 1,603 sections. Too long and too detailed to cover other than selectively. Accordingly, Mayo Research Institute focuses on several sections which otherwise might be lost in mass-media coverage.

<u>Section 1306</u> amends Section 1613 of the *American Recovery and Reinvestment Act of 2009* so that whenever it is in "the best interest of the Nation" the President may *waive* the *ARRA* requirement that designates unobligated funds at the end of 2012 for deficit reduction and prohibits using those funds as an offset for other increases in spending or decreases in revenues.

<u>Section 750</u> sets up an interagency working group of presidential appointees at the highest levels of government including the secretary of the Treasury and the heads of Environmental Protection Agency and the Securities and Exchange Commission to "conduct a study on the oversight of existing and prospective carbon markets to ensure an efficient, secure, and transparent carbon market, including oversight of spot markets and derivative markets." This study no doubt will re-assure the Obama administration of the wisdom of pending cap-and-trade legislation.

The 14-page <u>Section 1502</u> includes instructions to the Comptroller General of the United States to "submit to appropriate congressional committees a report that includes an assessment of the rate of sexual- and gender-based violence in the war-torn areas of the Democratic Republic of the Congo and adjoining countries."

<u>Section 1491</u> includes a finding by Congress that "the conservatorship for Fannie Mae and Freddie Mac has potentially exposed taxpayers to upwards of $5,300,000,000,000 worth of risk … [and that] efforts to enhance by the protection, limitation, and regulation of the terms of residential mortgage credit and the practices related to such credit would be incomplete without enactment of meaningful structural reforms of Fannie Mae and Freddie Mac." No such reforms are offered in *Dodd-Frank Act* even though Fannie Mae and Freddie Mac in 2009 reported combined losses of $93,600,000,000.

Section 113 empowers the Financial Stability Oversight Council which is chaired by the secretary of the Treasury to "determine that a U.S. nonbank financial company shall be supervised by the Board of Governors and shall be subject to prudential standards … if the Council determines … that the activities of the U.S. nonbank financial company could pose a threat to the financial stability of the United States." The phrase "including an affirmative vote of the Chairperson" in Section 113 gives the secretary of the Treasury veto power in these matters.

Section 1602 establishes a Financial Crisis Special Assessment Fund in which the monies in the Fund are to be "invested in obligations of the United States issued directly to the Fund having suitable maturities and paying suitable interest rates as determined by the Secretary [of the Treasury]." This fund in other words can be tapped to purchase Treasuries issued to cover a federal budget deficit. "The Fund shall not be used in connection with the liquidation of any financial company … or any financial stabilization action taken under this Act."

Section 1601 authorizes the Federal Financial Stability Oversight Council to impose "one or more special assessments on financial companies" with $50,000,000,000 or more in assets. Assessments are based on risk-related factors, but Fannie Mae and Freddie Mac which together in 2008 spent $9,640,000 lobbying Congress are explicitly excluded from any assessment obligation. This Fund is intended to "fully offset the net deficit effects of the provisions of this Act …" The Financial Crisis Special Assessment Fund is designed not to address a financial crisis but to meet PAYGO requirements.

Three Republican senators were crucial to the passage of the *Dodd-Frank Act*: Olympia Snowe, Scott Brown, and Susan Collins. According to the Center for Responsive Politics Snowe received $622,000 from the finance-insurance-real estate industry in 2005-2010, while Brown got $1,100,000, and Collins accepted $1,500,000. For all three senators, finance-insurance-real estate was the most important source of campaign contributions.

Democrats on the Senate Banking Committee that drafted the Act also got financial support from that industry in 2005-2010. Chairperson Chris Dodd, for instance, got $3,600,000, Chuck Schumer received $4,700,000, and Mark Warner took in $5,200,000. Barney Frank who chairs the House committee that helped craft the *Dodd-Frank Act* picked up $2,382,200 from finance-insurance-real estate sources. The new regulations set no limit on how much special interests can contribute to the re-election war chests of members of Congress including those who are charged with regulating those interests.

Washington insiders often discount the importance of campaign contributions to federal elected officials by asserting that money doesn't buy influence on Capitol Hill, it buys access. If it takes millions for a heavy-hitter to gain access to a member of Congress, what kind of access does an ordinary citizen get other than perhaps at a town-hall meeting?

In a recent policy brief Edward Kane who serves on the finance faculty at Boston College and is a past president of the American Finance Association observed the following.

> **Regulation begets avoidance activity, and avoidance eventually begets some form of re-regulation. Regulatory problems, adjustments, and market events unfold and mutate as part of alternating sequences in which either regulation spawns new forms of avoidance or the growing ineffectiveness of particular avoidance activities finally results in a threshold level of avoidance activity that call forth innovative re-regulation. Adapting regulatory protocols to innovative avoidance activity is an endless task.**

Predictably, the *Dodd-Frank Act* will trigger what Kane calls "regulation-induced innovation" which in turn will set in motion new regulatory legislation. With the access that heavy hitters gain through generous campaign contributions those new regulations very likely will have enough loopholes to accommodate a new line of financial products. Regulation-induced innovation, it's the American way.

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