Message from the Chair

To the Members of the Committee on Banking Law:

This newsletter offers a supplement to the usual fine articles by the "staff" of Charlotte Bahin, Travis Nelson, Tom Vartanian and Ray Natter. Joseph Vincent, General Counsel of the Washington State Department of Financial Institutions, becomes our first guest author as he explains the Washington Business Development Act of 2006, a unique response of the State of Washington to the challenges of preemption.

Our Committee audience of 1600 banking lawyers affords a unique opportunity for many of you to demonstrate your expertise, offer insights on difficult issues or espouse a position for which you are seeking support or feedback. We invite more of you to join Joe in submitting materials to Chris Bellini at cbellini@gibsondunn.com, the editor of this Committee newsletter. The newsletter is also posted on our Committee website.

Jim Scott
Chair, Committee on Banking Law
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Featured Articles

FDIC Proposed Rules to Implement the Federal Deposit Insurance Reform Act of 2005
Charlotte M. Bahin

After years of working to have deposit insurance reform legislation enacted by Congress, the Federal Deposit Insurance Reform Act of 2005 (the "Reform Act") was signed into law in February 2006. During the almost ten-year debate, a number of controversial elements divided the Federal Deposit Insurance Corporation ("FDIC"), Members of Congress, the two Administrations and the industry. Compromise was reached on several important elements, and the law contains changes to a number of provisions affecting deposit insurance including the level of coverage, the amount of premiums to be charged, and appropriate level for the designated reserve ratio for the new combined Deposit Insurance Fund. While the Reform Act represents sweeping change in a number of areas, the amendments are the natural evolution from earlier changes made in 1989, 1991 and 1996.

The Basel II Standardized Approach
Raymond Natter

The Basel II capital framework agreed to by the banking authorities of the world’s leading economic countries in 2004 envisions a three pronged approach to enhancing the safety and soundness of financial institutions: (i) new capital standards; (ii) enhanced supervision; and (iii) increased market discipline through additional public disclosures. Most of the attention has focused on the first pillar, the new capital standards.
Identity Theft and Financial Institutions
Travis P. Nelson, Thomas P. Vartanian

William Shakespeare, perhaps unknowingly, foretold the damage of identity theft: "But he that filches from me my good name/Robs me of that which not enriches him/And makes me poor indeed." 1

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[1] Othello, Act III, Scene 3

Joseph M. Vincent

The current preemption battle between the Office of the Comptroller of the Currency (OCC) and the states has again directed a spotlight on the state banking charter and the function of state banking regulation. This scrutiny has prompted many states to perform the kind of self-examination that has historically led to many improvements in banking. Indeed, throughout the history of the dual banking charter, the function of the states in financial institutions regulation has shown a great capacity and affinity for innovation. Examples of such innovation by the states, which were only later adopted by Congress, include checking accounts, bank branches, real estate loans, trust services, NOW accounts, reserve requirements, deposit insurance, adjustable-rate mortgages, automated teller machines, bank sales of insurance products, interstate electronic funds transfer systems, and interstate bank holding companies.

SUPPLEMENT:
Update on Watters v. Wachovia
Peter Heyward

The order of the United States Supreme Court granting certiorari in the case of Watters v. Wachovia, issued on June 19, 2006, has attracted considerable attention in the banking world, and for good reason. The case raises the question whether national banks’ operating subsidiaries are shielded from state laws by the regulation of the Office of the Comptroller of the Currency declaring that "State laws apply to national bank operating subsidiaries to the same extent that those apply to the parent national bank" [i.e., hardly at all]. 12 C.F.R. § 7.4006.
SUPPLEMENT:  
Some New Developments in Bank Securities Regulation  
Martin E. Lybecker

A. If It Walks like a Duck, and If It Quacks like a Duck, It is a Barift

Soon after the passage of the Garn-St Germain Depository Institutions Act in 1982 ("Garn-St Germain"), thrifts began to seek to be treated as a "bank" for purposes of the Federal securities laws. At the time, the cause celebre was acting as a securities broker, so thrifts sought to enjoy the exemption that a "bank" then had from the definitions of "broker" and "dealer" under the Securities Exchange Act of 1934 ("Exchange Act"). In 1983, the SEC issued a release asking a number of questions about whether a thrift should be treated as a bank, and no further action was taken. Meanwhile, culminating in the famous no-action letter issued to Chubb, most thrifts were able to avoid registration as a securities broker or a dealer by engaging in networking activities where another, fully-licensed broker-dealer, engaged in brokerage activities on the premises of the thrift institution.

More...
FDIC Proposed Rules to Implement the Federal Deposit Insurance Reform Act of 2005

By:
Charlotte M. Bahin
Lord Bissell & Brook LLP

After years of working to have deposit insurance reform legislation enacted by Congress, the Federal Deposit Insurance Reform Act of 2005 (the “Reform Act”) was signed into law in February 2006. During the almost ten-year debate, a number of controversial elements divided the Federal Deposit Insurance Corporation (“FDIC”), Members of Congress, the two Administrations and the industry. Compromise was reached on several important elements, and the law contains changes to a number of provisions affecting deposit insurance including the level of coverage, the amount of premiums to be charged, and appropriate level for the designated reserve ratio for the new combined Deposit Insurance Fund. While the Reform Act represents sweeping change in a number of areas, the amendments are the natural evolution from earlier changes made in 1989, 1991 and 1996.

Background

One of the fundamental changes granted the FDIC flexibility in establishing the designated reserve ratio and in determining the appropriate level of premiums necessary to protect the insurance fund. A companion bill to the Reform Act made technical amendments to the statute and requires a number of studies to be done. Congress included an aggressive rulemaking schedule in the statute, requiring that the necessary rules be issued by November 2006. The major changes include:

- After 25 years of no increases in the deposit insurance coverage levels, the coverage level for retirement accounts was raised to $250,000, and beginning in 2011, the FDIC (and the NCUA) may increase the coverage levels for other accounts every five years to an inflation indexed amount.
- The Bank Insurance Fund and the Savings Association Insurance Fund were merged into a single fund, the Deposit Insurance Fund (“DIF”).
- The 1.25 percent designated reserve ratio (“DRR”) was replaced with a more flexible range that permits the FDIC to establish the DRR at a point between 1.15 percent and 1.5 percent. The DRR is to be established on an annual basis.
- The FDIC may manage how the DRR varies within the range. If the DRR falls below or is expected within six months to fall below 1.15 percent, the agency must adopt a restoration plan that requires the DRR to return to 1.15 percent within five years. If the reserve ratio exceeds 1.35 percent, the FDIC must dividend to the industry half of the amount necessary to maintain the fund at 1.35 percent, unless the FDIC suspends dividends, after considering certain factors. If the DRR exceeds 1.5 percent, the FDIC must dividend to the industry the amounts above the amount necessary to maintain the DIF at 1.5 percent.
- The elimination of any connection between the DRR and the assessment rates, granting the FDIC the discretion to price deposit insurance assessments according to the risk of the institutions.
• A grant of a one-time assessment credit of about $4.7 billion in recognition of past contributions to the funds.

The timing of the collection of the assessments would change to the end of each quarter rather than in advance. The FDIC has proposed changes to the risk-based assessment system that will allow the agency to impose assessments that are much more sensitive to the risk presented by the institution. Further, the proposal would differentiate between small and large banks - those with under $10 million in assets and those with more than $10 million in assets. The assessment base is proposed to be based on average daily deposits for banks with $300 million or more in assets. Finally, the Reform Act removes the prohibition from assessing healthy institutions when the fund is at or above the DRR and expected to maintain the DRR. Additional operational issues are addressed in the proposals issued to implement the statute, including new required signage and advertising materials for use by banks.

The FDIC has issued proposed rules to implement all of the changes requiring regulations. The agency plans to present the initial invoices for deposit insurance assessments to the industry in June 2007. The comment letter due date for the proposals to establish the reserve ratio and the risk-based assessment framework is September 22, 2006. The comment period for the proposal to implement the one time assessment credit closed in mid August.

Controversy Over the Proposals

As the FDIC has issued the proposals for comment, several elements of these proposals have become controversial. In addition, the FDIC chairman and staff have indicated in speeches and meetings that the industry as a whole should expect that deposit insurance assessments will be high in the short term.

Assessment Credits. The statute requires the FDIC determine the aggregate amount of the one-time assessment credit, which institutions are eligible to receive credits, and the amount of each eligible institution’s credit. The amount of each eligible institution’s credit is dependent on how the agency defines “successor” for these purposes. Further, the FDIC must establish the procedures for the application of assessment credits and provide a reasonable opportunity for banks to challenge administratively the amount of credit. The determination of the applicability of the assessment credit after such a challenge will be final and not subject to judicial review. The statute also includes additional limitations on the application of the assessment credits based on the health and capitalization of the institution and the deposit insurance fund. The FDIC proposes that the assessment credits be transferable.

The aggregate amount of the one-time assessment credit that will be distributed among the eligible institutions has been determined to be $47 billion. The statute provides that the calculation to be used to reach the number is based on assessment rate of 10.5 basis points on the combined assessment rate for the BIF and the SAIF as of December 31, 2001.

For purposes of the proposal, an eligible institution is defined as one in existence on December 31, 1996 that paid assessments prior to that date or its successor. The amount of credit each institution will receive depends on the institution’s assessment base on December 31, 1996
divided by the total of all eligible institution assessment bases combined on that date. The FDIC has proposed that the successors to institutions in existence on December 31, 1996 be determined by following the charters of those institutions rather than the deposits.

The controversy with this proposal is that there are a number of institutions currently operating that were not in existence on December 31, 1996, and are not successors to institutions that were in existence on that date, that have grown very quickly and therefore have very large assessment bases. These institutions have never paid a deposit insurance premium and will not get the benefit of an assessment credit, based on the current proposal. In addition, one of the proposed changes to the risk-based assessment regulation is to require that de novo institutions - those that have been in existence less than seven years - will be assessed at a higher rate than more mature institutions. Depending on the age of these institutions, the assessment they are charged may be even higher. These rapidly growing, newer institutions have written to the FDIC about their concerns with the credit allocation. Further, several members of the Senate Committee on Banking Housing and Urban Development have weighed in with the FDIC.

The FDIC has created a calculator for institutions to use in determining their assessment credit. It can be found on the FDIC website.

Establishment of the Designated Reserve Ratio. A second area that is generating comment is the FDIC’s proposal to establish the DRR for the Deposit Insurance Fund at 1.25 percent. The Reform Act requires that the FDIC set a designated reserve ratio that may not exceed 1.5 percent of estimated insured deposits or be less than 1.15 percent of estimated insured deposits. Any changes to the DRR must be made by regulation after notice and comment. The FDIC must take several factors into account as they establish the DRR, including the risk of losses to the DIF in current and future years; the economic conditions generally affecting insured depository institutions; that sharp swings in assessment rates should be prevented; and other factors the FDIC considers appropriate.

A significant change made by the Reform Act was to separate the level of the DRR from the establishment of assessment rates. The FDIC does not have to bring the DRR up to a particular level within a specified time frame. The agency can use the DRR for different roles rather than as a trigger for determining whether deposit insurance assessments are necessary. One of the roles for the DRR would be to signal what the FDIC believes the optimal reserve ratio should be. The agency believes this would be useful to the industry in planning for future assessments.

Because the proposal issued by the FDIC has a DRR of 1.25 percent, one of the concerns expressed is how quickly the agency believes that goal should be achieved. The required use of the assessment credits will limit the assessment revenue and if the agency decides that the DRR is to be 1.25 percent and the current rate of deposit growth continues, increased assessments may be necessary to reach the DRR within a short time. The view of commenters is that the FDIC should not impose higher assessments just to reach the proposed DRR of 1.25 percent more quickly. A slower build up of the DRR is suggested.

Risk-Based Assessments. Since 1991, the FDIC has been required to have a risk-based deposit insurance system in place. The current system places institutions into risk categories based on
two criteria: capital levels and supervisory ratings. The current matrix used to determine the risk based assessment for institutions contains nine cells. About 95 percent of the industry is in the IA category and does not pay assessments.

The proposal consolidates the nine cells into four. Risk category 1 would have minimum and maximum assessment rates of two to four basis points. Based on data as of June 30, 2006, about 45 percent of institutions in Risk Category 1 would pay the minimum rate. An exception is proposed for de novo institutions or institutions less than seven years old. These institutions would be treated differently and would pay the maximum assessment rate as a result of their unique risk characteristics. This group represents 11 percent of all institutions.

The proposal uses a combination of CAMELS component ratings and financial ratios to determine risk-based assessment rates for small institutions. Additional information would be considered for larger institutions. For example, the information might include market data, financial performance and conditions data and stress considerations. The proposal is complex and one of the criticisms is that it is not transparent enough for institutions to use to determine their assessments. Another controversy is over whether de novo institutions should be required to pay higher assessments. The FDIC cites studies that indicate that de novos have a riskier profile.

**Impact of These Changes on Banks**

From a compliance and operations perspective, insured institutions need to aware of several of the changes and from a budget perspective. Institutions need to watch the final rules that the FDIC will issue establishing the reserve ratio, the risk based premium framework and implementing the one time assessment credit. Disclosures and signage in the bank and its branches will have to change and the impact of having a deposit insurance premium for the first time in ten years will have to be factored into the budgeting process.
The Basel II Standardized Approach

By Raymond Natter

Introduction

The Basel II capital framework agreed to by the banking authorities of the world’s leading economic countries in 2004 envisions a three pronged approach to enhancing the safety and soundness of financial institutions: (i) new capital standards; (ii) enhanced supervision; and (iii) increased market discipline through additional public disclosures. Most of the attention has focused on the first pillar, the new capital standards.

With respect to capital, the Accord permits banks to adopt one of two methods for risk-weighting of assets: the “standardized approach” or the “internal ratings based” (IRB) model. The IRB model provides for two alternatives: “Foundation” and “Advanced.” In the United States, the bank regulatory agencies have been proposing to implement only the Advanced IRB model. However, the regulatory proposal has been subject to criticism on the ground that the proposed standards to be applied in the U.S. are inconsistent with the internationally agreed upon capital framework, and will work to disadvantage U.S. depository institutions. Some trade associations have publicly advocated that the agencies permit wider choice for U.S. institutions, and in particular that they should be allowed to select either the standardized approach or a proposed new version of the existing capital standard, the so-called Basel I-A framework. Congress has also weighed in through House and Senate hearings, during which some prominent Members of the relevant committees have expressed the view that options would be appropriate.

In light of the recent publicity about the regulatory implementation of the Basel II accord, this paper will provide a summary and explanation of the standardized approach as described in the international accord.

Standardized Approach to Credit Risk

The Standardized Approach increases the risk sensitivity of the capital framework by recognizing that different counterparties within the same loan category present far different risks to the financial institution lender. Thus, instead of placing all commercial loans in the 100 percent risk weight basket, the Standardized Approach takes into account the credit rating of the borrower. The following examples illustrate the enhanced alignment between risk and capital under the Standardized methodology:

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1 Partner, Barnett Sivon & Natter, Washington, D.C. This firm currently represents financial institutions that are advocating changes in the proposed regulations implementing the Basel II advanced approach. However, this paper represents the views of Mr. Natter, and does not necessarily represent the position of any client institution.

• **Claims Against Corporations**  
Assets that represent claims against corporations (including insurance companies) are assigned a risk weight according to credit rating assigned to the corporation or the asset. The credit rating must be assigned by an external recognized rating agency that satisfies certain criteria described in the Accord.  

For unrated exposures, the risk weight is 100 percent. For rated exposures, the following chart correlates the credit rating and the risk weight:

<table>
<thead>
<tr>
<th>Credit Rating</th>
<th>AAA to AA-</th>
<th>A+ to A-</th>
<th>BBB+ to BB-</th>
<th>Below BB-</th>
<th>Unrated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk Weight</td>
<td>20%</td>
<td>50%</td>
<td>100%</td>
<td>150%</td>
<td>100%</td>
</tr>
</tbody>
</table>

• **Retail Exposures (Loans to Individuals and Small Businesses)**  
Loans to individuals and small businesses, including credit card loans, installment loans, student loans, and loans to small business entities are risk weighted at 75 percent, if the bank supervisor finds that the bank’s retail portfolio is diverse (for example, no single asset exceeds .2 percent of the entire retail portfolio, and no loan exceeds 1 million Euro (approximately $1.3 million). [Basel I – retail and small business loans are placed in the 100 percent risk weight basket].

• **Residential Real Estate**  
Prudently written residential mortgage loans are risk weighted at 35 percent. [Basel I - residential mortgage loans are placed in the 50 percent basket.]

• **Commercial Real Estate Loans**  
In general, loans secured by commercial real estate are assigned to the 100 percent risk basket. However, the Accord permits regulators the discretion to assign mortgages on office and multi-purpose commercial properties, as well as multi-family residential properties, in the 50 percent basket subject to certain prudential limits. [Basel I – commercial real estate assigned to the 100 percent basket]

• **Claims Against Sovereign Governments and Central Banks**  
Assets that represent claims against Governments or Central Banks are risk weighted according to the risk rating assigned to that Government by recognized Export Credit Agencies. The correlation between credit rating and risk weight is as follows: [Basel I assigns claims against OECD member countries to the 0% basket].

<table>
<thead>
<tr>
<th>Credit Rating</th>
<th>AAA to AA-</th>
<th>A+ to A-</th>
<th>BBB+ to BB-</th>
<th>Below BB-</th>
<th>Unrated</th>
</tr>
</thead>
</table>

3 For example, the credit rating agency must be independent, the methodology used should be publicly available, and the rating should be rigorous, systematic and subject to some form of validation.
### Claims on Banks and Securities Firms
Countries are given two options, but must apply the same option to all banks within their
country. The first option risk weights claims on banks and securities firms at one risk
weight category below the country’s risk weight.\(^4\) The second option is to risk weight
banks and securities firms based on an external credit assessment score, and with lower
risk weights for short term obligations (originally maturity of 3 months or less).
[Basel I assigns a 20 percent basket to claims on banks and securities firms organized in
OECD member countries].

### Standardized Approach to Off-Balance Sheet Items
Off-balance sheet items, such as loan commitments and guarantees, expose a financial
institution to credit risk. Both Basel I and the Standardized Approach recognize this credit risk
by converting the off-balance sheet item into an on-balance sheet asset, than placing the asset
into the appropriate risk basket. The following examples illustrate Standardized Approach to
these conversions:

- **Commitments**
  Commitments, such as an open line of credit, that have an original maturity of one year
  or less are converted to an on-balance sheet asset by using a conversion factor of 20
  percent. Longer term commitments are transferred by using a conversion factor of 50
  percent. [Basel I – commitments of one year or less are not converted to on-balance
  sheet assets. Longer term commitments are converted using a 50 percent conversion
  factor.]

- **Securities Lending**
  Securities lent or the posting of securities as collateral are converted to on-balance sheet
  assets using a 100 percent conversion factor.

- **Letters of Credit**
  Short-term self-liquidating trade letters of credit collateralized by the goods being
  shipped are converted using a 20 percent factor. [Basel I – same]

### Credit Risk Mitigation
Credit risk mitigation techniques, such as third party guaranty, are generally not
recognized under Basel I. The Standardized Approach greatly enhances risk sensitivity by
recognizing many more credit risk mitigation techniques. For example:

- **Collateral**

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\(^4\) Subject to a cap of 100 percent risk weighting, unless the country has a below B- credit score.
Banks have two options for recognizing collateral for capital purposes. Under the simple approach, the bank may adjust the risk weight for its exposure by using the appropriate risk weight for the supporting collateral instrument. The collateral must be marked-to-market and revalued at least every six months. A risk weight floor of 20 percent will also apply, unless the collateral is cash, certain Government securities, or certain repo instruments. Eligible collateral includes corporate debt instruments rated BBB- or higher, equity securities traded on a main index, and Government instruments.

Under the second option, or “comprehensive approach,” the value of the exposure is reduced by a discounted value of the collateral. The amount of the discount varies with the credit rating of the collateral. The Standardized Approach provides for the amount of the discount. For example, collateral consisting of A+ rated debt with a remaining maturity of five years or less, would be discounted by 6 percent. Alternatively, the regulatory agencies may permit the banks to calculate their own discounts based on internal models that take into account market volatility, historical performance, and foreign exchange rate movement. [Basel I recognizes only limited types of collateral, such as cash, Government securities, and Government agency securities].

- **Netting**
  Where banks have legally enforceable netting arrangements they may calculate capital on the basis of the net credit exposure. [Basel I recognizes bilateral netting agreements for derivative contracts]

- **Guarantees and Credit Derivatives**
  Guaranties and credit protection derivative contracts that provide equivalent protection are recognized provided certain conditions are met (e.g. the guarantee must be direct, explicit, unconditional and irrevocable). The risk weight of the guarantor is substituted for the risk weight of actual counterparty. Guarantors and credit protection sellers must have a credit rating of at least A-. [Basel I – guarantees issued by OECD Governments and GSEs, and by banks and securities firms chartered in OECD countries are recognized].

**Standardized Approach - Securitizations**

The Standardized Approach permits a bank to exclude securitized assets from the calculation of risk weighted assets if the credit risk associated with the assets have been transferred to third parties, and the bank does not maintain effective or indirect control over the transferred exposures. The assets must be beyond the reach of the bank and its creditors. However, the transferring bank may continue to service the assets.

- **General Rule**
  Banks that retain or acquire positions in a securitization, or have an off balance sheet

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5 Where appropriate, the asset must also be adjusted to reflect potential increases in value of the exposure, for example, the potential that securities lent may increase in value due to market appreciation.
exposure in a securitization, are required to hold capital with respect to these interests. The position is assigned a risk weight basket depending on the credit rating of the exposure as follows:

<table>
<thead>
<tr>
<th>Credit Rating</th>
<th>AAA to AA-</th>
<th>A+ to A-</th>
<th>BBB+ to BBB-</th>
<th>BB+ to BB- (Investors only)</th>
<th>B+ and below Unrated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk Weight</td>
<td>20%</td>
<td>50%</td>
<td>100%</td>
<td>350%</td>
<td>Deduct from capital.</td>
</tr>
</tbody>
</table>

- **Gain on Sale**
  Originating banks must deduct from capital any “gain on sale” that results from the transfer of the asset into the securitization pool.

- **Early Amortization**
  If a bank sells revolving assets (e.g. credit card receivables) into a securitization structure that contains an early amortization feature, the bank will be required to hold capital against a specified percentage of the assets sold into the securitization (the investor’s interest in the pool). The percentage increases as the excess spread account (which serves to protect security holders) declines.

**Standardized Approach – Operational Risk**

The Basel II Accord has three methods for determining a capital charge for operational risk: (i) the Basic Indicator Approach; (ii) the Standardized Approach; and (iii) the Advanced Measurement Approach (AMA). A bank may use the Standardized Approach for credit risk, and the AMA for operational risk.

- **Basic Indicator Approach**
  Under this approach the operational risk capital charge is set at 15 percent of the institution’s net positive annual gross income.  

- **Standardized Approach**
  This method divides a bank’s activities in eight business lines (e.g. corporate, finance, retail, asset management, etc.). Gross income for each of the eight lines is then multiplied by a specified factor, ranging from 12 to 18 percent. The Accord also recognizes an alternative under which outstanding loans are substituted for gross income with respect to retail and commercial banks.

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6 Banks that originate a securitization and retain a tranche that is rated BB+ or below must deduct the entire interest from capital.

7 If the most senior exposure in a securitization is unrated, the bank may use the risk weight applicable to the obligor under a “look through” approach. A risk weight of 100 percent, rather than a deduction from capital, is used for second loss positions of asset backed commercial paper programs.

8 Gross income is determined pursuant to adjustments detailed in the Accord.
**Advanced Measurement Approach (AMA)**

Under the AMA, the operational risk capital charge will be determined by using the bank’s internal operational risk measurement system. The Bank must track internal operational risk loss data and assess the relevance of that data to current operations. The data must capture all material activities and exposures in all systems and bank locations. External loss data must be used for events that are infrequent, yet potentially severe, such as an earthquake. Scenario analyses including expert opinion input must be utilized for high-severity events. The risk assessment should cover all key business environments and internal controls factors. Risk mitigation will be recognized. However, the recognition of third party insurance cannot exceed 20 percent of the total operational risk capital charge.
Identity Theft and Financial Institutions

By:

Thomas P. Vartanian*
Travis P. Nelson

William Shakespeare, perhaps unknowingly, foretold the damage of identity theft: “But he that filches from me my good name/Robs me of that which not enriches him/And makes me poor indeed.”¹

Back in 1969, words like “phishing,” “dumpster diving,” and “skimming,” or even “Internet” and “e-mail,” were not household terms, and “spam” was found in the grocery store. Yet it was in 1969 that U.S. Senator William Proxmire, author of the Fair Credit Reporting Act (“FCRA”), argued: “The consumer has a right to information which is accurate. He has a right to correct inaccurate or misleading information . . . . And he has the right to know when inaccurate information is entered into his file.” Thirty-seven years later, the importance of the consumer’s right to accurate information and the protection from those who would seek to threaten that right is among the forefront of national issues as put by President George W. Bush in February 2002: “One of the most harmful abuses of personal information is identity theft.”

Unlike crimes that involve a clear perpetrator and an obvious victim, identity theft harms both the individual whose identity has been stolen and the financial institution that unwittingly facilitated the fraudulent transaction. This article will examine the problem of identity theft and its impact on financial institutions and their customers, including the types of schemes that identity thieves perpetrate, and the financial and reputational consequences for financial institutions of such schemes.

¹ Othello, Act III, Scene 3.
“Identity theft” is a term that refers to a variety of crimes, all of which involve “stealing” someone’s personal identifying information. An identity thief may use a variety of methods to obtain information, ranging from “basic street theft to sophisticated, organized crime schemes involving the use of computerized databases or the bribing of employees with access to personal information on customer or personnel records.” Once an identity thief obtains the necessary information, he can assume the identity of the identity theft victim. The identity thief uses the information – and the victim’s reputation – to steal funds from the victim’s bank accounts, amass vast debts, or even commit crimes.

Though exactly what acts constitute “identity theft” is as complicated and the variety of schemes that identity thieves perpetrate, patterns have evolved which allow for the following classifications: financial institutions fraud, credit card fraud, fraudulent loans, communications and utilities fraud, and others. An identity thief’s fraudulent activities generally take one or both of two basic forms: “criminal identity theft” (providing a victim’s personal identifying information to law enforcement upon arrest) or financial fraud, further distinguished as “true name fraud” (using a victim’s identifying information to open new accounts in the victim’s name), and “account takeover” (gaining access to a victim’s existing accounts and making

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3 Id.
fraudulent charges). Although criminal identity theft does occur, the vast majority of identity theft concerns white collar and financial fraud crimes.

Identity theft can take many forms, however the Identity Theft Resource Center has identified several common schemes, for example:

- **Visa/MasterCard Alert:** A purported “employee” of a credit card issuer will call an unsuspecting customer trying to confirm unusual spending activity and ask for the security code on the back of the credit card.

- **Phisher Scams:** Identity thieves purchase a domain name that is similar to the domain name of a bona fide financial institution. For example, where the real website for a bank is “firstnationalbank.com” an identity thief will register “firstnationalbank-customerservice.com.” The thieves will then send out mass emails asking customers for verification purposes to supply their account information, social security number and other identifying information.

- **Dumpster Diving:** Rummaging through trash bins, recycling containers and dumpsters to find credit card slips, ATM receipts, loan or credit card applications or bank statements.

- **Change of Address:** The thieves fraudulently request a change of address for credit card statements, then request additional cards, pre-approved credit offers, and other information.

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7 U.S. Gen. Accounting Office, Identity Theft: Greater Awareness and Use of Existing Data Are Needed 3 (June 2002).

8 The OCC has provided guidance for financial institutions on phishing deterrence, focusing on prevention, detection, and response. OCC Alert 2003-11, Customer Identity Theft: E-Mail-Related Fraud Threats, September 12, 2003.
Spoofing: This is a method of creating fraudulent websites that look similar, if not identical, to an actual site, such as that of a bank. Customers are directed to these cites, and then lured into revealing confidential information that the identity thief will use to perpetrate the fraud, under the guise of legitimate banking business.9

Identity theft at financial institutions is caused by either carelessness in the handling of confidential customer information, or through intentional misconduct. Additionally, insiders at financial institutions use their access to confidential customer information to commit identity theft or aid and abet others in committing identity theft. In the past several years, the bank regulatory agencies have increased their efforts at combating these sorts of identity thieves through reviewing of previously filed suspicious activity reports (“SARs”). For example, the Office of the Comptroller of the Currency (“OCC”) reviews SAR reports for indications of identity theft, regardless of lost dollar amount, and then pursues such thieves under its “fast track” program.

In the late 1990’s, Congress took a substantial step toward deterring identity thieves through the Identity Theft and Assumption Deterrence Act of 1998 (the “Act”),10 which specifically labels identity theft as a crime.11 Prior to this Act, 18 U.S.C. § 1028(a) criminalized the unauthorized use or transfer of identity documents, such as a social security card, and 12 U.S.C. § 1029 criminalized the unauthorized use of credit cards, ATM codes, and similar information. The Act expanded the reach of these criminal statutes to include any person who


“knowingly transfers or uses, without lawful authority, a means of identification of another person with the intent to commit, or to aid and abet, any unlawful activity that constitutes a violation of Federal law, or that constitutes a felony under any applicable state or local law . . . .”12 The law defines “means of identification” as including, among other things, social security numbers, dates of birth, unique biometric data, telecommunications identifying information, etc.13 Most importantly, the Act recognized that criminals do not need the actual documents in order to harm their victims – “often they just need the information itself to facilitate these types of crimes.”14 Further, with passage of this Act, the crime of identity theft was no longer viewed as merely a crime against the financial institution from which the information was compromised, but against the individual about whom the information related as well. This Act also required the Federal Trade Commission (“FTC”) to establish a central complaint system to receive and refer identity theft complaints to appropriate entities, including law enforcement agencies and national credit bureaus. There are a variety of other federal criminal statutes that are implicated by identity theft.15

In addition to criminal statutes, there are several other laws that impose duties on financial institutions to protect and monitor confidential customer information, such as the FCRA, the Gramm-Leach-Bliley Act (“GLBA”), and the USA PATRIOT Act. More recently, in 2003, President George W. Bush signed into law the Fair and Accurate Credit Transactions Act

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13 Id. at § 1028(d)(3).
of 2003 ("FACT Act"). The FACT Act permanently reauthorized the national uniformity provisions of the FCRA, and was a response to the growing reality that the increase in information sharing and growth in technology was in part a catalyst for identity theft. For example, the FACT Act added § 605A to the FCRA, establishing three instances where consumers can direct a nationwide consumer reporting agency to include a fraud alert in each consumer report furnished on those consumers. These fraud alerts are designed to clearly and conspicuously notify users of consumer reports that the consumer may have been a victim of identity theft or other fraud. Through these fraud alerts, users of consumer reports are required to verify the identity of the consumer before establishing a new credit plan or loan obligation or issuing an additional card when requested by a consumer with an alert in his or her file. The FACT Act requires a consumer reporting agency to place a fraud alert on a consumer’s credit file when requested by the consumer, which then provides all prospective users of a consumer report on the consumer with a warning that the consumer does not authorize the establishment of any new credit plan or other new credit obligation in the consumer’s name, unless the user verifies the identity of the person making the request in an appropriate manner.

The FACT Act further requires the banking agencies, the National Credit Union Administration ("NCUA"), and the FTC (collectively the "Agencies") to jointly establish procedures for the identification of possible instances of identity theft – "red flag" guidelines and

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The legislative history for this provision elucidates that this requirement was expected to result in the development of broad guidelines, thus resulting in policies and procedures that vary from institution to institution. In July 2006, the Agencies offered proposed “red flags,” which the Agencies define as a pattern, practice, or specific activity that indicates the possible risk of identity theft. The guidance addressed indicators of existing identity theft, as well as the possible existence thereof. The guidance requires financial institutions to (i) design and implement identity theft programs, (ii) monitor on-going compliance with such programs, and (iii) establish “red flags” regarding possible consumer identity theft.

Under the proposal, financial institutions must have a written program that is based upon a risk assessment, which includes internal controls that address the identity theft risks identified through such assessment. Similar to the Agencies’ Information Security Standards, this program must be appropriate to the size and complexity of the financial institution and the nature and scope of its activities. It must also be flexible enough to address changing identity theft risks as they arise.

The program must include policies and procedures to prevent identity theft from occurring, including policies and procedures to:

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24 It is this linkage between such events and identity theft that led the agencies to include the precursors of identity theft as among the red flags.
• Identify those red flags that are relevant to detecting a possible risk of identity theft to customers or to the safety and soundness of the financial institution;

• Verify the identity of persons opening accounts;

• Detect the red flags that the financial institution identifies as relevant in connection with the opening of an account or any existing account;

• Assess whether the red flags detected evidence a risk of identity theft;

• Mitigate the risk of identity theft, commensurate with the degree of risk posed;

• Train staff to implement the program; and

• Oversee service provider arrangements.

The proposed regulation requires the board of directors of an institution, or an appropriate committee of the board, to approve the program. Further, the board, an appropriate committee, or senior management must exercise on-going oversight over the program’s implementation, and staff implementing the program must report at least annually as to the program’s compliance with the regulation.

The means to steal identities in an electronic information environment are varied and continually changing and increasing, so any “red flag” system must be regularly updated. The fact that many interfaces with the customer and much of the processing of electronic information and payments occurs through third party providers complicates the ability of any financial institution to completely control the implementation and execution of “red flag” systems.

In that regard, it should be clear that the regulation once adopted will establish a new standard of care. Consumers damaged by identity theft where the “red flag” system was not operable, up to date, effective or executed properly are likely to add a count to their complaints that the institution failed to comply with applicable standards of conduct required by law. This
will effectively provide consumers with a private right of action for an institution’s failure to conform to the requirements of the final regulation.

As with the Bank Secrecy Act, identity theft legislation and regulations impose substantial compliance requirements on the financial services industry. The failure of such compliance programs to detect wrongdoing generates significant reputation, supervisory, and litigation risk. These guidelines, though deliberately drafted to provide flexibility so that institutions can implement programs that are most conducive to their unique needs, will likely form a basis by which the Agencies measure conformity with standards of safe and sound operation for enforcement purposes.

As stated, the promulgated regulatory standards of care for financial institutions’ use of confidential customer information may lead to an increase in civil suits for such institutions’ mishandling of customer information, as such regulations establish a baseline measurement for an institution’s duty of care, a core element of any negligence complaint. Though it has met with mixed review in the courts, the common law tort of negligent enablement of imposter fraud remains a viable claim that may subject financial institutions to significant tort liability. Negligent enablement of imposter fraud is a narrowly framed cause of action that applies when the victim’s identity theft losses result from a financial institution’s negligence in assisting or furthering an identity thief’s efforts at stealing the victim’s identity.

The Supreme Court of Alabama, in *Patrick v. Union State Bank*, has upheld negligent enablement of imposter fraud where the imposter opened an account in the plaintiff/victim’s name, and wrote several worthless checks.25 The court notes that the “key factor” in such an

action is foreseeability, as well as “the nature of the defendant’s activity; . . . the relationship between the parties; and . . . the type of injury or harm threatened.”26 In upholding the duty that banks have to the public, the court noted:

Banks stand in the intimate relation of a fiduciary to those who are their customers, depositors, stockholders, and associate banks, as well as the public generally, whose members are affected by their operation. Ordinary corporations handle their own money, but banks handle the money of other individuals. They are quasi-public corporations by nature, subject to regulation and supervision by the state.27

Conversely, the South Carolina Supreme Court rejected a negligent enablement of imposter fraud claim by a noncustomer plaintiff/victim who claimed that the defendant bank breached its duty in issuing credit cards to the identity thief imposter.28 Citing a New York State Appellate Division decision, the South Carolina court rejected the plaintiff’s claim, noting “we . . . decline to recognize a legal duty of care between credit card issuers and those individuals whose identities may be stolen.29 The relationship, if any, between credit card issuers and potential victims of identity theft is far too attenuated to rise to the level of a duty between them.” This decision is at odds with a previous South Carolina decision not mentioned in the case, Murray v. Bank of America, where an identity theft victim sued the bank that opened an

26 Id. at 1368.
27 Id. at 1368.
account for an imposter in her name. The court determined that a relationship giving rise to a duty of care was created when the victim went to the bank and asked it to close the account opened by an imposter. The court took a somewhat unique position by concluding that, as one commenter explained it, the victim’s “demand for a remedy created the duty that gave rise to the remedy.”

Between these two approaches is a decision by the U.S. Court of Appeals for the Fourth Circuit in Eisenberg v. Wachovia Bank, N.A., where the court distinguished the stranger status of its victim from the status of the victim in Patrick. By emphasizing that the plaintiff had no cognizable relationship with the bank he sued, the Eisenberg court left open the possibility that a financial institution could owe a duty to an individual victimized by identity theft – particularly where the victim was a customer of the defendant. The Eisenberg court’s approach is particularly relevant as several prominent banks have their home state within the Fourth Circuit’s jurisdiction.

With the possibility that a special relationship may exist between a customer of a financial institution and that institution, there exists a growing likelihood that courts may allow suits for negligent enablement of imposter fraud to proceed past summary judgment. Further, with the FACT Act, and interagency guidelines on information security standards and identity theft prevention, courts may begin to recognize federal statutes and regulations as setting the standard of care for institutions to observe and by which they will be measured in tort suits.

The plague of identity theft has caused an increase in the responsibilities of chief privacy officers, whose role over the last decade has developed into that of a gatekeeper, protecting the

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31 301 F.3d 220 (4th Cir. 2002).
integrity of customer information, and monitoring its use by other institutional stakeholders, including third party providers. With the pressure of increased focus on financial institutions by federal regulators and plaintiffs’ attorneys, financial institutions must make the prevention and deterrence of identity theft, and swift and open remediation of security breaches involving identity theft, a top priority.

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Innovation in State Banking –
Washington State Business Development Company Act of 2006

By Joseph M. Vincent*

The current preemption battle between the Office of the Comptroller of the Currency (OCC) and the states has again directed a spotlight on the state banking charter and the function of state banking regulation. This scrutiny has prompted many states to perform the kind of self-examination that has historically led to many improvements in banking. Indeed, throughout the history of the dual banking charter, the function of the states in financial institutions regulation has shown a great capacity and affinity for innovation. Examples of such innovation by the states, which were only later adopted by Congress, include checking accounts, bank branches, real estate loans, trust services, NOW accounts, reserve requirements, deposit insurance, adjustable-rate mortgages, automated teller machines, bank sales of insurance products, interstate electronic funds transfer systems, and interstate bank holding companies.

In this same spirit self-improvement and innovation, Washington State this year enacted the Business Development Company Act (SSB 6168, 2006 Session Laws, Ch. 87), which thoroughly overhauled and modernized an obscure and seldom-used industrial development corporation act (Ch. 31.24 RCW).

The Act facilitates an innovative type of financial institutions charter, which encourages banks, thrifts and/or credit unions, the investment community, private entrepreneurs, and even government-sponsored entities (GSEs) to form business development companies that will lend to or invest in small business, agriculture, community development and/or historical preservation. Of the minimum of five initial incorporators of a business development company, three (3) of them must be federally insured depository institutions. Federal- and state-chartered institutions may participate with each other.

The legislation is in keeping with four important functions of state banking regulation. First, it promotes the financial integrity of state institutions by making it easier for state-chartered banks and thrifts to be in compliance with their Community Reinvestment Act obligations. Second, the Act will help assure banks and thrifts that the business development companies in which they invest abide by safe and sound practices. Third, it helps eliminate unfair barriers to entry for small business, agriculture and community development projects by improving access to credit and choice of financial products. And finally, by encouraging all of the above, the Act helps enhance the economic vitality of the state.

In drafting the Act, the Washington State Department of Financial Institutions had four main goals in mind. First, the Act had to be user friendly, in the sense that business development companies ought to be easier to charter, govern, raise capital, attract
stakeholder participation, and manage. If this was so, the Department felt that creative business plans might emerge that were market (need) driven. Second, the Department saw the need for open source stakeholder participation, rather than the previous law’s “closed system” of 10 or more banks with rigid rules for “membership” and “assessment.” In the ideal business development company, there would be a cross-fertilization of ideas through joint participation by depository institutions, the investment community, entrepreneurs, and GSEs. Third, the Department wanted a cafeteria plan approach to permissible company activity, which would permit flexibility and choice in how a stakeholder participated, thereby fostering sustained interest. And fourth, the Department sought to encourage stakeholder trust in participation by assuring banks and other participants that there would be proper regulatory oversight and safety and soundness in an atmosphere of confidential examination.

The creation and maintenance of a viable business development company charter will be subject to straightforward, flexible, and functional regulation. A business plan, management and appropriate core capitalization must be approved in advance before the Department will grant a business development company charter (doing business as either a corporation or limited liability company). The business development company will be subject to a state safety and soundness examination every 24 months. The company must maintain a minimum capital-to-asset ratio of 8%. In harmony with the principle underlying Regulation O and other similar laws, the aggregate amount of qualified loans and investments of the company to any single borrower or business entity may not exceed 25%. Insider transactions must be ratified by the company’s board of directors and are nonetheless subject to review upon examination by the Department. In keeping with statutes for state-chartered banks and thrifts, examinations reports will be confidential and exempt from Washington’s expansive public disclosure law.

For any inquiries and copies of the Act, you may contact Joe Vincent at 360.902.0516 or jvincent@dfi.wa.gov.

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The order of the United States Supreme Court granting certiorari in the case of *Watters v. Wachovia*, issued on June 19, 2006, has attracted considerable attention in the banking world, and for good reason. The case raises the question whether national banks' operating subsidiaries are shielded from state laws by the regulation of the Office of the Comptroller of the Currency declaring that "State laws apply to national bank operating subsidiaries to the same extent that those apply to the parent national bank" [i.e., hardly at all]. 12 C.F.R. § 7.4006.

As has been widely reported, this is the first national bank preemption case to be considered by the Supreme Court in almost a decade. Moreover, the granting of certiorari, despite the lack of conflict among the federal Courts of Appeal on the questions presented, has led to speculation that the Court may be about to end the OCC's long winning streak on preemption issues, either reversing the lower courts' determination that state laws generally do not apply to a national bank operating subsidiaries, or limiting the degree of deference due to the OCC when it issues preemptive regulations of the type at issue in this case.

*Watters* is scheduled for oral argument on November 29, and the possible implications of the Supreme Court's ultimate decision in the matter, whether it has been

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issued or not, will be the subject of a program at our Spring Meeting in March, jointly sponsored by the Banking and Consumer Financial Services Committees. A panel discussion on preemption is also on the agenda for the Banking Committee's Fall meeting next month.

For those readers who, like this writer, are not steeped in Supreme Court jurisprudence and have not been following the *Watters* case closely until now, I will try in this article to provide a primer on the dispute, including a summary of the proceedings below, a brief description of the questions on which certiorari was granted, and some thoughts about the strength of the parties’ respective arguments.

**The Proceedings Below**

The *Watters* case arises from the mortgage lending operations in Michigan of Wachovia Mortgage Corporation ("Wachovia Mortgage"), a North Carolina corporation. Although Wachovia Bank has no physical presence in Michigan, Wachovia Mortgage (previously First Union Mortgage Corporation) had been licensed under Michigan's Mortgage Brokers, Lenders and Servicers Licensing Act when it was a bank holding company subsidiary. However, in April 2003, Wachovia Mortgage notified the Michigan authorities that it had become a wholly owned operating subsidiary of Wachovia Bank on January 1, 2003, and that it would be surrendering its Michigan lending registration. Michigan's Office of Insurance and Financial Services advised the company that, effective July 1, 2003, Wachovia Mortgage would no longer be authorized to make mortgage loans in Michigan and Wachovia Bank and Wachovia Mortgage brought suit in federal court seeking declaratory and injunctive relief to prevent the State from
attempting to interfere with the exclusive visitorial rights of the Comptroller of the Currency.

The district court ruled for Wachovia.\(^2\) It reasoned that national banks are generally free from state visitorial powers under the National Bank Act,\(^3\) and that the Act also grants the OCC broad authority over national banks' operating subsidiaries. The court also noted that the OCC has promulgated regulations authorizing national banks to conduct bank-permissible activities through operating subsidiaries,\(^4\) subjecting operating subsidiaries to the OCC's visitorial authority to the same extent as their bank parents,\(^5\) and providing that operating subsidiaries are subject to state laws "to the same extent that those laws apply to the parent bank."\(^6\) Applying *Chevron* deference, the court rejected Michigan's argument that the promulgation of Section 7.4006 exceeded the OCC's authority. The court also gave short shrift to the State's contention that the OCC's regulation violated the Tenth Amendment to the U.S. Constitution by effectively converting state corporations like Wachovia Mortgage into instrumentalities of federal law, relying on Congress's authority under the Commerce Clause to regulate national banks. The United States Court of Appeals for the Sixth Circuit affirmed the decision following an essentially similar analysis of the issues.\(^7\)

*Watters* is one of four cases raising the question of state regulatory authority over national banks' operating subsidiaries that have been working their way through the federal courts in the past two years, all of which have been decided in favor of national

\(^3\) 12 U.S.C. § 484(a).
\(^4\) 12 CFR § 5.34(e)(1).
\(^5\) 12 CFR § 5.34(e)(3).
\(^6\) 12 CFR § 7.4006.
\(^7\) Wachovia Bank, N.A. and Wachovia Mortgage Corporation v. Linda A. Watters, 431 F.3d 556 (6th Cir. 2005).
banks and their operating subsidiaries at both the district court and appellate levels: Wachovia Bank, N.A. v. Burke, 319 F.Supp.2d 275 (D. Conn. 2004), aff'd, 414 F.3d 305 (2d Cir. 2005), petition for cert. pending, No. 05-431 (applying Chevron deference and holding that Section 7.4006 prevents the Connecticut Department of Banking from requiring licensing of or otherwise regulating Wachovia Mortgage); Wells Fargo Bank v. Boutris, 265 F.Supp.2d 1162 (E.D. Cal. 2003), aff'd, 419 F.3d 949 (9th Cir. 2005) (holding that Section 7.4006 prevents the California Commissioner of Corporations from exercising visitorial authority over mortgage lending operating subsidiaries of Wells Fargo Bank and National City Bank of Indiana; that the State licensing of such subsidiaries was field-preempted by the OCC's own regulations with respect to national bank operating subsidiaries; but that California's restriction on the charging pre-recording interest during certain periods was not preempted by the Depository Institutions Deregulation and Monetary Control Act of 1980); National City Bank v. Turnbaugh, 367 F.Supp.2d 805 (D.Md. 2005), aff'd, Nat'l City Bank v. Turnbaugh, 2006 U.S. App. LEXIS 20538 (4th Cir. 2006) (Section 7.4006 prevents Maryland Commissioner of Financial Regulation from exercising visitorial authority over, or enforcing Maryland restrictions on certain mortgage prepayment penalties against, operating subsidiaries of National City Bank).

**Questions Presented and the Parties' Main Arguments**

The Supreme Court granted certiorari with respect to both questions presented in Michigan's petition:

1. 12 USC § 484(a) of the National Bank Act limits visitorial powers over “national banks” except as authorized by federal law. National banks are defined and created under the National Bank Act. State-chartered nonbank operating subsidiaries of national banks are created under State

2. A national bank has been declared to be a national corporation in *Guthrie v. Harkness*. 12 CFR 7.4006 treats a State-chartered nonbank operating subsidiary of a national bank as equivalent to a national bank and, thus, as a national corporation. The Tenth Amendment to the United States Constitution is violated to the extent a statute permits the conversion of State corporations into federal ones in contravention of the place of their creation. *Hopkins v. Federal Savings & Loan Ass’n v. Cleary*. Does 12 CFR 7.4006, by equating a State-chartered nonbank operating subsidiary with a national bank for purposes of federal preemption of State regulation, violate the Tenth Amendment to the United States Constitution?8

The larger portion of the State of Michigan's Brief on the merits, filed on September 1, 2006, develops the State's contention that 12 C.F.R. § 7.4006, to the extent it purports to prevent a state from exercising visitorial authority over a state-chartered operating subsidiary, is plainly inconsistent with 12 U.S.C. § 484(a), which refers only to the OCC's exclusive visitorial authority over "national banks." Michigan also contends that the lower courts improperly applied *Chevron* deference in upholding the Comptroller's regulation, arguing that such deference is inappropriate when an agency interprets its own regulation to preempt State law in areas of traditional State police power, namely regulation of state-chartered entities and consumer protection.

In a shorter portion of its brief, Michigan argues that Section 7.4006 violates the Tenth Amendment because it "impermissibly federalizes a State corporation." The State

8 The Tenth Amendment states: "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."
places considerable reliance on the Supreme Court's decision in *Hopkins Federal Savings Loan Ass'n v. Cleary*, 296 U.S. 315 (1935). In *Hopkins*, the Supreme Court ruled that Section 5 of the Home Owners' Loan Act, 12 U.S.C. § 1464, which permits a state-chartered thrift institution to convert to a federal charter, may not, in light of the Tenth Amendment, be applied to permit such a conversion over the objection of the chartering state (in this case, Wisconsin). The Court, in an opinion by Justice Cardozo, reasoned that the formation, existence and supervision of what it called "building and loan associations," including the manner and timing of their dissolution, were "matters of [the State's] government policy, which it would be an intrusion for another government to regulate by statute or decision, except when reasonably necessary for the fair and effective exercise of some other and cognate power explicitly conferred." 296 U.S. at 337. Michigan contends that the effect of Section 7.4006, barring states from exercising visitorial authority over State-chartered corporations, is to similarly encroach on state functions in a manner prohibited by the Tenth Amendment to the Constitution.

As of this writing, Wachovia, having been granted an extension of time until November 3, has not yet filed its brief on the merits. But the main elements of its arguments presumably can be found in it Brief in Opposition to Michigan's petition and in the Brief for the United States as Amicus Curiae opposing the granting of certiorari in the similar *Burke v. Wachovia* case. The Brief for the United States makes the main argument succinctly:

In light of the unchallenged preemption of state laws with respect to a parent national bank, and the undisputed authority of a national bank to conduct its banking functions through an operating subsidiary, it follows that the Comptroller has authority to preempt the application of state laws to an operating subsidiary to the same extent that those laws would be preempted with respect to the parent national bank.
Brief for the United States as Amicus Curiae at 14, Burke v. Wachovia Bank (No. 05-431).

It seems likely that, when it is filed, Wachovia's Brief on the merits of the case will, in addition, describe fully all the horrible consequences that can be expected to ensue in the event national banks' operating subsidiaries should be forced to comply with local laws.

What Next?

It is understandable that the granting of certiorari on the two questions presented in Watters should have evoked serious concerns among national banks. Under Supreme Court Rule 10, a petition is granted "only for compelling reasons" and, of the reasons identified in the Rule for granting cert. in the absence of a disagreement among the courts of appeal, the only ones that seems to apply are:

- A United States court of appeals has decided an important question of federal law that has not been, but should be, settled by this Court, or has decided an important federal question in a way that conflicts with relevant decisions of this Court.


Since the lower federal courts that considered Watters and the similar cases in other circuits seemed to have had little difficulty deciding in favor of national bank preemption, it is natural to infer that the Justices perceive a problem that needs correction and can be expected to reverse the Court of Appeals as to at least one of the questions presented (although it would not be unprecedented for the Court, having granted cert. despite the absence of a conflict among the circuits, to affirm). 9

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It may be tempting, as well, to speculate that the presence of two new conservative Justices on the Supreme Court – Chief Justice Roberts and Justice Alito – will result in a tilt towards states' rights that makes a reversal in *Watters* more likely. However, it is questionable that Chief Justice Roberts and Justice Alito are more sensitive to federalism concerns than the Justices they replaced. A third member of the Court who might be expected to be generally sympathetic to states' rights – Justice Thomas - has apparently recused himself from the case.\(^\text{10}\) In any event, although states’ rights were long associated with the legal apparatus of segregation, federalism issues are no longer so readily susceptible to analysis along lines of left versus right. They may arise now in the context of states' attempts to implement policies more "liberal" than those enshrined in Federal law, such as permitting medical use of marijuana, conferring a right to end one's life voluntarily with a doctor's assistance or, indeed, protecting state consumers from predation or other perceived abuses by national mortgage lenders.

To predict the outcome in *Watters*, it may be more useful to consider the legal merits of the parties' positions rather than the ideological composition of the Supreme Court. In this regard, whatever the wisdom of the broad preemption of state laws in favor of national banks' operating subsidiaries as a matter of policy, the legal arguments in its favor seem persuasive. Michigan's assertion that preemption in this case is barred by the Tenth Amendment seems particularly unconvincing. To paraphrase the United States' brief as *amicus* in *Burke v. Wachovia*, if a national bank may lawfully carry out certain functions through a state-chartered operating subsidiary, why should state laws not be

\(^{10}\) Justice Thomas took no part in the consideration or decision of the petition for certiorari in *Watters*. Since he also took no part in the Court's decision in *Wachovia v. Schmidt* (addressing the question of a national bank’s citizenship for purposes of diversity jurisdiction), he apparently has recused himself from all cases involving Wachovia Bank.
preempted with respect to such a subsidiary to the same extent as with respect to its national bank parent? The *Hopkins Savings & Loan* case, on which the State places so much reliance in its brief, seems readily distinguishable. That case involved Wisconsin's assertion of an interest in its own continued jurisdiction over a specially chartered corporation that it had *itself* chartered. It is not self-evident that the State of Michigan has a similarly strong interest in the regulation of a corporation, such as Wachovia Mortgage, chartered by a *sister* state. Moreover, Justice Cardozo's opinion for the *Hopkins* court expressly indicated that the provision of HOLA that was in question did not implicate the Commerce Clause. In contrast, both the District Court and the Court of Appeals in *Watters* found that Congress has assumed authority to regulate national banks under the Commerce Clause, a basis of authority undercutting the State's Tenth Amendment claim. Therefore, if the Supreme Court decides that it is appropriate to correct in some fashion the legal approach followed by the lower federal courts in *Watters* and similar cases, it seems somewhat more likely that the Court will rule on the first question presented in Michigan's petition, regarding the degree of deference due to federal agencies when they preempt state laws, rather than invoking a sweeping right of the States, grounded in the Constitution, to regulate state corporations. A decision clarifying the appropriate degree of deference might even leave undisturbed the outcome below, while establishing a framework for more careful consideration of state concerns in future cases of this type.

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12. 451 F.3d at 563; 334 F.Supp.2d at 966.
Some New Developments in Bank Securities Regulation

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A. If It Walks like a Duck, and If It Quacks like a Duck, It is a Barift

Soon after the passage of the Garn-St Germain Depository Institutions Act in 1982 (“Garn-St Germain”), thrifts began to seek to be treated as a “bank” for purposes of the Federal securities laws. At the time, the cause celebre was acting as a securities broker, so thrifts sought to enjoy the exemption that a “bank” then had from the definitions of “broker” and “dealer” under the Securities Exchange Act of 1934 (“Exchange Act”). In 1983, the SEC issued a release asking a number of questions about whether a thrift should be treated as a bank,1 and no further

1 Investment Company Act Release No. 13666, [1983-1984 Transfer Binder] Fed. Sec. L. Rep (CCH) ¶83,462 (December 12, 1983). The SEC sought public comment on whether it should propose one or more of the following: (i) to adopt rules that would exempt certain thrifts from the definition of “investment adviser” in the Investment Advisers Act of 1940 (“Advisers Act”), and common and collective trust funds maintained by a thrift from the registration requirements of the Investment Company Act of 1940 (“Investment Company Act”) and the Securities Act of 1933 (“1933 Act”), and from the registration, reporting, and proxy requirements of the Exchange Act; (ii) to adopt rules defining the term “bank” in the Investment Company Act, the Advisers Act, and Sections 3(a)(12) and 12(g)(2)(H) of the Exchange Act to include thrifts which perform specified functions substantially equivalent to those performed by banks; (iii) to adopt an interpretation of the term “bank” for purposes of the Investment Company Act, the Advisers Act, the 1933 Act, and the Exchange Act that would include thrifts which perform certain functions; and (iv) to develop a legislative proposal to amend the Exchange Act, the Investment Company Act, and the Advisers Act to include thrifts within the definitions of “bank” in such Acts, at least for certain purposes. It concluded that the SEC should not, by administrative interpretation through no-action letters, without notice and opportunity for comment, eliminate the distinction that Congress appears to have drawn in the Federal securities laws between banks and thrift institutions. The SEC then discussed the scope of its rulemaking authority, and asked commentators to focus specifically on: (a) whether in view of their expanded powers, thrifts can meet the definitional prerequisites of the term “bank” as defined in the Exchange Act, the Investment Company Act, and the Advisers Act; (b) if certain thrifts can meet the statutory elements of the definition of the term “bank,” how should the SEC clarify their status under the Federal securities laws; (c) whether in taking action on any of the alternatives discussed above, there are significant investor protection or public interest concerns that should be considered by the SEC; (d) the costs to thrifts of maintaining common trust funds and collective investment trusts subject to the registration, reporting and proxy requirements of the Federal securities laws; (e) the costs to thrifts of establishing a corporate subsidiary to engage in the trust business, the advisory business, or both; and (f) whether SEC action to implement any of the alternatives discussed above would create regulatory disparities that would be unjustified.
action was taken. Meanwhile, culminating in the famous no-action letter issued to Chubb, most thrifts were able to avoid registration as a securities broker or a dealer by engaging in networking activities where another, fully-licensed broker-dealer, engaged in brokerage activities on the premises of the thrift institution.

Somewhat under the radar screen, thrifts had previously been given the power to engage in trust activities in Section 403 of the Depository Institutions Deregulation and Monetary Control Act of 1980, which amended Section 5 of the Home Owners’ Loan Act of 1933 to authorize the Federal Home Loan Bank Board (“FHLBB”) to grant trust powers to Federal savings and loan associations and to issue regulations regarding the proper exercise of trust powers. Thereafter, FHLBB proposed regulations, which closely paralleled the Comptroller of the Currency’s Regulation 9, and adopted them. FHLBB also noted at that time that it did not have jurisdictional parity with the other Federal bank regulatory agencies respecting the Federal securities laws, i.e., a thrift was not a “bank,” and directed its staff to prepare a legislative proposal for this purpose. To the author’s knowledge, no such legislative proposal surfaced during the legislative process that produced Garn-St Germain. In November 1989, the Office of Thrift Supervision (“OTS”), as regulatory successor to FHLBB, re-promulgated the trust rules without substantive change or renumbering.

Beginning in the mid-1990s, OTS began reporting that certain thrifts were engaging in trust activities, which suggested that those thrifts were effecting transactions for the account of others [acting as a broker], sponsoring common trust funds and collective investment funds [investment companies unless excluded], and giving investment advice [acting as an investment adviser] apparently without registration under either the Exchange Act, the Investment Company Act, or the Investment Advisers Act.

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3 Pub. L. No. 96-221, §403, 94 Stat. 132 (codified at 12 U.S.C. §1464(n)).


Act, or the Advisers Act. Needless to say, a situation where an entire industry is out of compliance is very unsatisfactory for all concerned.8

Next came Section 223 of the Gramm-Leach-Bliley Act in November 1999, which somewhat inexplicably changed the long-standing definition of “bank” in the Investment Company Act; that definition had been substantially identical to the definition of “bank” in the 1933 Act, Exchange Act, and Advisers Act. In a new twist, however, the new definition of “bank” provided by Section 223 solely for purposes of the Investment Company Act has at its core the definition of “depository institution” in the Federal Deposit Insurance Act, which includes thrifts.9 Section 223 had appeared in many of the previous versions dating back to the early 1990s of what would become the Gramm-Leach-Bliley Act, and had been routinely supported in Congressional testimony by various representatives of the SEC. Nonetheless, the anecdotal evidence suggests that the SEC staff was surprised to discover that the new definition of “bank” has the practical effect of allowing thrift-sponsored common trust funds and collective investment trust funds to rely on Sections 3(c)(3) and 3(c)(11) of the Investment Company Act. This left thrifts in an anomalous and asymmetrical position: their brokerage activities were not subject to the Exchange Act by virtue of the Chubb no-action letter and its successor provisions in Section 3(a)(4)(B)(i) of the Exchange Act and their collective investment vehicles were not subject to the Investment Company Act, but their investment advisory activities were fully subject to the Advisers Act.

In Spring 2001, the OTS began pursuing legislative and administrative channels to address what it considered to be unequal treatment accorded to thrifts under the Exchange Act and Advisers Act.10 In April 2004, the SEC proposed a new rule that would have exempted certain thrift trust activities from the Advisers Act, and would have exempted certain common trust funds and collective investment funds from the Exchange Act.11 The comment letters were very critical of the Advisers Act proposal.12

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8 To the author’s knowledge, the SEC has not brought an enforcement case against a thrift for violation of the 1933 Act, Exchange Act, Investment Company Act, or Advisers Act solely with respect to the status of its trust activities under those statutes, a remarkable act of forbearance.

9 Section 223 amends the definition of “bank” in Section 2(a)(5)(A) of the 1940 Act to refer to the definition of “depository institution (as defined in section 3(c) of the Federal Deposit Insurance Act) or a branch or an agency of a foreign bank (as such terms are defined in section 1(b) of the International Banking Act of 1978).”


It should come as no surprise, then, that giving thrifts parity with banks has been a perennial candidate for adoption in the various “reg relief” bills that have been considered by Congress in recent years. In Spring 2006, the Senate passed S. 2856, The Financial Services Regulatory Relief Act of 2006. Section 401 of S. 2856 provided, essentially, that a thrift would be treated like a bank for purposes of the Exchange Act and the Advisers Act. On September 30, 2006, the House passed its version of S. 2856 without making any changes to Section 401. As a result, when the President signed this legislation on October 13th, thrifts achieved parity with banks under the Federal securities laws, ending an amazing 26 year-journey to become a barift.

B. SEC Regulation B: May It Rest in Peace

The Gramm-Leach-Bliley Act was signed into law by President on November 11, 1999. Title II of the Gramm-Leach-Bliley Act became effective on May 12, 2001, eighteen months later. On the day before it was to become effective, the SEC adopted Interim Final Rules interpreting the new “push-out” provisions of Title II that would give the SEC functional regulation over bank broker and dealer activities.13 Because the Interim Final Rules had been issued without notice and opportunity for comment, the SEC immediately suspended their effectiveness so that comments could be submitted. The comments from the banking industry were uniformly critical, and the comment letter from the four Federal banking agencies was notable for its suggestion that, in interpreting the “push-out” provisions, the SEC staff had acted in “bad faith.” In testimony that summer before the House Financial Services Committee, Acting SEC Chairman Laura Unger promised that the SEC would propose changes to the Interim Final Rules that would be acceptable to the banking industry and four Federal banking agencies, and that there would be a substantial period granted before the revised rules would become effective even after they were finally adopted. In spring 2004, the SEC published Regulation B,14 and was again greeted by uniformly negative comments from the banking industry and four Federal banking agencies. With something close to a stalemate in hand, the Financial Services Committee in the House floated the concept of requiring joint rulemaking between the SEC and the four Federal banking agencies.15 Fourteen of the twenty Senators serving on the Senate Banking Committee wrote to the SEC urging substantial revisions to Regulation B.16

Fast forward to spring 2006 when the Senate passed S. 2856. Section 101 of S. 2856 would have nullified any rules adopted by the SEC to implement the “push-out” provisions of Title II, and would have required the SEC to engage in a joint rulemaking with the four Federal banking agencies within 180 days of the enactment of S. 2856. On September 30, 2006, the


House passed its version of S. 2856 and changed Section 101 to require the SEC to jointly propose with the Federal Reserve Board, in consultation with the three other Federal banking agencies, a rule implementing the “push-out” provisions of Title II.17 As a result, when the President signed this legislation on October 13th, almost seven years from the day when the Gramm-Leach-Bliley Act was signed into law, it put an end to a very sad and embarrassing chapter in the history of functional regulation of financial services. To quote SEC Chairman Christopher Cox in a speech before the Financial Services Roundtable Annual Meeting on September 21, 2006, “All in all, the seven-year stretch from enactment of Gramm-Leach-Bliley until today is a disappointing record of indecision and inaction.” Interestingly, Commissioner Cox also stated: “I fully intend to complete work on a proposed rulemaking this year, and I expect a final rule to be completed within six months.” Given where things now stand, that is a truly ambitious schedule and it would be a genuinely remarkable achievement.