Dodd-Frank: Discretion in an Age of Uncertainty

Louise Bennetts. January 11, 2013 .

It seems that "rules-based" is the new DC buzz phrase. There is little disagreement that a "rules-based" approach to financial regulation generates better outcomes than does one based on bureaucratic discretion or amorphous "principles." The thousands of pages of "rules" released under the Dodd-Frank Wall Street Reform and Consumer Protection Act [PDF] may lead a reasonable person to assume that we have entered an era where rules reign supreme. Upon closer inspection, however, many of these rules are "RINOs" — Rules in Name Only — or, put differently, discretion masquerading as rules.

Badly drafted statutes seldom result in good regulations, and Dodd-Frank is no exception. Rather than setting a clear mandate for regulators, Dodd-Frank creates a framework, underpinned by objectives and principles — often inconsistent — and gives regulators considerable leeway to implement the provisions as they see fit.

A key foundation of any rule-based system is that the outcomes should be the same regardless of who is enforcing the rule. Well-drafted rules minimize the temptation of regulators to pick winners and losers in the marketplace. Yet, under Dodd-Frank, outcomes will depend on who sits in the driver's seat at the major regulatory agencies. Many of Dodd-Frank's provisions are triggered by a determination of what has become known as "systemic importance." This concept is so poorly-defined and nebulous that even Paul Volcker has described it as "fuzzy." Dodd-Frank makes vague references to institutions whose failure "could pose a threat to the financial stability of the United States." However, any potential threat is in the eye of the beholder, and one regulator's "systemic event" may be another's market correction.

Additionally, Dodd-Frank's central pillar and the public's security against future bail-outs, the Orderly Liquidation Authority, gives the Federal Deposit Insurance Corporation — at the direction of the treasury secretary — the power to liquidate financial companies, bypassing the usual bankruptcy process. However, glaringly absent are both meaningful guidelines as to when this authority should be invoked and, once invoked, clear limitations on regulatory action. Given the absolute discretion that regulators have to use this tool, the question is: will they? Historical precedent suggests not. Seemingly no treasury secretary would want to initiate the failure of a major financial company. Also, it must not be forgotten that the Fannie Mae and Freddie Mac are subject to their own dedicated insolvency regime that is still begging to be used.

In a rule-based system, it must be clear which agency has the authority to draft rules, implement them and monitor compliance. Dodd-Frank gives multiple agencies overlapping jurisdiction over everything from living wills to derivatives regulation. Case in point: two competing initial drafts of the Volcker Rule — messy enough without the complication of multiple versions — were released. This sets the stage for a turf war among the agencies involved, as well as a general lack of accountability. For companies, adherence to rules is difficult when they do not even know which regulator they are supposed to report to.

Adding to the uncertainty is a recent agency trend to release regulations as "guidance" rather than rules, which is preferential from the regulator's perspective. It does not require the standard public notice and comment periods. It affords regulators maximum discretion to change the guidance without going through a formal revision process. Most importantly, it is far more difficult for market participants who feel that an agency has overstepped its authority to challenge regulatory guidance in the courts. Notably, this trend comes hot on the heels of a federal court decision [PDF] striking down a Securities and Exchange Commission (SEC) proxy rule, deemed to be "arbitrary and capricious." It seems that regulators are anxious to avoid a repeat of the SEC debacle.

The broad discretion that Dodd-Frank accords to regulators is as much by design as it is by accident. We cannot know where the next financial crisis will come from or what new products the sector will develop, the theory went, so we need to give regulators as much flexibility as possible. But flexibility comes at a cost. The financial industry's major regulators now have jurisdiction over products and firms that they have no experience monitoring. If regulators do not understand financial firms and products well enough to develop a coherent set of rules, why are they regulating them in the first place?

Giving regulators too much discretion creates uncertainty, and while uncertainty in the market is a fact of life, uncertainty in regulations is costly and ultimately self-defeating. We have had 70 years of the rule of the regulator, with decidedly mixed results. Perhaps it is time to give the rule of law a chance.