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THE U.S. DUAL BANKING SYSTEM ON THE EVE OF THE ELECTION: FINTECHS, PREEMPTION, JUDICIAL DEFERENCE, AND NATIONAL TRUST BANKS

To Our Clients and Friends:

Since the last presidential election, there have been several regulatory developments that go to the heart of the U.S. dual banking system – the quintessentially American system under which banking entities may choose either a state or federal charter. These developments have occurred at the Office of the Comptroller of the Currency (OCC), the regulator of national banks. Perceived as increasing both the number of federally regulated entities and the scope of preemption of state consumer law, these developments have been challenged by state regulators in New York, California and Illinois, and others, in lawsuits that are now pending. Potential issues for the upcoming election, therefore, may be the extent of state-federal regulatory balance and the degree of judicial control over federal regulatory actions. On the latter point, litigation over these developments will play out with a changed Supreme Court and one at which certain Justices have begun to question the traditional deference paid to regulators' interpretations of the statutes they administer. This Alert discusses the relevant issues at stake.

I. Fintech/Payments Charters

At the end of the Obama Administration, then-Comptroller Thomas Curry stated that the OCC had the authority under the National Bank Act to grant special purpose national bank charters to fintech companies "engaged in the business of banking," including to companies that did not take deposits. After his departure, the OCC slowly fleshed out a framework for evaluating such charters. Late this August, Acting Comptroller Brian Brooks seemed to accelerate this process by stating that the OCC was prepared to begin accepting charter applications for national banks engaged only in payments activities.The OCC's actions were challenged by state financial regulators. Most significantly, the New York Department of Financial Services (NYDFS) sued the OCC regarding the special purpose national bank charter. Last fall, NYDFS won an initial victory in the United States District Court for the Southern District of New York, where Judge Victor Marrero held that the suit was ripe for adjudication and that the OCC had no authority to issue charters for non-deposit taking banks other than those that Congress had specifically authorized, such as national trust banks.[1]

The OCC appealed this case to the U.S. Court of Appeals for the Second Circuit (Second Circuit), where briefs have been filed, including on the issue of whether, absent congressional authorization of exceptions, a federal charter to engage in the "business of banking" in the National Bank Act ***always*** requires deposit taking.

II. The OCC's "Valid When Made" and "True Lender" Regulations

The OCC's second action was to promulgate, in June 2020, a final regulation that would overturn the decision of the Second Circuit in the *Madden v. Midland Funding, LLC* case.[2] In *Madden*, the Second Circuit held that a borrower could assert a usury defense against a nonbank company that had purchased a loan originally made by a national bank, even though the loan when originally made was not usurious because of the National Bank Act's interest-rate exportation provision, 12 U.S.C. § 85 (Section 85), which allows a national bank to charge nationally the interest rate permitted under the laws of the state in which the bank is located.[3]

The OCC's regulation (Valid When Made Regulation) overrides the *Madden* holding and gives nonbank purchasers of loans from national banks and federal thrifts, including fintech lending companies that have national bank lending partners, the same usury protection as is available to national banks under Section 85.[4]

In late July, the States of California, Illinois and New York sued the OCC in the United States District Court for the Northern District of California, seeking declaratory and injunctive relief. The States argued that the Valid When Made Regulation was invalid as arbitrary and capricious and contrary to law, and that only Congress had the authority to overrule the *Madden* decision.[5]

Finally, just yesterday, the OCC finalized a second regulation relevant to this area. This regulation (True Lender Regulation) clarifies when a national bank or federal thrift is the "lender" for purposes of Section 85 and other statutes. It states that a national bank or federal thrift is the true lender if, as of the date of origination, it (1) is named as the lender in the loan agreement or (2) funds the loan.[6] The rule also specifies that if, as of the date of origination, one bank is named as the lender in the loan agreement for a loan and another bank funds that loan, the bank that is named as the lender in the loan agreement makes the loan.[7] State regulators may be expected to claim that, taken together, the True Lender Regulation and Valid When Made Regulation will facilitate so-called "rent a bank" schemes by nonbank lenders to avoid state usury and other consumer protection requirements.

III. Dual Banking System Effects

The special purpose national bank charter and Valid When Made and True Lender Regulations clearly implicate the dual banking system and particularly as applied to fintech companies. For example, to the extent that payments companies currently engage in money transmission, they must become licensed in every state having jurisdiction. A single federal non-depository bank charter for such entities is appealing from an efficiency standpoint and would likely attract many applicants. Similarly, some fintech lending companies partner with bank lenders, with the fintech acquiring the loan from the bank after it is made and then seeking to benefit from federal preemption. Certain states have alleged that this practice creates loopholes in their licensing and consumer protection schemes. It is therefore not surprising that states and regulators in jurisdictions with active consumer regulation have chosen to go to court to challenge the OCC's actions.

IV. Preemption and Judicial Deference: The Watters and Cuomo Cases and Beyond

It has been some time since significant decisions were handed down in cases involving the OCC and the National Bank Act – one has to look at *Waters v. Wachovia Bank, N.A.* in 2007 and *Cuomo v. The Clearing House Association L.L.C.* in 2009, both in the United States Supreme Court. Both cases were closely decided; *Waters* was 5-3 and *Cuomo* was 5-4. *Waters* held that national bank operating subsidiaries – subsidiaries that engaged in activities permissible for national banks – were not subject to state registration and examination requirements, but only the "visitorial powers" of the OCC.[8] *Cuomo* held that it was not a reasonable interpretation of the "visitorial powers" provision of the National Bank Act to preempt state *enforcement of* – as opposed to supervision with respect to – state consumer law against national banks.[9] *Waters* thus upheld the OCC's position with respect to one aspect of the preemptive effect of the National Bank Act's visitorial powers clause, while *Cuomo* rejected one. Interestingly, although the cases were closely decided, the split of the Justices was unusual: Justice Scalia and Chief Justice Roberts joined Justice Stevens' dissent in *Waters* that favored the state regulators, and Justice Scalia wrote the opinion in *Cuomo,* which was joined by the Court's more liberal Justices, holding that the OCC could not preempt state enforcement.[10]

Since the two cases were decided, the composition of the Supreme Court has changed substantially, and in particular, Justices Gorsuch, Kavanaugh, and Barrett have replaced Justices Scalia, Kennedy, and Ginsburg. The changed composition has resulted in speculation that the classic Chevron doctrine of deference to administrative agency interpretations of ambiguous statutes may, in an appropriate case, be refined. Justice Ginsburg wrote a classic example of Chevron deference in her opinion upholding the OCC in the famous VALIC bank annuities case. Justice Gorsuch, like Justice Thomas, has publicly criticized Chevron.

It is of course speculative whether any of the current actions against the OCC will reach the Supreme Court or how the Court might rule in them. It is certainly possible, however, that despite some commentators' wishes, the ultimate resolution to the issues raised by the fintech/payments charter and Valid When Made/True Lender regulations will depend not on policy judgments, but rather such traditional approaches to statutory construction as textual analysis of the National Bank Act and applying canons of construction, and without exhibiting Merovingian supineness to the OCC's interpretation.

V. The National Trust Bank Charter

With regulation unsettled, one of the special purpose national bank entities that bears a close look by companies seeking to innovate banking is the national trust bank charter. As even the District Court in *Lacewell v. OCC* conceded, Congress has specifically authorized the OCC to grant federal charters to non-depository institutions engaged in fiduciary activities.[11] Under the OCC's regulations, these activities include acting as trustee, executor, administrator, registrar of stocks and bonds, transfer agent, guardian, assignee, receiver, or custodian under a uniform gifts to minors act; investment adviser, if the bank receives a fee for its investment advice; any capacity in which the bank possesses investment discretion on behalf of another; or any other similar capacity that the OCC authorizes.[12]

More importantly, although a national trust bank does not accept deposits, it may engage in other activities that are authorized as part of the "business of banking" under 12 U.S.C. 24(SEVENTH) and are related to its business plan.[13] Such activities would include foreign currency activities (including virtual currency activities) and payments. A national trust bank is required to have *bona fide* fiduciary activities as part of its business plan, but it is not prevented from exercising other related incidental banking powers.[14]

There are other advantages to the national trust bank charter. A national trust bank benefits in the same manner as a national bank from federal preemption. A national trust bank is permitted to become a member of the Federal Reserve System. Controlling shareholders of national trust banks are not regulated as bank holding companies.

Conclusion

The Comptroller of the Currency may be removed by a President only "upon reasons to be communicated by [the President] to the Senate."[15] A change in Administrations could well mean a change in Comptrollers. Whether the "special purpose" non-depository charter continues to be embraced by the OCC under a Democratic President is an open question (but only an open one, as it was President Obama's Comptroller, Thomas Curry, who first proposed the national fintech charter). Even so, it is reasonable to expect the state litigation over special purpose charters to continue for some time. National trust bank charters do have explicit authorization by Congress; such entities, assuming that the bank has a *bona fide* fiduciary business, can engage in incidental banking activities like currency activities and payments that are related to the business plan and therefore may offer an alternative route forward to some firms until the larger questions affecting the U.S. dual banking system are resolved.

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[1] *Lacewell v. OCC*, Case 1:18-cv-08377-VM (S.D.N.Y. Oct. 21, 2019).

[2] *Madden v. Midland Funding, LLC*, 786 F.3d 246 (2d Cir. 2015).

[3] *Id.*

[4] OCC, Final Rule: Permissible Interest on Loans That Are Sold, Assigned, or Otherwise Transferred, 85 Fed. Reg. 33530 (June 2, 2020).

[5] *People of the State of California, People of the State of Illinois, People of the State of New York v. The Office of the Comptroller of the Currency*, Case No. 20-cv-5200 (N.D. Cal. 2020).

[6] OCC, Final Rule: National Banks and Federal Savings Associations as Lenders, available at https://www.occ.gov/news-issuances/federal-register/2020/nr-occ-2020-139a.pdf.

[7] *Id.*

[8] 550 U.S. 1 (2007).

[9] 557 U.S. 519 (2009).

[10] *See id.; Waters,* 550 U.S. 1, 22 (2007) (Stevens, J.).

[11] 12 U.S.C. § 27(a).

[12] 12 C.F.R. 9.2(e).

[13] *See, e.g.,* OCC Conditional Approval 877 (December 13, 1999) ("The OCC has not limited the operations of trust banks to the exercise of fiduciary powers, but has permitted a range of incidental and nonfiduciary activities. The OCC, when it chartered Trust Co., did not restrict or address its insurance agency activities. Hence, Trust Co.'s charter is sufficiently broad to encompass its proposed insurance and annuity sale[s].").

[14] *Id.*

[15] 12 U.S.C. § 2.

The following Gibson Dunn lawyers assisted in preparing this client update: Arthur S. Long and Samantha J. Ostrom.

Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact the Gibson Dunn lawyer with whom you usually work in the firm's Financial Institutions practice group, or the following:

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