

Cato Handbook *for* Policymakers

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56. Monetary Policy

Congress should

- replace the Federal Reserve’s dual mandate with a single stable-spending mandate;
- require the Fed to adopt an explicit rule consistent with fulfilling that mandate;
- reform the Fed’s operating framework, so that emergency Fed lending, either to banks or to nonbanks, is unnecessary;
- prohibit the Fed from engaging in direct lending;
- broaden the Government Accountability Office’s powers to “audit” the Fed, especially by allowing the agency to investigate violations of the Fed’s monetary rule and extraordinary open-market purchases;
- expedite the “normalization” of monetary policy, by prohibiting the Fed from paying banks to hold excess reserves, and by calling for it to shrink its balance sheet; and
- take steps to establish a “level playing field” between the dollar and either actual or potential alternative currencies.

The Federal Reserve (the Fed) is the ultimate source of the nation’s most liquid financial assets: bank reserves and circulating currency. As such, its overarching responsibility is to prevent liquidity shortages from causing unemployment or otherwise disrupting economic activity, while avoiding the unwanted inflation and unsustainable booms that result from excessive liquidity creation.

Replace the Dual Mandate with a Single Stable-Spending Mandate

The Fed currently operates under a mandate from Congress, calling for it to pursue both maximum employment and stable prices. This “dual”

mandate can be interpreted so as to be at least roughly consistent with responsible liquidity management. But the dual mandate's ambiguity prevents it from serving as a clear statement of the Fed's mission, as understood by Congress, much less as a device for assuring that the Fed adheres to that mission.

A single mandate to achieve *either* maximum employment *or* stable prices is not a good solution. A simple maximum-employment mandate might be understood as calling on the Fed to create liquidity to boost employment even when doing so would aggravate the boom-bust cycle or generate undesirable inflation, while a price stability mandate might compel it to stabilize prices even when doing so means countering price movements reflecting underlying changes to the overall availability of goods and services rather than excessive or deficient money creation.

Instead, Congress should replace the dual mandate with a single "stable spending" mandate, calling on the Fed to maintain a stable, though steadily rising, level of spending on goods and services or, in other words, a stable dollar value of national income. By creating sufficient reserves and currency to stabilize spending, the Fed would avoid unemployment linked to liquidity shortages, while also avoiding unsustainable booms and general inflation caused not by genuine changes in goods' overall scarcity, but by excessive supplies of money and credit.

Require the Fed to Abide by an Explicit Monetary Rule

Monetary policy works best when monetary authorities have a clear mission and can be trusted to stick to that mission. Otherwise, the public's fear that the authorities will veer from their assigned task can itself add to the challenge of avoiding monetary instability.

Both experience and theory show, however, that mere promises on the part of the authorities are not sufficient to gain the public's confidence. To make such promises credible, authorities must be held accountable for failing to keep them. Accountability can best be achieved by requiring monetary authorities to adopt explicit monetary policy rules, consisting of specific statistics they plan to target and sanctions to be applied if they fail to meet these targets.

Designing a rule appropriate to a stable-spending mandate is, fortunately, very straightforward. The simplest option is for Congress to require that the Federal Reserve commit itself to maintaining a specific growth rate for nominal gross domestic product (GDP)—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 nominal GDP somewhere in the range of 3 to 5 percent. Meaningful sanctions for violating the rule could consist of financial penalties imposed on members of the Federal Open Market Committee—the committee within the Federal Reserve System that determines the direction of monetary policy. For example, members could be assigned very modest base salaries with bonuses dependent on their success in meeting their targets.

Create a Flexible Open-Market Framework

At present, the Federal Reserve can add to the nation's monetary reserves in two ways. One is by purchasing financial assets in the open market (“open-market purchases”). The other is by directly lending money to banks or (using its emergency lending powers) to nonbanks.

Open-market operations have the advantage of minimizing the Fed's involvement in the *allocation* of credit: the Fed creates a certain amount of new reserves but lets private-market arrangements handle their distribution among different firms. In contrast, when it engages in direct lending, and especially when it targets its loans at specific firms, the Fed becomes more heavily involved in allocating credit, thereby increasing the risk of credit being distributed inefficiently. The Fed's tendency to employ its direct lending powers to support insolvent firms, including those that it considers too big (or “systemically important”) to fail, is particularly troublesome.

The ability of open-market operations to get credit where it is most needed is presently limited by the Fed's system of buying only certain kinds of assets, from only a limited number of financial institutions. Normally these limitations are not important; new liquidity, once exchanged for other assets at market prices, tends to make its way to the firms most in need of it. During extreme emergencies, however, normal private-market mechanisms for redistributing liquid reserves among solvent firms can break down. The claim that such a breakdown occurred during the 2008 financial crisis supplied a rationale for unprecedented Fed lending to both banks and nonbanks during that episode.

To make any similar resort to direct lending unnecessary in the future, Congress should make way for “flexible” open-market operations. Specifically, it should require the Fed to (1) conduct open-market purchases, not only with the firms it presently deals with, but also with all financial institutions that presently have access to the Fed's discount window; (2) extend the list of securities it stands ready to purchase to include all securities that are presently accepted as collateral for its discount-window

loans; and (3) replace its traditional auctions with “product mix” auctions, like those now employed by the Bank of England for some of its open-market purchases. Product-mix auctions would allow eligible counterparties with different sorts of eligible collateral on hand to compete more effectively for available Fed credit.

Prohibit Federal Reserve Direct Lending

Because a flexible open-market framework can provide for both the ordinary and the extraordinary liquidity needs of all solvent financial enterprises, having such a framework would make direct Fed lending unnecessary, even during emergencies. Nor should lending to systemically important financial institutions (SIFIs) be an exception: sound SIFIs could take part in the Fed’s liquidity auctions; insolvent SIFIs could safely be left to fend for themselves as long as firms that might suffer collateral damage from their failures were themselves able to compete for emergency funds. Congress should therefore prohibit the Fed from engaging in direct lending, including both discount window lending to banks and Section 13(3) lending to nonbanks.

The reforms outlined here would allow a single open-market facility to supply both ordinary and emergency liquidity, making it unnecessary for the Fed to serve as a “lender of last resort.” Instead, by attending to its duty to manage the total supply of liquidity in a manner consistent with achieving its stable-spending target, the Fed would automatically meet any emergency liquidity needs. Ordinarily, open-market operations would resemble traditional operations, with purchases largely—if not entirely—confined to Treasury securities, and dealings limited to specialized security dealers. During emergencies, however, other solvent firms facing temporary liquidity shortages would find it worthwhile to compete for new Federal Reserve dollars, using assets not normally employed for the purpose, in an auction specifically designed to ensure an efficient outcome and, especially, to prevent scarce funds from being assigned to undeserving firms.

Audit the Fed’s Performance

The Federal Reserve, as an agency empowered by Congress to maintain a liquid financial system, should, like all other government agencies, be accountable to Congress. In practice, that means Congress must, at the very least, be able to monitor the Fed’s success in performing its official

duties and report on whether it has employed necessary and proper means in performing them.

The Government Accountability Office (GAO) exists precisely for the purpose of evaluating, on behalf of Congress, the performance of government agencies. As a nonpartisan agency itself, the GAO is able to provide evaluations uninfluenced by partisanship, in response to specific requests. The Fed's current exemption from all GAO inquiries pertaining to its open-market operations and its dealings with foreign central banks thus represents an anomaly—one that Congress ought to correct. If extended to the reforms proposed here, the exemption would amount to a virtual ban on any GAO evaluation of the Fed's performance of its duties, since those duties would be performed exclusively by means of various open-market operations.

Fed officials, among others, complain that, by allowing the GAO to investigate (“audit”) Federal Reserve undertakings, Congress would pave the way for unwanted congressional interference with the Fed's setting of monetary policy. Such complaints are misguided for several reasons. First, GAO investigations simply provide information to Congress; they do not alter Congress's ability to challenge Federal Reserve policies. Second, Congress, having empowered the Fed in the first place, has the right, and indeed the duty, to assess the Fed's performance. Admittedly, Congress is capable of interfering unduly with the Fed's conduct of monetary policy. But the best way to avoid such unwanted interference is by clarifying the Fed's mission and responsibilities. By doing so, Congress would rule out politically motivated attempts to creatively “reinterpret” the Fed's responsibilities without having to exempt the Fed from ordinary congressional oversight.

Normalize Monetary Policy

Between 2007 and 2014, the Fed's balance sheet increased fourfold as a result of both unprecedented levels of direct Fed lending and the various rounds of large-scale Fed asset purchases known as “quantitative easing.” The expansion was accompanied by an almost equal increase in banks' holdings of excess reserves—that is, reserves exceeding minimum required levels—owing, at least in part, to the Fed's decision to pay interest on bank reserves, including excess reserves, beginning in October 2008.

These and other extraordinary developments have led to major changes in both the Fed's monetary control procedures and its overall involvement in credit allocation. The crisis having now passed, both the Fed's vastly

increased credit “footprint” and the uncertain reliability of its novel monetary control procedures have become objects of great concern.

Fed officials concede the desirability of eventual monetary policy “normalization,” meaning a return to precrisis monetary control arrangements and a reduced Fed balance sheet. But so far the Fed has neither taken any substantial steps in the direction of normalization nor committed itself to a definite deadline for doing so. Allowing the Fed to delay normalization indefinitely risks having it continue to play a much larger than desirable part in credit allocation. It also risks having the Fed choose to contain inflation, such as might follow a revival of bank lending, by raising the interest rate on reserves enough to quash the revival, instead of selling assets to reduce its own contribution to the money supply.

To avoid such risks, Congress should compel the Fed to begin regular sales of the securities—especially mortgage-backed securities—it acquired during the crisis. The schedule of minimum sales should ensure that the Fed can rid itself entirely of the less liquid securities in its portfolio within seven years. To avoid having such sales undermine monetary control, the Fed must be allowed to offset them, when necessary, by purchasing ordinary (short-term) Treasury securities.

Finally, to complete as well as expedite the normalization process, Congress should stipulate the phase-out of both interest payments on banks’ excess reserves and the Fed’s “overnight reverse-repo” facility, which serves as a means for making similar payments to various other financial institutions, including money market mutual funds. To the extent that it contributes to a revival of bank lending and investment, the phase-out of interest on excess reserves would allow the Fed to dispose of mortgage-backed securities more rapidly, or at least to resort to offsetting Treasury security purchases less frequently.

Establish a Level Currency Playing Field

Congress could further encourage the Fed to manage the dollar responsibly by establishing a level playing field between the U.S. dollar and its potential rivals. This move would also make it easier for U.S. citizens to use alternative means of payment when doing so makes them better off.

To level the field on which the dollar competes with other potential means of payment, Congress should repeal 31 U.S. Code § 5103, which makes Federal Reserve notes and Treasury coins “legal tender for all debts, public charges, taxes, and dues.” Specific performance of contracted obligations should instead be the sole remedy for breach-of-debt contracts,

no matter what means of payment they specify. Congress should also prohibit any taxation of private exchange media, whether physical or digital, that would make using such media more costly than using dollar-based monies. Among other things, that would mean exempting alternative exchange media from either sales or capital gains taxes.

Finally, Congress should repeal those parts of U.S. Code, Title 18, that make it illegal to make, possess, or circulate private metal coins or tokens that resemble coins. Although Congress has good reason to prohibit the actual counterfeiting of official coins, such counterfeiting is separately and adequately dealt with by 18 U.S. Code § 485.

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—*Prepared by George Selgin*

57. Financial Regulation

Congress should

- repeal the Dodd-Frank Act;
- short of repeal, make major modifications to Titles I, II, and X of Dodd-Frank, which cover the Financial Stability Oversight Council, orderly liquidation authority, and the Consumer Financial Protection Bureau;
- wind down Fannie Mae and Freddie Mac without establishing a new guarantee for mortgage risk, and reform the Federal Housing Administration;
- roll back recent expansions in federal deposit insurance;
- repeal the Community Reinvestment Act of 1977; and
- eliminate the Exchange Stabilization Fund.

From its earliest days, the American system of banking regulation has been characterized by state and federal authorities that bestow market power on banks through restrictions on the entry of competing firms into the market and through limitations on acquisitions and diversification. These entry and structural barriers have created economic rents for existing market players and resulted in a more fragile banking system. Examples of such restrictions include limitations on the geographical and product diversity of bank portfolios.

The relative fragility of the U.S. banking sector, a direct result of the restrictions, led to the creation of government safety nets, such as the Federal Reserve and the Federal Deposit Insurance Corporation. Countries that have avoided these types of restrictions on geographical and product diversity, such as Canada and Australia, have exhibited greater stability and adopted government safety nets for their banking systems much later, if at all. Moreover, entry barriers have created economic rents or excess

profits (a point that has not been ignored by politicians). A significant portion of modern banking regulation involves the redistribution of those excess profits, though, of course, the amount is difficult to measure. We are quickly reaching—and may have already passed—the point at which the redistribution of rents and the costs of other regulations outweigh the benefits that banks receive from both the safety net and entry barriers.

Any credible attempt to reform our system of banking regulation must address all these factors. A free, competitive, and healthy banking system is one with few barriers to entry, no safety net, and no redistribution of wealth/income. As long as safety nets are extensive, the resulting moral hazard will necessitate prudential regulation. Since prudential regulation is inferior to market discipline, an extensive bank safety net almost certainly will lead to a financial crisis.

Dodd-Frank

The Dodd-Frank Act expands the bank safety net and continues using the banking system as an avenue to redistribute wealth. Dodd-Frank will likely increase both the frequency and severity of financial crises by further reducing market discipline and increasing the political control of our financial system. The best solution would be to repeal the entire Dodd-Frank Act. Short of that, policymakers should focus on Titles I, II, and X.

Title I—Financial Stability Oversight Council

The Financial Stability Oversight Council (FSOC) is tasked with labeling companies, including nonbank financial companies, as “systemically important”—that is, “too big to fail.” That role gives regulators significant supervisory power over all large financial institutions and creates an implied government backstop for firms so labeled. To end the perception of too-big-to-fail, we must end the use of such labeling by government.

Title II—Orderly Liquidation Authority (OLA)

Orderly liquidation authority (OLA) empowers the federal government, via the Federal Deposit Insurance Corporation (FDIC), to take over and “resolve” failing nonbank financial companies and bank holding companies. That authority creates confusion and uncertainty in a crisis and codifies the potential for the regulators to discriminate between different classes of creditors or rescue creditors. The use of OLA is at the discretion

of the Treasury secretary, which means it is unlikely to be used, particularly if the Treasury can rely on other sources of funding to keep failing institutions afloat. All of the necessary tools to implement the resolution of a large systemic bank or other financial company can be achieved with some modifications to the bankruptcy code, such as creating a new Chapter 14 in the bankruptcy code.

Title X—Consumer Financial Protection Bureau

The Consumer Financial Protection Bureau (CFPB) promises to do for nonbank financial companies what the federal government has done for banks: subject them to political pressure to follow noneconomic lending standards. The CFPB also attempts to do to other forms of finance what the federal government has done to the mortgage market, namely, turn them into a source of systemic risk. While structural changes, such as putting the agency under a five-member commission, would be modest improvements, they fall short of correcting the worst flaws of the CFPB. Thus, full repeal is needed along with repeal of the various “protection” statutes mentioned earlier. Short of abolishing the CFPB, Congress should (1) place the CFPB within the congressional appropriations process, (2) change its governance structure to a board rather than a director, (3) direct the CFPB to define “abusive” with a notice-and-comment rulemaking process, (4) require cost-benefit analysis for all CFPB rules, (5) have a chief economist report directly to CFPB leadership, (6) remove CFPB involvement with the FDIC, and (7) require CFPB to include safety and soundness considerations in its rulemakings.

Mortgage Finance

Given their prominent role in the financial crisis, Fannie Mae and Freddie Mac should be wound down over a brief number of years, no more than six. That end can be accomplished by using the receivership mechanism in the Housing Economic and Recovery Act of 2008 (HERA). As HERA does not abolish their charters, Congress should sunset those charters, while also setting a path to reduce loan limits, increase down payments, and raise guarantee fees for Fannie Mae and Freddie Mac. The remainder of our financial system has sufficient capacity to absorb the activities of Fannie Mae and Freddie Mac and do so in a manner with significantly less leverage. Essentially, Fannie Mae and Freddie Mac are avenues for banks to transfer mortgage credit risk from themselves to the

taxpayers. Such a transfer increases the amount of credit risk in the system, so those guarantees should be ended and not replaced. If policymakers believe there is some economic value in the companies, their charters could be converted to bank holding companies, subjecting them to the same competitive and regulatory environment as commercial banks.

Federal mortgage subsidies, predominantly in the form of Federal Housing Administration (FHA) guarantees, have long led the mortgage market in the direction of riskier underwriting standards. FHA has paved the way for both very low down-payment and low borrower-credit lending. A significant portion of FHA loans would not be made by any lender under the current terms without a government guarantee. That means those loans should not be made as they leave the taxpayer and the financial system at considerable risk. While the long-term goal should be the elimination of FHA, Congress in the interim should (1) immediately require borrowers to make a 5 percent cash down payment, (2) require FHA to allow only reasonable debt-to-income ratios of no more than 30 percent, (3) restrict loans to borrowers with a credit history no worse than a 600 FICO equivalent, and (4) require in-person prepurchase counseling for FHA borrowers with FICO equivalents between 600 and 680. Eligibility should also be limited to borrowers whose incomes do not exceed 115 percent of the state median income.

Federal Deposit Insurance

Discussions of moral hazard during the financial crisis generally focused upon the incentives of management and equity holders, yet far more moral hazard results from a reduction in monitoring by creditors. The most important creditor class for a commercial bank is depositors, who provide about 75 percent of funding for the total banking system (the rest coming from equity and borrowed funds). Substantial academic literature demonstrates that depositors are capable of monitoring banks and that government-provided deposit insurance reduces that monitoring and results in greater risk-taking by banks.

The public interest would be best served if Congress were to reduce federal deposit insurance coverage to the pre-savings and loan crisis limit of \$40,000. To further the goal of reducing systemic risk, Congress should also limit the total deposit insurance coverage of any one bank to 5 percent of total insured deposits. Given the current size of the fund, over \$6 trillion, such a limit would imply that no one bank would hold more

than \$350 billion in insured deposits. Currently, four banks are above that level.

As of first quarter 2015, the FDIC backs \$6.3 trillion in deposits. That represents about 60 percent of outstanding U.S. domestic deposits. That also represents a 50 percent increase—more than \$2 trillion—in insured deposits since year-end 2007 and almost a doubling of insured deposits from 2003 to 2015. Part of the increase was due to the Federal Deposit Insurance Reform Act of 2005, which raised the limit for deposit insurance for retirement accounts to \$250,000. Congress should repeal those provisions of the 2005 act. Within the Troubled Asset Relief Program (TARP), Congress also raised the deposit insurance cap to \$250,000 until January 1, 2010. Dodd-Frank made permanent the coverage expansion contained in the TARP.

Dodd-Frank's section 335 extends the 2005 retirement coverage limit of \$250,000 to all accounts. According to the Federal Reserve's Survey of Consumer Finance, the median U.S. household holds \$4,100 in a checking account. For the fewer than 10 percent that hold certificates of deposit, the median holding is \$16,000. A cap of \$40,000 (the pre-savings and loan crisis limit) would more than adequately cover the vast majority of U.S. households, while also greatly improving market discipline on U.S. banks. Even the typical (median) retirement account, not all of which are held at banks, is under \$60,000.

The holdings of deposits are also highly concentrated. For instance, a fourth of all deposits are held by the wealthiest 1 percent of households. The top 10 percent of households hold 67 percent of all deposits. The wealthiest households also, on average, have considerable nondeposit sources of wealth. Even with significantly reduced deposit insurance coverage, middle- and low-income families could still be completely protected.

The argument behind expanding deposit insurance is that it reduces panics or bank runs. That may well be true in the short run, yet it comes at the cost of a tremendous reduction in market discipline. A World Bank study across more than 150 countries found that, all else equal, those countries with more generous deposit insurance schemes suffered more frequent banking crises. Similar results hold for the United States, as various academic studies have found that U.S. uninsured deposits provide substantial monitoring of bank health. The related decline in market discipline that results from deposit insurance has been documented across time and differing regulatory structures. Few relationships in economics have been found in so many different settings as the link between expanded deposit insurance and bank instability.

Community Reinvestment Act of 1977

A variety of statutes are intended to encourage banks either to make loans they would not otherwise make or to make loans available on terms they would not have made otherwise. Many of these statutes add considerable uncertainty to the lending process by giving borrowers an avenue to escape their obligations (or litigate) in the event of nonmaterial violations of these federal laws. The result is often to force lenders toward average cost pricing, such that better quality borrowers cross-subsidize poor-credit borrowers. These statutes are sometimes “justified” on the basis of the safety net benefits that banks receive from the government. Congress should roll back that safety net and repeal the Community Reinvestment Act (CRA).

CRA was passed to nudge banks into making loans to less creditworthy borrowers within their service areas. The law was enacted at a time when local banks did restrict the supply of loans due to their local market power. Initially designed as a “process-oriented” measure, in the 1990s, CRA began to resemble a quota system for lending. But, if anything, the recent crisis demonstrated an abundance of credit, rather than a shortage. CRA now represents a transfer from banks and higher-credit borrowers to lower-credit borrowers. Economist Jeffrey Gunther also found evidence that increased CRA activity comes at the expense of bank safety and soundness. Accordingly, the transfers inherent in CRA may well end up coming from the taxpayer. The act should be eliminated.

Exchange Stabilization Fund

Housed within the Treasury Department, the Exchange Stabilization Fund (ESF) was created to manage the gold–dollar parity, an activity that was abandoned decades ago. At this point, the ESF largely serves as a \$100 billion slush fund for the Treasury. In the absence of outright elimination of the fund (the preferred option), significant limitations should be placed upon Treasury’s power to use it. For example, the ESF should be used only to provide temporary, fully collateralized liquidity to solvent institutions. Treasury should not be entitled to use the fund to obtain equity stakes in, provide guarantees for, or otherwise assist insolvent institutions. Congress would also serve the public interest by prohibiting the use of the ESF to provide direct assistance to financial institutions; that is, the ESF could be better targeted to its intended purpose: exchange rate stability.

Conclusions

America continues a slow, weak recovery from the financial crisis. The legislative response to the crisis, most particularly the Dodd-Frank Act, has largely ignored the drivers of the crisis, leaving our financial system and economy as vulnerable as ever. To add insult to injury, financial regulatory reform postcrisis has greatly extended both explicit and implicit government guarantees of financial market risk taking, making future crises all the more likely. Our financial regulatory system is in dire need of wholesale reform. The proposals offered here are a starting point for such efforts. Additional reforms to impose market discipline and reduce political interference with our financial system are also needed if we are to achieve both robust economic growth and financial stability.

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—Prepared by Mark Calabria

58. Securities Regulation

Congress should

- repeal all legislation and regulations that mandate public disclosures relating to the purchase and sale of securities;
- replace those laws if necessary only with legislation that has been shown to actually promote price discovery or deter fraud without undue cost;
- extend the provisions of the IPO on-ramp in Title I of the JOBS Act of 2012 to all companies making an initial public offering;
- impose the terms of Section 404 of the Sarbanes-Oxley Act only on companies that have demonstrated insufficient internal controls;
- authorize public companies to use the offering exemption under Regulation A;
- define any off-exchange offering as “nonpublic” and therefore exempt from registration, and open all such offerings to investment from any investor regardless of wealth; and
- create a de minimis exemption for any offering of less than \$500,000.

The world benefits from the innovations brought to market by the companies that develop new medical treatments, safety features, communication technologies, and other products and services that make modern life as safe and comfortable as it is. These companies, both those in the United States and many based abroad, rely on the U.S. capital markets to fund their work. Capital markets exist to funnel resources to their best use. When functioning properly, the markets ensure that companies with the best ideas and best business models will attract the most resources.

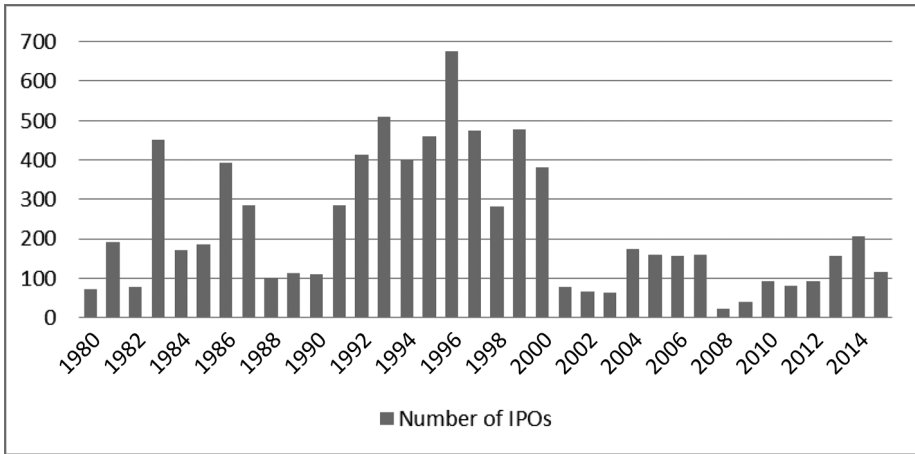
Regulation, however, can snarl these processes, leading companies to waste resources complying with inefficient or even counterproductive rules—resources that would otherwise have been employed improving lives. Over the roughly 100 years since the introduction of government-directed securities regulation, the securities laws and implementing rules have needlessly encumbered and often profoundly distorted the proper functioning of the capital markets. Those who advocate for increased regulation typically invoke the need for improved “investor protection” or, since the 2008 financial crisis, “financial stability.” But many of the existing rules, at best, have no bearing on investor protection and, at worst, harm investors by limiting the amount of risk (which includes the opportunity for gain) they may take on. Even rules that may promote investor protection—by, for example, reducing the risk of fraud—are rarely evaluated to determine the harm they may pose to the greater society. Such rules may be reducing the ability of companies to bring life-saving products to market or limiting growth, leading to lower employment levels and impaired economic growth overall.

Existing regulation of registered securities should be dramatically pared back. Ideally, each exchange would set the rules for what disclosures are required for listed securities. Investors interested in the kind of protection afforded by mandated disclosures could restrict themselves to investing in the securities on the exchanges whose rules they find best suited to their needs. To the extent that such extensive change is not possible and federally mandated disclosures continue, these should be only the minimum needed to deter fraud and promote price discovery. No disclosure should be required unless it has been shown that it affirmatively promotes price discovery or deters fraud, and that the burden it places on all parties is justified by the benefit it imparts. Specific recommendations for regulations that should be repealed follow below, but these are, for the most part, just the most egregious examples. The entire disclosure structure is ripe for overhaul.

The Decline of the IPO and Effects on Wealth Inequality

The U.S. capital markets are the envy of the world. Deep, liquid, and transparent, they have historically attracted investment from all parts of the globe. But since 2000, the number of companies opting to go public has been in decline. It is true that the nearly 700 initial public offerings (IPOs) that marked the peak of the dot-com heyday in 1996 may not be our benchmark. But even leaving out the boom years in the late 1990s,

Figure 58.1
Number of IPOs, 1980–2015



SOURCE: Jay Ritter, “Initial Public Offerings: Updated Statistics,” University of Florida, March 2016, Table 15.

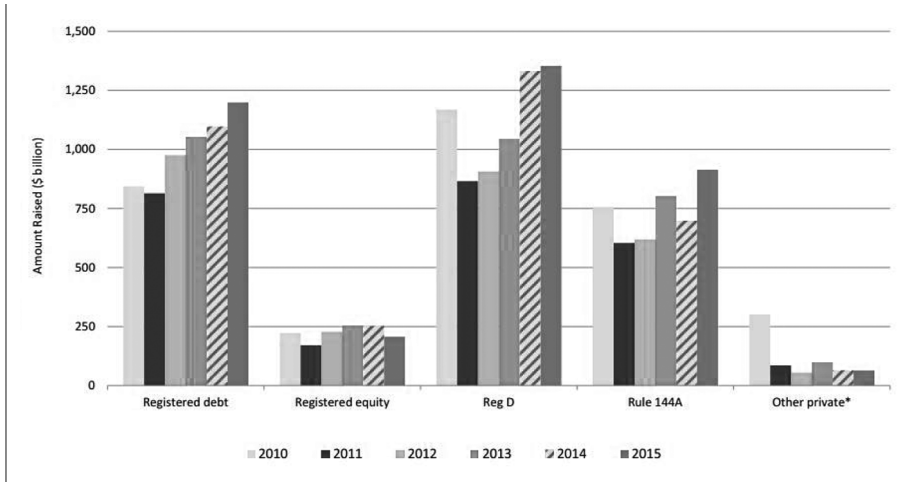
NOTE: IPO - initial public offering.

recent years have been anemic, averaging about 110 per year in the years 2001 through 2015 (see Figure 58.1). Because private investments are limited principally to institutions and wealthy individuals, the decline in IPOs contributes to wealth inequality, allowing only those who are already wealthy to share directly in companies’ most explosive early growth.

It is worth noting that the IPO decline has not been caused by negative factors alone. For example, accessing private investment has become easier since the 2012 passage of the Jumpstart Our Business Startups (JOBS) Act. As Figure 58.2 illustrates, the capital raised through private offerings dwarfs the amounts raised through public (i.e., registered) offerings. However, it is clear that the drop in IPOs cannot be solely attributed to companies freely choosing to raise only private capital. Corporate leaders express frustration at both real and perceived burdens imposed on private firms, and scholars commonly cite increased regulation as one of the main reasons for the decline in IPOs.

Congress passed the Sarbanes-Oxley Act nearly 15 years ago. It is time to revisit this legislation, evaluate its effects on the economy, and strip out those portions that have served principally as an anchor, weighing down the economy and impeding its growth. It may indeed be time to repeal the act in its entirety.

Figure 58.2
Public vs. Private Capital Raising, 2010–2015



SOURCE: Scott Bauguess, Rachita Gullapalli, Vladimir Ivanov, and Anzhela Knyazeva, “Private Securities Offerings post-JOBS Act,” Securities and Exchange Commission, PowerPoint Presentation, February 25, 2016. *Other private includes Section 4(a)(2) offerings.

The JOBS Act of 2012 provided a useful first step, exempting smaller companies from Sarbanes-Oxley’s controversial Section 404 provisions for a period of time following an IPO. Section 404 requires the management of public companies to report on the adequacy of internal controls—those procedures and internal rules that ensure the company is, among other things, in compliance with regulations and that financial information is likely to be accurate—and requires the company’s auditor to attest to management’s assessment. This process is costly and therefore the JOBS Act, to reduce barriers for companies considering an IPO, provides certain exemptions from these requirements. There has been no indication that this exemption has led to increased corporate criminality. These exemptions should, at a minimum, be made available to all companies making an IPO. Additionally, Section 404 requirements should be imposed only after a company has shown that it has insufficient internal controls, not against all companies. Companies that can competently manage their own operations without running afoul of the law should be permitted to do so without government intervention.

Such regulatory relief would likely entice more companies to pursue IPOs and restore some of the market’s lost vitality. It would also pave the way for additional review and repeal, allowing the law to be pared

back to only those components that have proven effective, if any are found to exist.

Halting the Expansion of the Current Disclosure Regime

In recent years, many activists have seized on public companies' mandatory disclosures as a means of promoting causes entirely unrelated to the purposes of these disclosures. That sets a dangerous precedent. Congress should repeal rules currently in place and commit to enacting no future legislation with similar rules.

The federal securities laws are a disclosure regime. Instead of requiring that offerings be approved by the Securities and Exchange Commission (SEC) as "fair, just, and equitable to the investor" as many state-level "merit review" regimes require, the Securities Act of 1933 and the Securities Exchange Act of 1934 require only that issuers provide a certain level of disclosure to the public as part of registering an offering for public sale. The scope of these disclosures has long been understood to encompass only information for which there is "a substantial likelihood that the disclosure . . . would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." That is to say, information should be disclosed if it would help an investor determine the appropriate price for the investment, given its potential returns.

The 2010 Dodd-Frank Act included a number of rule-making requirements motivated by activists' interests and not investor protection. The most notorious, the "conflict minerals" rule, mandates that public companies disclose whether any of certain minerals used in their products were sourced from specific geographic areas. The motivation behind the disclosure was, according to the SEC, congressional "concerns that the exploitation and trade of conflict minerals by armed groups is helping to finance conflict in the Democratic Republic of the Congo and is contributing to an emergency humanitarian crisis." The sentiment is noble, but it should not lead Congress to resort to, in the words of one former commissioner, "hijacking" existing regulatory regimes. A second, similarly misguided new rule requires public companies to disclose the ratio of the chief executive's pay to that of the company's average worker. Activists are currently working to add disclosure of political and other types of contributions to the list of disclosures.

Such disclosure requirements present two problems. The first and most pressing is that, if the SEC's disclosure regime becomes entirely untethered

from its original, price-discovery function, it can be bent to any purpose at all. Furthermore, it sets a precedent for hijacking other disclosure regimes throughout the federal government. Americans should feel secure that any disclosures the government requires are carefully cabined to encompass only that information directly related to the legislation's initial intent.

Second, these disclosures often have unintended consequences. Any disclosure by a public company carries the risk of litigation if the statement is found to be either false or missing key information. Because of the difficulty in accurately tracing the manufacturing chain for minerals sourced in a low-infrastructure country like the Congo, many companies have simply stopped buying from producers in that region. That decision is harmful to the very people the rule was meant to help because it starves the region of desperately needed industry and investment. It is easy to imagine similar consequences arising from similarly misguided rules.

Congress should delineate clearly the scope of disclosures that the SEC may require, tying them tightly to the type of financial and risk-based disclosures originally contemplated by the 1933 and 1934 acts. It should also repeal those sections of Dodd-Frank that directed the SEC to promulgate the conflict minerals and pay-ratio disclosure rules, and direct the SEC to repeal the relevant implementing regulations.

Advantages of the Mini-IPO

Title IV of the JOBS Act provided much-needed relief for issuers seeking to use the Regulation A exemption for smaller-scale offerings. The exemption from registration requirements had fallen almost entirely out of use; in 2011, the year before the JOBS Act was signed into law, only one Regulation A offering was completed. But though the JOBS Act changes have shown promise, they do not go far enough. Congress should direct the SEC to extend federal preemption to all Regulation A offerings and all secondary market transactions in Regulation A-issued securities, and should eliminate the restriction that makes Regulation A available only to nonpublic companies.

In a 2012 report, the Government Accountability Office found that one of the principal reasons Regulation A had fallen out of use was the considerable burden imposed by state-level requirements. Public offerings registered with the SEC are exempt from state registration requirements, as are any private offerings conducted pursuant to Regulation D. This preemption has been instrumental to Regulation D's popularity. In issuing implementing regulations for the JOBS Act's changes to Regulation A,

the SEC provided federal preemption for a subset of Regulation A offerings. But it is difficult to understand why some Regulation A offerings may proceed without state registration whereas others may not. Some states have banded together to create streamlined state registration process, dubbed “coordinated review,” to reduce the burden of state-level compliance. Whether coordinated review reduces the burden is beside the point, however, if state-level registration still provides less benefit than the cost incurred to comply. The North American Securities Administration Association, the state securities regulators’ industry group, has failed to explain how a two-level review process for Regulation A offerings provides any benefit to investors.

State-level regulation presents other problems as well. Although securities sold pursuant to a Regulation A offering are, from a federal perspective, freely tradable in the secondary market, state regulation puts such sales in jeopardy. Currently, restrictions remain at the state level on how a registered broker–dealer can handle these securities. Removing those restrictions on secondary trading would make the securities more liquid.

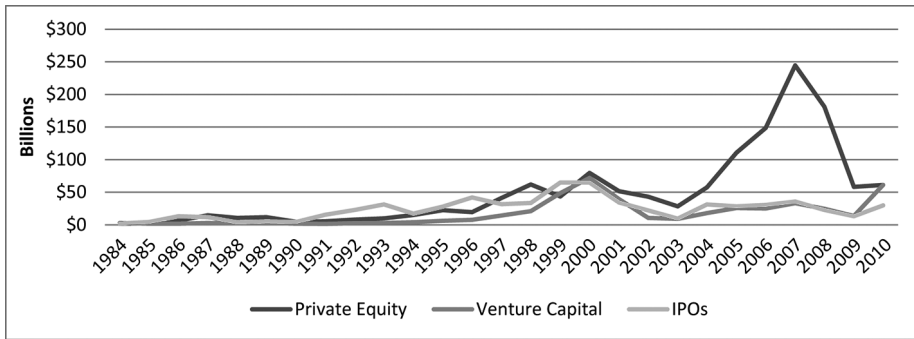
In addition, only nonpublic companies can make offerings through Regulation A. This restriction is illogical. Regulation A is a scaled-down version of a public offering, with limits on the amount a company can raise and, in some cases, on the amount investors can invest. The rationale for these limitations is that Regulation A reduces the disclosures required of the issuer. But if the issuer is a public company, it is already making the substantial and regular disclosures required of public companies. If the disclosures required under Regulation A are sufficient for an offering of that size, even without additional issuer disclosures, it is unclear why a company that makes *more* disclosures should be barred from using the exemption.

To the extent that issuers are turning away from the public markets, there is a need for attractive options that incorporate public investment. Regulation A mixes a light regulatory touch with investment opportunities for both retail and accredited investors, while maintaining provisions aimed at investor protection. Congress should ensure that its post-JOBS Act resurgence is fully supported by granting full federal preemption for all Regulation A offerings and opening Regulation A to public issuers.

The New Private Offering

Since the 1980s, private offerings have become increasingly popular with issuers and investors alike (see Figure 58.3). Private offerings, which include those made through private equity firms and venture capital firms

Figure 58.3
Private Equity and Venture Capital Fund Commitments
and IPO Dollars Raised, 1984–2010



SOURCE: Jay Ritter, “[Initial Public Offerings: Updated Statistics](#),” University of Florida, March 2016, Table 1A; Gregory Brown et al., “[What Do Different Commercial Data Sets Tell Us about Private Equity Performance?](#)” SSRN Working Paper, December 21, 2015, Table 5.

NOTE: IPO - initial public offering.

(the latter defined chiefly by their focus on young, high-growth companies), are characterized by their lack of required disclosures, making them both cheaper to issue and less transparent to competitors. Most are offered under Regulation D, a 1982 regulation that allows private offerings an exemption from state-level registration requirements. Although private offerings can be a boon for many companies, participation is restricted to certain investors. Currently, with very few exceptions, only individuals with more than \$200,000 in annual income (or \$300,000 jointly with a spouse) or assets in excess of \$1 million not including primary residence, and certain institutions may invest directly in private offerings. These restrictions, especially when paired with reduced IPO volume, can exacerbate wealth inequalities. Congress should open investment in private offerings to all investors, allowing investors themselves the freedom to choose between higher-disclosure public offerings and less-regulated private offerings.

Most private offerings use the safe harbor provided by Regulation D—in particular, Rule 506 of Regulation D. Rule 506 allows an issuer to raise an unlimited amount of money without registering either the company or the offering with the SEC, but it places restrictions on who may buy the securities and how the securities may be presented to potential investors. Issuers typically restrict their sales to accredited investors (for the most part, institutional investors, certain high-level company insiders, and individuals

who meet a specified wealth threshold) since offering the securities to nonaccredited investors triggers disclosure requirements.

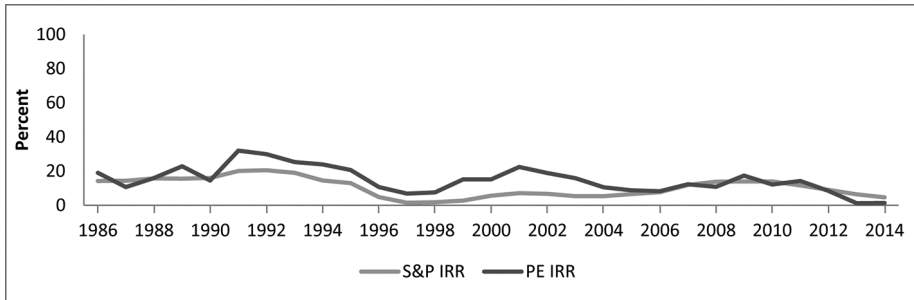
Currently, the wealth and income thresholds stand at more than \$1 million in assets, excluding the primary residence, or more than \$200,000 in annual income for the most recent two years, or more than \$300,000 jointly with one's spouse for the most recent two years, with the expectation in either case that the investor will continue to earn the same amount in the future. A recent SEC report estimates that 10 percent of American households qualify for accredited investor status.

The current focus on the wealth of the individual investor as a determiner of private offering status has created a regime in which sophisticated investors are arbitrarily barred from investing in certain offerings purely because they lack wealth, and investor protection has become a matter of protecting investors not from fraud but from bad investment decisions. It is to lawmakers' credit that federal securities laws are a disclosure regime in which any offering may be made to the public if the issuer provides the right disclosures. But an approach to investor protection that seeks to protect investors from poor choices subverts that regime, making the SEC the judge of who is and is not fit to invest. Although the federal regulator still does not conduct merit review of offerings, as many state regulators do, it in effect conducts merit review on the investors themselves, deeming only some sufficiently capable of making their own choices about how to invest and what risks to assume.

Additionally, although the restrictions on investment in private offerings are often attributed to their inherent riskiness, the numbers tell a different story. Cambridge Investments provides an index of available private investment performance data and constructs benchmarks of public indices that allow for a comparison of the internal rate of return (IRR). As Figure 58.4 shows, the IRR for private equity has largely tracked, or in many years outperformed, returns for the S&P 500.

The current rules have established private securities as an attractive investment that is, however, directly available only to an exclusive set of wealthy investors. Congress should define private offerings as any offering not listed on an exchange. And it should open all offerings to all investors. Congress could require that anyone offering securities in a private offering disclose to potential investors that the offering is private and that it therefore lacks the protections afforded by public offerings. Investors would then be able to choose for themselves whether to invest only in public offerings—if they prefer the protections in the 1933 and 1934 acts—or in more loosely regulated private offerings as well.

Figure 58.4
Private Equity vs. S&P 500 Internal Rate of Return, 1986–2014



SOURCE: Cambridge Associates, “U.S. Private Equity Index and Selected Benchmark Statistics,” PowerPoint presentation, December 2015.

If such a change in the securities laws is not politically feasible, then the category for accredited investors should at least be expanded to more accurately capture investors most likely to be able to “fend for themselves.” For example, those who have passed the Financial Industry Regulatory Authority’s (FINRA) basic stockbroker’s exam, the Series 7, and those who have passed the exam for financial advisers, the Series 65, should be deemed financially sophisticated and be counted as accredited investors. As the law currently stands, investment advisers may advise clients to invest in securities they themselves may not buy because they are deemed insufficiently sophisticated. The category could also be expanded to allow those with expertise in a particular field to invest in offerings related to that industry. Expertise could be defined as either a university-level degree in the field or a certain number of years of experience working in the industry.

Given the size of the private equity markets and the extent to which they currently dwarf the public markets, the bar that keeps the vast majority of the population from sharing in this engine of wealth is at odds with a democratic society. More opportunities for investment would result in more opportunities to build wealth as well as more opportunities for businesses to access needed capital to grow, adding jobs and building our economy.

Bringing Friends and Family Out of the Shadows

Although past guidance recommended a consideration of all facts surrounding an offering to determine whether it constitutes a “public” offering,

this understanding has largely faded. Regulation D and its predecessors, Rule 146 and Rule 242, as well as the *Ralston Purina* case helped cement the notion that whether an offering is public or private turns principally on whether the investors are rich or not. The absurd result is that even a tiny offering to a tiny group of investors who are close personal friends and relatives of the issuer's executives may still be deemed a "public" offering requiring registration. These tiny offerings—in which an aspiring restaurateur or a couple of friends building an app in someone's garage ask their parents, cousins, and good friends to "go in on" the enterprise with the hope of getting "a cut of the profits" down the road—still happen. And they happen without registration, often without the issuer ever understanding that the transaction being proposed is in fact a sale of securities (typically something akin to common stock) to unaccredited investors.

It is arguably within the SEC's authority to deem such offerings exempt, either as nonpublic offerings or through its authority to exempt "any class of securities . . . if it finds that the enforcement of [the registration requirements of the Securities Act] with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering." The SEC has not, however, used this authority to provide such an exemption. Instead, it continues to consider these offerings to be in violation of the securities laws. Although the SEC rarely pursues enforcement actions against such offerings, it has been known to pick up the phone and issue a stern warning to violators.

It is not clear, however, why the SEC should be involved with extremely small offerings, especially if those offerings are made exclusively to friends and family. These tend to be matters based as much in social and familial relations as financial. Because few issuers are even aware their actions are governed by securities laws (or indeed that they are even acting as "issuers"), the current proscriptions do little to prevent such extra-legal offerings. Instead, they only complicate the process when an issuer grows and moves on to more formal methods of raising capital. Then the issuer must engage a lawyer to unwind its investors' positions, providing rescission offers to all early investors.

A better solution would be for Congress to enact an explicit de minimis exemption. The exemption could include a cap, for example \$500,000, on the amount raised. If it was deemed necessary, there could also be a requirement that investors have a preexisting relationship with at least one senior executive within the company. This type of exemption would free

the offerings that already happen, and will continue to happen, of legal encumbrance, allowing entrepreneurs to focus on building the business and ensuring their friends' and family's investments are sound ones.

Conclusion

Capital markets direct the flow of resources to enterprises. Ideally, these resources flow freely, attracted to the companies that will put them to best use based on the needs and wants of the end consumers. Regulation functions like rocks in a stream, redirecting the flow. Too much regulation, and regulation implemented without regard to its effects, risks choking the flow of capital entirely, or artificially flooding one area of the economy while leaving another dry. The trend toward ever more regulation in the financial sector has left in place regulation that provides little good while imposing great cost. Continued economic growth and progress toward healthier, more comfortable lives depend on ripping out those regulations that neither deter fraud nor improve price and only serve to stymie growth and innovation.

Suggested Readings

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