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Daniel F.C. Crowley, J.W. Verret, Todd J. Zywicki
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PAIGE V. BUTLER: Let me introduce our moderator for this session, Geoff Lysaught. He is from the group who moved with us from Northwestern, and he is in charge of the Searle Civil Justice Institute, our long-term research arm. So, I will turn it over to Geoff and let him introduce everybody.

GEOFFREY J. LYSAUGHT: Great, thank you Paige. Well, today’s last session is sort of some emerging perspectives on the Dodd-Frank Wall Street Reform and Consumer Protection Act. I suspect this is a topic that you will be hearing a lot about, not only over the course of today but over the course of the next several years. I think we are just beginning to scratch the surface on what will probably be a very deep pool of litigation activities that will ultimately make their way in front of you. So, we have a great panel here.

One of the members of the panel will be here shortly; that’s Dan Crowley. He is a partner at K&L Gates, but we also have with us, two distinguished gentlemen: an Assistant Professor of Law, J.W. Verret, from George Mason University and Professor Todd Zywicki who you are also already familiar with. He promised that he will not encourage any more Jerry Springer moments on any future panels. So, J.W., take it over.

J.W. VERRET: Well, thank you and thank you, Henry, Paige, Geoff, Karen, all the rest of the LEC, and everyone else for putting this great event together and for allowing me to join you here. I am a connoisseur of political cartoons. Let me describe two of my favorites to you; although, I can’t surely do them justice. One of them shows a road up on a cliff that has a very small shoulder and a sharp drop on a cliff, and Barney Frank and Chris Dodd are in a road construction truck, and they’re going along putting down fences and each post alternatively says, “Dodd,” “Frank,” “Dodd,” “Frank.”

One of them says to the other one, “Thank goodness that we’re able to put this fence up to keep investors from going off the cliff in the future,” and Barney says, “Well, hey, what about the fencing in between the post? Shouldn’t we put that up?” And Chris says, “No, no, no, don’t worry the regulators and the lobbyists are going to come along in the next few years and put those up for us. So, it should be okay.”
There’s another one where it shows one scene of a Capitol Hill security guard all in a panic saying, “There’s an earthquake! There’s an earthquake!” And the next scene shows a hallway with a giant stack of papers on the floor, and in front of it is an intern that’s fallen on the floor in front of the three-foot-tall stack of papers. And Barney Frank is leaning out of his office and he says, “Hey, haven’t I told you don’t run in the hall while you’re carrying the Dodd-Frank bill because it’s going to cause a ruckus?”

So, a very big bill, a very expansive set of new rules to govern financial regulation. In fact, the specific set of rules I’m going to talk about, the corporate governance area, in its own right would have been sweeping, right? But it was housed in such a huge omnibus bill, such a death star of a bill, that it largely went unnoticed as all the other provisions went through. So, I’ll focus specifically on the securities law and corporate governance aspects and mention briefly as one area that I think is particularly controversial in which I have specialized.

First, one of the requirements that Dodd-Frank includes will be to require a so-called “say on pay” advisory vote at publicly traded companies. Now, this will mean that between every one and three years, shareholders will get to vote on the pay packages of the companies in which they own investments. The vote will be advisory. It will not be a binding vote, but a very specific set of executive compensation policies, including the triggers for bonuses, all that will need to be voted on by the shareholders. The United Kingdom has had say on pay for quite a while. It’s been a fairly sleepy affair over in the U.K., but the type of shareholders the U.K. has is very different from the United States. The United States has a set of very politically powerful shareholders in union pension funds and in state government pension funds; the corporate defense community will say they are the boogey man and they are going to abuse their powers.

They will say, “No, we’re solely interested in maximizing shareholder wealth. It’s not about political conflicts for us.” Though, they are run either by union managers or state-elected officials. I think the truth is probably somewhere in the middle, and certainly, the political conflicts of these institutions are going to inform their votes and inform the bargaining that they use these votes to accomplish. It will also require a say on pay vote on golden parachutes. These are change-of-control bonuses that really facilitate the market for corporate control. Firms will have to put those say on pay, those golden parachutes to an advisory vote as well.

The big kahuna here is proxy access. This is the most heavily argued over, most fought over corporate governance provision in Dodd-Frank. Now, this will give the shareholders who have at least 3% of the shares, either individually or as a group, and who have held those shares for three years, the right to put nominees on the corporate ballot that the company pays for. This will make it a lot easier to institute proxy fights for a minority representation on the board for up to a quarter of the board directors.
So, that means the AFL-CIO and the California pension fund, who by the way, were two of the most vocal proponents of this provision, will be able to put AFL-CIO and California pension fund representatives on the board of directors of publicly traded companies. This is a very contentious issue that the Chamber of Commerce and the Business Roundtable have filed suit under various provisions, including a First Amendment challenge, and the litigation is ongoing. The D.C. Circuit is looking into this. The SEC had a rule implementing proxy access, but they stayed implementation of the rule while litigation is ongoing.

So, we’ll see what happens with proxy access, but it is probably the most controversial and the provision I think most likely to be litigated over and over in the future at particular contests. So, we will keep an eye on that and after finishing this overview, I want to go back to proxy access for just a moment to talk about some of the work I have done in that area.

Compensation committees: each board of directors has a compensation committee that sets the compensation for the executives. There’s an added disclosure required. There’s a new requirement that the compensation committee be independent, and, also, some new provisions requiring disclosure of the consultants that work for these committees and the types of arrangements that these consultants have with the compensation committees of the board. Clawbacks are also going to be required.

So now, as a result of Sarbanes-Oxley we have clawbacks in certain instances. In other words, if an executive gets a bonus, as a result of some accounting irregularities that later required a restatement, and that executive did not really deserve that bonus, and they are the reason why the accounting was wrong in the first place, it does not seem fair to give them a bonus.

Sarbanes-Oxley in 2003 already gave us some new laws requiring they pay that bonus back, or the company claw that bonus back. Well, the new Dodd-Frank provision extends clawbacks much more widely to any executive who gets a bonus, who did not participate in the accounting irregularities at all, but they just got a bonus because some earnings target was hit, that was not really hit, but was the result of some accounting irregularities. Even if the executive did not participate in the accounting problems, in the wrongdoing that led to the misstatement, and did not fail to oversee people—in other words, did nothing wrong—they will still get their bonus clawed back.

That will make it difficult to have people feel secure in their bonuses. So, for three years after they get a bonus they will have to worry, “Maybe my bonus will get clawed back sometime in the future for something I had nothing to do with.” So, that’s a really controversial provision. There are some enhanced disclosures about executive compensation, particularly about internal pay equity.

Companies are going to have to show ratios of the highest paid workers to the average paid worker. This is going to be particularly difficult to implement for companies that have a lot of international employees, all
around the world, for whom a lot of compensation is not direct cash compensation, but is instead, indirect compensation; this is also particularly difficult for a lot of outside contractors and part-time employees. There will also be enhanced disclosure of employee and director hedging, whether or not a company allows an employee to hedge positions in the firm.

We want employees to hold—particularly high level executives—to hold options in a company so that they get a piece of the upside if the company does well. But, of course, there are lots of different financial instruments you can use to hedge positions that you take. So, the SEC under Dodd-Frank is going to implement new rules to enhance disclosure about employee hedging. That is going to be tricky, of course, because even if you just buy treasury bonds, that in some way hedges interest rate risk at a particular company. So, the SEC will have to think about what is a hedge and what is not a hedge.

Those are two types of animals that are very similar but have slightly different feathers. Also, new disclosure will be required about separation of the chairman and the CEO positions. Now, this is a bugaboo that has been coming up for the last fifteen or twenty years. And finally, now the rule is, rather than mandating separation of CEO and the chairman position, Dodd-Frank requires disclosure about it. Now, there’s no evidence to suggest whatsoever that there’s a change in earnings between companies that have the same CEO and chairman and those that have a separate CEO and chairman; but there will be disclosure about it nevertheless.

So, with respect to proxy access, I want to talk a little bit about where I see the future of proxy access going. The litigation that the Chamber of Commerce will bring against proxy access is uncertain. I am not sure what will happen or not, but I do know that even if the Chamber wins the SEC does have the authority to issue a proxy access rule even if it does not have the authority to issue the one it did. So, we’ll see on proxy access. It’s just a matter of what form it will take; and the next step that boards of directors will take is to defend against proxy access.

In instances where they feel like the conflicts are overwhelming, and the conflicts are going to damage the value of the company, and they are going to hurt other shareholders, boards of directors are going to feel obliged to defend against a hostile nomination. There are a couple mechanisms that could be used and a couple mechanisms that I’ve invented to defend against hostile proxy fights. And so, I’ll just talk about a few of them.

Number one, you can put into the bylaws of your company, qualifications for service on the board. The SEC gets to say who goes on your proxy statement or not, but state law still controls qualifications for service on the board. So, even if the SEC makes you put someone on the corporate proxy, and even if they win the election, if they do not meet the standards for qualification for service on the board, then they do not get to sit on the board; and I think that it’s all in the how you draft those qualifications.
Members of the board of directors are very interested in getting directors and officers insurance against personal liability under the securities law and state and corporate law. They are also very interested in being indemnified by the board. I see no reason why the board of directors should feel obligated to indemnify or insure members of the board whose election it did not support. Boards work by committee, issues are delegated to committee, and the boards get to decide who serves on the committee. I see no reason, if you feel like a conflicted director is going to damage your firm, why you should not keep those conflicted directors off the key committees and why you should not delegate more decision making to those committees.

And finally, there are a number of other types of mechanisms that we have already seen in a hostile takeover context used from time to time: poison pills, proxy puts, mechanisms that simply limit the ability of a challenger to make a hostile tender offer. Those mechanisms can also be adapted, I think, to proxy fights. And so, I think the design is useful. I think under state law, most of these will be upheld, and I think that the proponents of proxy access are going to be hopping mad about these provisions; at least if their response to my papers about it is any indication, they are already hopping mad.

They do not like me very much and have issued corporate governance alerts to all the union pension funds in the country. So, I see the potential for litigation about this in both federal and state courts, not just the SEC’s right to issue proxy access, but all the variety of defenses the boys are going to come up with including, hopefully, a few of the ones that I have invented. So, I see for all the members of the judiciary here, I think there will be plenty of other things for you to do.

Members of the board, I think there will be plenty of things for you to implement in response to that particular provision of Dodd-Frank, which I think is the most far reaching corporate governance provision of Dodd-Frank. I’ll turn it over now to my colleague.

**Geoffrey J. Lyons:** We are going to go to Dan next.

**Daniel F.C. Crowley:** The Dodd-Frank Act embodies a fundamental shift in policies with respect to capital markets generally. And I always like to use pictures wherever possible. This is a picture of the fall of the Berlin Wall, which really symbolizes the era of free market capitalism that came in the post-Reagan years.

In the Emergency Economic Stabilization Act of 2008, TARP, and all of the other policy responses to the credit crisis, we have essentially entered an era of government-managed capitalism, and that’s true globally. I am going quickly give you some context, at least from my perspective, on implementation of Dodd-Frank; from the standpoint of a financial services lobbyist that spends most of his time up on Capitol Hill. This is the con-
text. If you recall in October of 2008, most of the discussion was about systemic risk. In my opinion, that is a red herring.

When I was in business school, it was called systematic risk and it was the kind of thing you tried to diversify away from, but now, the government, in its infinite wisdom, has concluded that it can manage systemic risk, and that really is the overarching focus of Dodd-Frank. There were concerns about gaps and redundancies. Our financial services laws have evolved since the 1860s with the National Bank Act piecemeal. In the ‘20s and ‘30s we had enactment of the ’33 Securities Act, the ’34 Exchange Act, the 1940 Investment Company Act, and so forth, and so on, all were discrete efforts to deal with financial services.

This is the first time in history that Congress has taken a look at all of it at the same time and revisited it, simultaneously, with an eye toward filling the gaps. Remember Bernie Madoff and the fact that the SEC missed it, FINRA missed it, and there were also redundancies or overlapping jurisdictions, particularly in the banking agencies. So, the orientation and the policy response, predictably, was comprehensive legislation. The headlines say it all—July 21, 2010 ushered in the era of Dodd-Frank. And it set in motion an unprecedented amount of rulemaking. We have never seen anything like this. The last major financial services law before Dodd-Frank was Sarbanes-Oxley a decade ago.

That had, I’m trying to recall, fifteen to twenty rulemakings. Dodd-Frank has 315 rulemakings by our count, and, by the way, this is just the substantive rulemaking. Other law firms count it differently. These are both the mandatory and permissive substantive rulemaking and there are another 145 study requirements. Notice that 140 of these rulemakings are in the area of OTC derivatives and swaps. Title VII creates a whole new regulatory regime for swaps, largely in response to the credit default swaps that were the fundamental issue at AIG.

With respect to timeframe, some of it had to be done immediately. The Federal Reserve, for example, had to issue interim final regulations—if that is not an oxymoron—within ninety days of enactment, with no due process, and no notice or opportunity to comment. The Fed, to its credit, did reach out conscientiously to members of the regulated community and essentially created their own due process. But that was a very interesting provision in which the independent appraisers managed to get a requirement that the Fed promulgate rules on customary and reasonable appraisal fees without regard to whatever appraisal management companies might now be charging.

So, Congress carved out 70% of the industry and mandated that the Fed establish customary and reasonable fees with respect to what is essentially an archaic business model—but that’s what you get in Dodd-Frank across the board. One of my favorite expressions is that a camel is a horse designed by Congress. There is no better example than Dodd-Frank. And the judiciary, frankly, is going to be busy for years with this one.
This is one of the most fundamental aspects of Dodd-Frank that, in my opinion, has not received proper attention, which is the creation of a super regulator in the form of a Financial Stability Oversight Council (FSOC). The Secretary of the Treasury is depicted here as King Arthur and the FSOC as the Knights of the Roundtable for the very simple reason that the FSOC, as it’s now being called, requires two-thirds vote to do anything, and one of those votes has to be the Secretary of the Treasury. So now, de facto, he is the most influential regulator in Washington with respect to financial services, and I have yet to see a single press story making that point.

This is a depiction of what I believe is in the offering in terms of the implementation of Dodd-Frank. There are so many ambiguous provisions or provisions left to the discretion of the regulators, that everyone who is represented by lobbyists is going to be engaged in many cases in a zero-sum game in terms of how the regulations are written. These are the key reform issues. This roughly tracks Dodd-Frank—there are about fourteen, I guess sixteen titles. These are basically the issues by title in Dodd-Frank.

Some of the notable ones, in addition to OTC derivatives, which is my favorite, far and away of the whole bill, and we have already heard a very good presentation on the executive compensation and corporate governance provisions. Municipal securities is another area that an entirely new regulatory regime is being created for advisors to municipal securities and to municipalities who issue securities because of what happened in Jefferson County, Alabama. Insurance is sort of the sleeper issue here. Congress could not achieve consensus on what to do about federal regulation of insurance.

So, they have laid a number of pieces of the foundation for federal regulation including creation of an office of insurance at the Treasury, which has subpoena authority but no real mission other than to gather information. That is clearly foundation laying for rethinking insurance going forward. Preemption—we could spend an hour talking about the preemption issue alone. I won’t. Let me move on to what I believe are the implications of Dodd-Frank so far.

We historically, have had two competing schools of regulatory thought with respect to the financial markets: the capital markets approach, which is based on transparency and allowing investors to make informed investment decisions for the efficient allocation of capital, on the one hand, versus the banking model of safety and soundness, on the other hand. I would suggest to you that what we have in Dodd-Frank is the triumph of safety and soundness over the capital markets model. That is most obviously reflected in the FSOC where the SEC and the CFTC are now outnumbered by banking regulators in a sort of co-equal body.

The focus of policy in the new era is on harnessing the wealth that markets create, as opposed to the focus in the free market system, which is creation of individual wealth, and the implications for that are littered throughout Dodd-Frank. The focus on executive compensation is one, em-
powering the Fed to basically engage in utility rate making with respect to debit card interchange fees, without consideration of the cost to the plant and equipment, which is probably unconstitutional, and at least very controversial. Customary and reasonable appraisal fees I have already mentioned.

Concentration limits for financial institutions to make sure that nobody gets too big—arbitrarily, by the way—that is 10% of the size of all financial deposits. And then, consolidated supervision by the Federal Reserve. The idea here, is that once the FSOC designates an institution as large enough and integrated enough to warrant supervision by the Federal Reserve as essentially a holding company; it means that the Fed will now have authority to police all of your activities, even in subsidiaries that formerly had been regulated by, say, the SEC.

Take for example, an insurance company that has a mutual fund subsidiary. If it is big enough to be designated for supervision by the Fed, the Fed will now have the ability to supervise the mutual funds.

I'll go through very quickly the implications of the election. Not a single House Republican voted for Dodd-Frank, and only three Republicans in the Senate. And of course, we had an election which means that now Republicans will have the oversight gavel. There really is no real legislative history on Dodd-Frank. There is a Senate Banking Committee report on an earlier bill, but nothing authoritative to help with the Congressional intent on any of these ambiguous provisions. What that suggests is that the Congressional intent is essentially whatever the person holding the gavel of the oversight committee says it is. So, we are going to most likely have Spencer Bachus; Edward Royce is challenging him. We will find out this week who chairs the committee. The subcommittee chairs are all going to have considerable influence over the regulators during implementation. Scott Garrett, probably the most important, as Paul Kanjorski’s successor at the Capital Market Subcommittee.

Jeb Hensarling will not only chair the Financial Institutions Subcommittee, but he’s already been elected House Republican Conference Chairman: the fourth highest ranking position in House. And, of course, he was also on the Congressional Oversight Panel with Elizabeth Warren, who chaired it, and is now at the Treasury helping to implement CFPB; Jeb has told me that Tuesdays are reserved for CFPB oversight. In addition, the oversight committee, will have Darrell Issa as Chairman. He has asked each of his subcommittee chairs to hold no fewer than two hearings a week. If you do the math in the next year, that is about 240 hearings that the Administration can look forward to.

On the Senate side, Tim Johnson will most likely be Senate Banking Committee Chairman; Richard Shelby will be a strong ranking member who also very strongly opposed Dodd-Frank. Here are the takeaways: I think, looking at it at a macro level, Dodd-Frank really is a function of the
ratchet effect of government involvement in business for all financial services participants. Government is now effectively a partner, and I think a necessary facet on every strategic business plan going forward. The fundamental aspect of GOP oversight is going to be a requirement that all regulations have a cost–benefit analysis, which is not required in any way by Dodd-Frank.

And then you will see, I think, more nationalism and increasing protectionism. We are already seeing that in the fight over currency exchange rates. In Europe, they have basically said, “If you want to run a hedge fund in Europe, you have to have a European presence if you want to sell to European customers.” Sovereign wealth funds—you can think through the implications of the politicized markets when governments have their own money at stake. I am giving you this as a resource.

The firm, K&L Gates, is a global financial services firm, and what we have done with any of the issues that have come up through Dodd-Frank, is to have our experts prepare alerts that are publically available on our blog, which is www.globalfinancialmarketwatch.com. I hope that has been helpful.

**Geoffrey J. Lysaught:** Todd?

**Todd J. Zywicki:** I am going to primarily talk about the Consumer Financial Protection Bureau (CFPB) and the Durbin Amendment, which becomes part of that. And my story is that there was a lost opportunity to do something useful, and some of the things I’m going to talk about today I am also going to talk about at a more conceptual level tomorrow.

I think there is a real need to improve our consumer protections system when it comes to dealing with consumer credit. I think that simplicity is a real need; streamlining and one integrated consumer protection regulator, I think was a good goal. Certainly, one mortgage disclosure form was a good goal, and it would be great if the CFPB going into effect would do that, but unfortunately, I do not think it is. I think that what they have created is a monster that’s going to be contrary to the goals that we would have liked to have seen, which would be more simplicity, more competition and the like, for consumers.

So, I’m going to talk about what I see as the three major defects in the CFPB, which I hope will eventually be rectified, because I think they are laying the inevitable foundation for a train wreck down the road. The first one is the structure of the CFPB. Now, if you had sat down and tried to create a model of a bureaucratic monster that would be subject to every bureaucratic pathology that scholars and regulators have identified over the past thirty years, it would look exactly like the CFPB does.

It is as if the people who created this went to sleep during the Nixon Administration and woke up and basically kept doing the exact same thing we were doing thirty-five or forty years ago, without any recognition of
what we know about regulation and the regulatory process that we knew then. The way the CFPB works is it creates a one person director, appointed for a fixed five-year term, removable only for cause. The provisions affecting the deputy director are probably unconstitutional, at least as it will play out under the PCAOB Act. But it creates a one person director, and so, it basically is driven by whatever that one particular person decides to do.

It is housed inside the Federal Reserve, but is basically independent of the Federal Reserve. So, what they have done, is they have created an independent agency inside of another independent agency, which is relatively unprecedented, I think. It is very difficult to get oversight—it has a guaranteed budget. Basically, every year, the director of the Bureau simply sends a budget demand to the Federal Reserve Board, and the Federal Reserve Board must grant the budget demand as long as it is no more than 12% of the revenues of the Federal Reserve—no questions asked. It has a narrowly-focused parochial mission just on consumer protection related factors.

Finally, any regulation or decisions made by the CFPB can only be overruled or prevented by a two-thirds vote of the Regulator Council, and only if a decision of the CFPB would threaten the safety and soundness of the American financial system or the stability of the financial system. Two-thirds is a very high standard. Now, what they have done is created a perfect storm of conditions for the worst of bureaucratic pathologies as we have come to understand—they will have almost a tunnel vision focus on the Agency’s regulatory mission at the expense of all other missions. Excessive risk aversion will be likely, in terms of the impact it will have on dampening innovation and that sort of thing. And there is a real threat here of agency overreach to try to expand into other worlds, in addition to a real threat of capture by interested parties, such as big banks and the like.

What all that adds up to, is the big problem that this agency simply is not set up to do the most important thing that should be done by a consumer protection bureau, which is they should be able to balance the tradeoffs involved in consumer protection; which is balancing consumer protection goals, against other goals such as access to credit, competition in markets, and price for consumers.

I’ll give you an example: think about professional licensing under lawyers or doctors. What you can think about there is, yes, higher standards for becoming a lawyer might protect consumers. The evidence is not clear. At least it does not seem to be, but you can imagine how higher licensing could protect consumers, right? But at the same time, if you have higher licensing requirements, you have a lower supply of lawyers, and you increase the price for lawyers. There is some tradeoff there between consumers getting a lower price and more choice in lawyers, versus perhaps, consumer protection of licensing.

That is riddled throughout here, but the Agency is not set up in order to do that when it comes to, say, mortgage brokers, what kind of mortgages
will be sold, and that sort of thing. Now, this especially jumps out at me because as I said earlier today, I worked at the Federal Trade Commission. The Federal Trade Commission, up until now, has been the sort of main consumer protection agency of the Federal Government. The Federal Trade Commission is set up completely differently from how this is set up and it is set up specifically to process these sorts of trade offs. So, the FTC is set up with a five member bipartisan commission, so it brings different perspectives on these sorts of things.

It has an institutional balance internally between the Bureau of Competition, the Bureau of Consumer Protection, and the Bureau of Economics. And so, basically what you get is a sort of rivalry within the Agency at the Commission. Colloquially, if you were to take an alumnus of the Bureau of Consumer Protection and make them an independent agency with the authority to sue anybody they want to, pass any regulation they want to, impose fines, very high fines, do you think that would be a good idea? I think almost anybody who has worked at the FTC would think you had lost your mind. If the Consumer Protection Bureau could just run around suing anybody and passing regulations, soon, they would be out of control. And so, it works better with a five member bipartisan commission in line. But that is exactly what they have done here. They have created that farcical consumer protection agency that I described.

A second problem is the vagueness of a lot of these regulations to be filled in later. “Abusive” is a good example. The regulation gives the CFPB the power to go after unfair, deceptive, and abusive problems. “Unfair and deceptive,” although they seem vaguely defined, actually are just taken from the Federal Trade Commission definitions, and they have gotten cabined over time. Abusive is much more problematic; it is not clear what abusive means. As Dan noted, there is no legislative issue. Nobody has any idea where the concept of abusive came from. It just springs into the bill. If you look at the language, it is kind of hard to tell, but what it seems to suggest is that it would now give the government the power—obviously it means something other than unfair and deceptive, right? So, it is not just a matter of disclosure and making sure you are not defrauding people.

What abusive seems to mean in the regulation is some substantive level of understanding by consumers. That consumers actually substantively understand things, not just that you have disclosed it, but give them an opportunity to shop around, and that sort of thing. That is a real sea change in the way we think about consumer protection, number one. And number two, what it seems to suggest is that there are certain populations—for instance, who we should think of as being too stupid to be able to protect themselves—and these guys would get some sort of special protections under this, which of course means that these people will see less access to credit. It again, is not clear who would fit within that category.

Third, is the problem of preemption and arbitration, and Dan alluded to this. The idea here, is that it used to be that the federal banking regula-
tors could preempt state laws that they thought threatened the safety and soundness of the banking system. This law, Dodd-Frank and the CFPB, makes it much more difficult to preempt laws of consumer protection. Now, the logic here was that there was other enforcement of consumer protection laws. So now, the reason we were going to get rid of preemption is because we thought there was under-enforcement on consumer protection laws.

So, we needed to be able to turn the attorney generals and the state agencies loose on the banks in order to do it, right? The catch with that, is what? Well, we have gotten rid of that. We have created this new super regulator. Thus, it seems like we have gotten rid of the reason for getting rid of preemption, right? Because now, we have got this massive consumer protection agency that was the whole justification for getting rid of preemption in the first place. Instead, what we have now is both the new regulator and basically elimination of preemption.

And so, what we are getting is a piling-on effect where the idea of doing a coherent cost–benefit analysis of regulation, as this agency is set up to do very well, that problem is going to be exacerbated even more when you add on the fact that now state attorney generals are going to be able to pile on top of that as well. We see how this works in practice. The Searle Center has published work on so-called little FTC acts, which mirror the Federal Trade Commission Act, but what we see is states apply that very differently in a much more heavy-handed manner than the Federal Government does. So, we have gotten rid of the reasons why we did not want to preempt, and then, decided not to preempt anyway.

There are also provisions in here that would restrict arbitration. It gets rid of arbitration for mortgages and home equity loans when you enter into a mortgage. It also provides a provision for a study of arbitration in consumer credit contracts generally. How this can best be understood is really just a shop to class action lawyers—this basically is a way of giving them a new vehicle to pile on, still more, by getting rid of arbitration with respect to mortgages and the like.

Fourth, the big problem here is it really does nothing at all about the incentives that lay at the root here. But the underlying problem here really was not a problem of consumer protection, but the alignment of incentives that we saw here. Things like state anti-deficiency laws, cash-out refinanc- es, that caused people not to have equity in their home and that sort of thing. And in fact, what this actually does is exacerbates that problem. For instance, it requires a special notification if the consumer were to refinance their mortgage and thereby lose their protection of their state non-recourse or anti-deficiency law.

It eliminates prepayment penalties in a lot of mortgages and caps them in others, which, of course, makes it easier for consumers to refinance when their house goes up in value; which allows them to strip out their equity so that when their house price falls, they are going to more readily fall into
negative equity territory. The whole structure of the agency is set up on a particular theory about the financial crisis, which I think is only slightly correct, if at all, and is primarily wrong. What this illustrates is that they have failed to understand the moral hazard problems and the kind of problems that they are setting up. With some of these, they are just helping lay the foundation for the next financial crisis and exacerbating the things we saw over the past few years.

Final thing I want to talk about is the Durbin Amendment parts. Moving from the CFPB to the Durbin Amendment on credit cards and debit cards, which is the interchange fee regulation that Dan referred to. The interchange fee, you may recall, is the fee that the merchant pays when you swipe your credit or debit card.

The Durbin Amendment reduces interchange fees from 1.3% on the transaction, to 0.2% of the transaction. At this time, I've got to say two words to finish that up. First, the unintended consequences of this are obvious, which is they cap debit card interchange fees to now credit card interchange fees. Credit card interchange fees are higher than debit card interchange fees. All they are going to do, is they are going to cause people to move from debit to credit cards.

Finally, the last thing to talk about, to echo what Dan said, was this whole idea of this agency; the whole purpose is to redistribute wealth to merchants from issuers, and eventually from consumers. All of you now are going to have to pay for your debit cards instead. And it’s ingrained in this legislation, picking winners and losers by politics rather than by market processes, which I think is a really frustrating development.

GEOFFREY J. LYSAUGHT: Thank you very much. Why don’t we recirculate through the group. Any thoughts that were triggered J.W., as you listened to Todd and Dan speak?

J.W. VERRET: Sure. There were too many to mention when I listened to my colleagues, particularly Professor Zywicki, speak, and I think we often end up getting partnered on things. I think one of the thoughts that Professor Zywicki’s presentation triggered to me was the benefits of federalism and questions about preemption. He discussed the problems with the bill and that they do not permit federal preemption, and I want to draw out that distinction from my own side of things.

I’m generally a corporate federalism guy, right? I generally come at things from the point of view, that I support states as entities that charter companies and that govern the relationship between companies and shareholders. But at the same time, I tend to also support when the Fed, and the SEC at times, preempt state regulation. So, I want to make sure that schizophrenia has some kind of an intellectual basis.

And I think it’s simply this: when states charter institutions and states can internalize the cost of over-regulating those institutions, then, I trust the
states as sources of law in that respect; whereas, if states can bring an enforcement action or regulate an institution it did not charter, then I question the ability of states to internalize the costs of over-regulation and over-enforcement. I think that maybe adds some consistency to supporting the rule of states in chartering corporations, and even in chartering banks and regulating those banks that it does charter. But at the same time, it also speaks to the benefits of federal preemptions of state overregulation.

I will just call it the Eliot Spitzer effect. Essentially, the ability of a state attorney general to go after institutions with only the upside of bringing enforcement actions. I think if I was a Louisiana attorney general, and I saw a Texas bank that made a good target—and boy, whether or not they did anything wrong—I could go after them in court and say something about a complex banking regulation anyway. Why not bring a large expensive action against that Texas bank?

So, that might be one of those principles that I think ought to inform our thinking here, and I think regrettablly, was something where Dodd-Frank took the opposite approach. Where preemption was good, it didn’t allow preemption. Where preemption is bad, it went full speed ahead with all-out preemption of state law.

GEoffrey J. LySaught: Thank you. Dan?

Daniel F.C. Crowley: Well, I was thinking as Todd was speaking, that this is a unique regulator process. Typically, Congress passes a law, and the regulators go off, and interpret it, implement it with rulemaking in a linear fashion. I think this time, what we are going to see is much more circular.

Because of the absence of legislative history, because of the election, and people holding the oversight gavel who really do not like the law, you are going to see an unprecedented number of hearings, attempts to channel decisions by the regulators by calling them up and asking embarrassing or tough questions on the record, by little rifle shot amendments in various ways to try to clarify the legislative intent, by letter or colloquy on the floor. My favorite is withholding funding for agencies that do not quite get the intent of Congress, reflected by people passing appropriations bills.

But one example of this, I think, is the CFPB, because of the dynamic that Todd discussed with a single appointee who has all this power, not subject to review. The reason, by the way, why the CFPB is buried inside the Fed for funding is precisely to insulate it from annual Congressional scrutiny in the appropriations process. What has happened though, is that the President and his advisors concluded that Elizabeth Warren was not confirmable by the Senate, so he’s now appointed her to positions in Treasury and the White House, both of which are subject to annual funding pressures.
So, they set up an almost inevitable dynamic here where the Republicans not only are going to go after the funding for her position, but will block any effort to appoint a permanent director until they are able to make structural changes. So, I am going to go way out on a limb here and predict that as a condition for getting confirmation of who the President finally does nominate, it will be an effort by Republicans to revisit the composition of the CFPB along the lines of what Todd described by the five member bipartisan panel.

**GEOFFREY J. LYSAUGHT:** Questions from the group? Sir?

**AUDIENCE MEMBER:** Gentlemen, you certainly persuaded me that this is the same as the Bankruptcy Bill, which was so garbled after five years of study. Since you find nothing good in it, you imply that there was nothing wrong with our financial system, which required repair. And thus, could you tell me why our financial system collapsed, since it was so good before this bill was passed?

**DANIEL F.C. CROWLEY:** Fannie Mae, Freddie Mac, and mortgage interest deductions—I think we start there. Fannie Mae and Freddie Mac were not included in this bill. And frankly, it is a bit of a live wire. Republicans like to complain about it, but when they have the gavels and the White House, they find it’s a politically sticky wicket to undo that Gordian Knot, as much as the Democrats do. But Fannie Mae and Freddie Mac were not included in the bill at all, and I think it begins and ends at their doorstep.

**TODD J. ZYWICKI:** Well, some people here have seen me talk about this for at least an hour, but I will give the short version, as it relates to this. Basically the idea is, I don’t think everything was good with the financial system. Certainly, I do not think everything was good with the way consumer protection laws were written, as I said. But fundamentally, what drove this was misaligned incentives, and what we have ended up doing is diagnosing a safety and soundness problem as a consumer protection problem.

So, for instance, if I take out an interest only mortgage with no down payment in a state that has anti-deficiency laws, you can not collect against me when I walk away from my house. Then, my house goes down in value and I decide to walk away from the house. When I rationally respond to those incentives, that is not a consumer protection problem. We probably do not want to allow banks to make those loans. It is a safety and soundness problem. Why do we not want to allow banks to make those loans? Precisely because of the structured incentives that they set up.

What I think we needed to do is go in here, understand the structured incentives—whether it was Fannie and Freddie, whether it was Federal Reserve monetary policy—all these sorts of things created a system of in-
centives combined with moral hazard problems that these banks knew they were probably going to get bailed out. They have been getting bailed out for twenty years, going back to Continental, Illinois.

California today, knows it does not need to fix its budget because we are going to bail out California because it’s too big to fail. So, we have created this environment where banks rationally respond to doing incentives, consumers rationally respond to doing incentives, and this bill misdiagnoses almost all of that.

**Daniel F.C. Crowley:** It’s funny. The causes of the credit crisis, is sort of like a Rorschach test. People see different things in it. I do not disagree that the GSEs and the incentives were part of the problem. But from my standpoint, I think the fundamental problem was that banks did not appreciate the nature of the risks that they were assuming across the board. It was a lack of transparency on investor choices. There’s no doubt that there was a problem that needed correction, but it is interesting to me, the extent to which all of the previous work that had gone into trying to address capital market issues was ignored; there were a whole series of reports. The Treasury had a blueprint.

Hal Scott at Harvard had a whitepaper. Bloomberg and Schumer did one. It was about five of them. The last one was the G30 chaired by Paul Volcker that all said the same thing, which is, move to a more prudential model of regulation, streamline regulation, consolidate the banking regulators, merge the SEC and the CFTC. And the interesting thing to me about Dodd-Frank is that it does none of that.

**Geoffrey J. Lysaught:** I would be interested in your thoughts on this; sort of throwing rotten fruit at the actual legislation, and the process by which the legislation was created. We have teed up a huge fight for a future regulator process. When you think about investors or consumers of financial products, what, if anything, good can be attributed to this Act?

**J.W. Verret:** I would suggest the one good thing about proxy access is that it gives companies an opportunity to implement the defenses that I have designed. It gives people a chance to read my new paper on this in the *Journal of Corporation Law* coming out next month defending against proxy access and company defenses in the era of Dodd-Frank.5

**Todd J. Zywicki:** It’s hard for me to think of good things. When it comes to consumer protection, everybody agrees. I do not think I have seen a defender of the law question this. There’s no question that the impact that CFPB is going to have is to raise the price of credit and reduce access to credit. Defenders of the law do not question that. And, in fact, many defenders of the law say that is the point, to reduce access to credit. There was too much access to credit, right? So really, the only question then is
whether or not there is reason to raise the price of credit and reduce access to credit, a lot, or do it a little in places where the discretion lies in this.

There is a cycle of consumer protection in consumer credit over time that this fits into very nicely. The Durbin Amendment is an unmitigated disaster. Economically, it is utterly absurd. Everybody is going to pay more for debit cards. If you are lucky enough to consume other bank services, you might not notice it as much, but a lot of people are going to lose free checking. A lot of people are going to be forced to drop out of the banking system. It’s terrible economics, as I said.

It’s great politics because, as I said, it caps the interchange fees on debit cards but not credit cards, which means people are going to switch to credit cards, which have higher interchange fees. Well, within three months of this law going into effect, all the merchant groups are going to be back here spending millions of dollars trying to persuade Congress to extend price gaps to credit cards. And so, it’s beautifully phased in process for political purposes. Since I’m on the topic, I’ll just note how we ended up with debit cards higher than credit cards. So, they started with the economic engineering problem as to which would be easier to calculate, and then reversed engineered to put price caps on debit cards and not on credit cards. That is the only explanation I have been able to hear. As Dan noted, this is actually being challenged. The lawsuit has been filed, challenging the constitutionality of the Durbin Amendment in the Federal District Court of South Dakota.

I can see one good thing: there will be an integrated mortgage disclosure form that’ll make it easier for people to figure out what their costs are in mortgages. It’s easier for me to tell you what’s the worst provision in Dodd-Frank: I think it has to be in the investor protection provision—the whistleblower provisions which create a bounty for people to report securities law violations to the SEC. They can get somewhere between 10% and 30% of any recovery over a million dollars. And if that was not bad enough, we have added an anti-retaliation provision for employees. So, what we have done is created an incentive for your worst employees to not bring problems to the attention of the internal compliance department, but instead, to go to the SEC and file a complaint, where after their jobs are protected.

**Geoffrey J. Lysaught:** Any other questions? Well, given that we have discovered there will be less credit available, there will be more expenses, home prices are still propped up. We have a regulatory disaster awaiting us, I think it’s time to drink on somebody else’s dollar. Thank you.

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