

PREPARED STATEMENT OF JOHN M. SCHAIBLE
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Chairman Capito, Ranking Member Maloney, and Members of the Subcommittee on Financial Institutions and Consumer Credit: My name is John M. Schaible. I am the CEO, Chairman and founder of Atlas Federal Holdings. I commend the Chairman and the Members of the Finance Subcommittee for holding these hearings on the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank” or the “Act”) on small business with an emphasis of the financial services industry covered by small institutions. I am a businessman and an entrepreneur.

In my invitation to testify, the Subcommittee has requested I consider the following: (i) an overview of provisions in Dodd-Frank affecting small business; (ii) the effectiveness of the exemption in Dodd-Frank for institutions with less than \$10 billion in assets from the Consumer Financial Protection Bureau; (iii) the challenges faced by small institutions as a result of Dodd-Frank; (iv) the interaction of Dodd-Frank and current regulatory requirements and the effect this has on the ability to conduct business; (v) the link between the effects of Dodd-Frank on small institutions and the ability of small businesses to secure loans; and (vi) the effect of the current regulations on small financial institutions and the ability of small business to operate.

I have spent my career building a series of successful, innovative, forward thinking financial services companies. I founded NexTrade, one of the first electronic platforms to compete with the New York Stock Exchange and Nasdaq. NexTrade, which was ultimately acquired by Citigroup, helped democratize the stock market by empowering individual investors to compete on a level playing field with exchanges. I also founded Matchbookfx, the first spot foreign currency exchange platform delivered over the internet. Like NexTrade, Matchbookfx helped change the way foreign currencies were traded globally. Most recently, I founded Anderen Financial, a Florida state chartered bank and brokerage firm. Today, Anderen remains one of the best capitalized banks in the country.

Through these firms, I have employed or contracted thousands of Americans and facilitated billions of dollars of economic activity. I have also become expert at building enterprises dedicated to financial services. From this level, I hope my voice will resonate with the members of this committee as I address the implications of Dodd-Frank on small financial services firms and businesses in general.

Dodd-Frank has Resulted in Regulatory Uncertainty that is Undermining the Growth and Job Creation

In 2000 I appeared before the Subcommittee on Finance and Hazardous Materials of the Committee on Commerce to discuss Competition in the New Electronic Market. In that testimony I encouraged Congress and the Securities and Exchange Commission (“SEC”) to question each component of our current regulatory structure and ask this

question: “Does the additional cost of the regulation outweigh its benefit to the market and the individual investor?” I noted that rules that are beneficial should remain in effect and rules that detract from the market or impede competition should be eliminated. I believe this test is still valid and have viewed Dodd-Frank in this light. However, I have added a corollary to this test, I would add, rules or laws that create uncertainty should be eliminated.

Businesses in America need certainty and Dodd-Frank creates uncertainty. At the core of the legislation there is a philosophy inherently opposed to business development: the concept that regulations should be “flexible”. To a businessman, a “flexible” regulation is merely a euphemism for “arbitrary” regulation. Dodd-Frank is massive and unclear piece of legislation that delegates a number of regulatory agencies the drafting of critical rules that should have been discussed in Congress. Dodd-Frank is a jerry-rig, piled on top of a broken and archaic regulatory structure.

In the report of the Commission on the Regulation of U.S. Capital Markets in the 21st Century (the “Capital Markets Commission”), then Treasury Secretary Henry M. Paulson stated:

Unfortunately, the competitive position of our capital markets is under strain - from increasingly competitive international markets and from the need to modernize our legal and regulatory frameworks. Over the last two decades, markets have truly become global—corporations, accounting firms, investment banking firms, law firms, and now stock exchanges—all have internationalized. ***Yet, the U.S. regulatory structure is deeply rooted in the reforms put in place in the 1930s, a period that was closer in time to the Civil War than it is to today.***¹

Similarly, in testimony before the Financial Crisis Inquiry Commission, Mr. Paulson called the regulatory system that he confronted as secretary, from 2006 to 2009, “archaic and outmoded.”

To make matters worse, Dodd-Frank is specifically focused on financial services, the capital formation engine of the country. The uncertainty created by the Act is potentially toxic to any financial services start-up, in that it affects the ability of small and early stage companies to secure necessary capital. As the unemployment rate hovers near ten percent (10%), any legislation or regulation that impedes the ability of small and early stage companies to secure capital is detrimental to America’s economic recovery and the certainty required for economic growth and job creation.

¹ See *U.S. Capital Markets in the 21st Century: Report and Recommendations*, U.S. Chamber of Commerce, Executive Summary, March 2007 (Emphasis added).

Item A: An Overview of Provisions in Dodd-Frank Affecting Small Business

Dodd-Frank is Toxic to Financial Services and Small Business

Small businesses are critical to the financial well being of the U.S. According to the Small Business Administration (“SBA”), small businesses:

- represent 99.7 percent of all employer firms;
- employ just over half of all private sector employees;
- pay 44 percent of total U.S. private payroll; and
- have generated 64 percent of net new jobs over the past 15 years.

Small businesses in the financial services industry are critically important because they frequently act as the funding source or intermediary to the funding source for small businesses. Within financial services, relatively young start-up ventures can quickly grow to preeminence and become critical to the structure of capital formation. For example, the company that merged with, and arguably saved the New York Stock Exchange, Archipelago, was founded in 1997.² Hence, a direct link can be drawn between the impact of Dodd-Frank to the health of all small business.

A proper legislative act should afford all parties subject to the law, clarity with respect to the individual provisions of the law. Unfortunately, most of the provisions of the Act have delegated the burden of crafting rules and regulations to regulatory agencies that are either overburdened or that have little experience whatsoever in balancing the public good against the authority of big government.

Shortly after passage of Dodd-Frank, Davis Polk & Wardwell (“Davis Polk”) issued a summary of the legislation. A relevant portion of the summary notes:

The Act marks the greatest legislative change to financial supervision since the 1930’s. This legislation will affect every financial institution that operates in this country, many that operate from outside this country and will also have a significant effect on commercial companies.... U.S. financial regulators will enter an intense period of rulemaking over the next 16-18 months, and market participants will need to make strategic decisions in an environment of regulatory uncertainty. ***The legislation is complicated and contains substantial ambiguities, many of which will not be resolved until regulations are adopted,*** and even then, many

² See MarketsWiki - http://www.marketswiki.com/mwiki/Archipelago_Holdings.

questions are likely to persist that will require consultation with the staffs of the various agencies involved.³

Davis Polk counts two hundred forty-three (243) explicit rulemakings that are still required, which they cite as a significant underestimate because that number does not include rules to be issued jointly by several agencies and non-explicit rules deemed necessary by the various Agencies are not included. Further, Davis Polk cites sixty-seven (67) studies that are required to be conducted, largely in advance of the promulgation of these rules.⁴

At the highest level the businesses subject to the Act, the legal community and the regulatory agencies charged with implementing the Act, do not understand the full scope of Dodd-Frank. The full scope and impact of the Act will not be fully understood for some time, possibly years. As such, the uncertainty created by from Dodd-Frank severely impairs investment in new financial services companies.

Many members of Congress have started their own business. Anyone that has been through the process of raising capital for a new enterprise can attest to the difficulty of the process. The fundamental risk that cannot be eliminated is whether the business model for which one is raising capital is correct. Investors expect both the risk and the opportunity in assessing whether or not the company seeking capital is right in their model, however, any additional risk beyond that fundamental one is certain to preclude investment.

A company seeking to raise capital that is unable to clearly articulate to its potential investors the rules that regulate its business activities will never raise capital. No prudent investor, no investor with fiduciary obligations, and no investor in his right mind would invest in a business where the rules are uncertain because the activities that are part of a profit plan can be affected at the sole discretion of government agencies charged with legislative authority. Prudent investors are reluctant to put their money to work in capital investments due to the uncertainty created by Dodd-Frank. Nor should it surprise anyone that when Congress should have focused on a comprehensive rewrite of archaic financial services laws, the House and the Senate instead delegated this responsibility to craft rules to several agencies, that financial services firms are troubled by the uncertainty created.

To the extent the financial services industry can evaluate the specific provisions of Dodd-Frank, there are several provisions that are certain to negatively affect small business:

³ See Davis Polk & Wardwell LLP , Summary of Dodd-Frank Wall Street Reform and Consumer Protection Act. July 21, 2010 (emphasis added).

⁴ *Id.*

*Title I of the Act Grants the Federal Reserve Unprecedented Powers and Undermines
Financial Services Business Viability*

The Act establishes a subjective \$50 billion threshold for a Bank Holding Company (“BHC”) to be subject to the authority of the Federal Reserve System’s (the “Fed”) enhanced reporting and increasingly stringent prudential standards. In addition to the powers currently possessed by the Fed, the Act grants the Fed expansive new powers, including the authority to subject any Non Bank Financing Company (“NBFC”) to Fed authority based on the *perceived* risk the company poses to financial stability.

It would be a mistake for investors and financial services firms to believe the legislative history will serve to protect firms from being subject to the Act. If the Act is interpreted broadly based on its plain language, the courts may very well find that Congress meant to give the agencies that are covered by the Act, broad authority. No amount of legislative history to the contrary will undermine the authority of the agencies in the absence of plain language in the Act that such powers were meant to be limited.

The legislative history will be little comfort for investors in financial services firms.⁵ While the legislative history appears to support the position that the Act was meant to limit the number of companies under supervision of the Federal Reserve, potential investors in financial services companies must consider two distinct scenarios: one, the company in which they consider investing is placed directly under the Fed’s supervision or, two, that the company in which the investor is contemplating an investment is likely to become a customer or client (clearing, settlement, custody, leverage, stock loan) of a firm placed under Fed supervision.

An examination of the “anti-evasion” provision of Dodd-Frank demonstrates the unprecedented authority granted to the Fed. If the council determines that a company that is not even a NBFC or \$50 Billion BHC, but that is “organized or operates in such a manner to evade” the application of Title I of the Act, and it engages in financial activities, the council can place it under the supervision of the Fed. Consequently, is not merely being a \$1 billion (or \$1 million for that matter) company sufficient to “evade” the application of the standards? Title I of the Act grants the Fed the power to assert authority over firms whose activities are “not predominantly financial” and to subject them to “tailored” prudential standards. Just to make sure that the Fed has nearly unlimited power, the Act grants the Fed the authority to *examine* any NBFC to see if it poses a “*threat*” to stability. However, Congress failed to define in the Act what constitutes a “threat” to stability. Instead, Congress granted the Fed the authority to define what constitutes a “threat.”

Similarly, the unprecedented power of the Fed is enhanced by the authority for the Council to declare an NBFC is an “emergency threat” that is not subject to the hearing

⁵ See *FINANCIAL REFORM: 2010 The Final Dodd-Frank Wall Street Reform and Consumer Protection Act A Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010*, Gibson Dunn & Cruitcher LLP, July 23, 2010.

procedures set forth in the Act. The Council need only notify the NBFC “within four hours” after the fact.

Title II: The Orderly Liquidation Authority Trumps Legitimate Rights and Gives Unlawful Authority to Regulators

“It is interconnectedness more than anything.... If you fail, what else happens? Who else gets hurt? ... There will be some gray areas. At least in terms of resolution planning I would err on the side of inclusiveness.”⁶

The Act also affords the Fed nearly unlimited power to initiate an Orderly Liquidation of a firm. Under Dodd-Frank Orderly Liquidation Authority (“OLA”), the powers extended to the government during an “orderly liquidation” are practically limitless. While the stated intent of Congress was that this authority would seldom, if ever be exercised, the plain language of the Act does not reflect this intent. Under Dodd-Frank, this power can be exercised in at least two distinct scenarios: one, the company into which they consider investing is placed into OLA directly; or, two, the company into which the investor is contemplating an investment is likely to become a customer or client (clearing, settlement, custody, leverage, stock loan) of a firm placed under OLA. Again, it would be a mistake to assume that legislative history of the Act regarding the intention that the exercise of OLA powers was meant to be used in very limited circumstances would be adequate comfort for investors in financial services firms.

BNY Mellon, for example, holds \$24.4 trillion in assets under custody and administration. In 2010, through its Pershing clearing subsidiary BNY provided solutions to more than 1,150 institutions, BNY loaned more than \$2.5 trillion in stock loan facilities, and acted as the service provider for 44% of the ETFs in the U.S. market.⁷ Many start-up broker dealers and fund developers look to Pershing as a preferred provider for clearing and custody services. Investors in such start-ups now face the potential prospect of material service provider being liquidated under the OLA should the Fed determine such liquidation is required.⁸ While it may appear at first blush to be inconceivable that a firm as sound as BNY could be subject to the liquidation authority of the Fed, the same could have been said for any number of firms prior to the 2008 financial crisis.

Once a company is subject to the OLA, the firm and its customers’ financial activities will be subject to remarkably ambiguous and practically limitless authority. Moreover, the only defense for firms subject to the OLA is to prove in court that the decision to liquidate was “arbitrary and capricious”⁹ or that the company is not, in fact, a financial firm.¹⁰ However, proving such action was arbitrary and capricious after

⁶ Sheila Bair, FDIC Chairman, Reuters Feb. 17, 2011.

⁷ See “BNY Mellon at a Glance, Third Quarter 2010” <http://www.bnymellon.com/news/factsheet.pdf>

⁸ See *The New Financial Deal: Understanding Dodd-Frank and its Unintended Consequences*. Video. Professor David Skeel S. Samuel Arshat Professor of Corporate Law University of Pennsylvania Law School.

⁹ *Supra* Note 6

¹⁰ *Supra* Note 8

the OLA has been asserted will have little benefit for the firm. In effect the assertion of OLA will be a death penalty for any firm once asserted by the Fed, even if the authority was found by a court to have been improperly asserted.

Once FDIC takes over the company under OLA. The assumption, apparently, is that the FDIC has efficiencies from its experience with resolutions of banks. This is not a logical extension, as the resolution of depository institutions guaranteed by the government makes them the primary creditor in fact. However, this is not the case with respect to the resolution of non-bank entities. Nonetheless, even with securities firms the FDIC still takes over with the Securities Investors Protection Corporation (“SIPC”) as trustee. The process is not like a traditional bankruptcy, rather the FDIC can select creditor payments under the “preserve” stability mantra.

The FDIC can repudiate any “burdensome” contract at this point, but still demand performance of contractual obligations *despite termination rights*. Firms contracted to the firm being liquidated cannot do anything to accelerate, terminate, or obtain possession of any property for 90 days unless the FDIC says it is permissible. 90 days or 9 makes no matter to a small financial firm in limbo over the heart of its enterprise, it is a death sentence either way.

The FDIC can effectively freeze qualified financial contracts, such that if they seize a firm, and you are the counter party, you are completely at the whim of the government – unlike the Bankruptcy Code. Further, the fraudulent transfer provision is effectively a two-year claw back against transfers of property that the FDIC does not like because it may “hinder, delay, or defraud the regulators.

Title VI: Enhanced Regulation of Depository Institution Holding Company Creates Serious Liquidity Risks Across a Spectrum of Investments

The Securities Industry and Financial Markets Association (“SIFMA”) recently released an in-depth report about the unintended consequences and potential risks of the implementation of the Volcker Rule. In summary, SIFMA noted:

The risk of unintended consequences for investors and the U.S. economy is significant. Without the liquidity that dealers provide to U.S. capital markets, there could be substantial negative effects, including:

- Higher funding and debt costs for U.S. companies.
- Reduced ability of households to build wealth through participation in liquid, well-functioning securities markets.
- Reduced access to credit for small or growing firms with less established credit ratings and histories.
- Reduced willingness of investors to provide capital to businesses because of greater difficulties in exiting those investments.
- Higher trading costs and consequently lower returns over time for investors, such as pension and mutual funds.

- Reduced ability for companies to transfer risks to others more willing and able to bear them via derivatives, with a consequent reduction in overall efficiency of the broad economy.

Implementation should also acknowledge the risk that financial activity may migrate to the less regulated “shadow banking” system. Furthermore, the U.S. faces strong competition from overseas capital markets. Given the importance of this activity to the competitiveness, safety, and soundness of the U.S. financial markets and the stated goal of strengthening regulation of the financial system, a rulemaking implementation that pushes these activities outside of the most highly regulated parts of the U.S. financial system would be a particularly undesirable outcome.¹¹

Simply banning “proprietary trading” at banks reveals a serious deficiency in understanding of the breadth and the complexity of the issue. The action is similar to the far-reaching consequences of the Shad Johnson accord codified by the Securities Act Amendments of 1982. This myopic approach effectively banned single stock futures trading domestically for twenty years and still effectively precludes the trading of contracts for differences in the U.S., arguably the most important financial product developed since standardized options.¹²

It is incumbent upon Congress to recognize that poorly articulated regulations adopted over the last decade have driven an increasingly important portion of the financial services business out of the United States and to more competitive jurisdictions. In fact, “the rate of growth in the U.S. capital markets since 2001 has been outpaced more than two to one by competing financial centers – notably London, Singapore, and Hong Kong.”¹³ At this rate, members of the Congress should not be surprised that the U.S. will cease to be the leading global financial center in the next twenty to thirty years and will be replaced by China which will become in our lifetime the largest financial market.

As we have seen over the last ten years, investors will have greater access to a variety of financial products offered by firms in Brazil, Russia, India and China. I am sure that Congress did not intend this future for our children. I am sure that Congress would prefer to see America continue as the preeminent center for economic growth under a climate where investors have the required regulatory certainty that is necessary to fuel economic growth. I am confident that Congress will seek to amend the Act in a manner that will restore the necessary balance between the goal of growth and to ensure the regulators have clearly defined authority that is subject to the necessary limits to promote a fair and balanced regulatory regime. Dodd-Frank as it stands is neither fair nor balanced and looms as a dark cloud on the future of America.

¹¹ *The Volcker Rule: Considerations for implementation of proprietary trading regulations*, SIFMA.

¹² According to Tabb Report for LCH Clearnet, notional values of CFDs in 2011 will exceed \$1 Trillion. http://www.lchclearnet.com/images/tabb%20report_tcm6-55721.pdf.

¹³ *Supra* Note 11.

*Title VII: Wall Street Transparency and Accountability Provision Provides
Neither Transparency nor Clarity of
Accountability for End Users or Product Developers*

A great deal of attention had been given to a survey that found the proposed regulations to assess more prescriptive margin requirements to various derivatives would have a significant negative impact on the level of working capital required to operate certain businesses. A requirement to fully collateralize derivative positions would negatively impact job creation, research and development, acquisitions, and business investment and expansion.

An article from Glen Shapiro of Law and Tax News cited “the imposition of a 3% margin requirement on over-the-counter (“OTC”) derivatives held by non-financial end-users could cut the capital spending of major United States companies by \$5.1 billion to \$6.7 billion, and cost 100,000 to 130,000 jobs in the economy.”¹⁴ Mr. Schapiro continued:

The ambiguities in Dodd-Frank and the proposed regulations could cause hundreds of American companies to take their capital and jobs somewhere else,” said David Hirschmann, president and CEO of the USCC’s Center for Capital Markets Competitiveness. “Beyond the impact this will have on businesses, the higher costs of using derivatives also hurts consumers by increasing price volatility.”

“End users of derivatives had nothing to do with the financial crisis. These regulations broadly impact the U.S. business community, imposing a potentially costly, one-size-fits-all approach on a very diverse set of economic participants,” said Larry Burton, the BRT’s executive director.

Marie Hollein, president of Financial Executives International (“FEI”), added that “FEI members have experienced first-hand the importance of access to OTC derivative markets to companies who need to hedge risk in order to conduct everyday business practices, such as researching and developing new products. The survey results reflect what end-users have been communicating all along - that imposing burdensome margin requirements on American businesses will reduce capital spending and equal job loss.”

The Chairman of the House Financial Services Committee, Spencer Bachus, has stated that, while end users of derivatives did not cause the financial crisis, they were among its victims. “Although the Dodd-Frank Act was promoted as being directed at Wall Street, as we are coming to understand more clearly, it is the end users of derivatives who will bear so much of the regulatory brunt of this law. . . .”. The Chairman has also stated that the derivatives market has evolved to provide U.S. businesses with the ability to protect themselves against legitimate business risks. Requiring companies that did not cause nor contribute to the financial crisis to be treated like banks would unnecessarily remove capital from the economy. Specifically, he has stated:

¹⁴ Glen Shapiro, LawAndTax-News.com, New York.

The implementation of new derivatives rules should not occur in a vacuum, without regard for their impact on all market participants and ultimately the economy. The regulators have not only the authority, but the obligation, to ensure that changes are carried out in an orderly manner that does not disrupt market functioning, . . . If we are not careful, the result will be a patchwork of disparate rules that are both complicated to administer and needlessly increase costs on exactly those Main Street businesses that we are counting on to bring our economy back.¹⁵

Of fundamental concern to us should be the effect that prescriptive margins, particularly passed to end users, would restrict liquidity in the products. Lower liquidity would result in higher prices and less hedging. It is entirely conceivable that in an effort to reduce risk will actually result in more risk to the economy as a whole. Not only can we reasonably predict less hedging, but more volatile prices in hedge products in general.

To further compound the problems with Title VII, there is general ambiguity caused by the expansive definition of “swaps” that may force various products under the direct regulations of the SEC or the Commodity Futures Trading Commission (“CFTC”), or both. The SEC and the CFTC will regulate issues related to eligible counterparties, information flow, and central clearing. However, unless the SEC and the CFTC regulations mesh perfectly, which has not yet happened since the inception of both Agencies, any transaction involving a swap subject to by both agencies will be extremely costly to create, maintain, transfer or terminate.

According to a memo by Cadwalader Wickersham and Taft, LLP (the “Cadwalader Memo”) the “expansive” definition of swap potentially encompasses a variety of products, including: forwards without intent to deliver; commodity options; floating rate loans; certain loan participations; and insurance contracts. The Cadwalader Memo notes, “while Congress likely did not intend the words of the Derivatives Legislation to include all insurance, ***it is not safe to assume how the courts or regulators will determine this issue as to various types of insurance.*** As a practical matter, of course, insurance companies and buyers of insurance will likely have to reach a judgment as to the scope of the definition of the term ‘swap’ before it is ultimately clarified.”¹⁶

The decision to deem certain products and loans, a “swap” will prove costly for the U.S. economy. Assuming for the sake of argument that loan participation is deemed a security-based swap, the costs and potential liabilities associated with transacting with existing documentation would be major. According to Richards Kibbe & Orbbe LLP, there are at least four noteworthy consequences: first, transactions and activities in a security-based swap are now made subject to the antifraud and anti-manipulation provisions of the federal securities laws, including Section 10(b) of the U.S. Exchange Act and Rule 10b-5 promulgated thereunder, as well as the related new provisions added

¹⁵ *Id.*

¹⁶ See *Regulation of End Users of Swaps Under the Dodd-Frank Wall Street Reform and Consumer Protection Act*, Cadwalader Wickersham and Taft, LLP, July 20, 2010 (emphasis added).

by Dodd-Frank, including the new Section 9(j) of the U.S. Exchange Act, and the rules to be promulgated by the SEC thereunder.¹⁷

If a participation is subject to these provisions, counterparties would be prohibited from entering into, elevating, transferring or terminating the participation, or possibly administering the participation at all, while in possession of material non-public information without first disclosing such information to the counterparty or confirming that the counterparty has access to the same information. Since certain loan markets are largely “private” markets, with very little public information about borrowers or their loan agreements, it is difficult to conceive, at this time, how parties could transact in loans based on public information only, except in the rare case where adequate information is publicly available. If parties are compelled to trade participations “on the public side” due to the threat of antifraud liabilities under Dodd-Frank, then this change could impact a borrower’s ability to raise capital in the loan market, its disclosure obligations in the capital markets and the liabilities of its loan arrangers in the syndication process.

Second, Dodd-Frank requires certain players in the security-based swap markets to be registered with and regulated by the SEC as security-based swap dealers and major security-based swap participants - without the benefit of a robust exemption for foreign entities as currently exists under Rule 15a-6 under the U.S. Exchange Act for foreign broker-dealers. In addition, Dodd-Frank mandates central clearing and exchange trading in respect of some security-based swaps, and imposes capital, margin, reporting, record keeping, position limits and business conduct requirements in respect of all security-based swaps (depending on the types of market participants). It is entirely unclear how these rules might be applied to certain participations, or whether the rules are even capable of being so applied.

Third, the “sale” of a security-based swap, which includes entering into, terminating, amending or transferring the security-based swap, will be subject to the registration requirements of Section 5 of the U.S. Securities Act, unless both counterparties are “eligible contract participants” as defined in the U.S. Commodity Exchange Act. For purposes of an international participation, this likely means that a party could not enter into, elevate, transfer or terminate certain international participations unless both it and its counterparty were “eligible contract participants.” At the very least, grantors of certain international participations will need to ensure that their counterparties are “eligible contract participants” and obtain a contractual representation to that effect.

Fourth, transactions and positions in security-based swaps will be subject to the same regulations applicable to securities under the U.S. Securities Exchange Act, such as margin, capital and books and records requirements applicable to registered broker-dealers. Some of these requirements may overlap or even conflict with the requirements (described above) to be adopted by the SEC by rulemaking prior to the effectiveness of

¹⁷ *Dodd-Frank Crosses the Pond: Unintended Consequences for LMA-Style Loan Participations?* Richards Kibbe & Orbe LLP Memorandum, November 12, 2010.

Dodd-Frank.¹⁸

The SEC, on the other hand, released on February 2, 2011 its 464 page proposed rules to provide clarity to Dodd-Frank. Comments on these draft rules are due April 4, 2011.¹⁹ I commend the SEC and the CFTC for working diligently to craft rules that must somehow interact. However, as these rules are meted out, industry participants are left in limbo and capital formation for any nascent swap dealers is utterly frozen.

Moreover, for each specific new rule, industry participants must brace for future unintended consequences and the possible unintended impact on capital formation. As an example, in his comments to the SEC's proposed rules, Patrick Durkin, Managing Director of Barclays notes: "[r]egarding single-name [credit default swaps ("CDS")], one possible adverse outcome is higher funding costs for corporations. As the SEC is aware, a corporate entity's CDS spread is highly correlated to its cost of accessing the capital markets. This is because an important and primary purpose of single-name CDS is to allow banks to hedge credit risk and lower exposure to its banking clients."²⁰

Title X: The Consumer Finance Protection Bureau

As described in detail below, the reach of the Consumer Finance Protection Bureau ("CFPB") does not seem limited in any material way for any firm engaged in finance. In addition, as Congress has seen fit to delegate to the regulatory agencies the drafting of future rules, any entrepreneur considering entering the field of finance is left with a high degree of uncertainty with respect to the costs of complying with rules yet to be adopted. In turn, the process of gathering capital to fuel the engine of capital formation itself has been rendered essentially impossible.

The creation of the CFPB is a remarkable delegation of authority by Congress to a poorly defined agency. The unfortunate consequence of this decision, however, is real economic damage. Further, the formation of the CFPB as part of Dodd-Frank, reveals a deep misunderstanding of one of the primary causes of the financial crisis - government intervention. The financial crisis of 2008 – 2009 can be directly linked to the actions of two entities - the Fed and the government sponsored enterprises (the "GSEs").

For nearly a decade the Fed provided too much leverage under an explicit government guarantee and acted as a central point of failure. In addition, the Fed kept interest rates too low for too long fuelling the housing market and the growth of the role of the GSEs. As the role of the GSEs grew to dangerous levels, some members of Congress attempted to rein in the GSEs. However, those efforts were disregarded as Congress sought to promote home ownership. Accordingly, the GSEs fostered a risk to reward ratio for sub prime loans that was unsustainable and incredibly large to an extent only possibly through an implicit government guarantee.

Similarly, the SEC, by virtue of a restrictive approval process that imparted an

¹⁸ *Id.*

¹⁹ <http://www.sec.gov/rules/proposed/2011/34-63825.pdf>.

²⁰ *See* <http://www.sec.gov/comments/s7-34-10/s73410-56.pdf>.

aura of government approval upon the ratings agencies ratings, effectively erased notions of risk and limited the number of rating agencies to an incompetent, non-competitive, and arguably conflicted, self-dealing oligarchy. Actions to “save” the system were poorly timed and culminated with the Government’s unprecedented intervention in the financial services industry.²¹

When it is understood that Government played a major role in causing the financial crisis, it will be recognized that the entirety of Dodd-Frank and especially the CFPB is the exact opposite of what we need. I am reminded of that wonderful Saturday Night Live skit with Will Ferrell and Christopher Walken wherein Will is the “cowbell” player from Blue Oyster Cult and Walken, as the sage record producer Bruce Dickinson, demands ever “more cowbell!” when it is exactly what is not needed.

Ironically, the song covered is “Don’t Fear the Reaper” and while it is hysterical to watch a furry, bearded Ferrell gyrate in an obscenely tight tan shirt banging a cowbell to the point of destructive distraction, it is decidedly not funny to watch regulation asphyxiate economic growth. The economy has a fever, I do fear the Reaper, and the prescription is not “more cowbell!”

Item B: The effectiveness of the exemption in Dodd-Frank for institutions with less than \$10 billion in assets from the Consumer Financial Protection Bureau

The Exemption Will Be Swallowed by the General Rule

The exemption dealing with a \$10 Billion threshold can be bifurcated into two categories: (i) the Interchange Fees, and (ii) the general exemption from the Consumer Financial Protection Bureau (“CFPB” or the “Bureau”) for institutions with less than \$10 billion in assets.

With respect to the Interchange Fees, the American Bankers Association (“ABA”) addresses the topic with the following update):

Two recurring themes emerged (from the Senate Banking Hearing February 17, 2011): Consumers are not guaranteed any benefits and the exemption for small banks will not work.

Benefits to Consumers Are Not Guaranteed. Senator Johanns (R-NE) asked Bernanke to confirm that, as a result of the rule, big retailers will surely see the benefit while consumers may not. Bernanke responded, “**There’s no guarantee [that consumers will see benefits.]**”

Senator Corker (R-TN) commented to Bernanke, “I know you didn’t ask for this... but the price setting at only the transmission cost seems unfair. It also seems we are pushing people into credit cards... this is very perverse and short sighted on our part.”

²¹ See, e.g., John B Taylor, Stanford University Hoover Institute, *How Government Created the Financial Crisis*, The Wall Street Journal, February 9, 2009.

Bernanke said the statute allows the Federal Reserve to consider only incremental costs when setting the regulation and that **“some of the costs will be passed on to consumer and impact product offerings.”**

Small Banks Will be Impacted by Rule. Senator Tester (D-MT) asked Bernanke if there is a way, in practice, to fully exempt community banks and credit unions from the debit interchange rule. Bernanke responded **“there’s no way to guarantee it.”**

When questioned by Chairman Johnson (D-SD) about the exemption for small institutions, Chairman Bernanke said that statute **“has an exemption for smaller banks. We are not certain how effective that exemption will be** because merchants may be able to reject cards from smaller institutions... [the] **exemption may not be effective in the marketplace.”**

Later Bernanke continued, “by statute the smaller institutions will be exempt... **but in practice they may not be exempt...**[the proposed interchange rate] does not cover the full cost [of the service]... **some of those costs could be passed on to consumers...** which means that if the small banks do not have an exemption, **whatever forces are impacting the larger issuers will impact the smaller banks.”**

Tester followed up asking what prohibits a retailer from accepting one card over another. Bernanke responded “at this moment there’s nothing stopping them...**merchants might turn down small bank cards** and networks might not find it economical to have a two tiered system.”

FDIC Chairwoman Bair said the Fed’s proposal will “reduce the income they [banks] get from debit cards and they will have to make it up elsewhere... and could push them [banks and subsequently consumers] into prepaid cards.” She also said, “[i]t **might not be helpful to consumers** and has unintended consequences and really needs to be fixed.”

Tester asked if the proposal should be delayed, at which Bair responded, **“The full policy ramifications might not have been dealt with as thoroughly as it should have been.”**²²

The exemption is ineffective as costs associated with the interchange may be absorbed by the small financial institution as a result of merchants unwillingness to cover those expenses and consumers having to flee to prepaid cards to avoid the costs associated with the implementation of the rules.

²² See <http://regreformtracker.aba.com/2011/02/bernanke-small-institutions-not-fully.html> (emphasis in original).

With respect to the generalized exclusion, any claim that institutions under \$10 billion will be outside the CFPB is illusory at best. Dimore & Shohl, LLP notes:

Although Title X expressly exempts depository institutions and credit unions with total assets of \$10 billion or less (the “Community Financial Institutions”) from enforcement actions by the Bureau, these Community Financial Institutions, through their prudential regulators, are nonetheless subject to the regulations and rules promulgated by the Bureau. Enforcement of the Bureau’s regulations and the consumer financial protection laws is vested in the prudential regulators that already have oversight capacity for these Community Financial Institutions.

Additionally, the Bureau has enforcement authority over service providers that may have relationships with Community Financial Institutions, and the institutions may therefore be required to respond to investigatory demands in relation to investigations of a service provider.²³

The CFPB will likely reach into smaller institutions and trump the effectiveness of the exemption.

*The Act Grants the CFPB Authority over Financial Institutions
With Less Than \$10 Billion in Assets*

Title X of the Act grants the CFPB expansive power over all financial services firms, including those firms with less than \$10 billion in assets. Title X of Dodd-Frank also expands the authority to state attorneys general and state regulators. These changes will place a substantial burden on all financial services firms, particularly small banks and financial services firms that while not subject to supervision and enforcement by the new agency, will be subject to higher scrutiny by state attorneys general and state regulators. Also the Act grants the CFPB the authority to participate in examinations of smaller insured depository institutions with assets under \$10 billion and the CFPB may pass rules applicable to such firms.

Similarly, there is an open issue of whether CFTC and SEC registered entities and persons are exempt from the authority of the CFPB. While there is legislative history that supports the position that Title X is not meant to create duplicative supervision of SEC and CFTC regulated entities and persons, the lack of clear language to that effect in Dodd-Frank, could be interpreted by a court as meaning that Congress meant the agency to serve as an additional check on companies regulated by those agencies. We ask Congress to address this oversight in any amendments to the Act that may be passed.

Enforcement Authority. Although the current prudential regulators for Community Financial Institutions retain enforcement authority under the Act, the Bureau will enjoy certain authority over these institutions. The Bureau may require reports from these institutions "as necessary" to support its role of implementing federal consumer financial

²³ http://www.dinslaw.com/dodd_frank_title_x/.

protection laws, to support the Bureau's examination activities, and to assess and detect risks to consumers and financial markets. The Act requires that the Bureau use publicly available information and pre-existing reports provided to federal and state agencies to the largest extent possible. Although the Bureau may not examine Community Financial Institutions on its own, it can send examiners on a “sampling basis” to examinations performed by other prudential regulators and request any reports that result from those examinations from the prudential regulators. If the Bureau takes part in an examination on a sampling basis, the prudential regulator must involve the bureau agent in all aspects of the examination and consider the input of the agent in the scope, conduct and contents of the examination and any reports issued as a result of the examination.

Referrals From the Bureau and Sharing Information Among Regulators. If the Bureau believes that a Community Financial Institution has materially violated a federal consumer financial protection law, it can notify the appropriate prudential regulator in writing and recommend an investigation. The prudential regulator is required by the Act to provide a written response to the Bureau within sixty (60) days of receipt of the Bureau's referral. Additionally, the Act allows for significant sharing of information among prudential regulators and the Bureau. The Bureau is also required to share its reports of examination with state prudential regulators but the Act does not require state prudential regulators to share information with the Bureau.

Subpoena and Civil Investigative Demand Authority. The Act provides authority to the Bureau to issue subpoenas for documents and testimony. The Bureau may also issue civil investigative demands ("CIDs") compelling the production of documents, responses to interrogatories, or testimony of witnesses prior to instituting any legal proceedings. The Act does not limit who the Bureau may issue CIDs to, and because the Bureau has enforcement authority over service providers that may serve Community Financial Institutions, these institutions may find themselves subject to these CIDs in the course of a Bureau investigation. The Bureau is required to describe the nature of the conduct constituting an alleged violation and the provision(s) of law applicable to such violations.²⁴

Finally, it is unlikely that any new agency charged with drafting its own rules, will limit its own authority beyond the limitations set forth in the Act. Accordingly, any lack of clarity with respect to the power of the CFPB will be interpreted in a manner that affords the agency the maximum degree of authority. Consequently, potential investors in financial services firms must assume the proposed exclusions are illusory. In consequence, small financial services firms will face a substantial impediment to attracting capital while the full scope of such a powerful new regulatory regime is unknown.

²⁴ *Id.*

**Item C: The Link Between the Effects of Dodd-Frank on
Small Institutions and the Ability of Small Businesses to Secure Loans**

The ability of a small financial institution to offer loans is directly related to its capital. Under current capital ratio rules, small banks have an obligation to have Tier 1 regulatory capital equal to at least eight per cent (8%) of its assets. More than 240 U.S. banks have been closed in the period between 2008 and 2010, with more expected to close in the near future. The majority of these banks were closed because they had insufficient capital to operate.

The main reason banks have deficient capital is due to losses against capital resulting from unpaid loans or non performing loans that under current regulatory rules must be written off because of the uncertainty to recover even from pledged collateral. Once a bank enters into a spiral of loan defaults its capital is eroded below levels accepted as “well capitalized” in order to operate the bank in a safe and sound manner.

The ability of small institutions to attract capital has a direct correlation with the investor perception that any investment will have an attractive return of return that is subject to a reasonable degree of risk. It is unclear how anyone invests to recapitalize or capitalize a small financial institution when the risk to capital cannot be measured as a result of the uncertainty of how Dodd-Frank will affect the performance of the financial institution target of a rational investment. It is clear that *uncertainty kills capital attraction or investments in other financial vehicles*. In general and as describe above, for small business to secure capital as either equity or debt, providers of capital require certainty. In many cases, because of Dodd-Frank, providers of capital have a fiduciary duty not to invest in the current environment.

**Item D: The Interaction of Dodd-Frank and Current Regulatory Requirements and
the Effect This has on the Ability to Conduct Business**

Capital Creation and Job Creation will Suffer

Business is conducted with the primary objective of generating revenue, creating wealth, and efficiently granting investors a reward for taking monetary (investment) risks. Business is not conducted with the social objective of creating jobs. Job creation is a byproduct and consequence of capital investment, execution of a business plan, and efficient management. If the framework for investing in a business is impaired or removed, investor will be unlikely to invest with the expectation that the object of the investment is the creation of jobs. Rather, a prudent investor will rapidly exit any enterprise that is burdened by unclear regulation. The potential adverse consequences of the Act with respect to the conduct business have even been criticized by some of the regulators to which Dodd-Frank has delegated expansive authority.

SEC Commissioner Kathleen L. Casey has provided the following insightful

comments on “The Regulatory Implementation of Dodd-Frank,”²⁵ which are summarized as follows:

Severe Reduction in the Size of the Pool of Investors

For primarily smaller corporate issuers, capital formation will be affected by decreasing the pool of eligible accredited investors in small business through private placements under Regulation D, as a result of the removal of the value of an investor’s primary residence from the calculation of an investor’s net worth. Significantly affecting the ability of small business to raise small amounts of working capital to either grow an existing business or start a new business. Without working capital it will be impossible for any business owner to pay help and therefore the job market will see unemployment raise at levels not seen in the history of this country.

Capital Creation Decimation - IPOs to Suffer Significantly

Going public has historically been viewed as a significant and positive step in the lifecycle of a company. IPOs have been viewed as opportunities for companies to gain access to large pools of capital that will enable the company to grow in directions that may not otherwise have been possible. IPOs have also been viewed as enticing opportunities for investors to share in potentially outsized rewards associated with investing in young, dynamic, growing companies.

To the extent that a result of the new law’s requirements and the SEC’s rules is that the costs of being a public company are greater than the benefits, some companies that may have sought to expand through a capital infusion may choose not to expand.

Private markets are inherently less liquid than public markets, which can result in a “liquidity discount” in the price paid by investors for their securities. Moreover, because purchasers of privately placed securities do not benefit from liquid markets, retail investors have far fewer opportunities to invest in earlier stage companies with significant growth opportunities, and instead are largely relegated to investing in more mature, lower-growth public companies.

Small Businesses in the U.S. are Placed at Worldwide Disadvantage

In particular, to the degree that Dodd-Frank has overreached and increased the overall burden and cost on our financial markets, our competitiveness may be unduly harmed. Indeed, it remains to be seen whether Dodd-Frank will place the U.S. in a first mover advantage or disadvantage in our regulation of markets, like the OTC derivatives market. How the SEC and CFTC implement these new provisions will be particularly relevant to that outcome.

²⁵ See, e.g., Kathleen L. Casey, “The Regulatory Implementation and Implications of Dodd-Frank.” Directors’ Forum 2011 speech, San Diego, California, January 23, 2011. Available at <http://www.sec.gov/news/speech/2011/spch012311klc.htm>.

If addressed imprudently, we may end up with a highly prescriptive regulatory regime and no regulatees. Not only will our competitors in Asia and Europe be more than happy to have the business, and the jobs, we will make it more difficult and expensive for American companies that use derivatives to hedge their business, interest rate, credit, and currency risks.

As a result, there is a real risk of overcorrecting for perceived flaws in the financial system, and imposing costs and burdens on the market that may not lead to improvements in the market.

Loss of Jobs in the U.S.

Regulation or limitation of compensation for talent, that otherwise would drive growth to companies smaller than the big corporations, will result in the lack of interest of talented management who will prefer to either remain in big business or become uninterested because of the lack of compensation incentives. The net result will be for management to either remain in big business or rather seek another country where the true value of services can be earned. What is more alarming is the loss of jobs in the U.S. as smaller companies will choose to settle in more friendly countries, resulting in the loss of American jobs, the unintended transfer of talent to Latin America, Asia, and Europe, and the transfer of American wealth to other countries.

Item F: The Effect of the Current Regulations on Small Financial Institutions and the Ability of Small Business to Operate

The U.S. Regulatory Structure Is Not Competitive

On May 20, 1997, the United Kingdom realigned its financial services regulation and created a new regulatory body that would ultimately be named the Financial Services Authority (“FSA”). Shortly thereafter, the United Kingdom centralized the regulation of securities, futures, currencies, commodities, banking and all other significant financial services under this new regulator. In 2000, the Financial Services and Markets Acts were promulgated further consolidating regulatory control into the FSA in addition to requiring principles based enforcement policy. The net result of this consolidation was the creation of a highly effective balance of regulation and business opportunity.

In the United States, the world largest financial services economy, there has been a pronounced lack of evolution in the regulation of the industry. No significant structural changes with respect to the regulation of the financial services industry have occurred to streamline the regulatory regime, and Dodd-Frank is merely more regulation added to an archaic regulatory model. As a consequence of this archaic structure, separate regulators exert authority over the equities, futures, and banking activities. These differences compounded by state and federal levels of enforcement, result in conflicts between U.S. regulators. The addition of the CFPB into the regulatory mix will only exacerbate these problems.

Similarly, the bifurcated regulatory model for products regulated by the CFTC and the SEC, has historically produced compromises of alarming restrictiveness. The Shad-Johnson accord of 1981 (codified in 1982) generated a deleterious compromise by simply banning the trading of single stock futures for decades. Recently, the Commodities Futures Modernization Act lifted that ban, but under intense lobbying from the New York Stock Exchange it merely accommodated a compromise to codify duplicative regulation to allow single stock futures trading under margin rules designed to render the products inferior to actual equities. This increasingly cumbersome and bifurcated regulatory structure is proving inimical to the U.S. capital markets.

Possibly, the most significant and damaging regulatory change in the U.S. since the passage of the 1934 Securities Exchange Act and prior to Dodd-Frank was the enactment of Sarbanes-Oxley (“SOX”) in 2002. Passed in the wake of the Enron and World-Com debacles, SOX was designed to enforce stricter accounting and financial controls through greater punitive consequences for corporate misdeeds. Although the intent was noble, SOX is a heavy burden to U.S. corporations and enterprises that are indeed good corporate citizens. The burdens of SOX are particularly pronounced for smaller publicly traded companies.

The U.S. and the UK share common bonds of law and culture. The net result of the rising competitiveness of the UK’s market structure, versus the decline of the competitiveness of U.S. market structure, coupled with those natural commonalities, are causing a flight of talent, listings and capital from the U.S. markets to the UK markets. Prior to the introduction of SOX, 24 of the 25 largest IPOs occurred on U.S. markets. Following promulgation of SOX, 24 of the 25 largest IPOs have occurred on exchanges outside the U.S. Since the implementation of SOX, voluntary delistings of companies, foreign and domestic, have increased dramatically.

Conversely, the European Union, a leading competitor with the U.S. financial markets, has taken great strides to unify a largely fragmented financial market by means of the adoption of regulatory regimes like the Markets in Financial Instruments Directive which coordinates the regulation of the financial markets in Europe under a regime of laws adopted by each member of the European Union. Similarly, competitors in other jurisdictions such as Hong Kong and Singapore are making great strides in the development of regulatory regimes that are designed to encourage the capital formation process while protecting the integrity of the capital formation process. Not surprisingly, Hong Kong and Singapore assumed the top two rankings on the Heritage Foundation’s 2011 Index of Economic Freedom.²⁶ Other jurisdictions such as Brazil, Russia, India, China, Panama and Australia are increasingly important as capital continues to seek jurisdictions with a credible regulatory model that also include the requisite degree of certainty.

²⁶ <http://www.heritage.org/index/>.

Conclusion

Dodd-Frank is the most important piece of financial services legislation in nearly a century. Unfortunately, the Act lacks the necessary specificity to guide investors and financial services firms that will be subject to the legislation. More importantly, following the financial crisis of 2008 – 2009, Congress missed the opportunity to address the archaic regulatory structure of the U.S. financial services industry. We recognize our regulatory structure is untenable, but rather than correct it, we seek to bandage it by piling nebulous regulation on top of archaic and restrictive regulations.

Financial markets have existed for thousands of years and history reveals that imperfections caused by certain aberrations like fraud swiftly correct themselves when left to market forces. Trying to create a system where prevention of financial cataclysms is addressed by massive legislation where rules are undefined and unlimited authority is granted to government agencies to “legislate” over a dynamic ever changing financial landscape is tantamount to directing economic production from a centralized government. The approach of the Dodd-Frank leaves U.S. capital markets at a substantial disadvantage to competitors in Europe, Brazil, Russia, India and China who are developing regulatory models for the next century.

Ambiguous regulatory regimes such as Dodd-Frank, ultimately will fail to satisfy their intended purpose because they chase an increasingly dynamic economic and financial environment where borders are no longer an impediment to capital investments and transactions take place through electronic portals. Free markets are meant to function as a place where winners and losers exchange value. Participants that are unable to compete should be allowed to fail without the intervention of laws attempting to salvage the enterprise or giving the appearance that the government can and will choose winners and losers. Dodd-Frank gives unbridled authority to the agencies to pick winners and losers at their own “discretion.”

As this Committee works its way through these various public-policy issues, I would welcome the chance to elaborate on my testimony, and to contribute in the most constructive way possible to this important dialogue.



Respectfully submitted,

John M. Schaible

United States House of Representatives
Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:	2. Organization or organizations you are representing:
John Schaible	Atlas Federal Holding Corp
3. Business Address and telephone number:	
	
4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?
<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No	<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
6. If you answered yes to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.	
7. Signature: 	

Please attach a copy of this form to your written testimony.