Sound Financial Policy

Principled Recommendations For the 118th Congress

CATO INSTITUTE

Nicholas Anthony, Norbert J. Michel, Jennifer J. Schulp, George Selgin, and Jack Solowey • Co-editors: Norbert J. Michel and Ann Rulon

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Sound Financial Policy: Principled Recommendations for the 118th Congress

Many events in the past few years have illuminated how badly Congress needs to reform the monetary and financial system in the United States. Inflation spiked to a 40-year high, and Congress failed to enact any meaningful reforms—through the Federal Reserve or otherwise—to combat it. Separately, Congress and the regulatory agencies struggled to provide much-needed clarity for all sorts of cryptocurrencies, leaving the industry without the well-defined framework it needs. Congress also enacted legislation requiring individuals to report to the federal government sensitive private information regarding fellow citizens' financial transactions, and the Fed moved even closer to adopting a central bank digital currency, a form of payment currently employed by the Chinese government due partly to its utility as a surveillance tool. And, as environmental, social, and governance policy further politicized financial market regulation, Congress and the Fed implemented unprecedented spending programs, including those designed to prop up short-term credit markets.

Not only have Americans been dissatisfied with these recent policy changes and proposals, but they have long demonstrated that they distrust the federal government regarding financial privacy. Millions of Americans have chosen to remain unbanked rather than provide personal information to financial firms that are required to report to the government. It was no surprise, therefore, that Congress stoked a public backlash in 2021 when lawmakers tried to lower bank reporting thresholds to $600, a plan that 66 percent of voters opposed.[1] The Cato Institute's national survey of Americans' beliefs about the financial sector suggests that Americans broadly oppose the long-term regulatory trends in U.S. financial markets.[2]

Based on the survey results, most Americans appear to oppose expanding government regulation even though government officials have consistently expanded financial regulation. In fact, even though Congress tends to expand government regulation after a period of financial turmoil, Cato's survey results indicate that Americans oppose such an approach even in the wake of a crisis. The survey suggests that most Americans are open to the idea that more market-based regulation can be a better way to promote the public interest.[3]

Most people want the goods and services they use—including their *financial* products and services—to meet some set of quality and safety standards, but policymakers rarely contemplate *market* regulation as a potentially better alternative to more *government* regulation. While many assume that no standards would exist in the absence of government regulation, most companies set standards for their products and services independently of what government requires because doing so attracts customers and enables them to earn profits. Competition also provides incentives for other companies to adopt similar—or better—standards. While governments set standards through centralizing legal rules and requirements, markets set standards and enforce rules through competition.

Yet, both markets and governments make mistakes. A crucial distinction is that where markets have the flexibility to analyze and adapt, government rules are often sweeping and difficult to change. While many Americans believe there should be stricter oversight of the financial industry, they do not necessarily want the kinds of oversight found in sweeping bills like the 2010 Dodd–Frank Act. Instead, many want regulators to enforce the rules that are already on the books, and they do not necessarily support expanding the number of rules, especially those that dictate which financial decisions people can make.

According to the Cato survey, Americans believe that regulation should serve two primary functions: to protect consumers from fraud (64 percent) and to ensure financial institutions fulfill obligations to their account holders (53 percent). Other functions, such as restricting access to risky financial products (16 percent), are a priority among far fewer people (16 percent). And while public opinion surveys

have long reported that many Americans have little confidence in Wall Street banks and financial firms, Cato's survey results show that Americans distrust government financial regulators as much as they distrust Wall Street. Nearly half (49 percent) have "hardly any confidence" in either, and only 7 percent say they have a great deal of confidence in either Wall Street or government financial regulators.[4]

Even in the current environment, marked by above-average inflation and rising interest rates, these survey results can help Congress develop a better monetary and financial framework for the American people. For decades, Congress has empowered regulators to manage private risks and mitigate private losses to prevent financial-sector turmoil from spreading to the rest of the economy, but Cato's survey results suggest that most Americans are open to a different approach. For instance, 78 percent of Americans think regulations too often fail to have their intended effect, and more people negatively rate government regulators for protecting consumers (73 percent) than they do the free-enterprise system (50 percent).[5] Finally, most Americans do not think that regulators help banks make better business decisions (77 percent) or better decisions about how much risk to take (69 percent).[6]

A smoothly running financial system makes it easier and less costly to buy consumer goods, raise the capital necessary for launching or operating a business, borrow money for buying or building a home, and invest in ideas that improve productivity and increase economic opportunity. Just as in other areas of the economy, excessive government regulation and involvement in financial markets prevent firms from best serving the needs of their customers and, therefore, society. Cato's survey results suggest that most Americans are very sympathetic to this view.

For policymakers who want to improve financial markets, this policy guide provides many practical solutions to reduce excessive government regulation and involvement in financial markets. Here's a preview of the sections included in this policy guide.

Section 1: Financial Privacy

Americans' financial privacy has been eroding for over 50 years, often hidden in the details of complex policies. Congress can establish stronger financial privacy protections by eliminating many Bank Secrecy Act reporting requirements. If financial records are needed, law enforcement should be required to show probable cause to obtain a warrant, a reform that Cato's national survey suggests 83 percent of Americans favor.[7] Congress should also enact inflation-adjusted reporting thresholds for remaining Bank Secrecy Act requirements as well as the Internal Revenue Code, eliminate the exceptions in the Right to Financial Privacy Act, and establish better public oversight for the Financial Crimes Enforcement Network.

Section 2: Stablecoins, Central Bank Digital Currencies, and a More Competitive Financial Sector

Congress can implement many policies to improve competition and innovation in financial markets, including those that level the field on which the dollar competes with other potential means of payment. Two potential means of payment that have surfaced during the digital age are stablecoins and central bank digital currencies (CBDCs). Congress should provide disclosure-based regulations for stablecoins while preventing the Federal Reserve from issuing a CBDC for retail customers.

Section 3: Opening the Door to Cryptocurrency Innovation by Eliminating Unnecessary Regulatory Barriers

Cryptocurrencies remain subject to regulatory uncertainties that may hamper their development along with innovation more broadly. This potentially pushes entrepreneurs abroad and limits Americans' ability to take advantage of these advances. Policymakers ought to provide a clear, practical test for determining whether a crypto project is decentralized and amend securities statutes to clarify that securities laws do not apply to decentralized cryptocurrency projects. Congress should also clarify the meaning of legal tender in U.S.C. § 5103, clarify the prohibition on counterfeiting U.S. coins in 18 U.S.C. §§ 485–497,

remove the prohibition on minting coins of original design (in 18 U.S.C. § 486), and remove capital gains taxes applied to alternative currency use.

Section 4: Policymakers' ESG Concerns Should Not Override the Market's Allocation of Resources

Congress should ensure that financial regulators do not function as central planners deciding which enterprises are worthy of capital, especially in the name of environmental, social, and governance (ESG) policy. Congress should clarify the scope of mandatory securities disclosures and shrink bank regulators' responsibilities, thus limiting the extent to which ESG policy can politicize financial market regulation. Congress should clearly state that disclosures are limited to the type of information relevant to a company's prospects for financial success (as originally contemplated by the 1933 and 1934 securities acts) and repeal the sections of the Dodd–Frank Act that direct the Securities and Exchange Commission to promulgate the conflict minerals and pay-ratio disclosure rules. Congress should also require banking regulators to consider solely economic and financial factors when promulgating regulations, rather than factors that might affect the public's view of a bank, such as the bank's so-called reputational risks.

Section 5: Monetary Policy That Holds the Fed Accountable

So long as Congress is inclined to delegate responsibility for conducting monetary policy and limiting financial instability to the Fed, lawmakers should do more to improve the Fed's performance. For instance, Congress can narrow and clarify the Fed's legislative mandate and require that the Fed implement rules-based monetary policy. It can also level the field on which the dollar competes with other potential means of payment so that the Fed faces competitive pressure to preserve, and perhaps enhance, the U.S. dollar's attractiveness. A more vibrant financial sector would complement a sounder monetary policy framework, thus providing more economic opportunity for millions of Americans.

Section 6: Removing Barriers to Small Business Capital Formation and Expanding Investor Opportunities

Congress should enact an exemption to securities registration for equity offerings that raise funds below a certain threshold, such as $500,000 per year. It should also focus on decreasing the barriers to eligibility for accredited investor status. Congress, could, for example, consider investors advised by financial advisers who meet the current accredited investor definition as accredited themselves.

Section 7: Broad Reforms to Boost Competition and Innovation in the Financial Sector

Even if the 2010 Dodd–Frank Act is repealed in its entirety, a dysfunctional regulatory framework would remain. Nonetheless, the legislation solidified the harmful view that federal regulators can and should prevent people from losing money in financial markets. The Dodd–Frank Act provides a false sense of security by conferring an aura of safety on firms that play by the rules. It should be repealed in its entirety. Congress should also shrink the regulatory state by eliminating duplicative federal agencies, narrow Fannie Mae and Freddie Mac's focus to the financing of primary homes, revoke Fannie and Freddie's exemption from the requirement to register their securities offerings under the Securities Act of 1933, limit the Federal Housing Administration's single-family insurance portfolio to first-time homebuyers, and shrink the Securities and Exchange Commission's scope to regulate money market mutual funds.

Section 1: Financial Privacy

Financial privacy in the United States has been eroding for over 50 years. Much of this encroachment on the rights of Americans has been hidden in the weeds of old and complex policies. The issue was brought to the forefront of public discourse with two key events: the attempt in Congress in late 2021 to reduce Internal Revenue Service (IRS) bank reporting thresholds on customers to $600 and the use of the Emergencies Act in Canada in early 2022 to freeze the bank accounts of political protestors.[1] With those two events, Americans saw not only that the U.S. government was willing to violate their financial privacy on an unprecedented level in the pursuit of greater tax revenue but also that the government in Canada—a nation that ranks even higher than the United States on the Cato Institute's *Human Freedom Index*[2]—was willing to weaponize the financial system against its citizens to suppress unrest. While the latter event was north of the U.S. border, the same principles that made that attack on financial freedom possible are also engrained in U.S. law. In fact, it was less than a decade ago that the U.S. government pressured banks—in a project known as Operation Chokepoint—to deny financial services to politically disfavored businesses.[3]

Congress could, however, turn the tide and restore financial privacy in the United States. Congress could establish stronger financial privacy protections by eliminating many Bank Secrecy Act reporting requirements, enacting inflation-adjusted reporting thresholds for remaining requirements as well as the Internal Revenue Code, eliminating the exceptions in the Right to Financial Privacy Act, and establishing better public oversight for the Financial Crime Enforcement Network (FinCEN).

THE PROBLEM

The enactment of the Bank Secrecy Act in 1970 was met almost immediately with objections from groups concerned about violations of financial privacy.[4] By forcing banks and other financial institutions to record and report the financial activity of Americans, the Bank Secrecy Act essentially deputized financial institutions as law enforcement investigators. Less than a decade later, Congress enacted the Right to Financial Privacy Act in response to complaints against the regime. Yet critically, while some progress was made, the Right to Financial Privacy Act was crafted with a list of exemptions that superficially exclude its protections in many situations.

> "Thousands of reports are filed every day against Americans for merely using their own money."

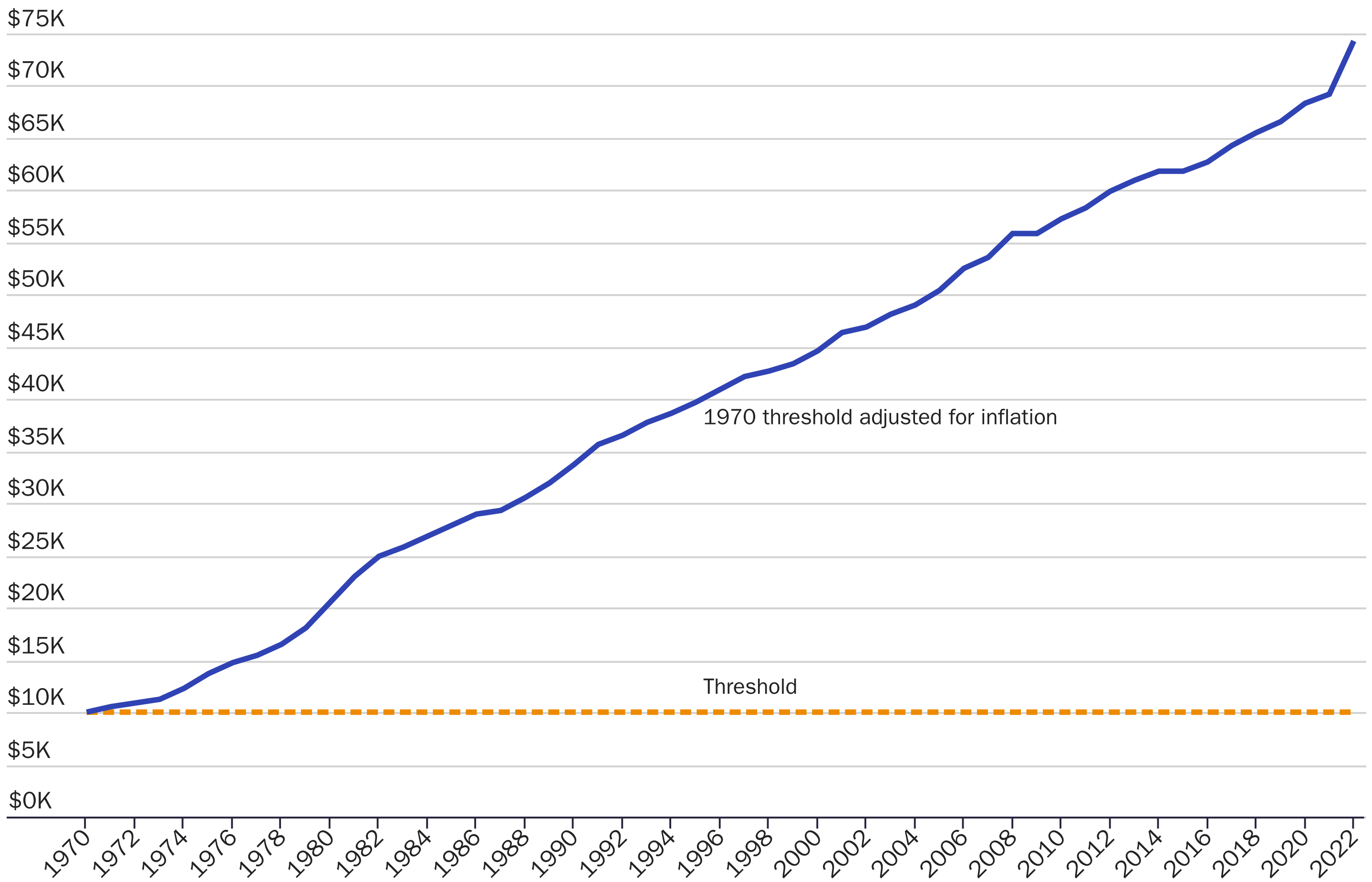
Since then, the Bank Secrecy Act has been officially expanded numerous times as part of both the war on terror and the war on drugs. In addition to being required to file currency transaction reports (CTRs) whenever a customer makes a transaction over $10,000, financial institutions must file suspicious activity reports (SARs) anytime a customer's activity might be interpreted as unusual. The result is that thousands of reports are filed every day against Americans for merely using their own money.

Moreover, inflation has unofficially increased the scope of activity that banks must report under the Bank Secrecy Act. For instance, the $10,000 threshold for CTRs was set in the 1970s but has never been adjusted for inflation. If it had, the threshold today would be closer to $75,000 (Figure 1).[5] Considering Supreme Court Justices Lewis Powell and Harry Blackmun held in 1974 that the Bank Secrecy Act was constitutional but noted that they felt it was not an undue burden because of its "high" threshold, it's only natural to wonder how they would characterize that burden under today's circumstances.[6]

With such a broad scope, it is of little surprise that more than 20 million Bank Secrecy Act reports were filed to

Figure 1

CTR reporting threshold would have been close to $75,000 in 2022, if it were adjusted for inflation



Source: Consumer price index as reported by the Bureau of Labor Statistics.
Note: CTR = currency transaction report.

FinCEN in 2019 alone.[7] This mass surveillance is conducted without so much as a warrant, and there is no way for the public to judge its effectiveness. FinCEN does not report any statistics regarding how the data from the reports are used. So, while some may be tempted to argue that combating financial crimes justifies infringing on financial privacy, there is little evidence to suggest that financial crimes are being effectively combated.

Worse yet, some government officials seek even larger collections of financial data. In early 2021, the Treasury Department introduced a proposal that, among other things, would require banks and other financial institutions to report on accounts in which $600 or more is moved over the course of a year.[8] In late 2021, Congress largely removed the proposal from consideration after there was widespread backlash from both the general public and the financial industry. Yet, an echo of the proposal remained—one that required payments services (e.g., PayPal, Venmo, or CashApp) to report on accounts with over $600 of annual activity—and was ultimately enacted in the American Rescue Plan.[9]

With all these problems in mind, it's no wonder that financial privacy is a serious concern for Americans across the country and across the political spectrum. Both privacy and trust have been cited as top concerns for why millions of Americans are unbanked.[10] Likewise, the Pew Research Center found that an average of 59.5 percent of Americans are against the government monitoring American citizens.[11] And Reuters found that 75 percent of Americans would not let investigators tap into their internet activity, even in order

to combat terrorism.[12] Finally and most recently, 66 percent of the comment letters on the Federal Reserve's proposal for a central bank digital currency opposed the idea because of the risks to financial privacy.[13]

> "Restoring Americans constitutional protections is long overdue."

Privacy may mean different things to different people, but the fact remains that most Americans are concerned about their financial privacy in the wake of this unchecked surveillance. Restoring Americans constitutional protections is long overdue.

SOLUTIONS

There are several reforms that would help turn the tide and restore financial privacy in the United States.

- **Revise the Bank Secrecy Act.** Congress should repeal the sections of the Bank Secrecy Act that require financial institutions to report on their customers. If financial records are needed, law enforcement should be required to show probable cause to obtain a warrant. Congress should amend 12 U.S.C. Sections 3402, 3413, and 3414 as well as 31 U.S.C. Sections 5313–16, 5318(a)(2), 5318A, 5321, 5325, 5326, 5331–32, 5341–5342, and 5351–55.
- **Eliminate the exceptions in the Right to Financial Privacy Act.** Although the Right to Financial Privacy Act was well-intentioned, the list of exceptions included in the act eliminates the bulk of the protections it otherwise offers. For instance, customers are not notified that the government is seeking their financial data, and they are not given the opportunity to object if the information is for Bank Secrecy Act reporting. To offer the protections everywhere except where it really matters is tantamount to offering no protections at all. Congress should strike 12 U.S.C. Section 3413 (c)–(r).
- **Eliminate Section 6050I reporting requirements.** No American should be forced by law to report on the activity of another American—especially when that activity is between only two parties. Yet, for financial transactions using cash or cryptocurrency, the law requires exactly that. Congress should strike 26 U.S.C. Section 6050I.
- **Require inflation adjustments for all Bank Secrecy Act and IRS payment thresholds.** Optimally, financial reporting requirements would be removed from the Bank Secrecy Act. However, if some are maintained, they should be updated to reflect the current value of money. Reporting thresholds should be adjusted annually for inflation.
- **Require FinCEN to publicly report the number of SARs and CTRs that effectively curb financial crime.** If Congress does not remove the reporting requirements of the Bank Secrecy Act, then FinCEN should be required to publicly report how many reports are received, reviewed, and requested by other governmental agencies. In addition, FinCEN should report how many reports resulted in a conviction, settlement, or additional charges in other investigations. The reports should make a clear distinction between criminal investigations that originated with SARs or CTRs and criminal investigations that merely used existing SARs or CTRs to strengthen existing cases.

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Section 2: Stablecoins, Central Bank Digital Currencies, and a More Competitive Financial Sector

Competition improves people's lives by pushing entrepreneurs to innovate and develop products that better satisfy customers, ultimately exposing weaknesses and inefficiencies in existing products. The financial sector is no exception. Competitive forces can reduce firms' costs, expand consumers' choices, and lower prices, thereby resulting in a more vibrant financial sector. Moreover, a more vibrant financial sector would complement a sounder monetary policy framework.

There are many ways for Congress to improve competition in financial markets, including leveling the current privileged position the U.S. dollar holds in competition with other potential means of payment. Two potential means of payment that have surfaced during the digital age are stablecoins and central bank digital currencies (CBDCs), both of which could affect competition in financial markets. At minimum, Congress should provide disclosure-based regulations for stablecoins while preventing the Federal Reserve from issuing a CBDC for retail customers, thus fostering innovation and competition in the financial sector.

THE PROBLEM

Strictly speaking, "digital currency" refers to electronic payments media that can pass directly and repeatedly from one digital wallet to another, much as paper currency can pass from one physical wallet to another. People thus would not need bank accounts to use and store their digital currencies. Consequently, digital currencies can allow even the unbanked—meaning those who can't afford to keep bank accounts or who simply prefer not to deal with banks—to take advantage of the speed, convenience, and low cost of digital payments. This ability also means that digital currencies are a source of potential competition for existing financial firms, particularly commercial banks.

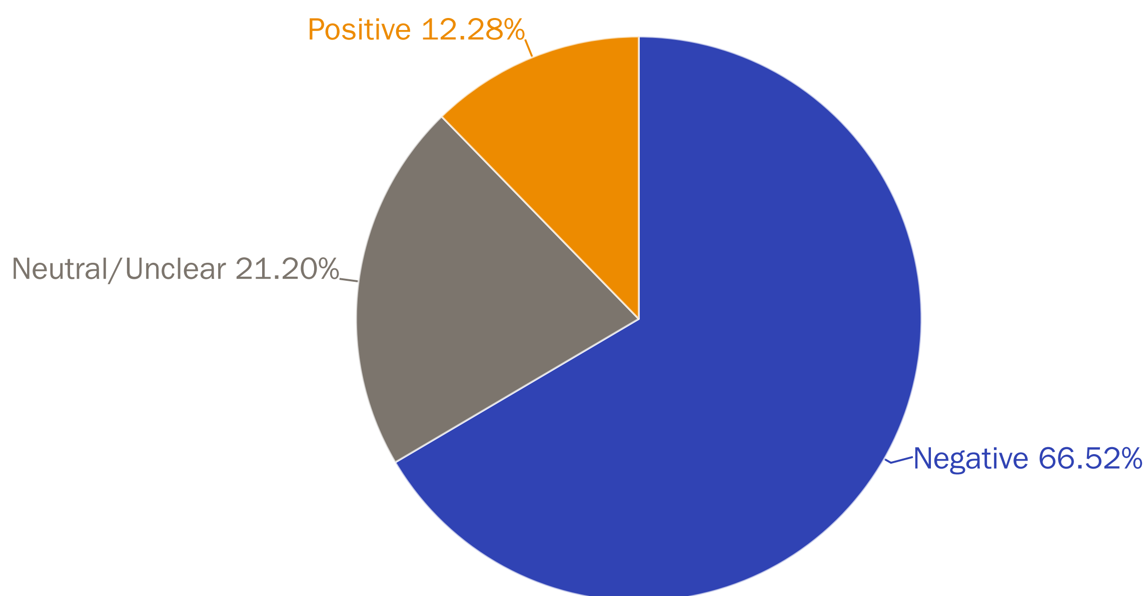
To date, digital currencies have not been used to the same extent as traditional government fiat currencies, but several innovations have surfaced to encourage their more widespread use. For instance, stablecoins are special cryptocurrencies designed to maintain a stable value rather than be subject to the volatile price movements seen with other digital currencies, such as Bitcoin and Ethereum. Although the details can differ widely, most stablecoins aim to achieve price stability by supporting their value with some other asset, typically cash and short-term securities.[1]

> "Competition improves people's lives by pushing entrepreneurs to innovate and develop products that better satisfy customers, ultimately exposing weaknesses and inefficiencies in existing products."

A properly structured federal regulatory framework for stablecoins would likely spur innovation in financial markets, benefiting millions of people with faster and more efficient methods of payment. Yet, many in Congress and the Biden administration are advocating for a framework that would prohibit anyone other than federally insured depository institutions from issuing stablecoins, a type of framework that will discourage competition and keep payments innovations—and the companies that create them—out of the United States.[2]

Figure 2

Two-thirds of commenters oppose the Federal Reserve's idea for a CBDC in the United States



Source: Author's calculations based on the responses to the Federal Reserve's request for comment on its CBDC discussion paper.
Note: CBDC = central bank digital currency.

Many opponents of stablecoins—as well as some supporters—believe that CBDCs for retail customers could provide the same benefits as stablecoins.[3] (Cato research shows that the majority of people view CBDCs negatively; see Figure 2.) While stablecoins are privately issued digital currencies, retail CBDCs would be issued by the Federal Reserve and consist of digital liabilities of the Fed that are widely available to the public. Thus, a CBDC could allow unbanked persons to transact digitally, if "unbanked" is understood to mean not banked by any private-market depository institution. Put differently, a retail CBDC would be a government-issued method of payment that serves as a close substitute for a privately issued stablecoin.

The prospect of the Fed providing a close substitute for stablecoins or other electronic transactions is why Congress should make sure that the Fed never issues a retail CBDC. Some CBDC supporters argue that privately issued stablecoins can coexist with a CBDC,[4] but this view is extremely short-sighted. Private firms cannot compete with a government entity that does not have to cover its costs, much less with the government agency that regulates them, and governments have tended not to tolerate monetary competition. It would be particularly difficult, for instance, for private stablecoin issuers to compete with a government-backed digital alternative that offers zero liquidity or credit risk to intermediaries and merchants. Ultimately, the existence of such a Fed-provided alternative would mean that the federal government, not privately owned commercial banks, would be responsible for issuing deposits.

The two payment methods—CBDCs and privately issued stablecoins—cannot peacefully coexist unless the government hands out special privileges or subsidies to privately issued stablecoins. Otherwise, private issuers could not compete with the Fed's CBDC, an alternative that automatically comes with zero credit or liquidity risk. Moreover, the Fed's current operating framework depends on paying interest to banks for their reserves, and there will be enormous political pressure for the Fed to pay individual CBDC holders at least the same rate of interest as it pays banks on reserves.

This feature would raise the costs to private stablecoin issuers who would have to compete with government-provided interest, as well as the usual political economy concerns associated with government transfers of funds. Even if a CBDC is initially restricted to a small number of underserved users, there will certainly be political pressure to expand the pool of people using the CBDC, thus further disintermediating the private banking sector.

> "A retail CBDC would give federal officials full control over the money going into, and coming out of, every person's account."

The fact that something called a CBDC even exists is only due to payment innovations that occurred in the private market.[5] Congress should foster these innovations rather than protect the federal government's privileged position and control over money. Aside from the direct harm to the private financial sector, retail CBDCs are also dangerous because there is no limit to the control that the government could exert over people if money is purely electronic and provided directly by the government. A retail CBDC would give federal officials full control over the money going into, and coming out of, every person's account—a level of government control that is incompatible with economic and political freedom.

SOLUTIONS

The competitive process is, ultimately, the only way to discover what people view as the best means of payment. To foster competition in financial markets, Congress should work to lessen government regulation while ensuring that the Fed cannot issue a CBDC. Implementing the following recommendations would produce more competitive and vibrant financial markets.

- **Create a disclosure framework for a limited purpose stablecoin issuer.** Congress could create this type of regulatory framework for stablecoin issuers using several different approaches. Congress could, for instance, amend the Investment Company Act to create a limited purpose investment company. This narrowly defined company would then be subject to basic reserve requirements and mandatory disclosure of relevant information about reserve holdings. The most important detail is that the framework should be designed to regulate—through a disclosure regime—the reserves that stablecoin issuers claim to hold. An alternative would be to create a similar financial entity regulated by a federal banking agency, such as the Comptroller of the Currency.
- **Require the Fed to grant master accounts to narrow stablecoin issuers.** Currently, nonbank financial firms, including stablecoin issuers and other fintech companies, can only access the Fed's wholesale services indirectly through bank correspondents. Instead of having the Fed enter the retail CBDC business, it should offer wholesale accounts and services to a broad set of stablecoin providers—and not just to insured banks and thrifts. Congress should amend Section 13 of the Federal Reserve Act to clarify that the Fed must grant master accounts to nonbank payments service providers, such as fintech firms that issue stablecoins backed exclusively by U.S. Treasury securities.

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Section 3: Opening the Door to Cryptocurrency Innovation by Eliminating Unnecessary Regulatory Barriers

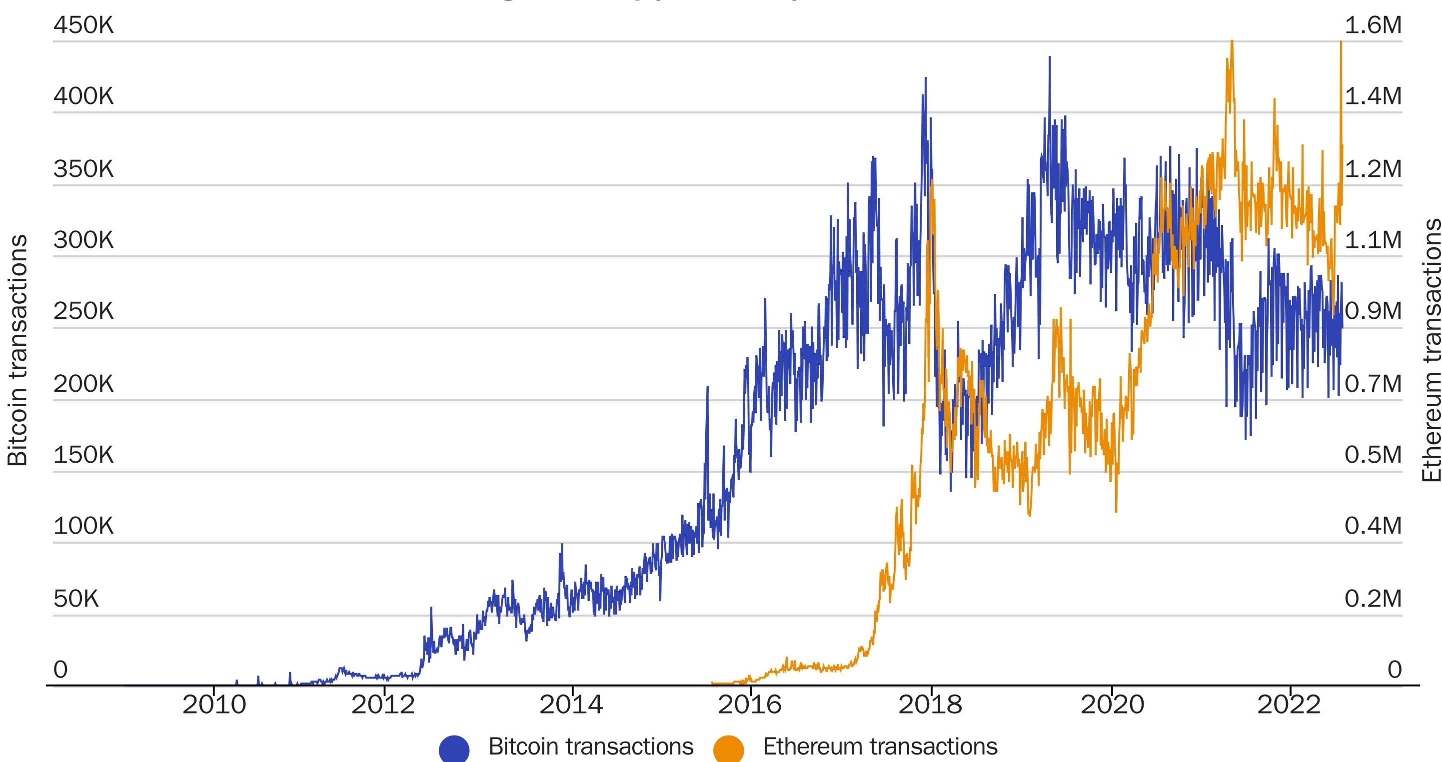
While cryptocurrencies may no longer be brand new, they have increasingly caught the attention of policymakers, regulators, and the public over the past several years. The global market capitalization of crypto investments has grown sharply (see Figure 3), even when factoring in recent market declines, and by some estimates, upwards of 21 percent of Americans have made crypto investments.[1]

Yet, cryptocurrencies remain subject to regulatory uncertainties that may hamper their development along with innovation more broadly, potentially pushing entrepreneurs outside of the United States and limiting Americans' ability to take advantage of these advances. Because the technology underlying cryptocurrencies also is foundational to additional innovations, including smart contracts, decentralized autonomous organizations (DAOs), and Web3, an inhospitable regulatory environment for cryptocurrencies could have far-reaching consequences.

Cryptocurrencies hold promise for liberty, providing individuals with choice in their currency, the potential to protect financial privacy and property rights, and the ability to engage in quick, cheap, and borderless transactions.

Figure 3

Bitcoin and Ethereum transactions have grown sharply in recent years



Sources: "Confirmed Transactions Per Day," Blockchain.com; and "Ethereum Daily Transactions Chart," Etherscan.

Whether these promises are realized depends in part on providing a regulatory environment for cryptocurrencies that does not unduly burden their abilities to innovate, transform, and grow.

Congress can take action to support cryptocurrencies, removing challenges to their use and development in the laws governing coins and currency, affording them sensible treatment under tax laws, and providing a clear regulatory framework for projects that are subject to securities laws.

THE PROBLEM

Cryptocurrencies can bring the benefits of competition to currencies, which have long been subject to a government monopoly. Competition not only has the potential to provide currency that better suits individuals' needs, but lessons learned from competition could also strengthen the dollar and preserve its status as the world's reserve currency.

Unfortunately, several laws place barriers in the way of such competition. First, laws governing coins and currency may deter both the development and use of cryptocurrencies. Both the Federal Reserve and Treasury Department recognize that "there is no federal statute mandating that a private business, a person, or an organization must accept currency or coins as payment for goods or services,"[2] but legal tender laws remain a center of confusion. These laws denote the acceptability of U.S. coins and currency for the payment of taxes, fines, and contracts, but many believe that they mandate the use of U.S. dollars and prohibit private businesses from refusing to accept them.[3] This misunderstanding, which arises from the statute's failure to define what it does and does not mean in practice, may stand in the way of widespread use of cryptocurrency in commercial transactions.

Coinage laws, written largely to prohibit the counterfeiting of U.S. coins, may also limit cryptocurrencies. The statute vaguely prohibits coins that have a "resemblance or similitude" to U.S. coins and coins of original design from being used as money. While these statutes apply to physical coins made of metal, the risk—alluded to during a congressional hearing with the U.S. Senate Committee on Banking, Housing, and Urban Affairs[4]—that they could be amended to include digital coins could deter both development and use of cryptocurrencies.

Second, subjecting cryptocurrencies to capital gains taxes impedes cryptocurrency's use as money. Because capital gains tax rates are structured to incentivize long-term holding, capital gains taxes penalize people for using cryptocurrencies as money for everyday purchases. Moreover, capital gains taxes impose a heavy—and at times impossible—administrative burden both on those who attempt to use cryptocurrencies as money and on those newly tasked with reporting cryptocurrency transactions to the Internal Revenue Service.

"Competition not only has the potential to provide currency that better suits individuals' needs, but lessons learned from competition could also strengthen the dollar and preserve its status as the world's reserve currency."

Taken together, these issues put a thumb on the scale against the use of cryptocurrencies as money and limit their potential competitive benefits.

More broadly, regulatory uncertainty hinders cryptocurrency development. Because a crypto token can alternatively be seen as a commodity, a security, a currency, or perhaps something else entirely, the application of existing laws and regulations to crypto projects is not always clear. A legal landscape characterized by this uncertainty, or that prioritizes legacy regulatory formalities regardless of their practical relevance to cryptocurrencies, risks becoming inhospitable for both entrepreneurs and users. Such a landscape would be detrimental to technological innovation, capital formation, and consumer welfare.

Resolving whether cryptocurrencies are regulated under securities laws or commodities laws is a prerequisite to addressing other questions about how to regulate the exchange of cryptocurrencies and their general interactions

with the financial system, including questions about custody and accounting.

Where crypto entrepreneurs sell tokens to the public to finance the development of their projects, it is reasonable to ask whether, when, and how securities laws apply to these sales. While several federal bills touching on these questions have been introduced—and the Securities and Exchange Commission has engaged with the issue in enforcement actions and informal guidance—no law or formal rule decisively clarifies the application of securities laws to cryptocurrencies.[5]

> "Policymakers should provide a clear, practical test for determining whether a crypto project is decentralized."

Securities laws evolved in no small part to address the risks posed by managerial bodies possessing information that investors do not and those bodies' capacity to act at odds with investors' best interests. The archetype of a covered entity under securities laws is a centralized enterprise with a corporate form, headquarters, and managerial hierarchy. But cryptocurrency projects aspire to upend this historical template, eschewing not only the physical plant of a 20th-century enterprise but also, more importantly, a managerial body exercising ongoing control over the project. Thus, a core innovation of decentralized cryptocurrencies is mitigating third-party risks through technology.

When a cryptocurrency project does not involve third-party management or control, applying legacy securities laws is both legally inappropriate and practically ineffective at addressing potential harm. But when a cryptocurrency project does involve third-party managerial control and when other criteria under securities case law are satisfied, applying safeguards designed to mitigate risks is appropriate.

Nonetheless, applying the existing securities registration and disclosure regime to crypto projects could create compliance costs that foreclose an important means of financing a cryptocurrency's development and thereby achieving decentralization. Accordingly, even where securities laws are appropriately applied to centralized cryptocurrency projects, the disclosure framework ought to be narrowly tailored to the specific risks of cryptocurrencies: fraud, deception, and manipulation by developers, sellers, and promoters who remain actively involved in the management of a cryptocurrency project.

SOLUTIONS

Congress can undertake several reforms to level the playing field for cryptocurrencies.

- **Amend the definition of securities to exclude decentralized crypto projects.** Policymakers should provide a clear, practical test for determining whether a crypto project is decentralized. The key question is whether the cryptocurrency purchaser is expecting profits solely from the efforts of others (i.e., relying on essential managerial or entrepreneurial efforts of third parties). The criterion is whether, in selling a cryptocurrency, the seller, promoter, or developer promises performance necessary to bring the crypto project and its stated benefits to fruition. If so, the cryptocurrency project at issue is centralized. If not, it is decentralized. Congress should amend securities statutes to clarify that securities laws do not apply to decentralized cryptocurrency projects.
- **Establish tailored disclosure for crypto projects on the path to decentralization.** Cryptocurrency projects can take time to achieve decentralization. Some projects may seek to sell their cryptocurrencies to finance their development, including via so-called initial coin offerings or token presales. Congress should legislate a tailored registration model that prioritizes disclosures related to the specific risks of cryptocurrencies and protections against fraud and misleading statements.
- **Clarify the meaning of legal tender.** Congress should clarify the meaning of legal tender in U.S.C. § 5103 to make clear that legal tender status does not require private businesses, persons, or

organizations to accept U.S. coins or currency as payments for goods and services.

- **Clarify the prohibition on counterfeiting U.S. coins.** Congress should amend 18 U.S.C. §§ 485–497 to clearly state the necessary conditions for a coin to be considered a counterfeit, rather than rely on vague terms like being in "resemblance or similitude."
- **Remove the prohibition on minting coins of original design.** Congress should amend 18 U.S.C. § 486 to remove the prohibition on coins of original design.
- **Remove capital gains taxes from alternative currency use.** Congress should remove capital gains taxes, at the very least, where cryptocurrencies are used to purchase goods and services.
- **Remove the Infrastructure Investment and Jobs Act's change to the broker definition.** As it stands, the law sets an impossible tax-reporting standard by including cryptocurrency miners and developers, among others, in its definition of brokers who must report cryptocurrency transactions. Congress should ensure that tax-reporting requirements apply only to those who perform traditional brokerage functions.

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Section 4: Policymakers' ESG Concerns Should Not Override the Market's Allocation of Resources

The U.S. financial system is the means by which capital resources are allocated. At its most basic, borrowers, lenders, and investors exchange funds to finance projects and pursue a return on their financial assets. The market allocates funds based largely on the returns that the parties to the transactions expect to earn on their investments. In this way, "good" projects—those that provide goods or services that are desirable—get funded and "bad" projects generally do not. While this process is not perfect, over time the incentives and signals provided by the market generally allocate scarce capital resources efficiently.

The market's allocation of capital resources, however, is threatened by the encroachment of regulations and policies that seek to enshrine environmental or social policy into the financial system's framework. This encroachment not only undermines the efficient allocation of capital and risks undermining growth and innovation, but it also represents an abuse by financial regulators who are not tasked by Congress (or voters) to implement environmental or social policy and who lack the necessary expertise to create such policy.

Congress can take action to ensure that financial regulators do not function as central planners deciding which enterprises are worthy of capital, including by clarifying the scope of mandatory securities disclosures and shrinking bank regulators' responsibilities.

THE PROBLEM

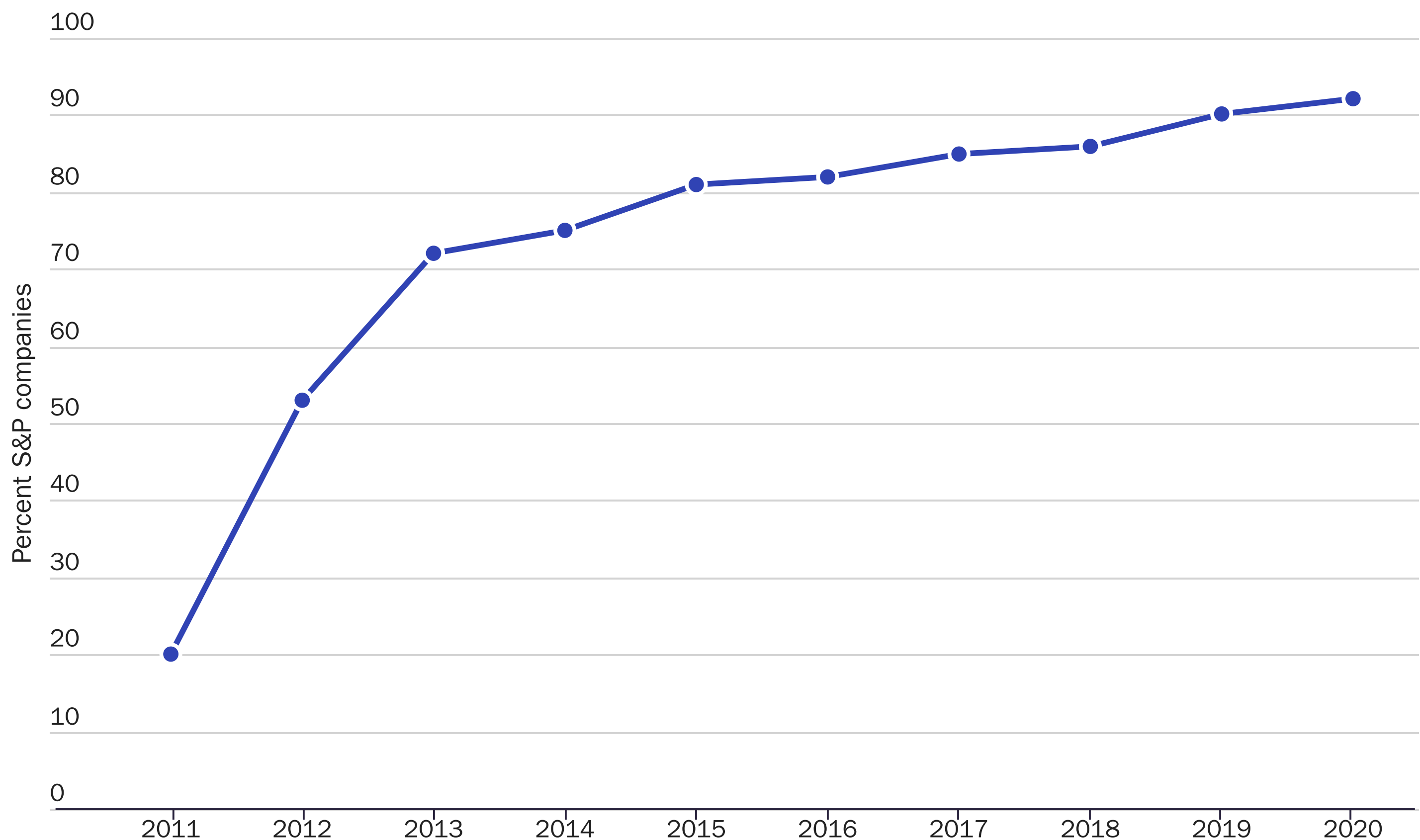
From public company disclosures to the regulation of bank capital, financial regulators have increasingly been seeking to implement environmental or social policy through the financial system's allocation of capital. Climate change policy is a priority for the Biden administration, which has called climate change a "systemic risk to our economy and our financial system," saying that "we must take decisive action to mitigate its impacts."[1] Those actions include Treasury Secretary Janet Yellen's announcement that she would start a climate hub within the Department of the Treasury to coordinate "wide-ranging efforts to fight climate change through economic and tax policies" and "focus on financing for investments needed to reduce carbon emissions."[2] The Securities and Exchange Commission (SEC) has already proposed wide-ranging climate-related disclosures for public companies and is preparing proposals on corporate board diversity and human capital management, which may include disclosures related to worker demographics and benefits. These types of regulation can place a drag on the economy by imposing high costs while inappropriately turning financial regulators into universal policymakers.

> "These types of regulation can place a drag on the economy by imposing high costs while inappropriately turning financial regulators into universal policymakers."

Take, for instance, public company disclosures, which are meant to provide investors with information about a company's financial prospects. Public companies' mandatory disclosures have expanded in recent years, at times serving as vehicles to promote extraneous policy goals. The Dodd–Frank Act requires companies to report on the origin of certain "conflict minerals" used in their products and to disclose the ratio of the CEO's pay to the company's median employee. This expansion is poised to continue as

Figure 4

Over 90 percent of S&P 500 companies already publish sustainability reports or disclosures



Source: "2021 Sustainability Reporting in Focus," Governance & Accountability Institute Inc., December 2021.

the SEC's agenda contains new mandatory public disclosures for a wide variety of information related to what is called "ESG" investing, meaning strategies or theories that take into account a company's environmental, social, and governance factors when making an investment decision. Notably, more than 90 percent of the largest U.S. public companies already publish sustainability disclosures without the SEC's mandate (see Figure 4).

Disclosures relating to climate change, board and workforce diversity, and corporate political contributions, among other things, stray far from the existing securities regulation framework of providing information relevant to price discovery. This expansion is problematic. If the SEC's disclosure regime becomes untethered from its price-discovery function, it can be bent to any purpose. Americans should feel secure that any disclosures the government requires are carefully cabined to encompass only information directly related to the legislation's initial intent. These disclosures also often have unintended consequences, particularly where the purpose of the disclosure is to drive non-securities-related policy change.

The banking sector similarly suffers when inappropriate policy aims drive the regulation of banks. Precedent already exists for federal officials using bank regulations to allocate credit to further political goals, including to discourage payday lending and to hinder financing for gun dealers. It is entirely plausible that federal officials could soon repeat such actions, disfavoring those firms in industries that disturb certain political sensibilities (such as fossil fuels and nonorganic agriculture) by limiting access to banking services and payment systems.

Many federal agencies can influence bank activities through the federal regulatory framework, potentially imposing climate change–related regulations through the examination process (among other ways), whether citing concerns over capital adequacy, reputational risks, or even

systemic risks. Regulators have a great deal of discretion in these cases, and banks have very little recourse. For example, the Federal Deposit Insurance Corporation can terminate a bank's status as an insured depository institution if it finds that the bank has engaged in "unsafe or unsound practices," and the agency alone is responsible for determining what constitutes unsafe or unsound practices. Moreover, when regulators determine that an insured depository institution has engaged in an unsafe or unsound practice, they have the explicit legal authority "to place limitations on the activities or functions of an insured depository institution or any institution-affiliated party."[3] Overall, bank regulators have enormous flexibility to develop regulations for anything that they deem a risk factor, including climate change, and banks will be very hesitant to push back against these requirements.

> "Bank regulators have enormous flexibility to develop regulations for anything that they deem a risk factor, including climate change, and banks will be very hesitant to push back against these requirements."

SOLUTIONS

Congress should undertake several reforms to protect the market's allocation of capital from distortion introduced by financial regulation of environmental and social causes.

- **Clarify scope of mandatory securities disclosures.** Although the scope of disclosures under the Securities Act of 1933 and the Securities Exchange Act of 1934 has long been understood to encompass information necessary for investors to value securities—primarily a company's financial performance and information about its business—the heated debate about the SEC's authority to promulgate climate risk disclosures indicates that a clear delineation of this scope is necessary. Congress should clearly state that disclosures are limited to the type of information relevant to a company's prospects for financial success, as originally contemplated by the 1933 and 1934 acts, and repeal the sections of the Dodd–Frank Act that direct the SEC to promulgate the conflict minerals and pay-ratio disclosure rules.
- **Exercise strong congressional oversight of the SEC.** Even where the agency may have authority to promulgate rules that touch on environmental and social matters, Congress should exercise active oversight to ensure that the SEC is focusing its limited resources on advancing regulation related to its core mission.
- **Shrink and clarify bank regulators' responsibilities.** Congress should require banking regulators to consider solely economic and financial factors when promulgating regulations, rather than factors that might affect the public's view of a bank, including the bank's so-called reputational risks. More broadly, Congress should reassert its control over financial policy and reduce the regulatory authority and discretion of financial regulators. Repealing Title 1 of the Dodd–Frank Act, thus eliminating the Financial Stability Oversight Council, would be one step in a positive direction. Congress should explicitly prohibit banking regulators from considering social or political objectives, including climate change, in the supervision and examination of banks or credit unions regarding assets rating, capital adequacy, reputational risk, lending limits, "prudential" standards, and financial stability.

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Section 5: Monetary Policy That Holds the Fed Accountable

Congress created the Federal Reserve in 1913 to put an end to financial crises and severe recessions. But some of the nation's worst economic crises have occurred since then, and recessions haven't become shorter or less frequent. The U.S. economy suffered its most severe bout of deflation during the early 1930s and endured its highest peacetime inflation rates in the late 1970s—and is again enduring high peacetime inflation rates today. Despite the Fed's failures, Congress has tended to further expand its discretionary powers.

So long as Congress is inclined to delegate responsibility for conducting monetary policy and limiting financial instability to the Fed, there is much it can and should do to improve the Fed's performance. For instance, Congress can narrow and clarify the Fed's legislative mandate and require that the Fed implement rules-based monetary policy. It can also level the current privileged position that the U.S. dollar holds in competition with other potential means of payment so that the Fed faces competitive pressure to preserve, and perhaps enhance, the dollar's attractiveness as both a domestic and an international exchange medium.

THE PROBLEM

Good monetary policy helps America's workers, retirees, and savers by ensuring that the economy does not stall because of an insufficient supply of money. It also helps Americans by safeguarding against excessive money creation that can increase inflation and promote unsustainable booms. To manage the money supply responsibly, the Fed should strive to maintain a stable flow of total spending—enough to keep general business earnings from either racing ahead of, or falling short of, the costs of producing current output. To conduct monetary policy responsibly, the Fed also should supply money in a manner that avoids favoring specific firms, industries, or sectors of the economy over others. If it were to conduct policy in this manner, the Fed would place only the smallest possible footprint on economic activity, avoiding as much as possible any tendency to influence the profits and losses of specific enterprises, favor government over private investment, create moral hazard problems, or transfer financial risks to taxpayers. Finally, the Fed should conduct monetary policy in a transparent manner, with real accountability to citizens through their elected representatives. Throughout much of its history, the Fed has failed to meet these requirements, and Congress has failed by not compelling it to meet them.

> "Congress can narrow and clarify the Fed's legislative mandate and require that the Fed implement rules-based monetary policy."

The so-called dual mandate calls for the Fed to achieve both "price stability" and "maximum employment." Because the Fed is also responsible for achieving financial stability, it really operates under a triple mandate.[1] All three mandates are ill-defined, and depending on how they are defined, they may also conflict with one another. Consequently, the Fed enjoys enormous discretion in interpreting and performing its duties, and Congress often lacks any means for holding the Fed accountable for fulfilling its responsibilities. Furthermore, because both the behavior of the price level and the extent of employment depend not only on the Fed's decisions but on factors beyond its control, it is unreasonable to blame the Fed for every instance in which these factors vary from some ideal. At the very least, therefore, Congress could improve monetary policy by holding the Fed responsible for the behavior of variables over which it exercises substantial control.

More narrowly, the Fed's price stability mandate is problematic because changes in the price level can also reflect changes in the scarcity of real goods and services. In other words, changes in the price level or in unemployment may not be evidence of poor Fed performance. In an economy experiencing rapid productivity growth, for instance, a low and perhaps even negative rate of inflation reflects rapidly falling costs and makes it easier for everyone to reap the benefits of those falling costs. Adverse supply shocks, on the other hand—like those caused by a war or the COVID-19 pandemic and related government shutdowns—cause prices to rise even when the demand for goods is not growing rapidly. A central bank that tightens monetary policy to check such supply-side based inflation only adds insult to injury because it provides even less money to purchase even scarcer items.

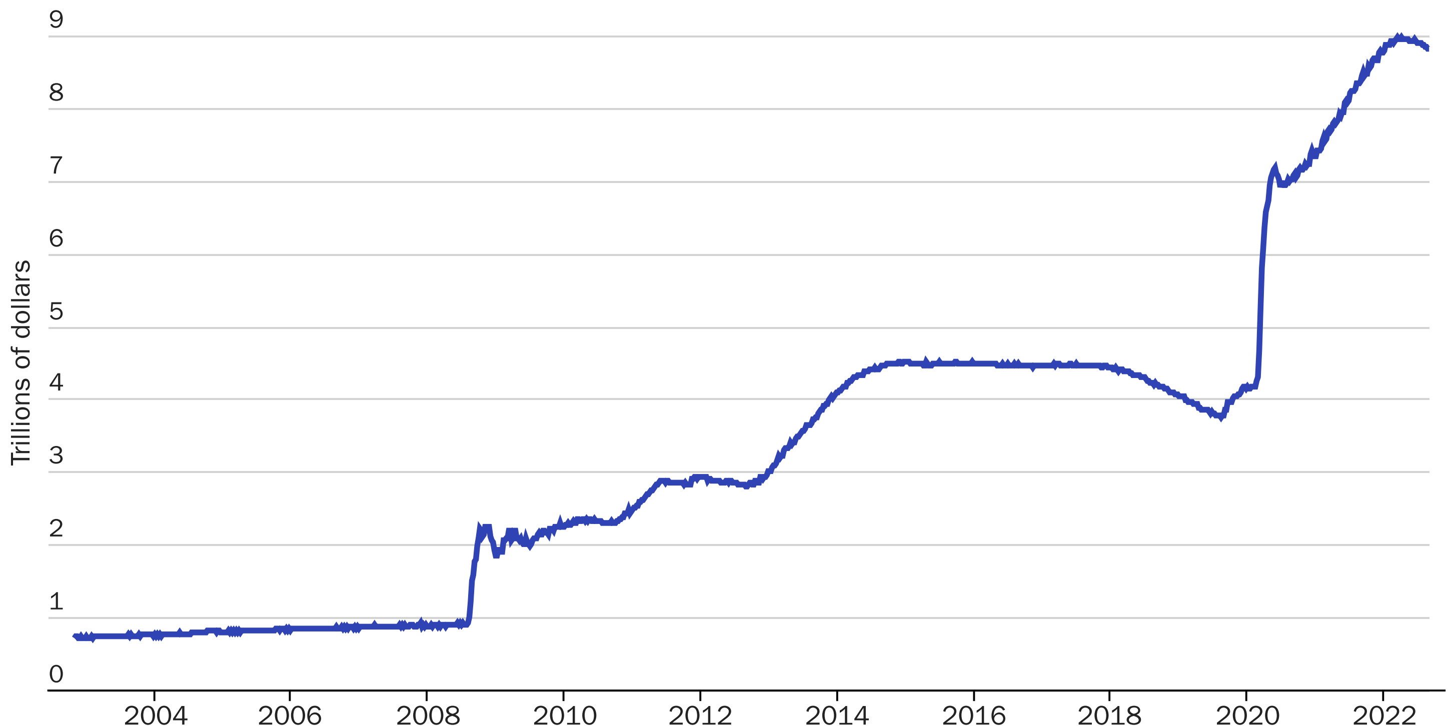
Separately, the excessive amount of discretion that Congress has bestowed on the Fed has allowed it to alter its operating framework in a manner that has seen its balance sheet grow to roughly 10 times its pre-2008 size (see Figure 5). The Fed's new operating framework, known as a "floor" system—has provided banks with a new risk-free investment choice, at a relatively high rate of return, thus causing banks to hold more funds as reserves. As interest rates rise, the Fed will have to pay larger and larger interest payments to banks to control inflation, an arrangement that increases the Fed's political risk and threatens its operational independence.

The new floor system also divorces the Fed's monetary policy stance from the size of the Fed's balance sheet by allowing the Fed to purchase as many assets as it would like, all while paying firms to hold on to the excess cash that these purchases create. This framework can all too easily allow the Fed to be a pawn of the Treasury Department. Put differently, the Fed's status quo operating system increases the risk that the Fed's quantitative easing (QE) powers will be abused for non-macroeconomic purposes, such as the funding of backdoor government spending.

Today, thanks to a Standing Repo Facility that the Fed established in 2022, there is no reason why the Fed cannot eventually undo all the post-2008 growth in its balance sheet.[2] Nor is there anything else to prevent it from returning

Figure 5

Federal Reserve's balance sheet has grown to roughly 10 times its pre-2008 size



Source: Board of Governors of the Federal Reserve System, "Assets: Total Assets: Total Assets: Wednesday Level," Federal Reserve Bank of St. Louis, 2022.

to a "scarce reserves" operating framework. In such a regime, instead of holding substantial reserve balances, banks strive to economize on reserves while turning more often to either the private repo market or the Fed's Standing Repo Facility to make up for occasional, temporary reserve shortages. The Fed's QE powers would then be correspondingly limited: although those powers would remain substantial so long as rates are at the "zero lower bound"—the only circumstance in which QE may be macroeconomically warranted—it would not possess them otherwise.

"Congress could improve monetary policy by holding the Fed responsible for the behavior of variables over which it exercises substantial control."

A scarce reserve regime therefore enjoys the distinct advantage over a "floor" system of avoiding the risk that the Fed's QE powers will be abused for non-macroeconomic purposes. To compel the Fed to return to a scarce reserve regime, Congress should insist that the Fed follow the 2006 Financial Services Regulatory Relief Act, a law that stipulates that the rate of interest the Fed pays on reserve balances should not "exceed the general level of short-term interest rates."

SOLUTIONS

The U.S. dollar has long been the preferred payments medium throughout the United States as well as in many international markets. Congress should do all that it can to preserve that high standing by seeing to it that the Fed is a good steward of the dollar. To do this, we recommend the following:

- **Narrow the Fed's statutory mandate.** Congress should replace the Fed's dual mandate with a single stable spending mandate. The mandate would require the Fed to maintain a stable, if steadily rising, level of total spending on goods and services or, in other words, a stable dollar value of national income. Congress should also repeal the financial stability mandates that it gave to the Fed in Title I of the Dodd–Frank Act.
- **Require the Fed to follow a policy rule.** Congress should require the Fed to implement a simple rule that Congress can easily monitor and use to hold the Fed accountable. The rule should require the Fed to commit itself to maintaining a specific growth rate for nominal gross domestic product (NGDP), a popular measure of total spending. The specific rate, as well as other details, might be left to Fed officials to decide, but most experts would place the desirable growth rate of NGDP somewhere in the range of 3–5 percent.
- **Shrink the Fed's balance sheet and reestablish a "scarce" reserve regime.** In a scarce reserve regime, instead of holding substantial reserve balances, banks would economize on reserves. To make up for temporary reserve shortages, banks would turn to either the private repo market or the Fed's Standing Repo Facility. To ensure that the Fed returns to a scarce reserve regime, Congress should insist that the Fed follow the 2006 Financial Services Regulatory Relief Act, a law that stipulates that the rate of interest the Fed pays on reserve balances should not exceed "the general level of short-term interest rates."[3]

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Section 6: Removing Barriers to Small Business Capital Formation and Expanding Investor Opportunities

Small businesses are the engine of the U.S. economy. Not only are they the primary generator of new jobs, but small businesses are also the incubators of innovation and the pipeline for future large businesses.[1] The ability of small businesses to find capital is critical to their growth and operations. Entrepreneurs financially support their businesses in many ways, including by tapping into their own savings and borrowing on their credit cards. When they turn to outside financing, many entrepreneurs look to banks for loans. But many small businesses do not have the ability to secure a bank loan because they have no stable revenues or few assets for collateral. For those businesses, including ones that rely on intellectual property that is difficult for banks to evaluate, the equity markets are an important source of capital.

> "There is little sense—and there should be little regulatory interest—in imposing the SEC's oversight where entrepreneurs seek to raise exceedingly small amounts of capital."

But tapping the equity markets can be difficult, especially for small businesses headquartered outside of major coastal cities or led by women or underrepresented minorities. That challenge is made more difficult by the complex web of regulations and exemptions that stand between an entrepreneur and raising capital in a securities market. Those regulations also limit the opportunities of most American investors to support small businesses through equity investment and prevent them from sharing in the potential high growth of startup firms. Taken together, these regulations mean that personal wealth often dictates the starting point for both entrepreneurs' businesses and investors' opportunities.

Congress can take action to support small business growth and individual investor opportunity by creating a micro-offering exemption for offers of equity securities and by increasing the pool of investors that can participate in private offerings.

THE PROBLEM

Many entrepreneurs struggle with navigating the complex equity capital–raising framework. As the Securities and Exchange Commission's (SEC) Office of the Advocate for Small Business Capital Formation notes:

> Even for the most technically sophisticated entrepreneur . . . the language of capital raising and the nuances of our complex rules are often inaccessible. Great entrepreneurial insight does not translate into fluency in almost a century of layered securities laws. . . . In other words: entrepreneurs who already find themselves cash-strapped must spend valuable—and often unavailable—resources just to understand their menu of options.[2]

These costs limit small business growth and economic development.

By default, securities offerings must be registered with the SEC, a complex and expensive process that includes detailed disclosures about an issuer's business operations, financial condition, risk factors, and management, as well

as audited financials. Most small businesses that seek to raise capital do so pursuant to exemptions from registration (see Figure 6). In theory, those exemptions offer a more simplified means of conducting a securities offering. But the exempt offering framework is far from simple. While legislative changes over the years, such as the Jumpstart Our Business Startups (JOBS) Act, have made equity capital raising more accessible to some investors, each new exemption and its implementing regulations have added another layer of complexity onto an already complex framework.

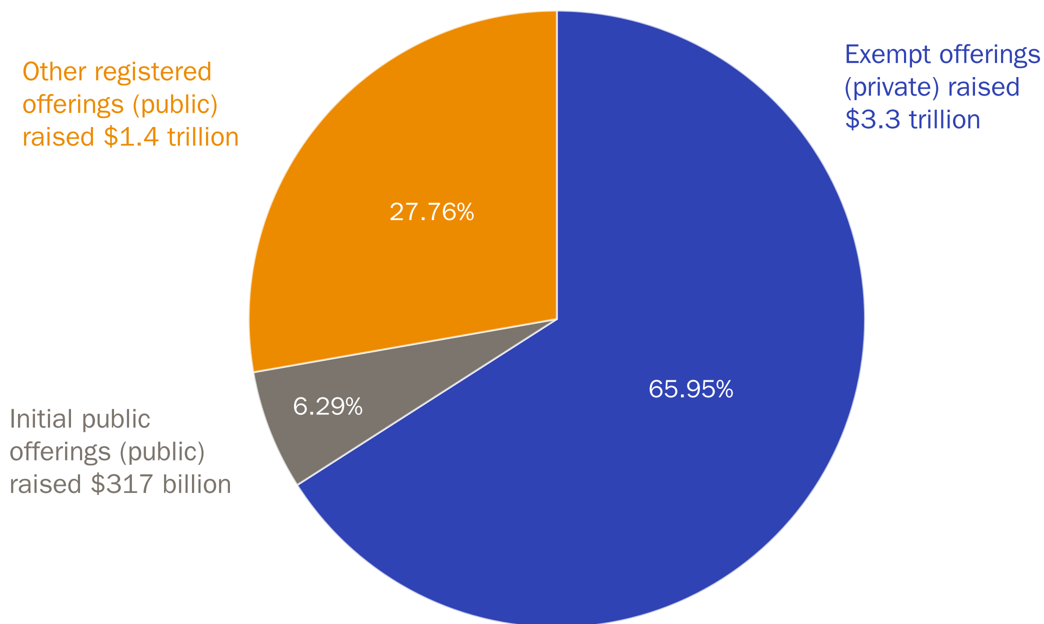
While equity crowdfunding, created by the JOBS Act, provided a somewhat streamlined method for entrepreneurs seeking to raise small amounts of equity capital, that process remains burdensome for the smallest entrepreneurs, who must meet a host of regulatory requirements and ongoing reporting obligations to take advantage of this exemption. The average equity crowdfunding capital raised in 2020 was approximately $309,000, and 40 percent of the entrepreneurs using crowdfunding were women or minorities.[3] There is little sense—and there should be little regulatory interest—in imposing the SEC's oversight where entrepreneurs seek to raise exceedingly small amounts of capital. This regulatory burden places a drag on small business development that may not be justified by any sort of investor protection interest.

Moreover, small offerings—for instance, in which an aspiring restaurateur or a couple of friends building an app ask their parents, family, and friends to get in on the enterprise with the hope of getting a cut of the profits down the road—still happen outside of regulated crowdfunding, without securities registration, and not pursuant to any existing exemption to registration. The issuer is often unaware of the need for securities registration, and the failure to follow the securities laws only complicates the process when an issuer grows and moves on to more formal methods of raising capital, often resulting in having to unwind those early investments.

The Securities Act of 1933 already recognizes that "the small amount involved or limited character of the public offering" may be an appropriate reason for the SEC to exempt such securities offerings from registration as "not necessary in the public

Figure 6

Over 65 percent of capital is raised through private offerings



Source: Office of the Advocate for Small Business Capital Formation, *Annual Report for Fiscal Year 2021* (Washington: Securities and Exchange Commission, December 2021).

interest."[4] But the SEC has not promulgated such an exemption. A statutory exemption would ensure that the smallest entrepreneurs would be unencumbered by securities regulations that are unnecessary for the protection of investors.

> "The accredited investor definition dampens small business growth by limiting the pool of investors available to entrepreneurs."

Where entrepreneurs seek to raise larger amounts of capital (i.e., those who typically look to raise money under the exemptions provided by Rule 506 of Regulation D), the general requirement that their investors be "accredited" harms both small business and investors. Regulation D offerings are popular; more than $1.9 trillion was raised through Regulation D offerings between July 1, 2020, and June 30, 2021, which exceeds the $317 billion raised in initial public offerings.[5] But, currently, individual investment in these private offerings is limited to those with more than $200,000 in annual income or assets in excess of $1 million, along with a limited number of individuals who hold certain securities licenses. The SEC is considering recommending updates to the accredited investor definition and is expected to increase the wealth thresholds that an investor must meet to qualify.[6]

The accredited investor definition dampens small business growth by limiting the pool of investors available to entrepreneurs; that effect is borne disproportionately by would-be entrepreneurs in less wealthy communities, both minority and rural, who have fewer opportunities to recruit investors from the people closest to them.

This limitation on entrepreneurs is not offset by an investor protection benefit. Indeed, the focus on wealth does not protect investors from fraud, and it arbitrarily bars investors from certain offerings. Making the SEC the judge of who is and is not fit to invest subverts the federal securities laws' disclosure regime that permits any offering to be made to the public if the issuer provides the right disclosures. In addition, these restrictions—especially when paired with reduced initial public offering volume and longer waits for companies to tap the public markets—can exacerbate wealth inequalities by limiting investment opportunities in potentially higher growth enterprises.

SOLUTIONS

While the entire exempt offering framework would benefit from an overhaul to reduce complexity and to make the equity capital–raising process more friendly for startups and small businesses, there are a few straightforward reforms that Congress can undertake to ease the path for small business capital formation.

- **Micro-offering exemption.** Congress should enact an exemption to securities registration for equity offerings that raise below a certain threshold, say $500,000 per year. Congress should direct that the SEC shall impose no other regulatory requirements on issuers that seek to take advantage of the exemption to ensure that entrepreneurs bear the minimum regulatory burden possible from the securities laws.
- **Accredited investor.** Congress should focus on decreasing the barriers to eligibility for accredited investor status. One way to do this is to consider investors who are advised by financial advisers who meet the current accredited investor definition as accredited themselves. This would resolve the inconsistency created by the SEC's rules that recognize some advisers as sophisticated but do not permit clients to rely on that sophistication for investment advice. Congress could also consider permitting investors to self-certify as to their level of sophistication or permitting any investor to make investments up to a certain threshold of their portfolio or net worth.

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Section 7: Broad Reforms to Boost Competition and Innovation in the Financial Sector

In the wake of the 2008 financial crisis, proponents of stricter regulation insisted that deregulation of the financial sector—especially non-bank financial firms, those in the so-called shadow banking sector—were the main drivers of the turmoil. According to the conventional narrative, these firms made excessively risky bets with derivatives, the housing bubble burst, and panic ensued. As the story goes, their activity nearly destroyed the financial system, but the federal government stepped in and prevented another Great Depression. The traditional banking sector, on the other hand, supposedly was prevented from taking such risky bets because it was so highly regulated.[1] Therefore, according to this narrative, the best way to guard against future crises was to regulate the non-banking sector more like commercial banks and to federally back their securities as if they were retail bank deposits backed by the Federal Deposit Insurance Corporation (FDIC).

> "Despite many good intentions, the U.S. financial system stifles innovation, protects incumbent firms from competition, and promotes taxpayer-financed bailouts."

This narrative is highly misleading. For instance, the 2008 financial crisis was not caused by a reduction in the scale or scope of financial regulations in the United States; rather, the number of financial regulations steadily increased after 1999, long before the 2010 Dodd–Frank Act was even contemplated.[2] Moreover, federal banking regulators approved of much of the so-called shadow banking activity because it took place in partnership with—and in many cases because of guarantees provided by—the traditional banking sector. Overall, the evidence suggests that both banks and non-bank financial firms made carefully targeted risky bets owing, in part, to regulatory and legal requirements. Thus, even if Congress repealed the 2010 Dodd–Frank Act in its entirety, America would be left with an overly burdensome and paternalistic regulatory and monetary system that is filled with harmful incentives. Among other problems, the system infringes on citizens' basic freedom and constitutional rights, increases the likelihood of taxpayer-financed bailouts, stifles innovation and competition, and lowers economic opportunities for millions of people.

THE PROBLEM

For decades, Congress has passed laws to address regulatory problems in U.S. financial markets. Despite many good intentions, the U.S. financial system stifles innovation, protects incumbent firms from competition, and promotes taxpayer-financed bailouts. For years, the shortcomings of the regulatory framework have reduced entrepreneurs' investment opportunities, reduced consumers' choices, increased prices, and obscured financial risks.

There are many problems spread throughout different sectors of U.S. financial markets. The following provides a brief overview of the most important issues.

The 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act

Many government officials, industry participants, and academics endorse an extensive federal role for financial regulation, one that requires regulators to promote financial stability by addressing systemic risks. This approach, embodied in the Dodd–Frank Act, requires regulators to

address known threats to financial stability as well as potential threats, typically without specifying any objective definition of these terms. It mandates more regulatory control of bank risk-taking and expands such control to the non-bank financial sector.[3] This approach is based on a mistaken belief that the 2007–2009 crisis stemmed from unregulated financial markets. Quite to the contrary, the government's extremely active role in directing the financial markets—and its promises to absorb the losses of private risk-takers—brought about the financial crisis.

Money Market Mutual Funds

Just as decades of increasingly strict bank regulations have failed to produce financial stability, so too have increasingly strict money market mutual fund (MMF) rules. The increasingly prescriptive regulatory framework for MMFs has also drastically limited investors' options, shrinking the private commercial paper market and pushing more of investors' money into government funds. The failure of the most recent MMF rule amendments even fulfilled one of the harmful scenarios that advocates insisted the new rules would prevent, directly reducing the funds available to finance private commercial activity as more money flowed into government-backed funds. Rather than acknowledge the failure of this top-down regulatory approach in short-term capital markets, a 2021 Securities and Exchange Commission (SEC) rule proposal doubles down, with even more prescriptive rules, such as mandatory swing pricing and explicit restrictions on how funds can use fees and gates.[4]

Housing Finance System

Robust mortgage financing exists in virtually every developed nation in the world without the high degree of government involvement found in the United States. While the perceived success of this involvement has helped create the belief that the private housing market cannot properly function without extensive federal involvement, the historical record demonstrates the opposite.

Most federal intervention in housing finance boosts demand, typically by making it easier to obtain a home mortgage, thus boosting consumer debt and home prices. Federal policies encourage borrowing by supporting the operations of Fannie Mae, Freddie Mac, and Ginnie Mae and by providing loan insurance through the Federal Housing Administration (FHA), the Department of Veterans Affairs home-lending program, and the Department of Agriculture's Rural Development Program. Prior to the 2008 financial crisis, the federal government controlled a dominant share of the U.S. housing finance system, and that share has since expanded. The operations of Fannie and Freddie and the FHA account for the bulk of this federal intervention. Rather than increase homeownership, this involvement has accelerated it for individuals who would otherwise obtain home loans later in the conventional market while costing taxpayers billions of dollars. It has done little to measurably increase U.S. homeownership rates.[5]

> "There has never been a substantial reduction in the scale or scope of financial regulations in the United States."

Massive Federal Regulatory Complex

U.S. financial markets have too many regulations and too many regulators. Depending on the activity, at least seven federal regulators could supervise, examine, or otherwise regulate a bank:

1. the Federal Reserve
2. the FDIC
3. the SEC
4. the Commodity Futures Trading Commission
5. the Consumer Financial Protection Bureau
6. the Federal Housing Finance Agency
7. various agencies within the U.S. Treasury Department

In addition to the SEC and Commodity Futures Trading Commission, the two U.S. capital markets regulators, much of the regulation of broker-dealers has been effectively

delegated to the Financial Industry Regulatory Authority, a private not-for-profit organization (see Figure 7).

Federal Regulatory Complexity

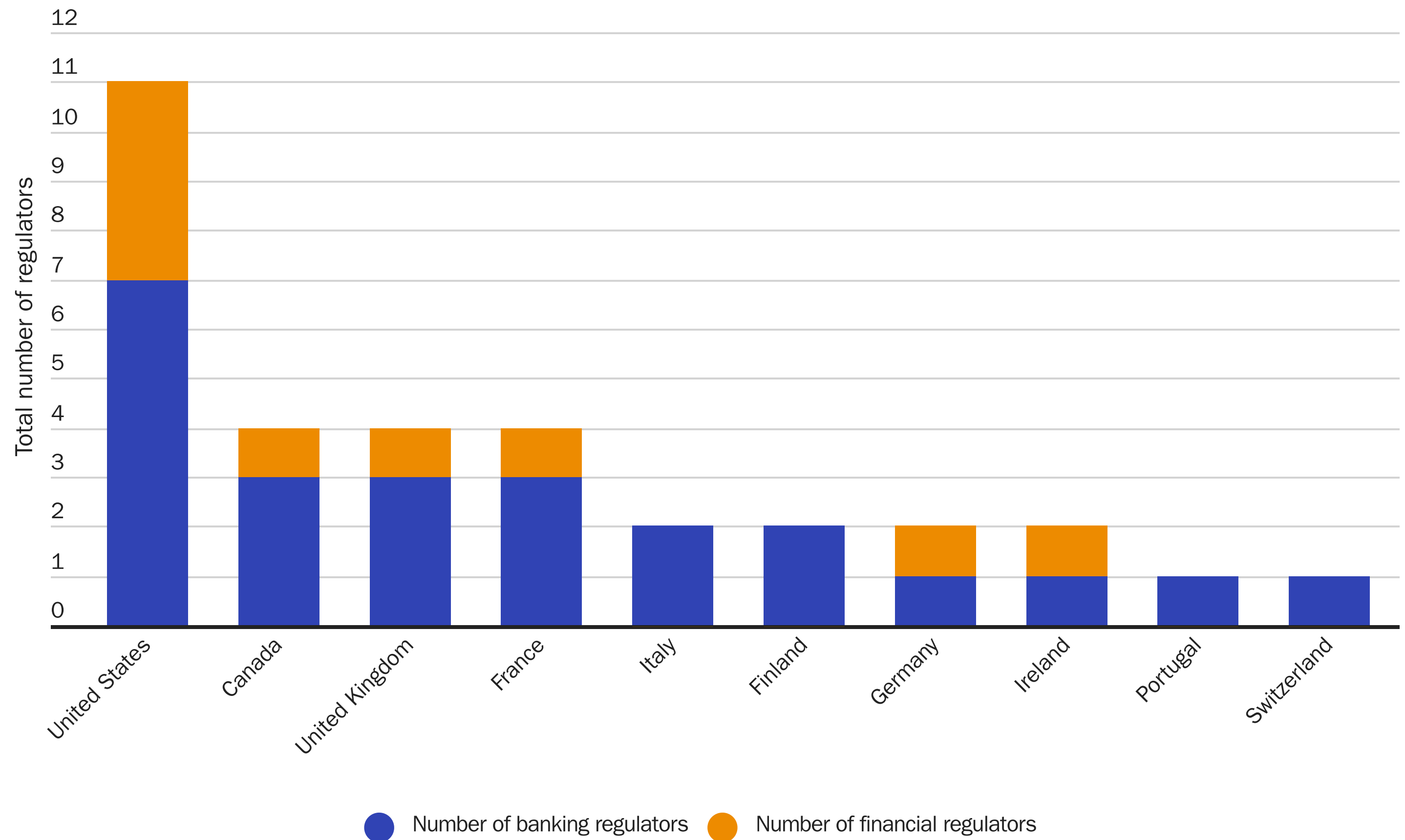
Banks are more heavily regulated than other financial firms, but virtually all financial companies are subject to extensive restrictions on their activities, capital, and asset composition. It is true that there have been many changes to these rules and regulations in the past few decades and that some of those changes allowed financial firms to engage in activities that they were previously prohibited from doing. However, there has never been a substantial reduction in the scale or scope of financial regulations in the United States. Government rules have increasingly been credited with guaranteeing financial market safety, creating a false sense of security, lowering private incentives to monitor risk, increasing institutions' financial risk, and protecting incumbent firms from new competitors.[6]

Federal Backing of Credit Markets

Americans are responsible for trillions of dollars in debt exposure from outstanding federal loans, loan guarantees, and subsidized insurance programs spread over more than 100 federal programs.[7] The government credit portfolio consists of direct loans and loan guarantees for housing, agriculture, energy, education, transportation, infrastructure, exporting, and small business, among other enterprises. Federal insurance programs cover bank and credit union deposits, pensions, flood damage, declines in crop prices, and acts of terrorism. Capital for mortgage lending by

Figure 7

United States has too many financial regulators



Note: State-level regulators are not included for the United States, and European Union regulators are not included for EU countries. This list is generally limited to regulators with the authority to examine or investigate private businesses, issue rulemaking or guidance, and conduct enforcement.

banks is provided by the government-sponsored enterprises (GSEs), such as Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. Taxpayer backing in the current framework also comes indirectly from the Federal Reserve, which has a long history of using its emergency lending and discount-window loan policies to support failing firms, as well as directly from deposit insurance provided by the FDIC. This redistribution of taxpayers' money erodes the nation's entrepreneurial spirit, increases financial risk, and fosters cronyism and corruption.

"Congress and federal agencies can implement many reforms to improve the overly burdensome and paternalistic regulatory and monetary system."

SOLUTIONS

Congress and federal agencies can implement many reforms to improve the overly burdensome and paternalistic regulatory and monetary system, thus strengthening citizens' basic rights, reducing the likelihood of taxpayer-financed bailouts, expanding innovation and competition, and increasing Americans' economic opportunities.

- **Repeal Dodd–Frank.** The 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act is among the most inappropriately named laws ever enacted in the United States. It neither reformed Wall Street nor protects consumers, and it imposed massive new regulations on banks far from Wall Street. Congress should repeal the law.
- **Fix MMF rules.** A better alternative to the current MMF rules would use the 1983 regulatory framework for MMFs as a baseline. From there, the SEC should pare down the prescriptive rules to the bare minimum so that they include little more than an average maturity restriction. The rules should not provide incentives for holding specific types of short-term assets, including government securities, in MMFs. Rather than trying to improve financial markets by saddling MMFs with more operating restrictions, the SEC should allow fund managers and investors to figure out what works best for them. This approach would foster more competition in short-term credit markets and make them more resilient by decreasing the uniformity of investment options. If the SEC refuses to adjust the MMF rules, Congress should rewrite the statute.
- **Shrink the FHA's role.** Congress should limit the FHA's single-family insurance portfolio to first-time homebuyers, without any refinance eligibility (through the FHA) over the tenure of the loans in force. Additionally, the FHA should decrease the value of loan limits eligible for FHA single-family mortgage insurance to (at most) the first quartile of home prices.
- **Wind down the GSEs.** Congress should shut down Fannie Mae and Freddie Mac and all their subsidiaries. Any legislation to close the GSEs should avoid creating a smaller version of the companies under a new name. While the GSEs still exist, the Federal Housing Finance Agency should raise Fannie and Freddie's mortgage guarantee fees, eliminate the geographic price differentials for the GSEs' conforming loan limits, narrow the GSEs' focus to the financing of primary homes, and gradually reduce conforming loan limits. Congress should also revoke Fannie and Freddie's exemption from the requirements to register their securities offerings under the Securities Act of 1933 and enforce the "excessive use" provisions in the GSEs' charters. Banking regulators should adjust risk-weighted capital rules so that financial institutions cannot treat GSE debt and mortgage-backed securities as if they are U.S. government obligations.
- **Reform the regulators.** Congress should shrink the regulatory state by eliminating duplicative federal agencies. There is no objective reason to have three federal banking regulators and two federal capital markets regulators. Congress should also improve the financial regulatory framework by taking an entirely different approach to regulating banks and

capital markets. This reform program should reduce impediments to capital formation and market efficiency, reduce unwarranted regulatory costs, and eliminate policies that socialize private investors' losses. Moreover, the main purpose of financial regulations should be to provide reasonable, scaled disclosure, enforce contracts, and deter fraud. The Fed's primary responsibility is monetary policy, and it does not need to be a regulator. Congress should also eliminate the Fed's ability to provide emergency lending and discount window loans directly to firms, thus limiting the Fed to providing system-wide liquidity.

- **Provide new financial firm charters.** Congress should create a new federal charter for financial institutions, broadly defined, that ensures owners will absorb their financial risks with higher equity stakes. Congress could pair these charters with regulatory off-ramps so that scaled regulatory relief is provided for firms that agree to hold higher equity funding.
- **Stop federally backing credit.** Unconstrained spending, unfettered losses, and rampant cronyism are only part of the cost of the government's vast credit backing system. Proponents say that such backing is necessary to spur economic growth or to mitigate "market imperfections," but government credit is a poor substitute for private financing where (to the contrary) great care is taken in lending decisions under the threat of loss. Well-intentioned or otherwise, there is abundant evidence that government-backed financing produces more harm than benefit for the nation as a whole and that these programs should be eliminated.

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