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Financial CHOICE Act of 2017: Will Collective Amnesia Triumph?

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Notwithstanding decidedly hostile testimony last month from this humble columnist,[1] the U.S. House of Representatives will soon pass legislation (probably on a strict party line basis) entitled "The Financial CHOICE Act of 2017" (H.R. 10) (which acronym stands for "Creating Hope and Optimism for Investors, Corporations, and Entrepreneurs"). Despite this cutesy and innocuous title, the CHOICE Act proposes dangerous and radical surgery that would gut those provisions of the Dodd-Frank Act that seek to prevent the failure of a single major bank from setting off a chain reaction that brings down all interconnected banks. Indeed, the Act reads as if it had been drafted by the staff of a libertarian think tank (say, the CATO Institute) after they had all smoked something very strong. Because such libertarian fantasies do not normally race through Congress (so far, anyway), the CHOICE Act's future in the Senate looks bleak—both because the Senate is a more deliberative body and because its voting rules (unless amended) will require 60 votes for passage.

But that does not mean the CHOICE Act can be safely ignored. Some of its key ideas may well be picked up by the Trump Administration. President Trump issued an Executive Order on Feb. 3, 2017, setting forth "Core Principals for Regulating the United States Financial System" and directing Treasury Secretary Mnuchin to report back on the extent to which existing laws and regulations promote those Core Principles. In this light, the CHOICE Act should be seen more as an attempt to lobby the Treasury Secretary in the hope that those ideas that he backs might get through the Senate. To that end, Republicans on the House Financial Services Committee have just released an elaborate document that is less legislative history than a campaign brief, combining political slogans with policy analysis in an attempt to generate political momentum behind the Act.[2]

Because the CHOICE Act is an unedited grab bag (extending for nearly 600 pages) of pet ideas and recycled bills, this column cannot attempt a comprehensive review, but rather will seek to engage its core ideas. Everyone recognizes that Dodd-Frank could be streamlined and simplified, but gutting it is a different matter. Thus, two conclusions should be stressed at the outset:

> (1) Justified only by the slogan "No More Bailouts," the Act eliminates every means by which central bankers could prevent a large bank's failure from generating a systemic collapse. Once the first domino falls, the rest could easily come tumbling down under this Act; and

(2) SEC enforcement—already criticized by many as tepid and equivocal—will largely evaporate under this legislation, chiefly because the SEC will lose the ability to conduct administrative proceedings.

Elimination of OLA

The first core idea in the CHOICE Act is to substitute a bankruptcy reorganization for an FDIC-initiated receivership for systemically significant banks. Section 111 of the CHOICE Act would repeal Title II of the Dodd-Frank Act, which permits regulators to place a major bank in receivership before it actually becomes bankrupt. Admittedly, considerable reason exists to believe that a robust bankruptcy alternative to Ordinary Liquidation Authority (OLA) would be desirable, at least as a supplementary option. But this Act offers much less. Moreover, the U.S. financial sector has geared up for several years now—through "living wills," stress tests, and other means—to adapt to, and prepare for, OLA, and this bill will pull the rug out from under that careful and deliberate planning. To abandon OLA for a bankruptcy substitute is to leap from the plane without a parachute. Indeed, it is even unclear whether the major banks favor this substitution.

This substitution has three dramatically dangerous consequences:

(1) Lack of Role for the Regulator. No decision-making role exists for any regulator (FDIC, Federal Reserve, or OCC) under the CHOICE Act's bankruptcy alternative. Although bankruptcy can be initiated by the debtor or its creditors, regulators are left to observe from the sidelines. This undercuts the value of "living wills" and other provisions, which are intended to arm and inform the regulators. Instead, an unprepared and uninformed bankruptcy judge, with no staff, will be asked to make the critical decisions. Thus, if regulators recognize that a systemically significant bank is about to fail, they can only wait for the inevitable (or perhaps criticize from afar). This implies that necessary interventions will be delayed, while losses mount. A failing bank is likely to hide its condition in the hope of a miraculous turnaround, filing for bankruptcy only at the last possible moment when it runs totally out of funds (as Lehman basically did). This will accentuate the impact on the financial system and increase the shock in comparison to that associated with an earlier resolution.

Worse, there is a culture associated with the bankruptcy process; it is long, slow and sometimes interminable. Its focus is on protecting creditors, not protecting the economy, which is the priority of Title II of Dodd-Frank. The principal attraction (for the Bar) of the Act's bankruptcy provision is that it will enable law firms to profit to a potentially obscene degree. (The Lehman bankruptcy is estimated to have already resulted in over $2 billion in legal and expert fees).

(2) The Absence of Liquidity. If a major bank is to be reorganized so that its insolvency does not set off a domino-like chain of failures, some source of liquidity must be found. OLA has a mechanism for supplying liquidity to a troubled bank: The FDIC provides funds at the same time it replaces the old management in a receivership. Many (and maybe most) major bank crises are essentially liquidity crises, rather than instances of true insolvency (even Lehman can be debated in this regard). In contrast, bankruptcy does not offer any feasible, short-term means of providing liquidity. The draftsmen of the CHOICE Act apparently believe that, after a bankruptcy filing, the sound assets of the bank would be transferred to a "bridge company" (the "good bank") and

the weak assets and liabilities would be left in the "bad bank." Then, the "good bank" could obtain financing in the private market without federal assistance. At best, this would take time, and in a challenged economy following a major bank's failure, all financial institutions might cease to lend, hoarding funds because they fear a general "run on the banks." Such a panicked freeze could collapse the economy. In any event, this assumption that the "good bank" could obtain financing without governmental assistance deserves the curt response: "Isn't it nice to think so." Things work this well only in fairy tales.

The simple truth is that successful reorganization requires the provision of at least short-term liquidity, and the CHOICE Act provides none. Instead, it offers only a slogan: "No More Bailouts." But is an FDIC loan really a bailout? The FDIC's fund must be replenished by the banking industry; hence, the cost does not fall on taxpayers. The House Financial Services Committee has tried to answer this point, by arguing that the cost of a major bank failure will exhaust the FDIC's fund and thus require the government to fund the difference. That is possible, but hardly inevitable. Worse, the logic of this position implies that the failure of one large bank would collapse all interconnected banks (and all are today interconnected). Unless liquidity is provided by someone, a large bank failure under the CHOICE Act implies that we will all be living in financial caves thereafter.

(3) Lack of Accountability Provisions. Dodd-Frank contains multiple provisions to hold the officers and directors of a failed bank accountable. The CHOICE Act provides none in its bankruptcy provision. This may be based on the premise that, if strict accountability provisions were authorized, no bank's management would ever willingly file for bankruptcy, even if they knew they were hopelessly insolvent. But the vast majority of Americans want accountability provisions that apply to reckless behavior by bank officers and directors that results in insolvency. By analogy, the CHOICE Act would absolve a Bernie Madoff (if he were running a bank) in order to encourage him to file bankruptcy.

Bottom Line: Although a robust bankruptcy code provision could supply a useful alternative to OLA, it is rash to remove the safety net that OLA affords without a proven alternative. The British Financial Conduct Authority has already publicly warned that if OLA is eliminated, it will have substantially less confidence in the safety and soundness of U.S. banks.[3] More generally, bankruptcy is primarily concerned with the protection of creditors; OLA is primarily concerned with the protection of the economy and the American public from a devastating systemic risk crisis. The CHOICE Act subordinates this latter goal (saving the economy) to the former (providing full value to creditors). That is a wrong CHOICE.

The Off Ramp

In probably its central provision, the CHOICE Act creates an "off-ramp" that permits financial institutions to escape Dodd-Frank's capital and liquidity requirements (and its activity restrictions) if they can satisfy a simple leverage ratio. Admittedly, that leverage ratio is demanding (10 percent—or well above the Basel III standard). Not all banks will be able to meet this standard, and, I concede, a case can be made for exempting smaller banks from most of Dodd-Frank.

But there are also three major problems associated with this "off ramp" strategy:

First, although this proposal might make sense for smaller banks, it applies to all banks (large and small). It judges them all exclusively in terms of a single metric (a 10 percent leverage ratio). Using only one metric is dangerous: One could have 10 percent leverage, but also assets consisting only of lottery tickets or the bottom tranche of some exotic securitization that was fully subordinated to more senior tranches. If the economy nosedives, such a bank would be toast, even with a good leverage ratio. That is why Basel III standards look to risk-weighted leverage.

Second, banks will be incentivized by it to shift towards a riskier portfolio of assets. That is, at any leverage ratio, banks can hold conservative assets (a portfolio of U.S. Treasury securities, for example) or risky securities (the junior tranche of a portfolio of real estate backed, sub-prime mortgage investments). In contrast, Basel III focuses on a risk-weighted leverage ratio.

Third, the CHOICE Act invites gaming by banks—in particular because the Act measures its key leverage ratio only on the last day of each quarter. Those with a memory that goes back before 2008 will recall that Lehman engaged on the last day of each quarter in elaborate, multi-billion dollar derivative transactions in order to manipulate its leverage ratio as of the last of each quarter (and then it returned to its normal, more leveraged state the next day). If Congress does not learn from this history, it is destined to repeat it.

This truth is inescapable: *Banks can change their portfolios very quickly.* They can move from safe assets to risky assets, or vice versa, and some will predictably play a game of regulatory arbitrage if they can escape Dodd-Frank by simply satisfying a single metric.

Bottom Line: No single metric—leverage, capital, risky activities—is sufficient to preserve the safety and soundness of banks that are "too big to fail." Basel III recognized this, but the CHOICE Act's draftsmen, in one of their moments of libertarian fantasy, decided that risk-weighting gave too much power and discretion to regulators.

The Volcker Rule

Title IX of the CHOICE Act (and specifically §901) repeals the Volcker Rule, which prohibits banks from engaging in proprietary trading or owning or sponsoring hedge funds. This is an amazing about face, which must have surprised the major banks that have now largely disengaged from these activities. No justification is provided for this radical shift. If the banks are "too big to fail" (and some clearly are) and if we do not wish them to be bailed out on insolvency by taxpayers, the only practical alternative is to regulate banks so that they do not fail. Risk-taking thus must be limited. The Volcker Rule is a reasonable means to this end. Further, because large banks have access to the Federal Reserve's discount windows, it is particularly unacceptable that they should be allowed to gamble with funds borrowed from the U.S. Treasury (and taxpayers).

Stabilization Fund Restrictions

Section 133 of the CHOICE Act places strict limitations on the Treasury's Exchange Stabilization Fund so that it cannot lend to, or guarantee, the obligations of a nongovernmental entity. In my judgment, the most plausible scenario for a financial panic in the future is that a money market fund will "break the buck" and thereby create a panic that leads to hundreds of

thousands of middle-income investors racing in panic to redeem their money market funds. This nearly happened in 2008 when the Primary Reserve Fund did "break the buck." The crisis was averted only when the Treasury used the Exchange Stabilization Fund to guarantee all money market funds. This is hardly an ideal solution, and the FSOC has suggested other solutions (which have been resisted successfully by the mutual fund industry). Still, use of the Exchange Stabilization Fund is a last resort solution that should not be denied to the Treasury. With little else adopted to avert a possible panic, it is foolish to abolish the government's ability to utilize emergency solutions. Yes, wholesale funds now have a "floating" Net Asset Value, but retail funds do not, and it is at the retail level where a panic would most likely start.

Financial Market Utilities

The Dodd-Frank Act requires most swaps to be cleared through clearinghouses. No one has challenged this reform because we all recall how the implosion of AIG's credit default swaps caused the 2008 crisis. But the creation of new clearinghouses also creates a danger: One might fail. Such a clearinghouse failure would likely be even more catastrophic than the barely averted failure of AIG. Thus, it seems paradoxical that the provisions of Dodd-Frank allowing financial regulators to supervise clearinghouses (and other financial market utilities) would be repealed by the CHOICE Act.[4] In an increasingly complex world (where cybersecurity concerns grow daily), payment and clearance systems also need supervision. The failure to recognize this need for oversight is to don self-imposed blinders.

Handcuffing the FSOC

The Financial Stability and Oversight Council (FSOC) is downgraded by a number of CHOICE Act provisions, but none is more important than the eliminations of FSOC's ability to declare a non-bank to be a "systematically important financial institution." To date, FSOC has only used this power in a few cases, and the courts may resolve the propriety of its use of that power. Still, this is an emergency power, and none of us can foresee when and where new and powerful financial institutions will arise in the future. To deny FSOC that power assumes inaccurately that we can know today that major changes in the financial environment will not occur in the future.

Risk Retention Rules

Section 842 of the CHOICE Act would repeal Dodd-Frank's risk retention requirements (except in the case of residential mortgage securities). The simple truth that we all learned in 2008 was that the "originate to distribute" model is dangerous and encourages reckless behavior by originators who do not have to hold any percentage of their own product. The most feasible response is to make originators keep some "skin in the game" by holding some percentage of what they originate. Residential mortgages are not unique; other financial assets can also be recklessly securitized, and the CHOICE Act will permit and encourage a return to such practices.

SEC Enforcement.

The CHOICE Act does desirably increase SEC penalty levels—and to a level that will surprise the Bar. In cases involving fraud, manipulation or certain regulatory violations, §211 of the CHOICE Act raises the top penalty level that the government may seek to the greater of three times the gain or the full loss of all victims. Thus, in an insider trading case in which the

defendant makes $1 million, but contemporaneously trading victims suffer a total loss of $1 billion, the government can seek the latter amount. Significant as this change is, it is likely to be more than offset by the following curbs:

(1) The De Facto Elimination of Administrative Proceedings. Section 823 of the CHOICE Act would enable a defendant charged civilly in a SEC administrative proceeding to require the SEC to move the proceedings to federal court. I suspect that the vast majority of such defendants would so opt—if only to slow the pace down. The SEC is severely resource constrained, and administrative proceedings permit the SEC to litigate at lower cost and more quickly. The slower the SEC must go, the more wrongdoers who escape sanctions. Although there may be constitutional issues surrounding the SEC's use of administrative proceedings,[5] these issues do not involve questions of due process, but rather issues of executive power, and they are best left to the Supreme Court to resolve in due course.

The SEC's dependence on administrative proceedings is best shown by two statistics: First, in fiscal 2016, the SEC initiated 868 enforcement proceedings, of which 692 (or roughly 80 percent) were administrative proceedings.[6] Second, when one looks more specifically at public-company related defendants, the SEC in fiscal 2016 brought 90 percent of such actions as administrative proceedings (while in 2010, it brought only 34 percent of such proceedings administratively).[7] If the SEC were denied administrative proceedings, it would have to cut back the total number of actions it could bring by a large percentage.

(2) New Standard. Even if a defendant opts to stay in the administrative proceeding, §831 raises the standard that the SEC must satisfy to that of "clear and convincing evidence." This is a standard usually reserved for proceedings involving the loss of civil liberties, rather than simply a monetary judgment. It adds another unnecessary obstacle to the SEC's ability to enforce the federal securities law.

(3) Officer and Director Bars. Section 825 would also repeal the SEC's existing authority to bar individuals from serving as officers or directors of a public company. Although I agree that such a sanction should not be imposed indiscriminately (and might even justify a "clear and convincing" standard of proof), there is no reason to take this power away from the SEC. Can anyone doubt that a Bernie Madoff (if he escaped criminal liability) should be barred from so serving as a director?

Conclusion

Slogans are dangerous. Proclaiming "No More Bailouts" may win votes, but it exposes the American economy to disaster. Possibly, I reveal my naiveté in continuing to believe that legislation should seek to solve problems, rather than only exploit voter frustrations. Nonetheless, less than a decade after the 2008 crisis, a contagion of collective amnesia is sweeping across Congress, and only the Senate stands in its way.

Endnotes:

1. This author testified before the House Financial Services Committee on the Financial CHOICE Act on April 28, 2017. Days later, the committee ignored my warnings and passed the

bill on a strict party-line basis. This author takes comfort from the fact that the prophets of the Old Testament were similarly ignored by the political leaders of their day.

2. See House Committee on Financial Services, THE FINANCIAL CHOICE ACT: A Republican Proposal to Reform the Financial System (April 24, 2017).

3. See Sam Fleming, Gemma Tetlow, and Barney Jopson, "U.K. watchdog warns Trump over scrapping rules on failing banks," Financial Times, April 24, 2017 at p.1.

4. See Section 141 of the CHOICE Act.

5. Compare Bandmere v. SEC , 844 F. 3d 1168 (10th Cir. 2016) (finding procedure to violate Constitution) with Raymond J. Lucia Cos. v. SEC , 832 F. 3d 277 (D.C. Cir. 2016) (contra).

6. See Securities and Exchange Commission, "Select SEC and Market Data, Fiscal 2016," available at https://www.sec.gov/files/2017-03/secstats2016.pdf.

7. See Securities Enforcement Empirical Database (SEED), "SEC Enforcement Activity against Public Companies and their Subsidiaries—Fiscal Year 2016 Update" (2016), available at http://www.law.nyu.edu/sites/default/files/SECEnforcement-Activity-fy2016-updated.pdf.