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Message from the Chair

To the Members of the Committee on Banking Law:

I am pleased to send you another quality edition of the Banking Law Committee Journal that will be posted on our Committee website. Several of the authors of the current and prior articles will be at the Spring Meeting in Dallas April 10-12, including at the Committee dinner at the Dallas Art Museum. They will be available there to discuss these articles in more detail and, as always, to autograph copies of the articles for your personal collection. We look forward to as many of you attending as possible.

I commend these and the now extensive set of prior articles on our website to you, both in terms of the relevance of the topics covered and the quality of the articles. These articles provide examples of the blending of legal expertise and practical experience that make the Committee very useful for lawyers who represent financial institutions, trade associations, and government regulatory agencies. Hopefully, this Journal will be the initial step you take in your use of the Committee as well as be helpful in acquiring practical insights in how to understand and address the legal, policy and compliance issues with which you are dealing.

Please also feel free to contribute to the dialogue, including by providing your opinion or analysis on current topical issues. Write a short article for the next edition and send it to any of the editors listed here. You will be speaking to the 1600 members of the Committee. Also, feel free to contact Chris Bellini at cbellini@gibsondunn.com or at our meetings if you want to discuss a proposed article or have other material suitable to be posted on our website for our members.

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Featured Articles

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Charlotte M. Bahin and Raymond Natter

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*Peter Heyward*

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What is all the fuss about? These investors have poured tens of billions of dollars into some of the biggest and most prestigious U.S. financial institutions, which sorely needed the cash infusions. This would seem clearly to be a very good thing. Nevertheless, it is apparent that SWF involvement in the U.S. economy evokes concern as well as relief among American policy-makers, business people and academics. In this article, I will try to provide an overview of SWFs and the issues that their recent investments have raised, focusing on investments in U.S. banking organizations.

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**Federal Appellate Court Overrules OCC on Auditor Liability**

*Travis P. Nelson*

Last month the U.S. Court of Appeals for the D.C. Circuit issued a significant decision affecting professional service firms in *Grant Thornton, LLP v. Office of the Comptroller of the Currency (OCC)*. Under review in this case was the Comptroller’s cease and desist and civil money penalty orders levied against Grant Thornton, LLP ("Grant Thornton") in connection with its external audit of First National Bank of Keystone, Keystone, WV. The OCC alleged several departures from accounting standards on the part of Grant Thornton, for example that it had relied upon oral confirmations of assets when prudential practices demanded obtaining written confirmations. Due to this and other alleged misfeasance, the OCC charged that Grant Thornton "recklessly engaged in an unsafe and unsound practice in conducting [Keystone's] affairs."

The Court reversed the Comptroller's decision, deciding instead that the OCC had not met its statutory burden for jurisdiction through which to exercise enforcement authority over Grant Thornton under Section 8 of the Federal Deposit Insurance Act ("FDIA").

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**Emerging Issues in UDAP: Preemption**

*Travis P. Nelson*

One of the broadest tools in a plaintiffs attorneys' arsenal, and that of public prosecutors as well, is state unfair and deceptive acts and practices laws, or "UDAP." Every state has enacted some form of UDAP law, sometimes called "little FTC Acts" after similar language found in Section 5 of the Federal Trade Commission Act: "Unfair methods of competition in or affecting
commerce, and unfair or deceptive acts or practices in or affecting commerce, are hereby declared unlawful." This article shall discuss some of the approaches that states have taken to UDAP legislation, and the application of preemption principals to UDAP cases.

More...
The Federal Reserve’s HOEPA Proposal and Subprime Related Legislation

by

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After receiving significant pressure from Congress, consumer groups and others, the Board of Governors of the Federal Reserve System issued a proposal that would address a number of the lending practices and concerns arising out of the current subprime lending situation.\(^1\) The proposal would amend Regulation Z, the regulation that implements the Truth in Lending Act, to implement provisions of the Home Ownership and Equity Protection Act (“HOEPA”). Previously, the Federal Reserve issued a regulation requiring the disclosures for high cost loans as defined by HOEPA.

**Background**

HOEPA was enacted in 1994 to address concerns regarding loans that meet the definition established in the statute for a “high cost” loan that is secured by the consumer’s principal dwelling, other than a residential mortgage transaction. Congress was concerned that consumers in particular neighborhoods were targeted by unscrupulous creditors who did not provide sufficient or clear disclosures and who offered loan products with abusive terms. Consumers would enter into transactions with these individuals and frequently lose their homes.

The loans covered by the statute have triggers based on the points and fees charged or on the interest rates charged. The Federal Reserve has the authority to revise the interest rate trigger within limits and the points and fees limitation is adjusted as necessary. Currently, a high cost loan is one that has an annual percentage rate at consummation that exceeds the yield on Treasury securities having comparable periods of maturity by more than eight percentage points for first lien loans, or by more than 10 percentage point for a subordinate lien loan. Alternatively, the total points and fees payable by the consumer at or before the closing exceeds the greater of eight percent of the total loan amount or $561. The dollar amount is adjusted annually. The Federal Reserve has issued regulations that require disclosures for loans meeting these requirements.

**Federal Reserve Authority**

The current proposal is considerably broader than the regulations. Under the Truth in Lending Act, the Federal Reserve has the authority to prohibit acts and practices in connection with mortgage loans that the Federal Reserve finds to be unfair, deceptive or designed to evade the provisions of HOEPA. The Federal Reserve may also prohibit acts and practices in connection with refinancing of mortgage loans that the Federal Reserve finds to be associated with abusive lending practices or not otherwise in the interest of the borrower.\(^2\)

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\(^1\) 73 Fed. Reg. 1672 (January 9, 2008)
\(^2\) 15 USC 1639(l)(2)
This authority is broad enough to reach mortgage loans that do not meet HOEPA’s rate or fee triggers as well as mortgage loans that are not covered by HOEPA, such as home purchase loans. The authority is not limited to regulating specific contractual terms of mortgage loan agreements, it extends to regulating loan related practices. Finally, the statute authorizes the Federal Reserve to adopt protections against unfair and deceptive practices when such practices are in connection with mortgage loans and protections against abusive practices in connection with the refinancing of mortgage loans. The statute does not establish a standard for what is unfair or deceptive.

The HOEPA Proposal

The proposal goes further than addressing high cost loans; it addresses unfair and deceptive practices for the vast majority of mortgage loans that are secured by a consumer’s residence. Among the issues addressed are broker steering, appraisal coercion, unwarranted serving fees, and deceptive advertising. The proposal also has a goal of providing consumers transaction specific disclosures early enough to use while shopping for a mortgage. The Federal Reserve has undertaken a project to test current disclosures and proposed disclosures with consumers. The scope of this proposal extends to all creditors, not simply insured depository institutions.

A number of the provisions in the proposal are similar to or the same as limitations to address practices identified in one or more the issuances of guidance that the agencies have developed over the past two years. However, as a regulation, the provisions will have more force than the guidance previously issued.

Prevention of unfairness, deception and abuse. The proposal includes seven new restrictions or requirements on mortgage lending and servicing that are intended to protect consumers against unfairness, deception and abuse. Some of these restrictions would apply only to higher priced loans and some would apply to all mortgage loans secured by the consumer’s principal dwelling. In addition to the specific prohibitions, the Federal Reserve would prohibit creditors from structuring closed end mortgage loans as open end lines of credit for the purposes of evading the rules. The following provisions would apply to higher priced loans:

- Creditors would be prohibited from engaging in a pattern or practice of extending credit without regard to the borrower’s ability to repay the loan from sources other than the collateral itself;
- Creditors would be required to verify income and assets on which they rely to make the loan;
- Prepayment penalties would be prohibited unless certain conditions are met; and
- Creditors would be required to establish escrow accounts for taxes and insurance, but borrowers would be permitted to opt out of escrows 12 months after consummation of the loan.

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3 Id.
The following protections covering closed end loans secured by the consumer’s dwelling are in the proposal:

- Creditors are prohibited from paying a mortgage broker more than the consumer had agreed in advance that the broker would receive;
- Any creditor or mortgage broker would be prohibited from coercing, influencing, or otherwise encouraging an appraiser to provide a misstated appraisal in connection with a mortgage loan; and
- Mortgage servicers would be prohibited from pyramiding late fees, failing to credit payments as of the date of receipt, failing to provide loan payoff statements upon request within a reasonable time, or failing to deliver a fee schedule to a consumer upon request.

**Mortgage Advertising.** The proposal also addresses advertisements for mortgage loans and the Federal Reserve proposes that advertisements for both open and closed end loans provide accurate and balanced information, in a clear and conspicuous manner about rates, monthly fees and other information. The following prohibitions are proposed:

- Creditors would not be permitted to advertise fixed rates or payments for loans whose rates or payments can vary without adequately disclosing that the interest rate or payment amounts are fixed only for a limited period of time;
- Creditors may not compare an actual or hypothetical consumer’s current rate or payment obligations and the rates or payments that would apply if the consumer obtains the advertised product unless the advertisement states the rates or payments that will apply over the full term of the loan;
- Creditors may not characterize that loans are part of “government loan programs” or “government-supported loans” or otherwise endorsed or sponsored by a federal or state government entity when the products are not part of a government supported or government sponsored program;
- Creditors may not send solicitation letters that display the name of the consumer’s current lender unless the advertisement discloses that the letter is from a lender that is not affiliated with the current lender;
- Creditors may not advertise that debts would be eliminated if the product advertised would replace one debt with another;
- Advertisements may not create a false impression that the mortgage broker or lender has a fiduciary relationship with the consumer; and
- Advertisements that contain certain information in a foreign language would be required to have the disclosures in the foreign language.

The comment period for the proposal closes on April 8, 2008. Seemingly, on a parallel track, Congress continues to debate as to what legislative changes may be necessary. Any final rule issued by the Federal Reserve may have additional restrictions and likely will include disclosures that have undergone consumer testing. Finally, the Federal Reserve has indicated that it will issue a general proposal on unfair or deceptive acts or practices in a few months.
Subprime Related Legislation

A number of Congressional proposals are being discussed in response to the market turmoil resulting from the problems in the mortgage markets. To date, only one has been signed into law: The Economic Stimulus Act of 2006. In addition to providing a direct fiscal stimulus through tax credits, this legislation is intended to enhance liquidity for larger mortgages by temporarily increasing the size of loans that Fannie Mae and Freddie Mac (GSEs) can securitize to 125 percent of the area mean, up to $729,750. The Federal Housing Administration (FHA) was also given the authority to insure home loans up to these new limits. However, the increased loan limits for the FHA and the GSEs will expire as of December 31, 2008 unless Congress takes action to extend the program or make it permanent.

With respect to the GSE’s, legislation is pending in Congress to provide a permanent increase in the size of the loans that these entities can purchase, coupled with a new regulatory structure that would provide for enhanced Federal oversight of these corporations. H.R. 1427 passed the House of Representatives on May 22, 2007. This bill establishes a new agency, the Federal Housing Finance Agency to examine, supervise and regulate Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. The agency is given powers similar to those of the bank regulatory agencies to set capital standards and take enforcement actions for safety and soundness violations. Senate Banking Committee Chairman Dodd has stated that he intends to introduce his version of a GSE reform bill in the near future.

With respect to the Federal Housing Administration, both the Senate and House have passed major reform proposals, and a compromise bill is expected to be ready soon. The House passed bill, H.R. 1852, would allow the FHA to insure mortgages up to $729,750, with a maximum term of up to 40 years, and without a minimum down payment requirement. A special insurance program is authorized for borrowers with FICO scores of 560 or below. The agency would be authorized to establish a risk-based premium structure. The Senate bill, S.2338, provides that the FHA could insure loans up to $583,800. The maximum term of the loan would remain 30 years, and the down payment requirement would be reduced from 3 percent to 1.5 percent.

Legislation also passed the House of Representatives to better regulate mortgage lenders. The bill, H.R. 3915, establishes a requirement for State licensing of non-depository mortgage originators, and would require all mortgage originators, including those working for a depository institution, to register with a National Registry. All mortgage originators would have a “duty of care” with respect to consumers, and would have to diligently work to present a range of “appropriate “products to any consumer who inquires about a loan. Anti-steering rules and other restrictions on originator compensation would be mandated.

With respect to lenders, the bill provides that creditors may only make a loan if they have determined that the borrower has a reasonable ability to repay the loan, according to its terms, and all applicable taxes, insurance and assessments. With respect to a refinancing loan, the creditor must also determine that the new loan will provide the borrower with a “net tangible

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5 American Banker, March 7, 2008 page 1.
benefit.” The bill establishes a presumption that certain loans meet these standards. For example, a first mortgage loan that has an APR that does not exceed 3 points over comparable Treasury rates is presumed to be acceptable. Assignees will have liability for loans that violate these standards, unless certain procedures are followed that are designed to prevent an assignee from accepting a loan that does not qualify under certain of the presumptions. However, assignees will always have potentially liability if the original creditor is no longer in existence.

In addition to these proposals, other ideas are being developed to relieve some of the liquidity problems in the mortgage markets. These ideas include resurrecting the Home Owners Loan Corporation (HOLC), which was established in 1933 to purchase non-performing loans in exchange for Government bonds. This Government owned loans were then restructured to provide borrowers lower payments, for example, by extending the maturity date.

Another legislative proposal which seems to be gaining support would be to establish a mechanism to purchase home loans from the creditor or securitization vehicle at a significant discount, provide for an FHA guarantee of the discounted loan, and then sell the loan into the secondary market, e.g. Fannie Mae or Freddie Mac. As part of this program an instrument would be created that would gain value if the home is eventually sold for more than the amount of the mortgage. This instrument, discussed as a “soft second,” would be a method for providing compensation to the FHA for ensuring the discounted loan, or could be used as an incentive for the current holders of these mortgages to sell them at a discount. Some suggest that an auction mechanism could be used in this process to establish the amount of discount that would be required.

An alternative to this proposal would eliminate the need to purchase the loan. Instead, the current holder of the loan, or a third party, could simply refinance the non-performing loan, again at a discount. If the refinanced loan meets certain standards, the FHA would ensure it. Again, a soft second would be created to ensure that any upside potential is allocated to the FHA or other appropriate party.
Are Sovereign Wealth Funds a Threat to the U.S. Banking System?

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A great deal of attention has focused recently on investments by “sovereign wealth funds” (“SWFs”) in the United States, particularly in banks and investment firms. SWF transactions regularly make headlines, at least in the business pages, and Congress has held three hearings on the subject in the last four months alone.2

What is all the fuss about? These investors have poured tens of billions of dollars into some of the biggest and most prestigious U.S. financial institutions, which sorely needed the cash infusions. This would seem clearly to be a very good thing. Nevertheless, it is apparent that SWF involvement in the U.S. economy evokes concern as well as relief among American policy-makers, business people and academics. In this article, I will try to provide an overview of SWFs and the issues that their recent investments have raised, focusing on investments in U.S. banking organizations.

Some Facts and Figures

Ted Truman, a Senior Fellow at the Peterson Institute for International Economics (and a former Director of the Division of International Finance at the Federal Reserve Board), describes SWFs as “separate pools of international assets owned and managed by governments to achieve a variety of economic and financial objectives.”3 They are not a

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1 The author is a partner in the Financial Services Group of Venable LLP in Washington. The views expressed in this article do not necessarily reflect those of other Venable lawyers or the firm’s clients.
2 On March 5, the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises and the Subcommittee on Domestic and International Monetary Policy, Trade and Technology of the House Financial Services Committee conducted a joint hearing on Foreign Government Investment in the U.S. Economy and Financial Sector. Less than a month before, on February 13th, the U.S. Congress Joint Economic Committee held a hearing entitled “Do Sovereign Wealth Funds Make the U.S. Economy Stronger or Pose National Security Risks?” On November 14, last year, the Senate Banking Committee had held a hearing to consider Sovereign Wealth Fund Acquisitions and Other Foreign Government Investments in the United States: Assessing the Economic and National Security Implications?
3 Testimony of Edwin M. Truman, Senior Fellow, Peterson Institute for International Economics, before the Senate Committee on Banking, Housing and Urban Affairs, November 14, 2007 (the “Truman Senate Testimony”). See also Testimony of Treasury Under Secretary for International Affairs David H. McCormick before the House Committee on Financial Services, March 5, 2008.
new phenomenon. The earliest ones are more than 40 years old, like the Revenue Equalization Reserve Fund established in 1956 by the Pacific island nation of Kiribati to manage revenues from phosphate deposits, or the Kuwait Investment Authority, established in 1960, and currently one of the world’s largest. The largest SWFs generally derive their revenues from commodity sales (like Kiribati and Kuwait, and many others) or trade surpluses (China). They can serve a variety of government objectives, such as diversifying revenues to avoid excessive reliance on a nonrenewable commodity export; setting aside reserves against the day when that crucial commodity has become depleted; or managing the potentially disruptive impact on domestic financial markets of large trade surpluses.

The new attention to SWFs is attributable, at least in part, to their rapid growth both in number and size in recent years, as well as the expectation that this growth will continue unabated for the foreseeable future. According to testimony of Treasury Under Secretary David McCormick in a March 5 Congressional hearing, there are now almost 40 SWFs, twenty of which have been created since 2000, with more than ten established since 2005. The funds’ total assets, estimated to range between $2 trillion to $3 trillion, are at least four times greater than in 2000. While their current size amounts to less than two percent of the $190 trillion stock of global financial assets, and is a small fraction of the $62 trillion managed by private institutional investors, it exceeds the total assets currently managed by hedge funds and private equity funds. SWF assets, moreover, are projected to continue increasing rapidly, with some expecting them to reach $10-15 trillion by 2015.

Countries with SWFs range from Azerbaijan ($2 billion in its State Oil Fund) to Abu Dhabi ($500-875 billion), and include close U.S. allies with democratic governments, such as Australia and Canada, as well as nations with which we have somewhat more guarded and wary relationships, such as Russia and China. The largest seven, in descending order of size, are those of Abu Dhabi; Singapore (two funds,

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4 See Truman Senate Testimony. According to another commentator, the Kuwait Investment Authority was launched in 1953. See State Capitalism: The Rise of Sovereign Wealth Funds, November 13th, 2007, a paper written by Gerard Lyons, Chief Economist and Head of Global Research at Standard Chartered Bank. Singapore SWF Temasek Holdings owns a 13% equity stake in Standard Chartered.

5 See note 3, above.

6 The data cited in this paragraph, all drawn from Under Secretary McCormick’s testimony, are generally consistent with estimates of other commentators.
totalling $208-438 billion); Norway ($329 billion); Kuwait ($213 billion); China ($200 billion) and Russia ($148 billion). Together, these seven account for well over two-thirds of total SWF assets.

If these statistics are not enough to command attention, SWFs in the past year have participated in a number of highly publicized transactions in the United States involving eye-popping sums, including:

- China’s $3 billion purchase in May 2007 of a nonvoting stake in the Blackstone Group, amounting to almost 10% of the company’s equity;

- the purchase by the Abu Dhabi Investment Authority, in November 2007, of a $7.5 billion investment in Citigroup, amounting to just under five percent of the voting stock, and edging out Saudi Prince Alwaleed bin Talal as the company’s largest single shareholder;

- Merrill Lynch’s December 2007 sale of $4.4 billion in new stock (with an option to purchase $600,000 more) to Temasek Holdings, an investment company owned by Singapore’s Ministry of Finance, concurrently with a sale of $1.2 billion in voting stock to Davis Selected Advisors, a U.S. private equity fund;

- Morgan Stanley’s sale of a $5 billion stake to China Investment Corporation, also in December 2007;

- Merrill Lynch’s agreement in January 2008 to issue $6.6 billion of mandatory convertible preferred stock to Korea Investment Corporation, Kuwait Investment Authority and Japan’s Mizuho Bank.8

Although not a SWF transaction, Bain Capital Partners’ bid to purchase network equipment maker 3Com Corp, in partnership with a Chinese investor, also drew attention to foreign governments’ growing role as investors here. The deal aborted last month

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7 Estimates of the size of the SWFs vary somewhat. These asset totals are taken from the Truman Senate Testimony, Table 1, except for China, taken from a September 2007 estimate by Morgan Stanley, cited in L. Tesik, Sovereign Wealth Funds, Council on Foreign Relations, January 18, 2008. The total asset figures for Abu Dhabi, Singapore, and Russia are also estimates.

8 SWFs have also made substantial investments in other countries’ economies, such as the $9.7 billion investment by the Singapore Investment Corporation in Switzerland’s UBS. The concerns such investments provoke are by no means confined to the United States. See, for example, the Statement of G-7 Finance Ministers and Central Bank Governors, issued on October 19, 2007, discussed in note 16 and the accompanying text.
when the transaction failed to obtain national security clearance from the interagency Committee on Foreign Investment in the United States ("CFIUS").

**What Are the Concerns?**

One might have expected that the substantial cash infusions in U.S. financial companies like Merrill Lynch, Morgan Stanley and Citigroup would have been greeted with unalloyed gratitude. After all, if any of these companies had failed to secure new capital, the repercussions for the wider U.S. economy could have been very serious. Moreover, it is reassuring to know that some investors, at least, have confidence in these icons of U.S. finance, and now have an even greater stake in the companies’ – and hence our country’s – continuing success and prosperity. These have indeed been the reactions of many market participants and observers, and not solely the shareholders and management of the companies involved. Moreover, even those who worry about the growing role of SWFs in international capital flows readily acknowledge the importance of keeping the United States open to foreign investment, recognizing the value of these investments in our financial institutions at a time of acute stress.

Yet, serious concerns have also been raised. They include a worry that SWFs owned by U.S. rivals will pursue their countries’ military and strategic objectives rather than ordinary business goals. Bain’s bid to acquire 3Com with a Chinese partner failed because of the perceived national security risks involved in the deal. In the House Financial Services Committee hearing on SWFs on March 5, a subcommittee chair fretted that a hostile power, in lieu of a direct military attack, might acquire a U.S. electric utility and then deliver an order to cut off our power.

In the banking context, the suspicions about foreign investors’ ulterior motives is partly based on the fact that canny U.S. investors are not coming to the rescue of our

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9 CFIUS, in its current incarnation, is itself a product of recent concerns about foreign investment in the United States. Its powers were enhanced in last year’s Foreign Investment and National Security Act of 2007, enacted after the ill-fated Dubai Ports deal heightened Congress’s concern about foreign acquisitions viewed as raising national security concerns.

10 Of course, reasonable people (and countries) might disagree as to what constitutes “ordinary” business goals and how they can be distinguished from government objectives thought to be motivated by non-economic concerns. For example, many SWFs have been established to ensure that wealth from nonrenewable resources is conserved for future generations. Such generational wealth transfer might be thought to be both good public policy and sound business planning.

11 This scenario was described by Representative Paul Kanjorski during the March 5 hearing described in note 2, above.
ailing financial firms. Therefore, the reasoning goes, the SWFs which are doing so must be seeking something more than a good return on investment.\textsuperscript{12} Even if a SWF is not pursuing military or other strategic objectives, might its government’s policy objectives trump the cool calculus of making money and thereby disrupt the smooth and rational functioning of markets driven solely by profit-seeking?

Another concern is that SWFs will gain control or influence over the companies in which they invest and use it for unfair advantage. In the past, critics of foreign government involvement in our banking sector have worried that government-owned banks might benefit from governmental subsidies or pursue lending or other policies designed to favor the business interests of home country companies, providing them with a competitive edge while distorting the credit allocation process.\textsuperscript{13}

And, even if SWFs pursue conventional investment objectives in their transactions, the sheer amount of money at their disposal might, it is thought, give them the power to move markets in ways that are disruptive and harmful to private sector participants. Some worry that foreign governments might stop investing here, or abruptly pull their money out, which might be even worse than the influence they arguably achieve by continuing to acquire U.S. assets. The prospect that foreign countries, like China, that hold large amounts of U.S. debt, might stop financing our deficits or even dump their current holdings is indeed sobering.\textsuperscript{14} However, the problem of an abrupt withdrawal of funds would seem to have limited relevance with respect to equity investments.\textsuperscript{15}

Fuelling these concerns is the fact that many SWFs are secretive and unaccountable to their own citizens, much less to the countries in which they choose to

\textsuperscript{12} See, e.g. Andrew Ross Serkin, “What Money Can Buy: Influence,” New York Times, January 22, 2008, quoting Felix Rohatyn: “They are making investments that they probably think are O.K. but not spectacular . . . there has to be a political objective over and above the rate of return.”

\textsuperscript{13} See, e.g., Statement of Federal Reserve Governor John LaWare, before the House Committee on Banking, Finance and Urban Affairs, May 8, 1992 (the “LaWare Statement”), noting the existence of such a concern but expressing the view that it was not justified by actual experience. The LaWare Statement is reproduced in 78 Federal Reserve Bulletin 495 (July 1992).


\textsuperscript{15} On March 4, the CEO of Dubai’s investment agency drew headlines, and may have contributed to a drop in Citigroup’s share price, when he commented that the multi-billion dollar equity investments in Citigroup already made by Abu Dhabi, Kuwait and Saudi Prince Alwaleed would not suffice to “rescue” Citigroup.
invest. For example, while Norway’s large pension fund is a model of transparency and good governance, disclosing both its holdings and the investment objectives they are intended to achieve, others – like Abu Dhabi’s – reveal little about such matters. The lack of transparency gives free rein to the worst fears regarding the motives of SWF investors and has led both supporters and critics of largely unrestricted international capital flows to support adoption of a code of “best practices” to be followed by SWFs. On October 19, 2007, the Finance Ministers and Central Governors of the Group of Seven issued a statement recognizing that their economies “can benefit from openness to SWF investment flows,” while calling for the World Bank, IMF and OECD to work on a code of “best practices of SWFs in such areas as institutional structure, risk management, transparency and accountability.” The OECD and the IMF are expected to issue proposals in March and April, respectively.

**Are the Concerns Relevant to Banks?**

However justified they may be as a general matter, the worries about SWF investments in the United States seem to have little relevance with respect to the banking sector. Control of a major U.S. bank, even if it could be achieved, would be unlikely to lead to preferential lending or other abuses. For one thing, the regulatory approval process for bank acquisitions – whether by a company, an individual, or a government agency – involves extensive vetting by federal regulators. A SWF seeking a significant stake in a U.S. banking organization would need to obtain approval under the Bank Holding Company Act, the Savings and Loan Holding Company Act or the Change in Bank Control Act. While a sovereign fund might be opaque to outsiders, U.S.

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16 Ted Truman’s testimony before the Senate Banking Committee on November 14, 2007, cited in note 2, includes several tables ranking SWFs according to various criteria, including Transparency & Accountability, Structure, and Governance. In Mr. Truman’s analysis, the Abu Dhabi Investment Authority and Corporation scored zero points out of a possible total of 12 for Transparency & Accountability. Even Singapore’s Temasek Holdings, often cited as a model of transparency, does not prominently disclose on its Web site that it is owned by that country’s Ministry of Finance.

17 See Statement of G-7 Finance Ministers and Central Bank Governors, October 19, 2007, available on the Web site of the Treasury Department, [www.ustreas.gov/press/releases/hp625.htm](http://www.ustreas.gov/press/releases/hp625.htm). The joint action of the G-7 officials reflects that the concerns about SWFs are shared by other industrialized nations that are experiencing similar economic pressures. Unsurprisingly, many of the SWFs question the need for such a code, pointing out that, to date, they have avoided political interference in the countries where they invest, and have good records as corporate citizens. See Steven R. Weisman, “Overseas Funds Resist Calls for a Code of Conduct,” New York Times, February 9, 2008.

18 A SWF organized as a business entity, as many are, would likely be treated as a “company” under the Bank Holding Company Act. A foreign government or government agency would not be so treated, but
regulators would require adequate disclosure of ownership and other material facts as a condition to approval of a bank acquisition. Moreover, the reporting and examination regime that would apply following the acquisition, as well as the restrictions on non-arm’s-length transactions under federal banking laws, would provide substantial safeguards against the types of abusive transactions feared by some.

To date, SWF investments in Citigroup and other U.S. financial institutions have been structured to fall below “control” thresholds and have not resulted in board representation, suggesting that these investors are aware of the concerns that larger investments might evoke, as well as, perhaps, that they have little appetite for being regulated as depository institution holding companies. The significant stakes of investors such as Saudi Arabia’s Prince Alwaleed and the Abu Dhabi Investment Authority in Citigroup no doubt provide them with influence over the organization, but this is to be expected, consistent with good corporate governance. There is no evidence that this influence has exceeded that which any large shareholder would expect or could legitimately exercise.

In addition, banks are not themselves, and do not generally possess, the types of strategic assets whose control by foreigners raises national security concerns. A foreign country that wishes to acquire control of a U.S. bank or securities firm in order to obtain the secret of its lending and securitization practices is welcome to have them!

Concerns about foreign government involvement in U.S. banking are not new. It seems almost incredible now, but Congress in 1992 considered legislation that would have precluded foreign government-owned banks from engaging in any financial transactions in the United States, whether through a subsidiary or a branch, other than extensions of credit for trade finance. Federal Reserve Governor John LaWare, in testifying against the proposal, provided a detailed account of the abuses that foreign government ownership might entail, including unfair competitive advantage and preferential lending. He reported then that “[m]ost foreign government-owned banks...
operating in the United States behave in a manner fully consistent with market practices and in compliance with law. Although we recognize that abuses have occurred, such abuses have been limited in number and cannot be attributed to the mere fact of government ownership.” Governor LaWare also assured his listeners that the Federal Reserve Board possessed the regulatory tools to deal with the issues presented by the operations of foreign government-owned banks. I believe the Federal Reserve would take the same positions today.

It would appear that wariness about SWFs stems, in part, from understandable uneasiness about our economy’s fragility, as well as, perhaps, the perception that the days of unquestioned American economic primacy and dominance are over. Xenophobia and partisan politics also seem to be playing a part. Much of the Congressional criticism of SWFs has come from Democrats, who evidently view the issue as a stick with which to belabor the Bush Administration, whose fiscal, trade and other economic policies they blame for contributing to the weakness of U.S. financial institutions and the strength of the SWFs that are riding to their rescue. Whether that blame is misplaced is debatable, but the problems of energy dependence, trade imbalances and deficit spending are real enough.

In sum, while the economic trends that have thrust SWFs into new prominence are a legitimate cause for concern, the prospect of more investments by these funds in the U.S. economy generally, or its financial institutions in particular, does not seem especially worrisome. The Peterson Institute’s Ted Truman expressed the point well: “We live in a risky world, but the economic and political risks to the United States from sovereign wealth funds do not make my top 100.”

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20 See the LaWare Statement.
Federal Appellate Court Overrules OCC on Auditor Liability

By:
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Last month the U.S. Court of Appeals for the D.C. Circuit issued a significant decision affecting professional service firms in *Grant Thornton, LLP v. Office of the Comptroller of the Currency (OCC)*. Under review in this case was the Comptroller’s cease and desist and civil money penalty orders levied against Grant Thornton, LLP (“Grant Thornton”) in connection with its external audit of First National Bank of Keystone, Keystone, WV. The OCC alleged several departures from accounting standards on the part of Grant Thornton, for example that it had relied upon oral confirmations of assets when prudential practices demanded obtaining written confirmations. Due to this and other alleged misfeasance, the OCC charged that Grant Thornton “recklessly engaged in an unsafe and unsound practice in conducting [Keystone’s] affairs.” The Court reversed the Comptroller’s decision, deciding instead that the OCC had not met its statutory burden for jurisdiction through which to exercise enforcement authority over Grant Thornton under Section 8 of the Federal Deposit Insurance Act (“FDIA”).

The rationale of the 2-1 majority in this case does not impart a feeling of certainty for service providers to financial institutions going-forward. The majority concentrated on the language in the FDIA, which in order to meet the standard for acquiring jurisdiction requires proving that the respondent recklessly participated in an unsafe or unsound practice in conducting the bank’s business. According to the majority, Grant Thornton was not “participating” in the conduct of Keystone’s business so as to invoke Section 8 jurisdiction and remedies because: (a) Grant Thornton was not engaged to perform a “banking practice,” (b) Grant Thornton played no “directive role” in Keystone’s affairs, and (c) nothing in the legislative history of the FDIA Section 8 suggests that poor auditing was the evil that Congress had intended to address in providing for third party liability. Moreover, the proper remedy for the OCC to address this type of issue lies, according to the Court, in the OCC’s debarment authority, not a CMP or C&D.

The concurrence, which probably applied the better rationale if the ultimate judgment is believed to be correct, disagreed with the heart of the majority’s theory that Grant Thornton is not liable because conducting an external audit to verify the bank’s books fails as a “banking practice” and therefore is outside the scope of Section 8. The concurrence instead focused on whether the conduct of the two Grant Thornton auditors could be imputed to the entire firm. According to Judge Henderson, such could only be accomplished if sufficient numbers of other partners in the Grant Thornton organization had participated in, or at least were aware of, the alleged misfeasance.

If we read the Court’s rationale narrowly, then we can view the Court’s holding as merely carving out one area of service provider conduct for which Section 8 liability might not attach,

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and punting the more difficult exercise of identifying a workable test for a later dispute. Another reading of the decision, however, suggests that the Court intended a broader interpretation of the “bank practice” concept. The Court notes that Grant Thornton’s activity “is not a ‘practice’ of a depository institution or bank.” The Court then proceeds to discuss the definition of a “depository institution” or “bank” as described in the FDIA and Webster’s dictionary, suggesting that in order for a federal bank regulatory agency to properly exercise enforcement jurisdiction under Section 8, the third party must be performing a “banking practice” normally identified with banks. This leads to the question of whether the scope of “banking practice” would mean traditional banking activities, such as deposit taking, lending, and the like, versus any of the number of activities “incident to” the business of banking that the agencies have addressed.

In the end, assuming that this decision is left to stand, future courts may opt to avoid the possible ambiguities of the majority opinion. Instead, they may take the road more easily traveled by the concurrence, and decide that regardless of whether or not the third party was participating in banking activities, the alleged misfeasance at issue was not so pervasive throughout the respondent company to warrant exercise of jurisdiction under the Section 8 of the FDIA.

Enforcement actions against professional services firms are inherently troublesome, both form the agency’s viewpoint, and that of the respondent firm. Unlike enforcement actions against in-house professionals, where an agency has jurisdiction to bring an enforcement action against an insider as an “institutional-affiliated party” or “IAP” merely by virtue of the insider’s status as an employee, the statutory definition of an IAP as applied to an outside third party service provider requires the agency to prove that the third party was “reckless” before they can be labeled an IAP. Not only does this present a tougher burden of proof for enforcement counsel, it also stands as an obstacle to resolving an enforcement action through a consent order (settlement) because the opening paragraphs of most settlement documents, which recite the basis for jurisdiction, put the respondent in the position of possibly stipulating to reckless conduct (i.e., stipulating to IAP status as a third party). The OCC has in the past attempted to avoid this problem by omitting any reference to the specific statutory provision on reckless IAPs, opting instead to merely label the respondent as an IAP with no further explanation, or as Tony Soprano would say: “It is what it is.”

Make no mistake, this case is a victory for accounting firms, law firms, and most other large companies that perform services for depository institutions, as regardless of the rationale of the Court’s decision, enforcement counsel at the bank regulatory agencies will be less likely to bring enforcement actions against an entire firm for the missteps of a few.

But will this make banks safer and more sound? Often times, the line between what third party professional service providers are retained to do for a bank, and what they actually do, is gray at best. Especially in the case of smaller banks, or even large banks encountering novel issues, outside professionals, like accountants, attorneys, and consultants, are initially called upon to address one particular issue, but are relied upon by the institutions to provide informal advice on a broader range of matters. Because of this, federal agencies like the OCC should be able to look beyond the four corners of the engagement agreement, and examine what the professionals were actually doing. Did the accountant, attorney, or consultant’s conduct become, if not “directive,” at least “highly persuasive” to the institution’s policymakers such that they have become quasi-officers themselves? We will have to wait for the next major failure to find out.
Emerging Issues in UDAP: Preemption

By: Travis P. Nelson

One of the broadest tools in a plaintiffs attorneys’ arsenal, and that of public prosecutors as well, is state unfair and deceptive acts and practices laws, or “UDAP.” Every state has enacted some form of UDAP law, sometimes called “little FTC Acts” after similar language found in Section 5 of the Federal Trade Commission Act: “Unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce, are hereby declared unlawful.” This article shall discuss some of the approaches that states have taken to UDAP legislation, and the application of preemption principals to UDAP cases.

Overview

Each state’s UDAP statute contains its own variants on the federal model, with provisions for private rights of action, enforcement by state officials, and exclusions. For example, the Maryland Consumer Protection Act contains fourteen enumerated unfair or deceptive practices including making “false, falsely disparaging, or misleading oral or written statement, visual description, or other representation of any kind which has the capacity, tendency, or effect of deceiving or misleading consumers,” and “deception, fraud, false pretense, false premise, misrepresentation, or knowing concealment, suppression, or omission of any material fact with the intent that the consumer rely on the same in connection with . . . the promotion or sale of any consumer goods[.]”

New Jersey’s Consumer Fraud Act provides:

The act, use or employment by any person of any unconscionable commercial practice, deception, fraud, false pretense, false promise, misrepresentation, or the knowing concealment, suppression, or omission of any material fact with intent that others rely upon such concealment, suppression or omission, in connection with the sale or advertisement of any merchandise or real estate, or with the subsequent performance of such person as aforesaid, whether or not any person has in fact been misled, deceived or damaged thereby, is declared to be an unlawful practice; provided, however, that nothing herein contained shall apply to the owner or publisher of newspapers, magazines, publications or printed matter wherein such advertisement appears, or to the owner or operator of a radio or television station which disseminates such advertisement when the owner, publisher, or operator has no knowledge of the intent, design or purpose of the advertiser.

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4 N.J.S.A. § 56:8-2. The term “merchandise” for purposes of the Act include[s] any objects, wares, goods, commodities, services or anything offered, directly or indirectly to the public for sale.” N.J.S.A. § 56:8-1(c).
Pennsylvania’s Unfair Trade Practices and Consumer Protection Law ("UTPCPL") provides twenty-one illustrative examples of unfair or deceptive acts or practices, with the twenty-first being a catch-all provision prohibiting: “Engaging in any other fraudulent or deceptive conduct which creates a likelihood of confusion or of misunderstanding.”

The epicenter of UDAP activity in the nation of late has been California’s Unfair Competition Law, or “UCL,” more commonly referred to as “§ 17200.” The UCL prohibits “any unlawful, unfair or fraudulent business act or practice and unfair, deceptive, untrue or misleading advertising,” and carries a range of remedial tools, including enforcement by the state and by private individuals, and the ability to sue for injunctive and restitutionary relief.

Preemption

One of the most debated areas of UDAP law in recent months has been the application of federal preemption principals to the California UCL.

The most recent round of preemption battles began in December 2007, when a federal district court in California ruled, in Jefferson v. Chase Home Finance (Jefferson), that the UCL is not preempted by the National Bank Act (NBA).

At issue in this case was the practice of an operating subsidiary of Chase, a national bank, of applying additional mortgage payments received after the full monthly payment to principal only if the payments are specifically designated as principal prepayments. As explained by Chase, if it receives extra funds in the same check as the regular monthly payment, Chase automatically applies the extra funds directly to the prepayment of principal. If, however, Chase receives undesignated funds after the borrower has made a regular monthly payment, Chase places the funds in “suspense,” and requests the borrower to specify how those funds should be applied in the next monthly statement (e.g., to the following month’s payment, to principal, to unpaid fees, or to escrow).

The reasoning for this practice, according to Chase, is that many borrowers send in multiple undesignated partial payments each month to make up a regular monthly payment, if Chase were to process partial payments as prepayments of principal those borrowers might not have sufficient funds to make up a regular mortgage payment at the end of the month, and inappropriately incur a late fee.

The plaintiff in this case argued that Chase’s practice was inconsistent with the stated terms of its contract with borrowers, and that as such Chase engaged in “unfair, fraudulent, and unlawful practices in violation of the UCL. The plaintiff based its UCL claim on alleged violations, including (1) California’s prohibition on false advertising, (2) misrepresentation theories, specifically that the contractual misrepresentations were “fraudulent” because they are likely to deceive the public, and (3) that the representations were “unfair” insofar as they constituted a systemic breach of contract.

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5 Cal. Bus. & Prof. Code § 17200
California state courts have held that under the UCL even a “perfectly true statement couched in such a manner that it is likely to mislead or deceive the consumer” is actionable. The defendant argued, among other things, that the plaintiff’s state law claims were preempted because they were either expressly preempted by or in conflict with the NBA and implementing regulations promulgated by the Office of the Comptroller of the Currency (OCC).

In ruling that federal law does not preempt the UCL claim at issue in this case, the Jefferson court stated that “laws of general application, which merely require all businesses (including banks) to refrain from misrepresentations and abide by contracts and representations to customers do not impair a bank’s ability to exercise its lending powers. They only ‘incidentally affect’ the exercise of a Bank’s powers, do not fall into the enumerated categories of [OCC preemption regulations], and are therefore not preempted.” “The core issue in this case,” according to the Court, “will be not whether or when Chase is permitted to place payments in suspense accounts, but whether Chase misrepresented to customers what it would do with their payments.”

This case presents an example of the on-going debate surrounding the seemingly unlimited reach of the UCL. One of the key issues has been whether the UCL can stand alone as a cause of action, or whether it must be tethered to an independent substantive, statutory protection or prohibition. In this case, the plaintiff presented its UCL claim as a stand alone claim, as well as part of a violation of the California Consumer Legal Remedies Act (CLRA). However, the CLRA does not contain technical requirements or prohibitions, but rather prohibits conduct that is “likely to deceive” a reasonable consumer. As this case blesses both “tethered” and “untethered” theories, it does not bring clarity to this debate.

Another important and related issue that this case raises, and which has been a topic of debate for practitioners, is the applicable preemption principles. If the UCL claim was based on a substantive statute that purported to impose technical restrictions on the activities of national banks, such as a prohibition on collecting certain non-interest charges, or limiting credit terms, then that substantive statute, and any claims based on that statute, such as a UCL claim, would likely be preempted. As for a general claim that a lender’s practice is “unfair,” the Court acknowledged in dicta that such a claim “may well be preempted.” However, the Court declined to engage in that analysis.

By allowing the plaintiff to proceed under the UCL for practices that are entirely truthful and technically compliant with all applicable disclosure laws, the California courts have created the distinct possibility that California consumers may attempt an end-run around federal preemption by arguing that substantively compliant disclosures or documents are nonetheless “unfair or deceptive.” This will frustrate the purpose of the preemption doctrine as contained in the NBA and present operational headaches and added costs particularly for banks’ compliance departments, who will be forced to determine not only that their products and disclosures are technically compliant with disclosure laws such as the Truth-in-Lending Act, but also that they are compliant with UCL-type claims.

It remains to be seen how the preemption analysis of state UCL laws may be affected by federal rulemaking on UDAP currently being contemplated by the Federal Reserve Board and the Office of Thrift Supervision (OTS). It is conceivable, particularly for OTS UDAP regulations, that such federal regulations may be viewed as displacing state UDAP laws.
Just over a month after *Jefferson*, the U.S. Court of Appeals for the Ninth Circuit issued its ruling in *Rose v. Chase Bank USA, N.A.* (*Rose*).\(^7\) The plaintiffs in this case alleged that Chase, a national bank chartered by the OCC, sent its customers convenience checks that failed to contain certain disclosures required under California law. The plaintiffs asserted three theories of liability under § 17200.

First, the plaintiffs alleged that the failure to provide the required disclosures violated substantive disclosure requirements under California law and therefore constituted an “unlawful” practice. Second, the plaintiffs argued that the failure to provide the disclosures (regardless of whether the defendant’s actions violated substantive disclosure law) constituted a “fraudulent” business practice, or was “deceptive or misleading advertising.” Third, they argued that the failure to provide the disclosures at issue was an “unfair” business practice, again regardless of whether a technical violation of law occurred.

The court rejected all of the plaintiffs’ theories. The court found that requiring a national bank to observe the state disclosure law would hamper the federally permitted activities of a national bank, and therefore are preempted by the NBA. As to the more general alleged “unfair” and “deceptive” practices, the Court found that regardless of the exact state law claim alleged, the legal duties underlying the plaintiffs’ UCL claims were the same purported duties to disclose imposed by the technical disclosure provision. In other words, the more abstract unfairness and deception allegations were so close to the violation of the state’s technical disclosure requirement that those state law claims must also fail as preempted under the NBA.

One of the crucial points of the *Rose* decision, and what will likely emerge as the basis for citing to *Rose* in subsequent decisions, is the following passage:

> Regardless of the nature of the state law claim alleged, however, the proper inquiry is whether the “legal duty that is the predicate of” Plaintiffs’ state law claim falls within the preemptive power of the NBA or regulations promulgated thereunder. Here, from the face of Plaintiffs’ complaint, the district court correctly found that Defendants’ alleged legal duties that underlie Plaintiffs’ UCL claims for “deceptive” or “unfair” business practices are the same purported duties to disclose imposed by Cal. Civ. Code § 1748.9, and that are preempted by the NBA and OCC regulations.\(^8\)

This language has striking, and perhaps fatal, implications for the so-called “teathered” use of § 17200 claims, wherein the violation of some substantive statute (e.g., a statute requiring certain technical disclosures) is used as the basis for a UCL claim.\(^9\) As the excerpted passage indicates, where the substantive statute is preempted, then so is application of the state UDAP law.

What neither of these cases addresses, and what may be the next topic to be examined under California’s UCL, is whether the NBA shields national banks from UCL claims that are wholly unrelated to any substantive law, and instead merely allege that a national bank’s conduct, while

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\(^7\) 2008 WL 185491 (9th Cir. Jan. 23, 2008).

\(^8\) *Id.*

\(^9\) Notably, this teathering approach is often used where the remedies available under the UCL are more favorable than those available under the substantive statute, if any.
fully consistent with the NBA and OCC regulations, is simply “unfair” or “deceptive” (possibly under Federal Trade Commission Act precedent).

**Conclusion**

The above cases beg the question as to whether it is possible for a national bank to act in full compliance with federal law and yet act in an unfair or deceptive manner under state law. Given the structure of our federal system, it seems unlikely that a state UDAP statute will be successfully applied against a federally-chartered institute that is otherwise in full compliance with technical requirements of federal law as well as its own representations, but we will await the next legal decision on the issue.