May 2, 2016

Robert E. Feldman, Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429

Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: Covered Broker-Dealer Provisions under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act
(RIN 3064-AE39 / File Number S7-02-16)

Dear Sir or Madam:

Occupy the SEC1 (“OSEC”) submits this comment letter in response to the notice of proposed rulemaking jointly issued by the Federal Deposit Insurance Corporation’s (“FDIC”) and the Securities and Exchange Commission (“SEC”) regarding the orderly liquidation of covered brokers and dealers under Title II of the Dodd-Frank Act (“Title II”).

Title II of the Dodd-Frank Act contains vital provisions that, if properly implemented, would help address the pressing and ongoing problem of “Too Big to Fail” (“TBTF”) financial institutions. The current financial system is replete with moral hazard in that TBTF institutions are incentivized to undertake catastrophic risks because they enjoy an implied promise of impunity that can take the form of government bailouts. We are heartened that the FDIC and SEC are poised to promulgate regulations that would implement Title II as applied to designated broker dealers. We urge both agencies (“the Agencies”) to finalize and implement the regulations in a thorough and vigorous manner so as to spare taxpayers the undue burden of supporting the kind of colossal financial conglomerates that led to the 2008 financial crisis.

1 Occupy the SEC (http://occupythesec.org) is a group of concerned citizens, activists, and financial professionals that works to ensure that financial regulators protect the interests of the public, not Wall Street.
I. Introduction

Please note that OSEC has previously written the FDIC in connection with that agency's SPOE strategy for orderly resolution under Title II. For the sake of brevity, the arguments contained therein are not restated here verbatim. While that letter related to the orderly resolution of banks, we believe that it nevertheless contains important considerations that are highly relevant to the broker-dealer context as well.

The Proposed Rule is highly efficient because it utilizes existing frameworks, such as the FDIC's SPOE strategy for orderly resolution in the broader context, and the SEC's SIPC liquidation process for troubled (though non-systemically risky) broker-dealers. The Proposed Rule offers clear procedures for claims resolution and hews close to statutory language, thereby reducing the risk of burdensome litigation should the orderly resolution of a broker dealer be required under Title II. The Rule, if utilized, will help preserve property and benefit market participants (i.e., claimants/customers, creditors, and competitors) during the next systemic crisis.

That said, we believe that the Rule can be strengthened in a number of ways. Most importantly, the Rule should incorporate punitive measures that would apply against the managers and directors of broker-dealers forced to undergo orderly resolutions. Such measures would reduce the likelihood of orderly liquidation being needed in the first place, and would also mitigate some of the moral hazard problems that are implicit in guarantees of SIPC customer insurance. The Agencies should guard against excessive executive compensation at troubled broker dealers so as to protect against dissolution of customer and other property and provide for more optimal market outcomes. Moreover, the Agencies should consider that a bridge broker-dealer (or any bridge company under Title II) could still pose antitrust or systemic risks. Accordingly, the regulations should consider adopting strategies that alleviate such risks as part of the resolution process. The discussion below amplifies some of our concerns in these areas.

II. The Rule Establishes a Streamlined Procedure that will Benefit Customers and the Markets

The Rule establishes a clear procedural framework that effectively utilizes existing regulatory regimes and applies them to the specific context of the orderly resolution of broker dealers. The Rule dutifully follows Title II's mandate that orderly resolution follow the liquidation model already utilized by SIPC, while clarifying ambiguities in the legislative text. The Rule resolves some of the uncertainty that exists in the text of Title II with respect to claims priority, customer property, and the proper roles of the FDIC and the SIPC.

The markets and customers are generally familiar with the long-standing SIPC liquidation process, and the Rule creditably relies on that framework for claims processing. The general bar on expedited claims determination is beneficial in that it prohibits savvy, institutional investors from gaining advantage over others. The Rule's clarifications about claims processing also reduce the risk of litigation that could otherwise arise because of unclear statutory provisions.

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The Rule is beneficial to customers and claimants in sustaining their ability to maintain market positions through the bridge broker dealer, while reducing the risk of firesale liquidations. The bridge mechanism allows regulators to improve economic welfare by providing liquidity at a time when free-functioning markets would otherwise collapse. This intervention supports not just discrete customer accounts but also counterparties market-wide. The Rule's provision for the quick estimation of customer accounts is also commendable because time is of the essence when markets are under fire, and delayed regulatory accounting only exacerbates that concern.

The stipulated timeframes for claims processing and determination are generally beneficial because they increase the likelihood that customer property will be preserved despite the covered broker dealer's troubles. That said, we wish to highlight a stark disparity in claims processing deadlines that exists for customer accounts versus general creditors. The Rule tracks Section 8(a)(3) of SIPA by mandating that customer claims of net equity must be filed within 60 days after the date the notice to creditors to file claims is first published. In contrast, general creditors of the covered broker dealer have six months to file their claims, and are privileged with a good-faith exception for late filings. No such exception exists for customers to lay claim to their rights to net equity. We recognize that the SIPA framework generally establishes a 60-day outer limit for net equity claims. However, nothing in Title II compels the Agencies to follow this 60-day timeframe in the orderly resolution context. In fact, Section 205(d)(1)(A) specifically prohibits the FDIC from adversely affecting the rights of a customer to customer property. The Agencies should promulgate a late filing exception for net equity claims that is comparable to the one that exists for general creditors. They should also strongly consider expanding the timeframe for net equity claims beyond 60 days.

III. The Rule Should Reduce Moral Hazard by Imposing Restrictions on Executive Compensation

While the Proposed Rule is effective in detailing some of the mechanics of how orderly resolutions of broker dealers would take place, it fails to adequately penalize senior management, employees and advisors who are complicit in producing the covered broker dealer's financial instability.

By statute, both the FDIC and the SEC are required to impose restrictions on the compensation of such individuals. Section 204 of Title II specifically states that a central mandate of the orderly liquidation regime is that:

(3) the Corporation and other appropriate agencies will take all steps necessary and appropriate to assure that all parties, including management, directors, and third parties, having responsibility for the condition of the financial company bear losses consistent with their responsibility, including actions for damages, restitution, and recoupment of compensation and other gains not compatible with such responsibility.

4 §§ 380.64(b)(3) and 302.104(b)(3), as proposed.
5 Id.
7 Id. at § 5384(a)(3).
Unfortunately, the Proposed Rule fails to address this broad legislative mandate. In fact, the Proposed Rule does not mention compensation at all. Moreover, one cannot argue that the Agencies lack the power to actually implement this mandate. The Act provides broad authority to the FDIC to act as receiver, including the authority to “perform all functions of the covered financial company, in the name of the covered financial company.”\textsuperscript{8} Such authority would apply for designated broker dealers as well.

The Proposed Rule should be revised to impose compensation-based penalties that will serve as a deterrent to risk-taking by broker dealer managers and executives. For instance, the Rule should incorporate performance-based clawbacks on compensation that exceed existing industry standards. Such clawbacks will produce market discipline that is necessary to counteract bailout expectations at broker-dealers.

As present, the safety net of SIPC insurance encourages broker-dealer employees to take outsized risks (often through one-sided performance-based bonuses) because they know that client accounts are insured for up to $500,000. The moral hazard created by this SIPC backdrop is redoubled by virtue of the guarantees inherent to Title II orderly resolution. On the one hand, broker-dealer employees are often compensated with performance-based bonuses that vest upon growth and positive returns. On the other hand, such employees know that their clients' money is largely insured by government guarantees. This arrangement creates perverse incentives for profiteering. By instituting stiff clawback penalties under Title II, the Agencies will make broker-dealer employee think twice before running their companies into the ground.

We urge the Agencies to institute across-the-board levies on compensation for senior employees of a covered broker dealer. For instance, such levies could be based on some percentage of salary earned, with higher amounts payable by higher earners. This type of mathematical, non-discretionary penalty would likely survive judicial scrutiny because of \textit{Chevron}\textsuperscript{9} deference. In contrast, any attempts to impose compensation levies or clawbacks on a case-by-case basis would like face stiff challenge in court.

Imposing compensation penalties on covered broker dealers will not just benefit the broker dealer and its customers. Rather, the broader market will also be benefited. The risk of clawbacks and other compensation-based discipline will limit risk-taking across broker-dealers. This in turn will produce pareto-optimal allocations of capital that have secondary benefits as to liquidity and stability.

The FDIC can also utilize its broad managerial authority as receiver to help reduce market contagion borne of a systemically important broker-dealer's failure. Part of the reason why broker-dealers face jeopardy is that they push their clients' money (or their own money) into speculative investment strategies that do not benefit the broader economy. If a covered broker dealer is selected for orderly liquidation under Section 205, most likely the broader markets will be in turmoil as well. In such a scenario, the FDIC should utilize its broad authority under Section 210(a)(1)(B) to encourage trading, investments and/or lending in \textit{truly productive}

\textsuperscript{8} Id. at § 5390(a)(1)(B).
enterprises (with the objective, of course, of producing reasonable returns.) In doing so, the FDIC could leverage the failure of one broker-dealer to increase stability in the broader market.

IV. The Rule Should Reduce Systemic Risk by Utilizing Novel Bridge Mechanisms

The Proposed Rule establishes a framework under which a bridge entity is established under receivership to temporarily continue the operations of the covered broker dealer. This arrangement helps to avoid firesale conditions that would otherwise imperil customer accounts.

The Agencies should also consider and encourage the establishment of multiple bridge entities to limit over-concentration and interconnectedness risk. Simply substituting one troubled broker-dealer with an alter-ego under receivership may not be enough to mitigate the risks of contagion produced by a covered broker dealer's holdings. In contrast, systemic risk would be reduced through the establishment of multiple bridge entities with varied risk profiles and industry exposures. Aside from diffusing risk, a multi-prong receivership strategy would also address any antitrust concerns previously applicable to the covered broker dealer. Moreover, the establishment of additional bridges would help avoid market inefficiencies resulting from oligopolistic market dominance or undue political influence.

V. Conclusion

In crafting regulations implementing Title II, the FDIC has been given an historic opportunity to redress the grave issue of TBTF financial institutions, the machinations of which caused the most recent financial crisis. While we recognize that broker-dealer failures played a relatively minor role in producing the last crisis, we nevertheless believe that Section 205 is a vital tool in regulators' arsenal. Increased capital requirements and the Volcker Rule are pushing credit intermediation into the periphery, and broker-dealer may well be the locus of the next financial crisis. Accordingly, it is vital that the Agencies produce Title II regulations that not only establish a clear orderly resolution procedure, but also actively reduce perverse market incentives and inefficiencies.

Thank you for your attention to this matter of great public interest.

Sincerely,

/s/
Occupy the SEC

Neil Taylor
Akshat Tewary
Josh Snodgrass
Annexure A
March 18, 2014

Robert E. Feldman, Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429

Re: Resolution of a Systemically Important Financial Institution: The Single Point of Entry Strategy

Dear Sir:

Occupy the SEC\(^1\) submits this comment letter in response to the Federal Deposit Insurance Corporation’s (“FDIC”; “Corporation”) Request for Comment (“Notice”) on its proposed Single Point of Entry Strategy for the resolution of failing Systemically Important Financial Institutions (“SIFIs”).

Title II of the Dodd-Frank Act (“DFA”) contains vital provisions that, if properly implemented, would help address the troublesome risks presented by “Too Big to Fail” (“TBTF”) financial institutions. The current financial system is replete with moral hazard -- TBTF institutions are incentivized to undertake catastrophic risks because these institutions enjoy an implied promise of impunity that can take the form of government bailouts, unfettered access to tens of trillions of dollars of easy financing under the discount window and quantitative easing, and other government policies. We are heartened that the FDIC is poised to promulgate regulations that would implement Title II in a thorough and vigorous manner that could spare taxpayers the undue burden of supporting the colossal financial conglomerates that led to the 2008 financial crisis.

I. The FDIC Must Utilize Its Authority Under Title II

As elementary as it sounds, the first step that the FDIC must take in its implementation of Title II is to ready itself to actually utilizing that authority. Section 203 of the Dodd Frank Act permits

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\(^1\) Occupy the SEC (http://occupythe/sec.org) is a group of concerned citizens, activists, and financial professionals that works to ensure that financial regulators protect the interests of the public, not Wall Street.
the FDIC and the Federal Reserve Board to recommend, on their own initiative, that the Secretary of the Treasury appoint the FDIC as a receiver if a financial company is “in default or in danger of default.”

Oftentimes whether a bank is “in danger of default” is not altogether clear until the very last minute. The FDIC need look no further than the example of Lehman Brothers, which quickly collapsed largely under the weight of risky bets in illiquid markets. If the Agencies wait until a SIFI has already collapsed, Title II receivership would be of limited use as the SIFI’s assets would be valued under fire sale conditions. Such post-hoc designation under Title II would be akin to “closing the barn door after the horse has left.” For this reason, the Agencies must be aggressively poised to proactively designate financial companies “in danger of default.”

We fully anticipate that the FDIC will doubtlessly face a tumult of resistance to recommending that a particular company be placed under Title II receivership. Such resistance will take the forms of both industry lobbying and political pressure from pro-business Members of Congress. Even so, we emphasize that the Corporation must exercise its independent judgment as a non-political administrative agency and, together with the FRB, actually make Title II recommendations as liberally as possible under the law. Title II authority can only benefit taxpayers if it is actually used in a timely manner.

II. The FDIC Must Attach Stringent Conditions to Utilization of the Orderly Liquidation Fund

At its core, the Orderly Liquidation Fund (OLF) is a bailout fund. It is imperative that the FDIC attach “strings” to any financial company’s reliance on the fund. The mistakes made by the government in handing out a billion dollar under the Troubled Asset Relief Program (TARP), completely free of any meaningful warrants or conditions, must not be repeated. Any guarantees or loans made pursuant to the OFL must be accompanied by interest rates that greatly exceed industry standards and limitations on executive compensation for senior management at the borrowing company.

As will be explained below, excessive compensation should be viewed as an impermissible drain on capital, particularly for troubled companies on the verge of bankruptcy. Indeed, we encourage the FDIC to require that OLF funds be paid ahead of executive compensation for senior-level management at the bridge financial company and any subsequent NewCos.

For instance, the FDIC could establish a ceiling for executive compensation (e.g. at $100,000), and subordnate any owed compensation in excess of that ceiling to OLF repayment. This arrangement would help the government achieve its goal of promoting market discipline. Senior management would be punished for failing to repay OLF debts (by losing any salary above $100,000), and would concomitantly be rewarded for repaying OLF debts (by possibly keeping any salary above $100,000). Such an arrangement would also fully comport with Section 204 of the Dodd Frank Act, which directs the FDIC to “take all steps necessary and appropriate to

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assure that all parties, including management, directors, and third parties, having responsibility for the conditions of the financial company bear losses consistent with their responsibility.”

III. The FDIC, as Receiver, Should Aggressively Exercise Its Broad Managerial Authority

The Act provides broad authority to the FDIC to act as receiver, including the authority to “perform all functions of the covered financial company, in the name of the covered financial company” and “manage the assets and property of the covered financial company, consistent with maximization of the value of the assets in the context of the orderly liquidation.” This veritable statutory carte blanche grants the FDIC a wide swathe of managerial authority. We recommend that the FDIC undertake a number of important steps pursuant to that authority, so as to mitigate systemic risk and to minimize the chances of future taxpayer bailouts.

A. The FDIC Should Recoup Compensation from Culpable Management in a Systematic Fashion

The FDIC is authorized to recoup at least two years worth of executive compensation from those substantially responsible for the failed condition of a covered financial company. We encourage the FDIC to avoid the fraught task of identifying those “substantially responsible” on a case-by-case basis. Any particular decision by the Corporation to penalize one executive instead of another will likely result in litigation opposing that decision.

Instead of making particularized decisions, the FDIC should levy an across-the-board recoupment against all executives in the top .1% of compensation at the troubled financial company. This approach makes sense, as the highest paid employees will invariably be those with the greatest level of authority (and consequently, culpability) vis-à-vis a failing company’s operations. After all, once a company is under Title II receivership, its senior-most management has incontrovertibly failed. Congress has granted the FDIC broad authority to define the contours of Title II recoupment, and the systematic approach suggested here would likely survive judicial scrutiny under Chevron’ deference. In contrast, judicial deference may be less obtainable if the FDIC approaches the recoupment issue haphazardly.

B. The FDIC Should Set Limits on Executive Compensation at Bridge Financial Companies Under Receivership in Order to Avoid Draining Capital

In addition to establishing an across-the-board levy on executive compensation, the FDIC should also set hard caps on executive compensation in light of the fact that excessive executive compensation at a trouble SIFI would only serve to drain vital capital, which in turn would exacerbate the risk that taxpayers may need to eventually bail out the company.

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5 Id. at § 5390(a)(1)(B).
6 Id. at § 5390(s).
Recent history has demonstrated that large financial institutions are prone to dissipating exorbitant amounts of capital on employee compensation. In most industries, bonuses are not issued if a particular company has experienced financial distress or a recent history of losses. Banks and other major financial institutions are different. At these institutions, the inquiry is not whether to issue employees exorbitant bonuses, but how large a bonus to give. Former Attorney General of New York Andrew Cuomo’s investigation into Wall Street bank bonuses found that “when the banks did well, their employees were paid well. When the banks did poorly, their employees were paid well.”

For instance, a February 2012 report by New York State’s comptroller found that total payouts to finance industry employees in New York in 2011 only dropped 14 percent during bonus season, even though profits had plunged by a whopping 51 percent. Securities firms in New York earned $13.5 billion in 2011, down from $27.6 billion in 2010. Nevertheless, these firms paid roughly $20 billion in year-end cash bonuses, averaging $121,150 per person. A.I.G. famously issued multi-million-dollar bonuses to employees even though it was relying on a $100 billion lifeline to stay solvent. Excessive compensation can also take the form of shares and share options, which can have a dilutive effect on equity, not to mention revenues and retained earnings.

Excessive employee compensation is a drain on a financial institution’s resources, and is therefore a liquidity/capital issue just as dividends and share repurchases are. One can easily anticipate the bank lobby’s retort: that exorbitant compensation is (ostensibly) necessary for retention of qualified employees. This argument rings hollow when one compares bank compensation in the United States to that in overseas markets.

[Financial institutions] have claimed it is impossible to recruit people without paying such compensation. Yet, if you look at the pay levels in Europe and in a lot of Asian countries, somehow they manage to find people who can run major global firms while making a fraction of what they make in the U.S.

The fact is that employee compensation at major U.S. banks and other large-scale financial institutions is largely unmatched world-wide, especially for higher level employees. Non-pareto-optimal compensation is essentially equivalent to wasted capital that could have been better utilized for the purposes of financial stability, liquidity and capital adequacy.

C. The FDIC Should Set Limits on Executive Compensation at Bridge Financial Companies to Minimize Systemic Risk

The FDIC should also impose hard caps on executive compensation at financial companies under receivership in order to reduce systemic risk.

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The Notice recognizes that the current TBTF system essentially compels the government to provide bailouts in order to avoid disorderly bankruptcies of SIFIs.11 Market participants are also well aware of this fact. This creates a classic agency problem whereby financial companies are incentivized to reward risky activities that could maximize profit (or lead to financial ruin). When these risky activities are undertaken at systemically important financial institutions, such risk is borne not just by the financial institution but by the global economy as a whole.

Compensation plays a significant role in creating these perverse incentives for risk-taking. German economists have developed a theoretical model demonstrating that financial companies (and their shareholders) react to bail-out expectations by designing bonus schemes that reward managers for taking higher levels of risk.12 Where bailout expectations are high, the potential downside of speculative activity is stripped away, leaving only the upside. However, this situation hurts the overall economy, as society-at-large ends up bearing the costs of inefficient speculation. According to the German model, “ceilings on bonus payments can be welfare-increasing, especially if bail-outs are expected with a high probability.”13 “[A] sufficiently large increase in bail-out perceptions always makes it optimal for a welfare-maximizing regulator to impose ceilings on bank bonuses.”14 Thus, the imposition of compensation ceilings counteracts bailout perceptions and removes incentives for excess risk-taking, thereby promoting prudent risk management.

Therefore, it behooves the FDIC to maximize economic welfare by increasing the role of compensation restrictions in its implementation of Title II. The interests of overall financial stability demand this action, even if it comes at the detriment of a select few.

IV. The FDIC Should Encourage Spinoffs of Subsidiaries for Capital Accumulation and Risk Management Purposes

The FDIC should exercise its broad authority under Title II to encourage spinoffs of subsidiaries of troubled SIFIs as well as sales of subsidiary assets.

A SIFI under Title II receivership is very likely to be strapped for cash. Selling off subsidiaries or their assets can be a ready source of capital for these companies. Encouraging such divestitures would also reduce both intra-conglomerate risk as well as systemic risk (especially for the largest systemically important financial institutions). If a SIFI under Title II receivership is forced to divest itself of subsidiary assets, that only serves to dilute risk across a greater number of entities, which in turn reduces the risk that any of those entities will be considered “Too Big to Fail” due to systemic inter-connectedness.

13 Id. at 2.
14 Id. at 3 (emphasis in original).

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Moreover, reducing the footprint of troubled financial conglomerates through subsidiary spinoffs would help placate legitimate concerns about the inordinate market power of TBTF SIFIs. The financial industry is essentially an oligopoly, with only a handful of major players dominating the industry. Under classical economic theory, the most efficient markets are typically those having an almost infinite number of competitors, while the most inefficient ones are monopolies and oligopolies. Thus, the FDIC can help promote greater market efficiency by trimming the balance sheets of bloated SIFI-oligopolists. Financial markets can only benefit where a larger number of firms are permitted to compete in the stead of inefficient and failing SIFI conglomerates under Title II receivership.

The FDIC’s Comment raises the prospect of ringfencing by foreign regulatory bodies, and describes how such ringfencing would impede its SPOE strategy. We remind the Corporation that subsidiary spinoffs could serve as a ready solution to the ringfencing problem. If the FDIC, as receiver, causes foreign subsidiaries to be sold for cash, U.S. regulators no longer need to rely on the cooperation of their foreign counterparts (which, realistically speaking, cannot be expected in every case anyway).

We fully anticipate that the FDIC would face stiff opposition to the strategy of spinning off SIFIs’ subsidiaries. For instance, financial companies may argue that they should retain their subsidiaries because they enjoy economies of scale from owning those subsidiaries. Such arguments miss the mark. In the case of troubled SIFIs, the dangers attendant to scale, including risk concentration and interconnectedness, should be foremost on the FDIC’s agenda. Indeed, if a SIFI conglomerate truly enjoyed valuable economies of scale, presumably those economies would have averted the need for Title II resolution in the first place.

V. Conclusion

Two points are certain. First, the country will invariably face another economic downturn in the future. Second, the nation’s largest financial institutions are now bigger than ever, and there is no real prospect of that trend abating in the near future. The combination of these facts means that the FDIC will almost certainly need to rely on Title II resolution at some point in the future. This somber reality underscores the pressing need for the FDIC to promulgate stringent Title II regulations that insure that taxpayers are not charged with future bailouts.

In crafting regulations implementing Title II, the FDIC has been given an historic opportunity to redress the grave issue of TBTF financial institutions, the machinations of which caused the most recent financial crisis. We hope that the FDIC will take up this task by promulgating bold strictures that protect the interests of taxpayers and not SIFI management. It is imperative that the FDIC craft punitive measures, such as the compensation and spinoff requirements suggested here, into its Title II regulations. The final regulations must contain serious disincentives for


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SIFIs to undergo Title II receivership, otherwise the resolution process will become just another version of a government bailout.

Thank you.

Sincerely,
/s/

Occupy the SEC

Akshat Tewary
et al