The Regulatory-Credibility Gap:
Why U.S. Rules are set for a Redo in Congress and the Courts

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This evening, I will lay out why U.S. financial regulation is set for a radical rewrite resulting not only from Washington action, but also from an increasing spate of cases challenging the rules and how federal agencies implement them. A decade after the financial crisis fired up, we are about to experience a wholesale rewrite of the policy framework driving critical aspects of financial-industry strategy. Had the Administration that crafted these rules been followed by its chosen successor, the post-crisis framework would have remained largely as is. Of course, that didn't happen and one reason it didn't is that the American public isn't buying that the new rules make banks anything but even bigger and still more bullet-proof. The public also doesn't think that the U.S. economy is anything but still more skewed to favor the rich and powerful. As a result, the post-crisis paradigm is now about to crack wide open.

Yes, I know, the U.S. Congress can barely keep the federal government's lights on, let alone craft sweeping financial reform. However, it's critical to remember that policy-makers who agree on almost nothing else are as one when it comes to lambasting post-crisis financial policy – monetary and regulatory. Of course, they don't always agree on how to fix the framework, but they agree on more than enough to create a consensus from which a new crop of Trump-appointed regulators will work. They also create a platform for wide-ranging challenges in both the regulatory and litigation arenas to the rules as they are and the way in which each now is implemented.

Tonight, I'll focus specifically on:

- what Financial Reform 2.0 is likely to look like. Some are suggesting it will only be a software change – i.e., some new rules – even as the Administration and Congressional leaders contemplate new hardware – i.e., new law. There's no question that getting a new iPhone makes a difference, but all of the software updates have essentially reconfigured my old phone into a new one. The same thing is pending for U.S. financial regulation; and
- what my experience as an expert witness in regulatory-policy cases tells me about the next round of court challenges to key pillars of the post-crisis framework. Despite continuing applicability of *Chevron*, courts are far less inclined than they were to kowtow to federal agencies. Key to persuading them then to act in favor of a financial institution is explaining the policy context of a dispute and how a combination of quantitative and qualitative factors backstop the legal arguments you are also presenting. Judges think they know the law but they know they don't know financial policy and the markets it often defines.

Is 2.0 an Upgrade?

Let me first turn to "Financial Reform 2.0." Time tonight doesn't permit a detailed discussion of all of the moving pieces of the various Trump Administration orders, the personnel situation, and the new "Choice Act." Time also doesn't permit me to tell you which of these moving pieces is in my view going the right way. I hope we'll have time to engage on these questions during the discussion after these remarks.

What I would like now to emphasize is that there are key elements in this complex arena on which the left and right fundamentally agree. The more the Trump Administration presses for big-bank "break-up" -- no matter what this means in practice – and for other populist and community-bank objectives, the greater the likelihood of substantive statutory and regulatory change. One caveat: legislation will only advance if strong-minded Republicans in the House agree to separate contentious questions such as CFPB restructuring from the broader 2.0 rewrite.

In very short, the key pieces of 2.0 likely to be implemented by rule or law include:

- an end to OLA. Even if the law doesn't change, the Trump Treasury will be loath to make the findings required by Dodd-Frank necessary to trigger OLA absent an all-out catastrophe (by when it may be too late). Bankruptcy Code reform may well be enacted, but I think it addresses only one part of the systemic-resolution picture;
- a significant restructuring of regional-bank regulation that dramatically alleviates regulatory burdens. I expect that some of these will further distance the U.S. from the Basel framework, dealing it a crushing blow even if EU ring-fencing doesn't;
- realignment of U.S. BHCs and foreign banks to ring-fence "traditional" and "non-traditional" financial services, with the non-traditional ones covered by a far more lenient regulatory framework. What goes where is of course a complex undertaking as is deciding how capital rules apply across the company and the extent to which insured depositories can do business with their siblings. Still, I think some form of the misnamed Glass-Steagall 2.0 – I prefer to call it FHC-heavy – will come to pass; and
- a regulatory system as is or still more favorable to large non-banks, including asset managers, private-equity companies, and fintech.

Telling It to the Judge

A recent article in the *American Banker* details the raft of new cases challenging regulatory orthodoxy in areas such as systemic designation, regulatory chartering authority, state enforcement powers, and even examiner findings such as CAMELS ratings. The majority of the cases redefining the Dodd-Frank framework come from non-banks far less shy about taking on a federal regulator. With these victories now in evidence, I think banks will quickly begin not only to file comment letters against policies to which they object, but also litigate to the full extent you advise if enforcement negotiations or comment letters prove unpersuasive. As I've said, success breeds courage.

Thinking litigation of this sort through requires a careful calculus not only of applicable law, but also of the policy framework that made the law and colors the thinking of a judge or arbitration panel. In one recent case on which I provided expert-witness reports, a Court of Appeals tentatively sided with the plaintiff against my banking client on the critical question of the extent to which a holding company owed a source-of-support duty. By going through what the banking agencies demand and what happens to bankers when they reject these demands, the District Court found for the bankers because the judge realized that they had no choice but to save the subsidiary insured depository regardless of prior decisions out-gunned by crisis-era rules and related enforcement authority.

In another case on which I worked, a battle over contractual obligations was resolved in the bank's favor because the arbitration panel was persuaded that new rules required the bank to do what it did and, indeed, it could have done little else under applicable federal law. As in the first case, the law determined the outcome, but how the judge and panel understood the law in actual application made a critical difference. Case law can show you who won where why, but it often doesn't affect the changing regulatory and policy circumstances applicable to the actual actions at dispute in a particular case.

Because these rules and the broader market are changing at a record clip, these contextual factors can make a dramatic difference in litigation outcome.

Finally, as markets evolve, it becomes easier to point to “arbitrary and capricious” actions by reference to real-world outcomes in financial markets as well as to relevant legal rationales in this increasingly-important area. An understanding of the global regulatory process also illuminates understanding of why a foreign financial institution challenges a regulatory or enforcement action. The intersection between traditional banking and fintech could be one in which litigation outcome is particularly dependent on a broader understanding of regulatory policy. While law of course trumps argumentation, argumentation demonstrates why a bank may be unwilling to accede to demands from certain third parties or even some federal and state regulators.

How to know when policy provides vital ammunition to legal considerations? Cases in which similar allegations were made, settled, and then played out in the financial markets can have as much bearing as legal precedent when they validate arguments about legal risk or other assertions. An explanation of how a party’s actions are anticipated in law, rule, or regulatory statements (and even speeches) shows a judge or arbitrator that your client is acting well within accepted understanding of law and rule even when the facts aren’t as clear as all that. And, sometimes just showing with rigorous analytics why one party’s assertions would have led to systemic risk, macroeconomic damage, and harm to consumers puts a new spin on seemingly clear-cut assertions. This is particularly true when a financial institution threatens a federal agency seemingly acting only in the best interests of every other policy stake-holder.

Conclusion

Unless or until the public is reconciled to financial policy, financial policy is a fragile edifice subject to much of the change the Trump Administration has outlined and that some parties are pursuing in the courts. It’s a sad testament to ten years of very hard work trying to repair the U.S. financial system after a devastating crisis, but it is what it is. This is why I believe you all play so critical a role guiding your clients through the policy shake-up and determining when you can “just say no” to demands that once might have been met from what were once invincible federal regulatory agencies.