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REGULATORY ARBITRAGE IN BANKING

The existence of numerous types of financial institution charters in the United States offers to potential investors the possibility to arbitrage the different powers and limitations associated with each entity. There are several different types of bank charters, and significant overlap between the businesses and permitted activities of banks and securities firms.

Below we list certain differences among the charters that offer different options:

1. State v. Federal banking law

State chartered banks have existed since States were first formed in America. The State of New York has been granting State charters for hundreds of years. The National Bank Act was passed in 1864 and authorized the creation of federally chartered banks. Each form of charter authorizes its users to engage in separately defined banking activities. Many States have “wild card” provisions permitting State banks to exercise any power permitted to national banks. In general, national charters offer banks the ability to engage in permitted activities across State lines without regard to contradictory State laws. State charters may offer banks the ability to engage in a larger variety of activities than do national charters.

In recent years, many larger banks have “flipped” their charters to national charters in order to take advantage of aggressively interpreted federal preemption of State laws regarding licensing, lending and fees. Preemption has become the largest issue for banks to consider in determining what charter to choose. There has been a significant amount of litigation concerning the extent to which inconsistent State laws are preempted. Below is a primer on preemption:

Applicable Provisions of the National Bank Act—12 U.S.C. § 1 *et seq.*

The National Bank Act specifically authorizes national banks to engage in many types of real estate lending. National banks are also authorized to exercise powers incidental to their banking business. The NBA provides that banks have the power “[t]o exercise . . . subject to law, all such incidental powers as shall be necessary to carry on the business of banking.” 12 U.S.C. § 24 (Seventh).

Applicable Federal Regulations—12 C.F.R. § 34.4 and 12 C.F.R. § 7.4008

OCC regulation 12 C.F.R. § 34.4, which covers real estate lending, provides that: “[e]xcept where made applicable by Federal law, state laws that obstruct, impair, or condition a national bank’s ability to fully exercise its federally authorized real estate lending powers do not apply to national banks. Specifically, a national bank may make real estate loans under [applicable federal statutes], without regard to state law limitations concerning” licensing, interest rates, escrow accounts, etc. However, the regulation also provides that state laws on certain subjects “are not inconsistent with the real estate lending powers of national banks and do apply to national banks to the extent that they only incidentally affect the exercise of national

banks' real estate lending powers.” Those subjects include contracts, criminal law, taxation, zoning, and torts. A similar OCC regulation, 12 C.F.R. § 7.4008, deals with the non-real estate lending activities of national banks and provides that national banks may make sell, purchase, participate or deal in loans and interest in loans that are not secured by liens on or interests in real estate “subject to such terms, conditions, and limitation prescribed by the OCC and any other Federal law.”

Inapplicability of the Presumption Against Preemption of State Law

Ordinarily a presumption against preemption applies in areas of regulation traditionally governed by the states. United States law allows for banks to be chartered under both federal and state law. National banks are chartered pursuant to the NBA and are subject first and foremost to federal law. Accordingly, no presumption against federal preemption applies to state laws affecting national banks because of the history of significant federal presence in national banking. *Bank of America, N.A. v. City & County of San Francisco*, 309 F.3d 551 (9th Cir. 2002). Federal statutes and federal regulations have the same preemptive effect. *The Clearing House Association LLC v. Cuomo*, 2007 U.S. App. LEXIS 27938 (2d Cir. 2007). However, national banks are not entirely immune from application of state law. States can regulate them to the extent permitted by federal law.

OCC Intervention and Interpretive Letters

The OCC has intervened in a number of cases involving large national banks as defendants and state or local laws with the potential of having a significant impact on national banks' exercise of their powers. *See e.g., Clearing House Association LLC v. Cuomo*, 2007 U.S. App. LEXIS 27938 (2d Cir. 2007) (New York state attorney general sought to exercise visitatorial powers to enforce national banks' compliance with antidiscrimination laws).

Relevant Case Law Regarding National Banks and Federal Preemption of State Law Affecting National Banks

National banks are instrumentalities of the federal government and subject to the authority of the United States. *Marquette National Bank v. First of Omaha Serv. Corp.*, 439 U.S. 299 (1978). The Supreme Court has consistently recognized this unique status of national banks and the limits placed on the states' ability to pass laws affecting them. Courts have invalidated many state and local restrictions on national banks where the activities of the national banks are authorized by federal law. When state or local laws have restricted wholly or partially the exercise of an authorized national bank power, courts have invalidated those laws finding that they are preempted by federal laws and/or regulations. *Bank Activities and Operations; Real Estate Lending and Appraisals*, 68 Fed. Reg. 46,128 (OCC, Aug. 5, 2003); *see also Bank of America v. City and County of San Francisco*, 309 F.3d 551 (9th Cir. 2002).

However, national banks remain subject to state laws of general application in their daily business. State or local law applies to national banks in circumstances that do not alter, condition or interfere with a national bank's ability to exercise a power granted by federal law. *Barnett Bank of Marion County v. Nelson*, 517 U.S. 25 (1996). States may regulate national banks in areas such as contracts, debt collection, taxation, zoning, criminal law, and tort law.

These laws “do not materially affect the real estate lending powers of national banks or are otherwise consistent with national banks’ Federal authority to engage in real estate lending.” *Bank Activities and Operations; Real Estate Lending and Appraisals*, 68 Fed. Reg. 46,128. These state laws “do not attempt to regulate the manner or content of national banks’ real estate lending, but instead form the legal infrastructure that surrounds and supports the conduct of that business. In general, the types of laws that are not preempted are those that promote national banks’ ability to conduct business, rather than obstruct national banks’ exercise of their real estate lending powers.” *Id.*

Federal Preemption of State and Local Tort Law

In *Austin v. Provident Bank*, 2005 U.S. Dist. LEXIS 37113 (N.D. Miss. July 26, 2005), plaintiffs brought suit against a national bank alleging that the bank committed a number of state law torts. The court found that although the complaint was framed in state tort law terms, the complaint sought remedies for the charge of excessive fees and interest from national banks in connection with real estate loans and was preempted. The court held that allowing redress under state tort and contract laws for the claims would result in a more than incidental effect on the exercise of a national bank’s real estate lending powers, and would circumvent preemption of the NBA and regulations promulgated by the OCC. *See also Penner v. Chase Bank USA, N.A.*, 2006 U.S. Dist. LEXIS 53179, at **14-15 (W.D. Wash. Aug. 1, 2006).

However, in *Johnson v. Wachovia Bank, N.A.*, 2006 U.S. Dist. LEXIS 3992 (D. Md. Feb. 2, 2006), the district court found that plaintiff’s tort claims against a national bank were not preempted by the NBA. Plaintiff brought suit against Wachovia based on allegations that her signature on deeds of trust supporting loans were forged and that a bank employee negligently notarized the deeds. She asserted state law claims for fraud and negligence. The court found that plaintiff’s claims were not preempted. There was nothing unique about national banks in considering this question because any business entity is under a duty not to base a commercial transaction on forgery, and standards governing that duty are traditionally established by state common and statutory law. Therefore, plaintiff’s tort claim based on the acceptance of forged documents fell within the exception created by 12 C.F.R. § 34.4(b) for the application of state contract and tort law to national banks. *See also Jefferson v. Chase Home Finance*, 2007 U.S. Dist. LEXIS 94652, at **28-29 (N.D. Cal. Dec. 14, 2007).

Recently, the 9th Circuit Court of Appeals held that three causes of action based on California tort law alleging unfair credit card practices were preempted by the NBA. *See Rose v. Chase Bank USA* (9th Cir. Jan. 23, 2008).

Federal Preemption of State and Local Contract Law

Courts have found that mere allegations of breach of contract by a national bank are not preempted by the NBA or regulations promulgated thereunder. For example, in *Levitanksy v. FIA Card Services, N.A.*, 492 F. Supp. 2d 758 (N.D. Ohio 2007), the court found that plaintiff’s allegations that defendant national bank charged a transaction fee higher than that which the parties agreed to amounted to a simple breach of contract claim. Because plaintiff did not allege that the fees were usurious or illegal, plaintiffs’ claims were excluded from preemption by the exception in 12 C.F.R. § 34.4(b) for state contract laws only incidentally affecting the bank’s

lending power. *See also Patterson v. Regions Bank*, 2006 U.S. Dist. LEXIS 86029 (S.D. Ill. Nov. 27, 2006).

Case Notes for Federal Preemption

- The United States Supreme Court held that a national bank's mortgage business, whether conducted by the bank itself or through the bank's operating subsidiary, is subject to oversight by the OCC, and not by state banking laws or regulators. *Watters v. Wachovia Bank, N.A.*, 127 S. Ct. 1559 (2007).
- The Court held that a federal statute that permits national banks to sell insurance in small towns preempts a state statute that forbids them to do so. *Barnett Bank of Marion County v. Nelson*, 517 U.S. 25 (1996).
- The Second Circuit found that the New York State attorney general was properly enjoined from investigating national banks with respect to alleged racial discrimination in their mortgage lending. Since visitorial powers over national banks rested solely with the OCC, the New York attorney general could not exercise such powers in enforcing federal or state antidiscrimination laws. Although the antidiscrimination law was not preempted, its enforcement by state entities was preempted by federal law. *Clearing House Association LLC v. Cuomo*, 2007 U.S. App. LEXIS 27938 (2d Cir. 2007).
- The Ninth Circuit permanently enjoined the cities of San Francisco and Santa Monica from enforcing municipal ordinances prohibiting banks from charging ATM fees to non-depositors. The ordinances were preempted by the NBA. *Bank of America v. San Francisco*, 309 F.3d 551 (9th Cir. 2002).

2. Commercial bank v. Thrift

Among depository institution charters (at both the federal and State level) is the option to charter a commercial bank or a thrift/savings institution. While commercial banks may take insured deposits and make all manner of loans, two-thirds of the assets of a thrift must be invested in housing related loans or securities.

Commercial banks have existed in the United States for hundreds of years since States first granted banking charters. Federal thrifts were established in 1933 pursuant to the Home Owners Loan Act in order provide specified source of bank lending dedicated to home ownership. While State chartered savings and loans had existed before, it was during the Great Depression that the focus of thrifts as a focal point of home ownership lending began.

Commercial banks and thrifts have significant overlap between their charters (in fact, the recent Paulson report proposed to abolish the thrift charter and to fold federal thrifts into national banks). However, there are significant differences in both the activities in which each entity may engage and also how each entity is supervised on a consolidated basis.

Thrifts are supposed to support the housing industry. As such, the bulk of their assets are required to be invested in housing loans or housing loan related securities (such as Fannie Mae or

Freddie Mac securities). Thrifts are chartered and supervised at the federal level by the Office of Thrift Supervision. Federal thrifts enjoy the same preemptive rights as to inconsistent state laws as do national banks; in fact, the preemption provision in HOLA is even broader in application than that of the NBA.

Until the adoption of the Gramm-Leach-Bliley Act of 1999, an entity could charter a single thrift and not be regulated as a holding company under federal law (a “unitary thrift”). Many commercial and insurance entities that could not qualify to become bank holding companies were permitted to charter thrifts before that law was enacted. Since 1999, an entity chartering a thrift will become an S&L Holding Company, and be subject to limitations on its non-financial activities, consolidated capital requirements and affiliate transaction restrictions. However, many of these regulations are more flexible in application than those applicable to bank holding companies pursuant to the Federal Reserve.

3. Bank v. Non-bank lender

In the aftermath of the subprime lending crisis, a significant amount of regulatory arbitrage was thrust into the spotlight – that state chartered non-bank lenders are not regulated by any federal regulator. The existence of these entities offered a great arbitrage opportunity to entities that did not wish to become bank holding companies – as these lenders are not “banks” for purposes of federal law, entities that own them are not regulated as bank holding companies.

The sale of almost every financial product is subject to some form of federal supervision or regulation (save for insurance), especially if sold to retail purchasers. Not so mortgage loans by non-banks. In most states, non-bank entities making loans to retail investors are required to be licensed by those states. However, the licensing requirements are inconsistent, as is the amount of supervision, regulation and enforcement performed by each state. In comparison, a bank entity making the same type of loans would be subject to examination and supervision by its primary regulator (whether federal or state), as well as a secondary federal regulator (whether the Federal Reserve or the FDIC). While certainly not perfect, this system tends to enforce appropriate loan underwriting and sales practices, as well as capital requirements that limit inappropriate firm leverage.

This dichotomy was apparent with respect to subprime lending. Public estimates state that more than 90 percent of the subprime loans now in default or potential default were made by state-licensed non-bank lenders. In retrospect, it is easy to understand how this happened – there are thousands of non-bank lenders, and the state regulators were hard pressed to exercise significant supervision over them, especially as they implemented increasingly complex lending products.

4. U.S. bank v. U.S. branch of foreign bank

Foreign banks seeking to engage in banking activities in the United States face a choice of options: chartering a *de novo* U.S. bank subsidiary or obtaining a license for a U.S. branch or agency. These options offer arbitrage possibilities. Each option offers significant advantages and disadvantages. In the same way as U.S. banks, foreign banks may license a branch pursuant to State or federal law (all foreign bank branches must also be approved by the Federal Reserve pursuant to the requirements of the Foreign Bank Supervision Enhancement Act of 1991).

A U.S. bank owned by a foreign bank may engage the full range of activities permitted to all banks, and is subject to the full comprehensive set of U.S. laws and regulations applicable to such entities, including U.S. capital requirements.

A U.S. branch of a foreign bank is generally permitted to engage in most of the same activities as are U.S. banks. A significant limitation is that U.S. branches of foreign banks are not eligible for FDIC deposit insurance, and therefore may not accept retail deposits. However, these branches are not subject to U.S. capital requirements, though certain States require branches to deposit certain cash amounts in a U.S. bank based on the amount of assets held by the branch.

A further difference in the supervisory treatment between a U.S. bank and a U.S. branch of a foreign bank is with respect to how an insolvency is managed. The insolvency of a U.S. bank is generally managed as a receivership pursuant to the Federal Deposit Insurance Act by the FDIC. Under the federal depositor preference law, insured and uninsured depositors are paid prior to any unsecured creditors. U.S. branches of foreign banks are liquidated subject to the laws of the state (or federal) from which they received their license. These laws vary significantly. Some states, such as New York, are extremely creditor friendly and offer significantly better treatment to creditors *vis a vis* depositors.

5. Securities offering platform

An often overlooked arbitrageable power of banks is to register and issue securities with their federal bank regulator rather than the SEC. Pursuant to the Securities Act of 1933, the issuance of securities by banks is managed by their appropriate federal regulator which is instructed to generally follow the rules and procedures of the Securities Act.

Thus, for national banks, the OCC reviews and authorizes the issuance and sale of bank securities. For state non-member banks, the FDIC fills this role, as does the OTS for thrifts. Presumably, the Federal Reserve would do so for state member banks, though it has not issued any such regulations.

Being able to bypass SEC review of a prospectus offers a significant advantage to banks in terms of speed and ease of approval. While most banks only register securities upon organization, many banks use the exemptions from registration (which are roughly the same as those available under the securities laws) to issue linked securities and other tailored products.

6. Bank v. securities firm

Banks and securities firms carry different charters and answer to different regulators – either to the bank regulators or to the SEC and FINRA or other SROs. However, these financial institutions often engage in the same or similar activities, making them competitors that follow different rules. Until recently, one example of this potential arbitrage was the brokerage of securities, an activity in which both banks and securities firms were authorized to engage. This regulatory competition was mostly ended on September 19 and 24, 2007 when, respectively, the SEC and the Federal Reserve voted to adopt new “Regulation R” -- to implement the “broker” exceptions for banks under Section 3(a)(4) of the Securities Exchange Act of 1934. Regulation R was codified in identical form at 12 C.F.R. Part 218 and 17 C.F.R. Parts 240 and 247, respectively.

Before Regulation R since 1934, the Exchange Act had contained a complete exemption from the definition of “broker” for banks, thus allowing banks to conduct all securities brokerage activities without being required to register with the SEC. That complete exemption was not a happy result in the view of the SEC. The SEC, historically, viewed the conduct of securities brokerage by banks as being under-regulated and under-supervised, as compared with the conduct of the same services by SEC-registered broker-dealers, which are subject not only to the SEC’s rules under the Exchange Act but also to the rules of the securities industry self-regulatory organizations. At one point, the SEC even sought to undo the Exchange Act’s legislative exemption through rulemaking - the SEC in 1985 adopted Rule 3b-9, which required banks actively engaging in the securities brokerage business to register as broker-dealers under the Exchange Act. The American Bankers Association sued to enjoin the SEC from enforcing the rule. The D.C. Circuit Court rejected the SEC’s position that the Exchange Act called for functional regulation, and held that the literal language of Section 3(a)(4) expressly excepted banks from the definition of “broker.” American Banking Association v. SEC, 804 F.2d 739, 743-744 (D.C. Cir. 1986).

Following that failed attempt by the SEC, the role of banks (and through bank holding companies, their non-bank securities affiliates) in the securities business increased dramatically, significantly increasing competition in the securities industry. SEC-registered broker-dealers complained that they were subject to additional regulation to which their bank competitors were not. The SEC lobbied successfully in the adoption of the Gramm-Leach-Bliley Act (the “GLBA”), to implement functional regulation of securities that would require all such activities to be “pushed-out” to securities firms.

Section 201 of the GLBA appeared to preserve banks’ traditional brokerage activities to be regulated by the federal bank regulators, though the SEC and the bank regulators could not agree upon the scope of these exemptions for almost nine years and through two rejected SEC proposals. The final Regulation R defined the scope of securities agency activities that banks may conduct without registering with the SEC as a “broker.”

Notwithstanding the joint adoption of Regulation R, the dueling press releases of the agencies disclose their disparate view of its effects. The press release issued by the SEC states that Regulation R is intended to give effect to the bank broker exceptions “in a way that accommodates the traditional business practices of banks, ... stimulate[s] greater competition in the financial services industry, and give[s] investors a wider array of services at lower prices.” The Board issued a statement by Board Governor Randall S. Kroszner in which he stated that

“Congress recognized that banks had been providing securities services to their customers for decades without significant securities-related concerns ... [and] the Board and the other federal banking agencies have a long history of effectively supervising the securities functions of banks through regular on-site examinations, regulations and supervisory guidance.”