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BankThink We need more than half-measures to right-size regulation

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A decade after the start of the 2007-2008 financial crisis, and seven years after the passage of the Dodd-Frank Act, it seems both the legislative and executive branches may be making small steps toward financial regulatory reform. Earlier this month, the Treasury Department released the second in a series of reports on the U.S. financial sector, this one focused on the capital markets. And last week, the House Financial Services Committee passed a suite of bills aimed at reforming many areas of financial regulation.

While passing legislation out of committee is only the first of many steps toward enactment, it is encouraging that several of the House bills passed with either unanimous or bi-partisan support. Although the House notably passed the Financial Choice Act earlier this year, a bill that would serve effectively as a repeal-and-replace template for Dodd-Frank, that bill passed on a strict party-line vote, with only Republicans voting in favor. Therefore, the fact that many of the most recent bills had some support from Democrats may bode well. Of course, any action will require Senate approval as well. There has not yet been a Senate answer to the House version of the Choice Act, although there is still time in the year.

Both the Treasury Department report and a House bill would expand the definition of who can invest in private offerings, but that change would not go far enough.

But even though this recent regulatory reform activity is a step in the right direction, much more needs to be done. And in terms of the reforms envisioned in the Treasury report and the recent suite of House bills, they're a mixed bag. To be sure, some proposed reform follow recommendations that many of us have been pushing for a while now. For example, the Treasury report recommends that all companies considering an initial public offering (IPO) be permitted to file confidentially and "test the waters," that is, sound out potential investment interest before pulling the trigger on a costly IPO. Right now, only companies below a certain size are permitted to do this. There has been widespread concern about how few IPOs have taken place in recent years, and how few public companies now exist. Given the fact that investment in privately-held companies is tightly restricted, if companies eschew the public capital markets, average investors lose out. This change is one that may entice more companies to go public, with little risk to either investors or the markets.

But other changes would be half-measures, better than the status quo but still short of the mark. For example, both the Treasury report and one of the House bills address the restrictions on investment in private companies. Under current securities laws, investment in private offerings is effectively limited to institutions and wealthy individuals, defined as those who either earn at least $200,000 per year or have at least $1 million in assets excluding their primary residences. Both the Treasury report and the House bill would expand the definition, including individuals who can show financial sophistication through licensure or other means.

Expanding the definition is certainly a start. As it stands, existing regulation has absurd results. For example, an investment advisor who advises wealthy clients can recommend investments she herself cannot make since current law deems her insufficiently sophisticated if she is not also wealthy. Expanding the definition to remedy this would at least make the results less ridiculous. But this change doesn't go far enough. Why should there be any restriction on how a person can spend money he has actually in hand? After all, anyone can spend money on all kinds of silly purchases, thankfully, without government interference. But if a person would prefer to make an investment with that money, current regulation is patently paternalistic: If the person is not wealthy, he, for the most part, cannot use that money to invest in private companies.

Another half-measure concerns a bill that would repeal the controversial Department of Labor rule governing broker advice for the sale of retirement investments. This rule, which would require those providing advice while selling certain investments to adhere to the very stringent "fiduciary duty" standard, has been criticized on two grounds. First, that the Department exceeded its authority, shoe-horning the rule into its limited jurisdiction over employer-sponsored retirement accounts. Second, that the rule itself would result not in better advice for moderate-income Americans, but *no* advice as brokers are likely to abandon low-value accounts due to the increase in compliance costs the rule would impose.

Repealing the rule is a good place to start. However, the bill passed by the House committee would only remove the rule from the Department of Labor's (DOL) jurisdiction. While the legislation does not expressly impose a fiduciary standard, as the DOL's rule does, it still uses language suggesting a heightened duty of care. Brokers are, in reality, salespeople who give recommendations incidental to that role. There may be some argument for requiring that such brokers disclose the fact that they may be paid based on a commission structure, to ensure that investors are not confused about their role. But any rule must ensure that the compliance costs of a higher duty of care do not outweigh the benefits, or place inappropriate requirements on those in a sales role. Otherwise the result is likely to be reduced access to information for the people who need it most. In fact, some initial reports show that this has already begun to happen in some firms under the current DOL rule.

The efforts by Treasury and the House Financial Services Committee are welcome. It is encouraging that some of the House bills passed with considerable support from both political parties. Given the breathtaking scope of Dodd-Frank's changes, and the harmful effects it has had on the economy, any change is welcome. But there is still much, much more that can and should be done.

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