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May 29, 2020

VIA EMAIL to comments@fdic.gov

Mr. Robert E. Feldman, Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20249

Re: Comments on the Proposed Rule: Parent Companies of Industrial Banks and Industrial Loan Companies (RIN 3064-AF31)

To Whom It May Concern:

We appreciate the opportunity to comment on the FDIC's proposed rulemaking ("Proposed Rule") requiring certain conditions and commitments for deposit insurance applications, changes in control, and mergers involving FDIC-insured industrial banks and industrial loan companies that are subsidiaries of companies not subject to consolidated supervision by the Federal Reserve Board ("FRB").

We understand that the stated purpose of the Proposed Rule is to codify existing practices utilized by the FDIC to supervise industrial banks and their parent companies, to mitigate undue risk to the Deposit Insurance Fund ("DIF") that may otherwise be presented in the absence of federal consolidated supervision of an industrial bank and its parent company, and to ensure that the parent company that owns or controls an industrial bank serves as a source of financial strength for the industrial bank, consistent with section 38A of the Federal Deposit Insurance Act ("FDIA").[1]

In general, we agree with the principles underlying the Proposed Rule; however, we disagree with its necessity. We also seek clarification on the application of the Proposed Rule to grandfathered unitary savings and loan holding companies ("GUSLHC") (also known as

[1] Parent Companies of Industrial Banks and Industrial Loan Companies, 85 Fed. Reg. 17771, 17771-72. (proposed March 31, 2020) (to be codified at 12 C.F.R. pt. 354) [hereinafter *Proposed Rule*].

grandfathered unitary thrift holding companies), which is addressed in our comments to Question 1 in the Proposed Rule. This letter responds to the following questions set forth in the Proposed Rule:

(i) The Proposed Rule should not apply retroactively (*Question 1)*, and it should explicitly provide that it does not apply to GUSLHCs;
(ii) The Proposed Rule should not make individuals responsible for capital and liquidity requirements of the industrial bank or its parent company (*Questions 3 and 4)*; and
(iii) The Proposed Rule should provide for a 50% threshold for director independence *(Question 11)*.

We would appreciate confirmation of these views as part of the final rulemaking associated with the Proposed Rule.

Question 1: Should the proposed rule apply only prospectively, that is, to industrial banks that become a subsidiary of a parent company that is a Covered Company? Or should the proposed rule also apply to all industrial banks that, as of the effective date, are a subsidiary of a parent that is not subject to Federal consolidated supervision by the FRB? What are the concerns with each approach?

Comment:

Retroactive Application

The Proposed Rule should only apply prospectively. Specifically, industrial bank charters and activities that pre-date the Proposed Rule are not part of the "evolution" seen by the current FDIC administration. Existing industrial banks are seasoned, lower risk franchises. It would be inequitable to apply new conditions and commitments on parent companies of industrial banks that have not voluntarily engaged in transactions such as mergers or changes in control altering their historic structure.

The FDIC justifies the Proposed Rule due to the "continuing evolution of the industrial bank charter."[2] However, the industrial bank charter has not evolved. The definition of "industrial banks," as provided in the Proposed Rule, are entities excluded from the definition of "bank" in the Bank Holding Company Act ("BHCA"),[3] which by definition is a charter available in a limited number of states, with authorized activities as defined by those chartering states as of March 5, 1987. With such limitations, it is unclear what evolution is referenced as the geographic footprint and nature of activities is limited. Further, while it has been seven years since the moratorium on industrial bank charters ended in July 2013, the charters of the 23 industrial banks in existence as of

[2] *Id.* at 17772.
[3] *Id*. at 17771 n.2.

the Proposed Rule all pre-date 2008.[4] As noted in the Proposed Rule, until the two recent charter approvals of Nelnet and Square, only four industrial bank charters were granted in the last 20 years.[5] Moreover, between 2017 and 2019, the FDIC only received nine industrial bank deposit insurance applications and one change in control application.[6] The FDIC estimates the Proposed Rule would apply to four filings per year by companies seeking to establish or acquire an industrial bank.[7] The "continuing" evolution is also unclear because the number of industrial banks has declined from 58 in 2007 to 23 in 2020.[8]

Further, and as noted in the Proposed Rule, only two industrial banks failed during the financial crisis.[9] These failures were referenced within the Proposed Rule as "small industrial banks that did not present circumstances raising concern with respect to industrial banks proposed prior to the crisis."[10] The limited number of failures further calls into question the necessity for the Proposed Rule, but also underscores that retroactive applicability is not needed.

While there has not been a significant historic evolution of the industrial bank charter since 2007, even after the end of the moratorium in July 2013, perhaps the FDIC's noted evolution "has less to do with their size and scope and more to do with who owns them—or wants to,"[11] which is what led to the 2007 FDIC moratorium on deposit insurance applications and what drove the previous FDIC notice of proposed rulemaking in 2007[12] after Wal-Mart and Home Depot sought industrial bank charters.[13]

The current Proposed Rule also comes after the two recent FDIC approvals of deposit insurance for Nelnet and Square. Because the FDIC's cited "evolution" appears to start with these recent approvals, the Proposed Rule should go no further back in time than those. To the extent the Proposed Rule is adopted, it should only apply prospectively, as those are the companies seeking an industrial bank charter to "operate unique business models"[14] or have "diversified business

[4] *Id*. at 17773.
[5] *Id*.
[6] *Id*.
[7] *Id*. at 17780.
[8] *Id*. at 17773.
[9] *Id*.
[10] *Id*. at 17776.
[11] Federal Reserve Bank of Saint Louis, Industrial Loan Companies Come Out of the Shadows, REGIONAL ECONOMIST (July 1, 2007), https://www.stlouisfed.org/publications/regional-economist/july-2007/industrial-loan-companies-come-out-of-the-shadows.
[12] Industrial Bank Subsidiaries of Financial Companies, 72 Fed. Reg. 5217 (proposed February 5, 2007) (to be codified at 12 C.F.R. pt. 354).
[13] *Proposed Rule*, *supra* note 1, at 17774.
[14] *Id*. at 17776.

operations and activities that would not otherwise be permissible for BHCs under the BHCA and applicable regulations."[15]

It would be inequitable to apply the Proposed Rule retroactively to entities that have previously been granted industrial bank charters and during the process of obtaining deposit insurance were assessed and examined for their risk by the FDIC, including with respect to their parent companies. There would be no added benefit to depositors or the DIF by applying the Proposed Rule retroactively to those parent companies that have already demonstrated the ability to serve as a source of strength to their subsidiaries. Additionally, this would be inequitable for entities that strategically entered into transactions or engaged in activities in order to receive the benefits offered by the industrial bank charter at the time of such transaction, most of which were decades ago. Such retroactive application could lead to economic uncertainty due to the deprivation of notice to entities of the Proposed Rule's application.

The inequities of a retroactive rule would be further exacerbated because the FDIC has sufficient supervisory tools to monitor parent companies of industrial banks. The FDIC's existing practice is to tailor conditions as appropriate to the institution and the parent company, as described in more detail later in this letter. Rulemaking resulting from the FDIC's historically tailored approach is not a clarification or codification of an existing rule that would allow for retroactive application of a consistently applied existing practice.[16] Nor is it, as provided in the Administrative Procedure Act, being done in connection with "interpretative rules and statements of policy."[17] The FDIC's prior treatment of parent companies of industrial banks has not been consistent, nor is the Proposed Rule an interpretative rule or statement of policy as the Proposed Rule would have the force and effect of law.[18] Further, if the Proposed Rule was in fact a means to

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[15] *Id*.

[16] In the *Matter of Lodavina Grosnickle* (Release No. ID-441; Administrative Proceeding File No. 3-14408; November 10, 2011, citing *SEC v. First Pacific Bancorp*, 142 F.3d 1186 (9th Cir. 1998), wherein the Court considered the newly-created officer and director bar of the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 (Penny Stock Act). The Court in *First Pacific Bancorp* applied the bar retroactively, noting that the Penny Stock Act "merely codified the equitable authority to impose [an] officer and director bar which the courts already possessed and exercised." *Id*. at 1193 n. 8. The Court in *Grosnickle,* noted "Dodd-Frank lacks an express retroactivity provision, and 'normal rules of [statutory] construction do not reveal Congress' intent regarding retroactivity" (citing *Pezza v. Investors Capital Corp.*, 767 F. Supp. 2.d. 225 (D. Mass 2011)). In *Grosnickle*, the Court did not uphold the associational bar against Grosnickle as it related to municipal advisors because "before Dodd-Frank's enactment there was no associational bar or similar provision with respect to municipal advisors," as it was not an existing practice. *Grosnickle*, at 10.

[17] 5 U.S.C. § 553(d)(2).

[18] Todd Garvey. *A Brief Overview of Rulemaking and Judicial Review*. Congressional Research Service (March 27, 2017) (Rules that carry the force and effect of law are known as legislative rules. These rules are to be distinguished from non-legislative rules, such as interpretive rules and policy statements, which lack the force and effect of law. *See, e.g.*, *Appalachian Power Co. v. EPA, 208 F.3d 1015, 1020, (D.C. Cir. 2000)* ("Only 'legislative rules' have the force and effect of law ... A 'legislative rule' is one the agency has duly promulgated in compliance with the procedures laid down in the statute or in the Administrative Procedure Act."); *Nat'l Mining Ass'n v. McCarthy, 758 F.3d 243, 250 (D.C.*

- "codify existing practices utilized by the FDIC to supervise industrial banks and their parent companies,"[19]
- "codify the FDIC's informal standards,"[20]
- "codify certain supervisory requirements,"[21] or
- to generally "codify the FDIC's current supervisory processes and policies,"[22]

as provided in numerous instances in the Proposed Rule, such rulemaking authority would not require notice or publication as provided in the Administrative Procedure Act.[23]

In fact, the scope of the Proposed Rule is far broader than a clarification or codification of existing practices or procedures. First, the FDIC's existing practice, which is consistent with its supervisory and enforcement authority granted by 12 U.S.C. § 1831o-1(b), has been conducted on a case-by-case basis derived from the risks presented by the application.[24] The current procedure of the FDIC is tailored and not uniformly applied to the parent companies of industrial banks, while the Proposed Rule seeks to standardize and generally apply conditions and commitments to the parent companies of industrial banks, which is not an existing practice. Second, conditions imposed in writing in connection with FDIC action typically expire, either by their terms or by further FDIC action. The Proposed Rule would apply conditions in perpetuity.[25] Accordingly, it would be inequitable to apply the Proposed Rule retroactively.

The scope of the Proposed Rule is overbroad and conflicts with the express legislative intent of Congress. The proposed text of Section 354.1(b)(1) provides that the requirements of Part 354 do not apply to "[a]ny industrial bank that is or becomes controlled by a company that is subject to Federal consolidated supervision by the FRB."[26] As noted above, the scope of the Proposed Rule is beyond a codification or clarification of an existing practice or procedure of the FDIC. The scope of the Proposed Rule seeks to apply federal consolidated supervision by the FDIC where FRB

Cir. 2014) ("Legislative rules have the 'force and effect of law' and may be promulgated only after public notice and comment.")).

[19] *Proposed Rule*, *supra* note 1, at 17772.

[20] *Id*.

[21] *Id*. at 17776.

[22] *Id*.

[23] 5 U.S.C. § 553(b)(A) (providing that general notice of proposed rulemaking must be published in the Federal Register except for *"interpretative rules, general statements of policy, or rules of agency organization, procedure, or practice…"* so long as notice or hearing is not required by statute). There is no statutory notice or hearing required by statute based on the legal authority provided in the Proposed Rule.

[24] *See* Federal Deposit Insurance Corporation, Deposit Insurance Applications Procedures Manual, 1.1-1, 1.1-2 (2019) (providing that "…staff will process each application in a fair, objective, timely and forward-looking manner that considers each applicant's specific risk attributes and any mitigating elements") [hereinafter *Applications Procedures Manual*].

[25] *Proposed Rule*, *supra* note 1, at 17785.

[26] *Id.*

consolidated supervision does not exist.[27] However, through the Competitive Equality of Banking Act of 1987 ("CEBA"), Congress broadened the definition of "bank" under the BHCA to include banks that were insured by the FDIC as defined under the Federal Deposit Insurance Act ("FDIA") in Section 3(h),[28] but expressly excluded industrial banks, which were also banks insured by the FDIC.[29]

The substance of the Proposed Rule, which is to apply federal consolidated supervision by the FDIC, requires action by Congress should Congress desire to apply such consolidated supervision by a federal banking agency, including the FDIC. As noted in the 2005 General Accounting Office ("GAO") report regarding industrial loan corporations[30] ("2005 GAO Report"), no such executive action was recommended by the GAO, and such a position was strongly seconded by the then-Chairman of the FDIC, Mr. Donald E. Powell, who opposed any such federal consolidated supervision of a parent company of an industrial bank by a federal banking agency.[31]

Further, any action by Congress is unnecessary in light of the Proposed Rule's professed purposes of addressing safety and soundness and undue risk to the DIF[32], as such concerns are already sufficiently addressed by current legislation. The Proposed Rule references sections 6, 7(j), 18(c), and 38A of the FDIA, which require that any deposit insurance, change in control or merger application is reviewed for numerous factors, including safety and soundness and risk to the DIF, as part of the application process.[33] The most appropriate avenue to provide guidance, transparency or clarification on the FDIC's practices and procedures to applicants based on current legislation would be through a manual or handbook, similar to the FDIC's Deposit Insurance Applications, Procedures Manual Supplement, Applications from Non-Bank and Non-Community Bank Applicants or OCC's Change in Bank Control Licensing Manual, as described further in response to questions 3 and 4 below.

It is important to note that Mr. Donald E. Powell, the FDIC's Chairman at the time of the 2005 GAO Report, sent a comment letter dated August 29, 2005 to the GAO in connection with the 2005 GAO Report, wherein the Chairman acknowledged that the GAO was not recommending executive action by Congress.[34] However, he made clear that he opposed federal consolidated supervision of parent companies of industrial banks and stated that the suggested recommendations by the GAO were "unnecessary from a safety and soundness perspective, and would inappropriately

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[27] *Id. See* definition of "Covered Company" at 17785.
[28] 12 U.S.C. §§ 1841(c)(1)(A) and 1813(h).
[29] 12 U.S.C. § 1841(c)(2)(H).
[30] U.S. Gov't Accountability Office, GAO-05-621, Industrial Loan Corporations: Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority (Sept. 2005) [hereinafter 2005 *GAO Report*].
[31] *Id*. at 92.
[32] *Proposed Rule*, *supra* note 1, at 17776.
[33] *Id.*, at 17772 and 17775.
[34] *2005 GAO Report*, *supra* note 30, at 92.

change the relationship between the federal banking agencies and non-bank sector of the U.S. economy."[35] The letter also stated that:

> We believe the GAO's finding is founded on a misinterpretation of the legal basis underlying the regulatory authorities of both the FDIC and the Federal Reserve Board of Governors (Federal Reserve). The core of each banking agency's statutory mandate for supervision is preserving the safety and soundness of insured depository institutions. We believe the record shows the FDIC's authorities are as effective in achieving this goal as are the authorities of consolidated supervisors.[36]

The letter further stated that "a supervisory approach that focuses on insulating the insured financial institution and the federal safety net from external risks (the bank-centric approach) is an appropriate supervisory model for ILCs and their parent companies."[37] In light of these expressed views by the FDIC[38], it is unclear how the professed purposes of increased safety and soundness and mitigation of undue risk to the DIF will be addressed since the regulatory landscape has not changed significantly since the 2005 GAO Report, nor has the industrial bank charter or the industry significantly evolved since then.

<u>Clarification of Application to GUSLHCs</u>

As noted above, we seek clarification on the treatment of GUSLHCs under the Proposed Rule. The definition of "Covered Company" in the Proposed Rule "means any company that is not subject to Federal consolidated supervision by the FRB and that controls an industrial bank…".[39] The commentary to the Proposed Rule provides that it will not apply to BHCs and SLHCs as they are "subject to Federal consolidated supervision by the FRB *and are generally prohibited from engaging in commercial activities*" (emphasis added).[40] The Proposed Rule creates confusion by stating that SLHCs are generally prohibited from engaging in commercial activities, but not acknowledging the permissible commercial activities of GUSLHCs. The Proposed Rule should not apply to industrial banks or industrial loan companies that have GUSLHCs as parent companies. GUSLHCs, although subject to FRB supervision, are a type of SLHC permitted to engage in "grandfathered" activities, which may include commercial activities. The Proposed Rule's reference

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[35] *Id.*
[36] *Id.*
[37] *Id*. at 93.
[38] See U.S. Gov't Accountability Office, GAO-12-160, Bank Holding Company Act: Characteristics and Regulation of Exempt Institutions and the Implications of Removing the Exemptions (Jan. 2012) [hereinafter *2012 GAO Report*] ("…[V]iews on the adequacy of the regulation varied with *FDIC and OCC and regulated institutions viewing it as adequate* and the Federal Reserve and Treasury viewing it as lacking.") (emphasis added).
[39] *Proposed Rule*, *supra* note 1, at 17776.
[40] *Id*. at 17772-73.

to the prohibition related to "commercial activities"[41] causes confusion as it is not clear whether - due to the nature of the parent company's permissible activities - GUSLHCs will be treated differently than SLHCs under the Proposed Rule.

The *Home Owners' Loan Act* ("HOLA")[42] provides for the regulation of SLHCs, including GUSLHCs, and imposes restrictions on their activities. The FRB is primarily responsible for enforcing the provisions of HOLA. Each SLHC is required to register with the FRB and is required to provide ongoing reports to the FRB that provide updates on the operational and managerial status of the SLHC.[43] This is typically completed through the Form Y-6 and Y-9 reports that are filed by SLHCs with the FRB.

The Proposed Rule and its imposition of additional conditions and commitments in order to ensure a parent company of an industrial bank does not pose undue risk to the DIF and serves as a source of strength is not necessary for GUSLHCs as the FRB is granted extensive supervision and enforcement authority over SLHCs, including GUSLHCs.[44] The FRB is granted the authority to examine a SLHC (including GUSLHCs), and each of its subsidiaries, in order to inform itself of the SLHC's (i) nature of operations and financial condition of the SLHC; (ii) the financial, operational, and other risks within the SLHC that may pose a threat to (a) the safety and soundness of the SLHC or of any depository institution subsidiary of the SLHC, or (b) the stability of the financial system of the U.S.; (iii) the systems of the SLHC for monitoring and controlling the risks described; and (iv) compliance with HOLA, other federal laws that the FRB has specific authority to enforce, and other applicable provisions of federal law.[45] In other words, SLHCs, including GUSLHCs, are already subject to federal consolidated supervision, including FRB authority to ensure that SLHCs and GUSLHCs are appropriately mitigating risk and serving as a source of strength for their subsidiaries. Additional regulation by the FDIC would be redundant and unnecessary.

As noted above, one of the distinctions between SLHCs and GUSLHCs is the nature of activities in which each can engage. In addition to the broad supervision and enforcement authority of the FRB, the FRB's authority to supervise a GUSLHC's activities extends to any intermediate holding company of a GUSLHC as well.[46] All financial activities of GUSLHCs are subject to supervision by the FRB as provided in 12 U.S.C. § 1467b. Further, a GUSLHC's grandfathered activities are also subject to review by the FRB.[47] If the FRB determines that a certain grandfathered activity presents conflicts of interests, unsound practices, or is not in the public interest, it has the

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[41] *Id*. at 17773.
[42] 12 U.S.C. § 1467a.
[43] 12 U.S.C. § 1467a(b)(2)(A).
[44] 12 U.S.C. § 1467a(g).
[45] 12 U.S.C. § 1467a(b)(4)(A).
[46] 12 U.S.C. § 1467b.
[47] 12 U.S.C. § 1467a(c)(6)(D).

authority to terminate such grandfathered activity.[48] Additionally, even for those GUSLHCs that engage in grandfathered activities that may constitute "commercial activities," due to FRB consolidated supervision, such entities do not pose an undue risk on the DIF and instead serve as a source of strength for their subsidiaries, rendering the application of the Proposed Rule to such entities unnecessary. We ask that the final rule expressly carve out GUSLHCs from its application for the purposes of clarity and transparency.

As summarized in the foregoing, the current regulatory framework adequately addresses the purposes of the Proposed Rule as it relates to GUSLHCs. The FRB has authority to ensure risk is mitigated and that GUSLHCs (including any intermediate holding company) serve as sources of strength to their respective industrial bank subsidiaries. Any further regulation as it relates to these entities will be duplicative and lead to confusion, not transparency. Moreover, given the varied nature of underlying industries for parent companies of industrial banks, and accordingly, varied risk, any final rule must appropriately address these differences. As noted in the Proposed Rule, its provisions "are intended to establish a level of information reporting and parent company obligations similar to that which would be in place if the Covered Company were subject to federal consolidated supervision."[49] Because GUSLHCs are already subject to such reporting and obligations,[50] the Proposed Rule should not apply to them, despite their ability to conduct commercial activities.

Question 3: Should the proposed rule apply to industrial banks that are controlled by an individual rather than a company?

Question 4: If an individual controls the parent company of an industrial bank, should the individual be responsible for the maintenance of the industrial bank's capital and liquidity at or above FDIC-specified levels? Should an individual who controls a parent company be responsible for causing the parent company to comply with the written agreements, commitments, and restrictions imposed on the industrial bank? How should the rule be applied in such a case?

Comment:

The Proposed Rule should not apply to industrial banks controlled by an individual or parent companies of industrial banks that are controlled by an individual. Any such individual should not be responsible for the maintenance of the industrial bank's capital and liquidity at or above FDIC-specified levels and for other written agreements, commitments and restrictions. The conditions and commitments of the Proposed Rule are overly broad and commitments tailored to the particular

[48] Id.
[49] *Proposed Rule*, *supra* note 1, at 17778.
[50] 12 U.S.C. § 1467a(b)(2).

application at hand are more appropriate and more consistent with the treatment of other insured depository institutions.

There is no acute necessity expressed in the Proposed Rule to require individuals who control industrial banks or their parent companies to be treated differently than individuals in control of other depository institutions or their holding companies. For instance, change in control regulations of the OCC define a "controlling shareholder" as "any person who directly or indirectly or acting in concert with one or more persons or companies, or together with members of his or her immediate family, owns, controls, or holds with power to vote 10 percent or more of the voting stock of a company or controls in any manner the election or appointment of a majority of the company's board of directors."[51] The "controlling shareholder" of such national bank must file a notice with the OCC in connection with any change of control,[52] but bank and company level conditions, such as responsibility for capital and liquidity requirements and for causing the parent company to enter into written agreements, commitments, or restrictions, are not imposed on the controlling shareholder.[53] This is reinforced by the OCC's Licensing Manual on changes in control, which provides that in certain situations, non-standard conditions in a notice of change in bank control may be imposed, including conditions to address supervisory, safety and soundness, or compliance concerns where conditions are imposed to address factors that would otherwise result in disapproval but are enforceable under 12 U.S.C. § 1818.[54] Such conditions may require "the acquiring person to take, or refrain from taking, certain actions, such as initiating a material change in the business plan or operations,"[55] or use best efforts to require an acquiring "company" to enter into an agreement to provide ongoing capital and liquidity support to the target bank.[56] The OCC may also condition its approval on the controlling shareholder using its best efforts to vote his or her shares or exercise influence as a member of the board or management to cause the target bank to enter into a written agreement with the OCC to maintain capital or liquidity at certain levels or to address supervisory, policy, or legal concerns.[57] These conditions are treated similarly to FDIC's "non-standard conditions," described below. Unlike the Proposed Rule, the OCC may impose certain commitments on the controlling shareholder related to the ownership of shares and how the controlling shareholder exercises shareholder rights; however, the OCC does not impose bank-level commitments, such as capital maintenance, on the shareholder.

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[51] 12 C.F.R. § 5.50(d)(5).
[52] *Id*. at (b).
[53] Office of the Comptroller of the Currency, Comptroller's Licensing Manual: Change in Bank Control, 1, 9, (Sept. 2017) (providing that the OCC may require a controlling shareholder "to cause *the target bank* to enter into an enforceable written operating agreement with the OCC to maintain capital or liquidity at certain levels or to address supervisory, policy, or legal concerns") (emphasis added) [hereinafter *OCC Manual*].
[54] *OCC Manual*, *supra* note 53, at 8-9.
[55] *Id*. at 9.
[56] *Id*.
[57] *Id*.

Similar to the OCC, the FDIC has a system to apply conditions on a controlling shareholder in connection with an application. In accordance with FDIC's Applications Procedure Manual ("APM") on standard and non-standard conditions, non-standard provisions are conditions that are used based on the "risk profile presented, unique elements of the filing, other circumstances related to the application, or [when] required actions [are] not yet completed at the time the approval or non-objection is issued."[58] The APM notes that such written agreements address a variety of circumstances regarding supervision, corporate governance, and the control exercised over the insured depository institutions.[59] This individualized approach to imposing non-standard conditions demonstrates that the unique circumstances of any individual application require tailoring on a case-by-case basis, and therefore should remain in the form of licensing guidelines and procedures, rather than regulation in the form of the Proposed Rule. Not tailoring conditions and commitments to the individual situation may lead to burdensome and potentially unnecessary requirements. For instance, additional risk may be posed to the DIF due to the contemplated nature of activities identified in the business plan or in the financial or personal background of a potential controlling individual that seeks to acquire control of an industrial bank, which may not be present in another application. To impose conditions and require commitments that are not tailored to the circumstances can be unduly burdensome on applicants with simple business models and no other capital or financial concerns present in their application. The current case-by-case approach allows for flexibility, and the APM is a sufficient means to provide transparency.

From a corporate law perspective, it is the role of the board of directors of the industrial bank to oversee the capital and liquidity requirements and to authorize entry into any written agreements, commitments or restrictions applicable to the industrial bank. The board's responsibility with regard to capital and liquidity management can be traced to federal and state law imposing capital adequacy and surplus restrictions on industrial banks.[60] This responsibility is then underscored by the board's common law and statutory fiduciary duties, which generally impose liability on those directors who fail to fulfill their fiduciary duties. Further, numerous states also impose liability on management for knowingly violating provisions of the applicable banking code, including provisions related to capital adequacy and surplus.[61] Finally, the FDIC has emphasized in both its capital and liquidity manuals that management is ultimately responsible for identifying, monitoring and controlling risks

[58] *Applications Procedures Manual*, *supra note* 24, at 1.11-2.
[59] *Id*. at 1.11-2 – 1.11-3.
[60] *See e.g.* CO ST §§ 11-103-201 (imposing capital restrictions on CO banks) and 11-103-501 (providing that affairs of CO banks shall be managed by board of directors); HI ST §§ 412:9-401 (establishing reserve requirements for HI depositary financial services loan companies) and 414-191 (providing that HI corporation, including HI banks, shall be managed by board of directors); and IN ST §§ 28-5-1-14 (restricting the ability of IN state banks to pay dividends and imposing surplus requirements) and 28-13-9-1 (establishing the authority of board of directors to manage affairs of IN state bank).
[61] *See e.g.* IN ST § 28-5-1-13; HI ST § 414-223; and NV ST § 668.115.

associated with capital adequacy and liquidity.[62] Thus, the board of directors, rather than the controlling or principal shareholder, has a fiduciary responsibility to manage and oversee risk of an industrial bank with respect to capital adequacy and liquidity.

Moreover, the role of shareholders with regard to capital or liquidity adequacy is generally limited, as demonstrated by courts' rare imposition of liability on shareholders as a result of the failure to maintain adequate capital or liquidity. Courts have pierced the corporate veil and imposed liability as a result of a failure to be adequately capitalized only when a shareholder "has actively caused or participated in such misuse of the corporate form…".[63] Said another way, the default position, at least when considered through the lens of liability, is that management of capital and liquidity is properly within the purview of the board of directors rather than the shareholders. Only when shareholders take an abnormally active role in the decisions leading to a failure to maintain adequate capital and liquidity may the veil be pierced. The limited nature of shareholders' potential liability for the failure to maintain adequate capital and liquidity demonstrates that management of such should generally occur at the board level.[64]

Further, as noted in the 2012 GAO Report regarding BHCA exempt institutions ("2012 GAO Report"), the GAO noted that the parent companies of industrial banks did function as a source of strength and that the capitalization of the parent companies of industrial banks was higher than bank holding companies.[65] This calls into question the necessity for written agreements, commitments, or restrictions imposed on the parent companies of industrial banks as provided in the Proposed Rule, specifically the need for any capital and liquidity commitments. The 2012 GAO Report states as follows:

> To assess whether these holding companies could be a source of strength to the financial institution, we analyzed the capitalization of holding companies for ILCs and credit card banks. On average, the holding companies of ILCs and credit card banks we analyzed had higher ratios of equity-to-total assets over the 5-year period than bank holding companies... The higher ratio shows that these holding

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[62] Federal Deposit Insurance Corporation, Risk Management Manual of Examination Policies, 1.1-1, 2.1-14 and 6.102 (November 2019) [hereinafter *FDIC Risk Manual*].
[63] William P. Hackney and Tracey G. Benson, *Shareholder Liability for Inadequate Capital*, U. Pitt. L. Rev. 837, 876 (1982).
[64] *See Minton v. Cavaney*, 56 Cal. 2d 576, 579-80 (1961) (providing that "[t]he equitable owners of a corporation…are personally liable…when they provide inadequate capitalization and actively participate in the conduct of corporate affairs"); Robert W. Hamilton, *The Corporate Entity*, 49 Tex. L. Rev. 979 (1971) (providing that "…it would appear desirable to hold only the shareholders who participated in the misrepresentation, trick, deceit, coercion, etc., and exonerate shareholders who are not active in management of the corporation or who were unaware of the undesirable conduct.")
[65] *2012 GAO Report, supra note* 38, at 23.

> companies had a higher, stronger cushion against losses that might occur. The average equity-to-total assets ratios for limited-purpose credit card banks remained above 20 percent over the period. In comparison, the average equity-to-total assets ratio of bank holding companies with total assets of more than $500 million that were required to file financial data with the Federal Reserve remained below 10 percent during the same period.[66]

Question 11: The proposed rule would limit board of directors (or similar body) representation to 25 percent of the members of the board of directors (or similar entity). The FDIC has chosen this threshold with the idea that 25 percent is a key threshold for control purposes. Is another threshold more appropriate? If so, what and why?

Comment:

The Proposed Rule's commitment (6) requires that the parent company's representation on the industrial bank's board of directors be limited to 25 percent of the members of the board of the industrial bank.[67] To require independent representation of 75 percent of the industrial bank's directors from the parent company is excessive and a more appropriate standard would be a majority. This is more consistent with the FDIC's past practices in connection with industrial bank charter approvals. According to a 2006 report from the FDIC Office of Audits, in only 1 out of 11 orders for deposit insurance did the FDIC require a majority of an industrial bank's board of directors to be independent.[68] Thus, it seems that the FDIC previously took the position that majority independence was not required in most cases, demonstrating the excessiveness of a 75 percent independence standard.

Further, the FDIC has acknowledged in its Risk Management Manual that "[b]ank holding companies… may be able to provide individual banks' boards with lending and investment counseling, audit and internal control programs or services, profit planning and forecasting, personnel efficiency reports, electronic data processing services, marketing strategy and asset appraisal reports."[69] Additionally, the Federal Reserve requires bank holding companies to serve as a "source of strength" for their subsidiary banks by committing "available resources" to the bank in periods of distress.[70] The valuable managerial assistance that the holding company can provide is one such "available resource" that allows the holding company to serve as a source of strength for

[66] *Id.*
[67] *Proposed Rule*, *supra* note 1, at 17785-86.
[68] Report No. 06-014, Federal Deposit Insurance Corporation (July 2006), https://www.fdicoig.gov/publications/reports06/06-014-508.shtml.
[69] *FDIC Risk Manual*, *supra* note 62, at 1.1-1, 4.1-5.
[70] Board of Governors of the Federal Reserve System, Bank Holding Company Supervision Manual, Supervision of Subsidiaries, 1, 2 (Dec. 31, 2017).

its subsidiary bank. Sacrificing this resource by imposing the 75 percent restriction is excessive in light of the fact that most board decisions will still be made independently as they will require majority approval.

The FDIC even asks bank examiners to consider whether "the composition of the board of directors of [an] affiliate mirror or overlap with the board of directors of the bank?"[71] The implication of such a question is that in certain circumstances, the FDIC has found it appropriate for a bank's board composition to mirror that of its affiliates. Further, it should be noted that none of the states that have chartered industrial banks or industrial loan companies have imposed such a burdensome requirement. Only Utah requires that a majority of the industrial bank's directors be independent.[72] Relatedly, not even the New York Stock Exchange or Nasdaq have imposed such a restriction on publically listed companies. Instead, both require that the board of directors of listed companies be made up of only a majority of independent directors.[73] To impose a more stringent independence standard than that applicable to publicly listed companies is excessive. We also note that there are already rules regarding director independence for audit committees.[74] We understand that "control" of an entity is triggered at 25 percent, as noted in the Proposed Rule,[75] but this does not affect the independence of the industrial bank's board of directors, as the inside directors will not have a majority necessary to take most corporate actions.

We appreciate the opportunity to submit these comments in connection with the Proposed Rule. Should you wish to discuss any of the above or desire any clarification, please contact Heather Eastep at heastep@huntonak.com ((202) 955-1954) or Sumaira Shaikh at sshaikh@huntonak.com ((202) 955-1586).

Sincerely,

[redacted] [redacted]

Heather Eastep Sumaira Shaikh

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[71] Federal Deposit Insurance Corporation, Consumer Compliance Examination Manual, I-1.1, X-5.2 (Jan. 2015).
[72] Utah Department of Financial Institutions, *What is a Utah Industrial Bank*, https://dfi.utah.gov/financial-institutions/industrial-banks/what-is-a-utah-industrial-bank/.
[73] NASDAQ Rule 5605(b)(1) and NYSE Rule 303A.01.
[74] *See* 12 C.F.R. Part 363.
[75] *Proposed Rule*, *supra* note 1, at 17785.