Loyola Consumer Law Review

Volume 21 | Issue 3 Article 2

2009

Challenging the Roots of the Subprime Mortgage Crisis: The OCC's Operating Subsidiaries Regulations and Watters v. Wachovia Bank

Wook Bai Kim

CHALLENGING THE ROOTS OF THE SUBPRIME MORTGAGE CRISIS: THE OCC'S OPERATING SUBSIDIARIES REGULATIONS AND *WATTERS V. WACHOVIA BANK*

*WookBai Kim**

TABLE OF CONTENTS

* B.A., 1998, Korea University College of Law (South Korea); LL.M., 2006, Georgetown University Law Center; S.J.D. Candidate, 2009, Indiana University Maurer School of Law—Bloomington. The author gratefully acknowledges valuable advice and encouragement from Professor Sarah Jane Hughes. He also wishes to thank Professor Donna M. Nagy for helpful comments on an earlier draft of this article.

CHALLENGING THE ROOTS OF THE SUBPRIME MORTGAGE CRISIS: THE OCC'S OPERATING SUBSIDIARIES REGULATIONS AND *WATTERS V. WACHOVIA BANK*

WookBai Kim

In 2007, the Supreme Court in Watters v. Wachovia Bank finally sided with the OCC's preemption of state consumer protection laws which had policed operating subsidiaries of national banks. In drawing this conclusion, the OCC's unchallenged interpretations of the incidental powers of the NBA—the argument that "the national bank has incidental power to conduct business through operating subsidiaries"—played a determinative role, effectively rendering those subsidiaries subject to the exclusive regulation of the OCC. However, this paper argues that the OCC's construction is contrary to law and is unreasonable given the plain language of the NBA, precedential case law and the structure of the NBA. The OCC's arguments only reflect its self-interest to be "an umbrella bank regulator" of the operating subsidiary, a state-chartered corporation.

To rethink debates concerning the regulatory jurisdiction over operating subsidiaries has significant implications. Operating subsidiaries which engage in originating subprime mortgages have created serious allegations of abusive lending practices. In particular, the preemption of state laws over operating subsidiaries since 2001 has deteriorated consumer protection in the subprime mortgage market, which is, to a substantial degree, responsible for the subprime mortgage crisis. The immunization of operating subsidiaries of national banks from stringent state consumer protection laws has been used to spread the agenda of deregulation over the entire sub-prime mortgage market for the past several years.

I. INTRODUCTION

Several years' worth of controversy concerning regulatory jurisdiction over national bank operating subsidiaries was settled in the decision of the Supreme Court in *Watters v. Wachovia Bank*[1] in April 2007. The Court affirmed the 2001 interpretation of the Office of the Comptroller of the Currency ("OCC")[2] that the National Bank Act ("NBA") and the OCC's regulations preempt state consumer protection laws which had policed national bank operating subsidiaries. The Supreme Court disagreed with the State of Michigan's argument that

[1] Watters v. Wachovia Bank, N.A., 127 S. Ct. 1559 (2007).

[2] The Office of the Comptroller of the Currency ("OCC") is a primary federal bank regulator for national banks.

mortgage-lending subsidiaries were "subject to multistate control" in addition to the OCC's regulatory authority,[3] noting that the Court had "treated operating subsidiaries as equivalent to national banks with respect to powers exercised under federal law."[4]

As a bank policy, the OCC's preemption in 2001[5] has had significant implications. It has had a crippling impact on consumer protection because the state was prohibited from policing activities of operating subsidiaries which produce serious abusive lending practices in the subprime mortgage market. Furthermore, this preemption, combined with the OCC's subsequent preemption measures and state parity laws, deteriorates the level of consumer protection, which is strongly associated with the recent subprime mortgage crisis. Ostensibly, the OCC's preemption seems to have impacted the national bank and its operating subsidiaries, but the immunization from strong state consumer protection laws has extended beyond the national bank to the entire field of subprime mortgages.

Recognizing the close connection between the OCC's preemption and the subprime mortgage crisis, this paper critically approaches the OCC's preemption in 2001 and concludes that the OCC's construction is contrary to law and unreasonable. In drawing this conclusion, this paper challenges the incidental power to use an operating subsidiary and the OCC's superintendence of operating subsidiaries for the first time. The OCC's interpretation of incidental powers in the NBA that "the national bank has incidental power to conduct business through operating subsidiaries" played a central role in justifying preemption. The Supreme Court in *Watters* repeatedly emphasized that Michigan did not dispute the national bank's incidental power to use operating subsidiaries and the OCC's authority to regulate operating subsidiaries in the same manner as national banks.[6]

However, examining the limitations of incidental powers in light of the plain language of 12 U.S.C. § 24(7) ("§ 24(7)") and the regulatory structure of the NBA demonstrates: (i) that the incidental power to use an operating subsidiary exceeds the OCC's interpretive authority under § 24(7); (ii) the OCC is not generally empowered to regulate an operating subsidiary pursuant to § 24(7), "consolidated supervision," and section 121 of the Gramm-Leach-Bliley Act ("GLBA").[7] Consistent with the NBA, the Court should limit the

---

[3] *Watters*, 127 S. Ct. at 1571-72.

[4] *Id.* at 1570-71.

[5] Applicability of State Law to National Bank Operating Subsidiaries, 12 C.F.R. § 7.4006 (2008).

[6] *See infra* notes 88, 116 and accompanying text.

[7] Gramm-Leach-Bliley Act ("GLBA"), § 121(a)(2), 113 Stat. 1378 (codified at 12 U.S.C. § 24a(g)(3)(A)) [hereinafter "§ 24a(g)(3)(A)"].

national bank's incidental power to the ability to "own and control" operating subsidiaries and the OCC's regulatory authority to the oversight of the national bank's conduct as a shareholder of its subsidiaries.[8]

Part II briefly explains that the OCC's preemption has contributed to the subprime mortgage crisis. Part III.A shows how the OCC's construction of incidental powers conflicts with state laws. Part III.B and III.C analyze the OCC's regulatory scheme for operating subsidiaries, including their creation and justifications, together with the Supreme Court's decision in *Watters*. Part IV challenges the undisputed concept of incidental power in *Watters*. Part IV.A shows that key justifications for the OCC's assertion of preemption create impermissible constructions of incidental powers. Part IV.B finds limitations on incidental powers from the plain language of § 24(7). Part IV.C shows that the OCC is not authorized to exclusively regulate operating subsidiaries under the regulatory framework of the NBA. Finally, Part V provides concluding remarks.

II. REGULATIONS FOR OPERATING SUBSIDIARIES AND THE SUBPRIME MORTGAGE CRISIS

A. National Banks' Involvement in the Subprime Mortgage Market and Predatory Lending, and States' Efforts to Protect Consumers

From the late 1990s, a radical growth of the subprime mortgage market drove national banks to engage in the secondary market.[9] Usually the banks' operating subsidiaries and affiliates have originated subprime mortgage loans,[10] and the banks themselves have purchased, securitized, and sold those securitized loans in the capital market.[11] Many banks could make huge profits in this risky business, while

---

[8] *See* Discussion *infra* Part IV.

[9] *See generally* Evan M. Gilreath, Note, *The Entrance of Banks into Subprime Lending: First Union and the Money Store*, 3 N.C. BANKING INST. 149 (1999) (explaining that "one of the most important changes is the increased participation of banks in the subprime mortgage market"); *see also* Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 393 (explaining that "by early 2000, big banks controlled eight of the ten largest subprime mortgage companies" and further stating that "Citigroup became the biggest subprime mortgage consumer lenders" in 2000).

[10] In fact, most national bank operating subsidiaries participate in the subprime mortgage business. *See* Julia Patterson Forrester, *Still Mortgaging the American Dream: Predatory Lending, Preemption, and Federally Supported Lenders*, 74 U. CIN. L. REV. 1303, 1342, 1369-70 (2006) [hereinafter "American Dream"]. As of the end of 2007, 348 national bank operating subsidiaries transacted directly with consumers for a majority of the mortgage lending business. *See* OCC, National Bank Subsidiaries Doing Business with Consumers (Dec. 31, 2007), *available at* http://www.occ.treas.gov/consumer/ OperatingSubsidiaries.pdf (last visited Nov. 13, 2008).

[11] *See, e.g.*, American Dream, *supra* note 10, at 1349-50 (describing how banks can profit in the process of securitization of subprime mortgage loans).

dispersing high risks to investors through the securitization of subprime mortgages.[12]

The reason for banks to use operating subsidiaries is to circumvent various risks which might occur when the bank itself originates subprime mortgages—for example, the deterioration of the bank's safety and soundness, litigation risks and reputational damage. In addition, there are regulatory advantages when the bank utilizes its operating subsidiaries. First, the most significant advantage of the parent-subsidiary structure is to insulate the parent bank from the liability of the riskier business of the subsidiary because the subsidiary has a separate legal status under state corporate laws.[13] Second, the limited liability also helps banks avoid legal risks from much litigation claiming that they are engaged in predatory lending practices. Third, banks can minimize reputational threats by conducting subprime mortgage business through their operating subsidiaries. In particular, to originate loans without reviewing borrowers' repayment ability and then to foreclose their houses may significantly damage the banks' reputation,[14] exposing banks to litigations, financial loss, or a decline in their customer base.[15] Another significant advantage is the avoidance of bank regulations.[16] The operating subsidiary in itself, as a non-bank mortgage company, is not subject to the safety and soundness regulations, such as the capital requirements applicable to the parent bank.[17] Also, §§ 23A and 24B of the Federal Reserve Act, which govern transactions between a bank and its affiliates, do not apply to the bank's transactions with its operating subsidiaries.[18] Thus, for instance,

---

[12] *See* U.S. Dep't of Hous. & Urban Dev. & U.S. Dep't of Treasury, *Curbing Predatory Home Mortgage Lending: A Joint Report* at 45 (2000), *available at* http://huduser.org/publications/hsgfin/curbing.html (last visited Nov. 13, 2008) (explaining that banks and thrifts increased their profits in the subprime mortgage market). In particular, the securitization of subprime mortgage loans offered preferable conditions for lenders, such as lower funding costs and dispersion of credit risks. In addition, higher interest rates on subprime mortgage loans maintained higher interest spreads, guaranteeing greater profits. *See* American Dream, *supra* note 10, at 1326-27.

[13] *See infra* notes 105-106 and accompanying text.

[14] *See* OCC Advisory Letter AL 2003-3, Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loans at 5 (Feb. 21, 2003), *available at* http://www.occ.treas.gov/ftp/advisory/2003-3.pdf (stating that lenders' reckless underwriting may face significant reputation risk at the time of home foreclosure).

[15] *See* OCC, MORTGAGE BANKING: COMPTROLLER'S HANDBOOK at 5-6 (Mar. 1998), *available at* http://www.occ.treas.gov/handbook/mortgage.pdf.

[16] *See* U.S. Gen. Accounting. Office, *OCC Preemption Rules: OCC Should Further Clarify the Applicability of State Consumer Protection Laws to National Banks* 24 n.30 (2006), *available at* http://www.gao.gov/new.items/do6387.pdf [hereinafter "GAO Report"] (citing the OCC's statement that using an operating subsidiary has advantages in "transactions with affiliates, regulatory capital requirements, and accounting considerations").

[17] Even though the OCC regulates national banks and their operating subsidiaries on a consolidated basis, subsidiaries themselves are not subject to the OCC's prudential regulations, such as minimum capital requirements. *See infra* notes 258-272 and accompanying text.

[18] 12 U.S.C. §§ 371c(b)(2)(A) and 371c-1; *See also* JONATHAN R. MACEY, GEOFFREY P. MILLER & RICHARD SCOTT CARNELL, BANKING LAW AND REGULATION 475-76 (3d ed. 2001) (explaining that section 23A does not apply to the bank's transactions with subsidiaries and section 23B is applied when banks and their subsidiaries transact business with affiliates).

banks can make transactions with their operating subsidiaries without the application of the percentage-of-capital limitations[19] and dealing with affiliates at arm's length.[20] This statutory exemption permits subsidiaries to obtain unlimited funds from parent banks on terms and conditions favorable to the operating subsidiaries.[21] In short, national banks can utilize their operating subsidiaries under regulatory forbearance, which facilitates the subprime mortgage business, while parent banks entertain limited legal liability and minimized criticism for conducting subprime mortgage business.

Stiff competition among subprime mortgage lenders resulted in loosening mortgage underwriting criteria which has caused a proliferation of predatory lending practices.[22] In response, in the early 2000s, state governments vigorously investigated consumers' complaints and enforced their current laws[23] as well as enhancing predatory lending acts, such as the Georgia Fair Lending Act ("GFLA") of 2002.[24] Such state efforts included conducting investigations and bringing enforcement against the national bank's operating subsidiaries and affiliates.[25] For example, in late 2002 California attempted to enforce its real estate mortgage laws against Wells Forgo Home Mortgage, Inc. and National City Mortgage Co. which were operating subsidiaries of Wells Fargo National Bank and National City Bank of Indiana, respectively.[26] The year before, North Carolina forced

---

[19] 12 U.S.C. § 371c(a);(b). A bank's covered transactions—such as extension of credit and purchasing assets—with one affiliate and all affiliates cannot exceed 10% and 20% of the bank's capital respectively. Also, covered transactions must be fully secured by qualifying collateral and basically the bank cannot purchase low-quality asset from affiliates. *See generally* MACEY ET AL., *supra* note 18, at 472-75.

[20] 12 U.S.C. § 371c-1(a)(1) (providing that a bank and its subsidiaries must transact business with affiliates on market terms).

[21] This exception implies that benefits of governmental subsidies toward the national bank spill over to its operating subsidiaries unrestrictedly in conducting the subprime mortgages business in light of the funding and sale of subprime mortgages. *See* American Dream, *supra* note 10, at 1352-53. Notably, these regulatory advantages also offer parent banks an incentive to conceal their financial loss by transferring their subsidiaries' good assets to themselves while leaving bad assets in the subsidiaries, which will increase the losses of the subsidiaries' outside creditors. When the market condition is in distress and banks' losses are imminent, this scenario can occur by transactions between banks and their subsidiaries.

[22] The term of "predatory lending" is frequently defined by reference to a variety of lending practices, fundamentally characterized as aggressive marketing of credit to blemished borrowers without regard to the ability to repay and predominantly relying on the liquidation value of the collateral. *See* OCC Advisory Letter AL 2003-3, *supra* note 14.

[23] *See* Arthur E. Wilmarth, Jr., *The OCC's Preemption Rules Exceed the Agency's Authority and Present a Serious Threat to the Dual Banking System and Consumer Protection*, 23 ANN. REV. BANKING & FIN. L. 225, 314-15 (2004) (explaining that during 2003, states performed more than 20,000 investigations of abusive lending practices and conducted more that 4000 enforcement actions).

[24] GA. CODE ANN. § 7-6A-1 (2004). *See also infra* notes 34-36 and accompanying text.

[25] *See* Arthur E. Wilmarth, Jr., *supra* note 23, at 314-15; American Dream, *supra* note 10, at 1349-50.

[26] *See, e.g.*, Wells Fargo Bank, N.A. v. Boutris, 419 F.3d 949 (9th Cir. 2005); Brief of National City Bank as Amicus Curiae In Support of Respondents, at 16-19, Watters v. Wachovia Bank, 127 S. Ct. 1559 (2007) (No. 05-1342).

Associate First Capital, a non-bank affiliate of Citigroup, to pay 20 million dollars to settle allegations of predatory lending practices.[27] In addition, large national banks—for example, Bank of America, Citibank, Bank One, J.P. Morgan Chase and Wells Fargo—and their operating subsidiaries or affiliates were involved in suits charging predatory lending practices.[28]

The burdensome state litigations were, however, recognized as significant obstacles to the subprime mortgage business of the national banks. The banking industry wanted to avoid the states' intervention, which also coincided with the OCC's aim to be the sole regulator of the national banks.[29]

B. Aggressive Preemption and the Impact on the Subprime Mortgage Market

1. Preemptive Regulation for Operating Subsidiaries and Subsequent Preemption

In 2001, the OCC construed the NBA and the OCC's regulations as preempting state consumer protection laws which had policed national bank operating subsidiaries for more than 30 years.[30] By treating operating subsidiaries as "the equivalent of departments or divisions of their parent banks," the OCC claimed that state laws were applicable to operating subsidiaries "only to the extent that they are applied to national banks."[31] Relying on this construction, national

---

[27] *See, e.g.*, Christopher L. Peterson, *Preemption, Agency Cost Theory, and Predatory Lending by Banking Agents: Are Federal Regulators Biting off More Than They Can Chew?*, 56 AM. U. L. REV. 515, 522 (2007) (explaining that North Carolina drove Citigroup to reach settlement on predatory lending). In 2002, Citigroup also agreed to pay $240 million to settle predatory claims filed by the FTC and customers against Associates First Capital. *See* Arthur E. Wilmarth, Jr., *supra* note 23, at 314-15; American Dream, *supra* note 10, at 1304-06.

[28] *See* Arthur E. Wilmarth, Jr., *supra* note 23, at 315; NAT'L CONSUMER LAW CTR., COMMENTS OF THE CONSUMER FEDERATION OF AMERICA, NATIONAL ASSOCIATION OF CONSUMER ADVOCATES, AND U.S. PUBLIC INTEREST RESEARCH GROUP TO OFFICE OF COMPTROLLER OF THE CURRENCY, OCC DOCKET NO. 03-16, BANKING ACTIVITIES AND OPERATIONS; REAL ESTATE LENDING AND APPRAISALS (Oct. 6, 2003), *available at* http://www.consumerlaw.org/issues/preemption/content/10_6_occ_content.html [hereinafter "NCLC COMMENTS"] (illustrating 23 cases against national banks and their operating subsidiaries or affiliates which were involved in illegal or predatory lending).

[29] *See* Arthur E. Wilmarth, Jr., *supra* note 23, at 236. In spring 2003, the OCC was concerned with states' efforts to regulate mortgage lending by national bank operating subsidiaries because it would add regulatory costs and lead to litigations such as the case in California. *See* OCC News Release NR 2003-30, Remarks by John D. Hawke, Jr. Comptroller of the Currency Before the Exchequer Club Washington, D.C (April 16, 2003); OCC News Release NR 2003-36, Chief Counsel Julie L. Williams Provides Historical Perspective On Issues Facing the National Banking System (May 14, 2003).

[30] 12 C.F.R. § 7.4006 (providing that "[s]tate laws apply to national bank operating subsidiaries to the same extent that those laws apply to the parent national bank").

[31] Investment Securities; Bank Activities and Operations; Leasing, 66 Fed. Reg. 34,784, 34,788 (July 2, 2001) (codified at 12 C.F.R. § 7.4006).

bank operating subsidiaries refused to comply with state laws requiring registration, paying fees, and filing financial reports, or cooperate with state investigations and examinations over consumer complaints.[32]

In 2003 the OCC determined that the NBA preempts Georgia's predatory lending law, the GFLA,[33] the strongest state law aimed to curb predatory lending practices.[34] The act included restrictions or prohibitions on predatory lending practices such as refinancing, prepayment penalties, balloon payments and loans made without regard to the borrower's ability to repay.[35] Also, in order to impede flows of capital to unscrupulous mortgage lenders, the act imposed strict assignee liability on investors of securitized subprime mortgages when the underlying loans were deemed predatory loans.[36] However, the OCC concluded that a national bank is not subject to many provisions of the GFLA because they limit, condition, or otherwise impermissibly affect a national bank's real estate lending.[37] The operating subsidiaries could avoid the application of the GFLA given the 2001 preemptive regulation which immunizes operating subsidiaries from state visitorial powers.[38]

Finally, the OCC in January 2004 promulgated two regulations to broaden its preemption purview—the bank activities rule and the visitorial powers rule ("Preemption Regulations").[39] The Preemption Regulations were prompted by states' intensified efforts to intervene in the subprime mortgage lending business.[40] These regulations provide sweeping authority to preempt state laws if they "obstruct, impair, or condition" a national bank's ability to engage in real estate lending and other lending; thus, a state law governs only when it incidentally affects the national bank's business.[41] At the same time, these regulations make clear that the OCC exclusively enforces state laws that govern the content and conduct of the banking activities of the national banks,

---

[32] *See infra* notes 83-85 and accompanying text.

[33] OCC, Preemption Determination and Order, 68 Fed. Reg. 46,264 (Aug. 5, 2003).

[34] *See* American Dream, *supra* note 10, at 1320 (explaining that "the statute, in its original form, was the strongest in the nation").

[35] GA. CODE ANN. §§ 7-6A-2 to 5.

[36] GA. CODE ANN. § 7-6A-6 (providing that the assignee of a high-cost loan "shall be subject to all affirmative claims and any defense with respect to the loan that the borrower could assert against the original creditor...").

[37] OCC, Preemption Determination and Order, 68 Fed. Reg. at 46,264.

[38] *Id.* at 46,280-81.

[39] OCC, Bank Activities and Operations: Real Estate Lending and Appraisals, 69 Fed. Reg. 1904 (Jan. 13, 2004) (to be codified at 12 C.F.R. pts. 7, 34); Bank Activities and Operations, 69 Fed. Reg. 1895 (Jan. 13, 2004) (codified at 12 C.F.R. § 7.4000).

[40] Preemption Regulations were proposed by the OCC in Aug. 2003 when the OCC preempted the GFLA. *See* Julie L. Williams & Michael S. Bylsma, *Federal Preemption and Federal Banking Agency Responses to Predatory Lending*, 59 BUS. LAW. 1193, 1203-04 (2004) (stating that Preemption Regulations were proposed to "specify the types of restrictions and requirements applicable to any real estate lending activities by national banks").

[41] Preemption Regulations, 69 Fed. Reg. at 1904.

regardless of whether the laws are preempted or not.[42] With respect to operating subsidiaries, the OCC, on the assumption of the 2001 preemptive regulation, construed the Preemption Regulations to govern the activities of national bank operating subsidiaries to the same extent as that of their parent banks.[43]Accordingly, the states' ability to enforce their consumer protection laws was effectively eliminated and, in fact, a regime of de facto "field preemption" of the states' regulatory power has been created.[44]

2. Strong Association With the Subprime Mortgage Crisis

While a series of OCC preemptions have facilitated the operating subsidiaries' subprime mortgage activities, opponents of those preemptions, such as state governments, consumer groups and many scholars, have consistently criticized them as being inconsistent with Congress' intent under the NBA and as undermining state efforts to combat predatory lending.[45] They have argued that state consumer protection laws should not be preempted because states have strong local interests to protect consumers and, in fact, have enacted stringent consumer protection laws and enforced them vigorously. [46] Commentators further argued that the OCC is not a consumer protection agency, but, rather, is responsible for the safety and soundness of national banks,[47] so that it has no motivation to take strong measures to enhance consumer protection.[48] The OCC has, in fact, adopted lax predatory lending standards and has not strictly investigated or enforced such regulations.[49]

---

[42] *Id.* at 1900. These Preemption Regulations also provide that an exception of visitorial powers under 12 U.S.C. § 484(a), "vested in the courts of justice," does not give the state enforcement power against national banks and operating subsidiaries by simply filing complaints in a court. Rather, the OCC has exclusive authority to initiate administrative or judicial proceedings to enforce state laws against its constituents. *See id.* at 1899-1900.

[43] *Id.* at 1900-01.

[44] *See* Arthur E. Wilmarth, Jr., *supra* note 23, at 233-37 (arguing that the Preemption Regulations give a national bank and its operating subsidiary the same immunity from state laws that the federal savings association and its operating subsidiaries possess under the "field preemption" of the Office of Thrift Supervision).

[45] *See generally* Arthur E. Wilmarth, Jr., *supra* note 23; Nicholas Bagley, *The Unwarranted Regulatory Preemption of Predatory Lending Laws*, 79 N.Y.U.L. REV. 2274 (2004); Keith R. Fisher, *Toward a Basal Tenth Amendment: A Riposte to National Bank Preemption of State Consumer Protection Laws*, 29 HARV. J.L. & PUB. POL'Y 981 (2006). *See also* American Dream, *supra* note 10, at 1359-70; GAO Report, *supra* note 16, at 7, 17 (explaining that state officers and consumer groups argue that the OCC's interpretation is wrong); NCLC COMMENTS, *supra* note 28 ("strongly urging the OCC to withdraw the proposed regulation preempting the application of state laws to the consumer loans made by national banks and the operating subsidiaries").

[46] *See, e.g.*, Arthur E. Wilmarth, Jr., *supra* note 23, at 293-316.

[47] *See* Nicholas Bagley, *supra* note 45, at 2309; American Dream, *supra* note 10, at 1369 ("The OCC's primary responsibility is to monitor the safety and soundness of national banks and their affiliates.").

[48] *See* American Dream, *supra* note 10, at 1370.

[49] *Id.* Although the OCC's predatory lending standard bars banks from making loans by

Also, state parity laws have contributed to expanding the OCC's preemption purview to state-based mortgage lenders. In response to the OCC's preemption, most states adopted parity laws declaring that state laws were not applicable to state-based depository institutions if they were preempted for national banks and their operating subsidiaries.[50] On the one hand, parity laws address potential transfers to the national bank charters by conferring on state-based banks, at least, the same powers, rights and privileges as national banks,[51] allowing them to enjoy the OCC preemption applicable to national banks and their operating subsidiaries. On the other hand, the state's effort to curb predatory lending practices was barred by its parity laws because the state repealed its own stringent consumer protection laws against state-based subprime mortgage lenders.[52] Accordingly, prevailing predatory lending in the subprime mortgage market was left unchecked both at the federal and state level.[53]

By the mid-2000s, there were warning signs that the subprime mortgage market would deteriorate and, thus, banking regulators would have to take strong consumer protection measures.[54] The capital market's increasing appetite for securitized subprime mortgages and intensified competition among mortgage lenders resulted in widespread predatory lending practices, characterized by reckless or loosened reviews on the borrower's repay ability, deceptive and unfair terms, exorbitant interest rates or combinations thereof.[55] In particular, subprime mortgage lenders predominately sold risky nontraditional mortgage products—for example, "interest only" mortgages loans,

---

relying predominantly on foreclosure or the liquidation value of the borrower's collaterals, banks can actually adopt any method to determine a borrower's repayment ability. 12 C.F.R. §§ 34.3(b) and 7.4008(b) (as standards for making loans, "[a] bank may use any reasonable method to determine a borrower's ability to repay"); *see also* Keith R. Fisher, *supra* note 45, at 992-94 (asserting that the OCC's lending standards direct toward safety and soundness rather than toward consumer protection itself).

[50] *See* GAO Report, *supra* note 16, at 34-36.

[51] *Id.*

[52] *See* Nicholas Bagley, *supra* note 45, at 2284 ("The preemption regulation, although technically applying only to federally chartered institutions, effectively guts state predatory lending legislation.").

[53] *Id.*

[54] *See* John Kiff & Paul Mills, *Money for Nothing and Checks for Free: Recent Developments in U.S. Subprime Mortgage Markets*, IMF Working Paper No 07/188 1-3 (2007), *available at* http://www.imf.org/external/pubs/ft/wp/2007/wp07188.pdf [hereinafter "IMF Working Paper"] (pointing out that there were "warning signs" for the "U.S. subprime mortgage crisis"); Yuliya Demyanyk & Otto Van Hemert, *Understanding the Subprime Mortgage Crisis* 25 (Fed. Res. Bank of St. Louis, Working Paper 2007-05 2008), *available at* http://stlouisfed.org/banking/SPA/WorkingPapers/SPA_2007_05.pdf [hereinafter "Understanding the Subprime Mortgage Crisis"] (demonstrating that problems in the subprime mortgage market were apparent, at least, by the end of 2005).

[55] *See* IMF Working Paper, *supra* note 54, at 7 (explaining that "strong investor appetite for higher yielding securities in 2005-06 probably contributed to looser underwriting standards," together with making "loans on the basis of expected collateral appreciation"); Christopher L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185, 2214-21 (2007) (emphasizing that an increase in securitized subprime mortgages resulted in predatory lending).

"payment-option" adjustable-rate mortgages and 2/28 adjustable-rate mortgages ("hybrid 2/28")[56]—based on low introductory teaser rates, little or no down payment or verification of borrowers' income, and inadequate disclosures. [57] As a consequence, delinquency and foreclosure rates started to soar and the safety and soundness of subprime lenders worsened. [58] At last, pessimistic views on this secondary market were realized: since early 2007, a failure in the subprime mortgage market has deteriorated the entire financial market in the U.S., which has since spread to the global market.[59] This subprime crisis has been considered the worse financial crisis since the Great Depression.[60]

This financial turbulence is generally believed to be driven by the combined effects of a number of factors, including the slowdown in housing prices and regional economic distress, the expansion of improvident mortgage lending and failures of regulatory oversight, excessive investments in complex mortgage-backed securities and over-reliance on the evaluations of the credit rating agencies.[61] However, the fundamental causes would be looser lending standards in the subprime mortgage origination combined with regulatory failure to curb such

---

[56] The basic nontraditional mortgage product was a hybrid 2/28, which offers a fixed rate for two years and then adjusts to a variable rate for the remaining 28 years. Subprime borrowers who obtained these products often were confronted with unaffordable monthly payments two years later; and thus, failed to make payments and lost their homes. Adjustable-rate mortgages originating at that time demonstrated even higher delinquency and foreclosure rates than before and have become the main factor that has wrought havoc in the mortgage market. *See* IMF Working Paper, *supra* note 54, at 7-9; Understanding the Subprime Mortgage Crisis, *supra* note 54, at 1, 6-10.

[57] Responding to growing concerns about the subprime mortgage market, federal bank regulators in October 2006 jointly issued guidance on nontraditional mortgage products. Yet they could not effectively address the problems mainly because the guidance focused only on "interest-only" and "payment-option" adjustable-rate mortgages and left unregulated the hybrid 2/28. Not until July 2007 did federal bank regulators regulate this risky product. However, it was too late to prevent the subprime crisis which had already begun. *See* Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58,609 (Oct. 4, 2006); Statement on Subprime Mortgage Lending, 72 Fed. Reg. 37,569 (July 10, 2007); *see also* LAURIE S. GOODMAN, SHUMIN LI, DOUGLAS J. LUCAS, THOMAS A. ZIMMERMAN & FRANK J. FABOZZI, SUBPRIME MORTGAGE CREDIT DERIVATIVES 308-11 (2008) (arguing that the October 2006 Guidance should have regulated the hybrid 2/28).

[58] *See* IMF Working Paper, *supra* note 54, at 8-11.

[59] *See, e.g.*, INTERNATIONAL MONETARY FUND, WORLD ECONOMIC OUTLOOK: HOUSING AND THE BUSINESS CYCLE (Apr. 2008) (explaining that the crisis that originated in a small segment of the U.S. subprime mortgage market has spread to the broader cross-border credit and funding market).

[60] *Id.* at 4.

[61] *See, e.g.*, Ben S. Bernanke, Chairman, Fed. Res. Speech at the Women in Housing and Finance and Exchequer Club Joint Luncheon: Financial Markets, the Economic Outlook, and Monetary Policy (Jan. 10, 2008), *available at* www.federalreserve.gov/newsevents/speech/bernanke20080110a.htm (expressing that the financial turmoil was complicated by a number of factors); U.S. DEP'T OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 78 (2008), *available at* http://www.treas.gov/press/releases/reports/Blueprint.pdf [hereinafter "BLUEPRINT"] (highlighting regulatory loopholes in the U.S. oversight system for the mortgage origination market).

practices.[62] Given that consumer protection deregulation is, to a substantial degree, attributable to the federal preemption of state consumer protection laws,[63] some analysts suggest the origin of the recent mortgage crisis is in the shortsighted preemption of the federal agencies.[64] For instance, Eliot Spitzer, former Governor of New York, criticized the federal government "as a willing accomplice to the lenders" who caused the subprime mortgage crisis because it utilized the OCC's preemption which is detrimental to consumer protection.[65] Professor Paul Krugman of Princeton University also argued that the federal government's anti-regulation was one of the causes of this crisis, specifically noting the use of "obscure powers of the Office of the Comptroller of the Currency" to "block state-level efforts to impose some oversight on subprime lending."[66]

In this context, Part III will consider the OCC's regulatory schemes over national bank operating subsidiaries and explore how the OCC's constructions preempt state consumer protection laws over those subsidiaries, which is strongly associated with the roots of today's consumer protection crisis.

III. THE OCC'S OPERATING SUBSIDIARY REGULATIONS AND *WATTERS V. WACHOVIA BANK*

A. Before Preemption: Dual Control of the National Bank Operating Subsidiaries

Until 2001, when the OCC promulgated preemptive regulations for national bank operating subsidiaries, states controlled the activities of those subsidiaries. Since each state has authority to regulate not only its chartered corporations but also out-of-state corporations that

---

[62] *See* IMF Working Paper, *supra* note 54, at 7 (pointing out that the crisis was prompted by the growth of riskier subprime lending against rising house prices); Understanding the Subprime Mortgage Crisis, *supra* note 54, at 5, 25 (claiming that a deterioration of lending standards and unsustainable growth resulted in the collapse of the market).

[63] *See* Christopher L. Peterson, *Federalism and Predatory Lending: Unmasking the Deregulatory Agenda*, 78 TEMP. L. REV. 1, 96-97 (arguing that preemption closely pertains to a deregulation agenda).

[64] *See* Michael P. Malloy, *The Subprime Mortgage Crisis and Bank Regulation*, 27 No. 3 BANKING & FIN. SERVICES POL'Y REP. 1, 6 (2008) (concluding that "the roots of the subprime mortgage crisis are to be found in the aggressively preemptive, market-oriented policies of the current Administration"); Eliot Spitzer, *Predatory Lenders' Partner in Crime: How the Bush Administration Stopped the States From Stepping In to Help Consumers*, WASH. POST, Feb. 14, 2008, at A25; Nicholas Bagley, *Subprime Safeguards We Needed*, WASH. POST, Jan. 25, 2008, at A19 (arguing that if state laws had been effective, the subprime mortgage market crisis might have been a mini financial turmoil).

[65] Eliot Spitzer, *supra* note 64, at A25.

[66] PAUL KRUGMAN, THE RETURN OF DEPRESSION ECONOMICS AND THE CRISIS OF 2008 p. 164 (1st ed. 2008).

transact business within its boundaries,[67] they had policed the operating subsidiaries of the national banks, which are also corporations created pursuant to state corporation laws.[68] Regarding the policing power of the state, the Supreme Court held that each state is legitimately concerned with protecting the interest of its citizens by regulating corporations not only of its own chartering but also foreign corporations which do business within its borders.[69]

In particular, the Court in *Lewis v. BT Investment Managers, Inc.*[70] made clear that the state can regulate out-of-state banks and non-bank corporations on the grounds of its general police power because sound and honest practices of financial institutions are a "profound local concern" related to the protection of the economy and its citizens.[71] Accordingly, the states exercised general supervision and control over national bank operating subsidiaries in areas such as registration, fee payment, document maintenance and state law compliance investigations. Also, state officers brought enforcement actions against operating subsidiaries, while the parent bank was immune from the exercise of enforcement powers based on the OCC's exclusive visitorial powers under the NBA.[72]

To illustrate, Michigan laws, which were at issue in *Watters,* have: (i) provisions requiring an operating subsidiary of a national bank, which is a mortgage lending company conducting business in Michigan, to register with the state's Office of Insurance and Financial Services;[73] (ii) provisions requiring the registrant to pay the initial application for registrations and an annual operating fee; [74] (iii) provisions requiring the operating subsidiary to file an annual financial statement and to retain its books and records open to inspection by OIFS examiners; [75] (iv) provisions placing the registrant under investigation and examination of consumer complaints if a complaint is not "being adequately pursued by the appropriate federal regulatory authority";[76] and (v) provisions allowing the Commissioner to take action based on violations of provisions prescribed.[77]

---

[67] *See* Arthur E. Wilmarth, Jr., *supra* note 23, 324-25 (2004).

[68] *Id.*

[69] *Id.* (quoting Union Brokerage Co. v. Jensen, 322 U.S. 202, 208 (1944)).

[70] Lewis v. BT Investment Managers, Inc., 447 U.S. 27 (1980).

[71] *Id.* at 38.

[72] 12 U.S.C. § 484(a). *See also infra* note 139 and accompanying text.

[73] MICH. COMP. LAWS §§ 445.1652 and 493.52 (2002).

[74] MICH. COMP. LAWS §§ 445.1658, 445.1657(1), 493.54, and 493.56a(2) (2002).

[75] MICH. COMP. LAWS §§ 445.1657(2), 445.1671, 493.56a(2), and 493.56a(13) (2002).

[76] MICH. COMP. LAWS § 445.1663(2) (2002) ("[T]he commissioner... shall make no investigation of the complaint if the complaint is being adequately pursued by the appropriate federal regulatory authority.").

[77] MICH. COMP. LAWS §§ 445.1665, 445.1666, 493.58-59, and 493.62a (2002).

B. Watters v. Wachovia Bank*: Affirmation of the OCC's Construction*

Such state authority, however, was overruled by the OCC's preemption regulation in 2001. The overlap between state laws and the OCC's regulations raised contentious debates regarding whether the NBA and the OCC regulations preempted state laws over the operating subsidiary. The courts have sided in favor of the OCC.[78] The district court and the appeals court found in favor of Wachovia Mortgage Corporation ("Wachovia Mortgage") and Wachovia Bank, a national bank,[79] and in April 2007, the Supreme Court in *Watters,* in a 5-3 decision, sided with the OCC's construction of the NBA.[80] The court held that an operating subsidiary is exclusively subject to the OCC's visitorial powers under the NBA.[81]

In *Watters*, Wachovia Mortgage filed suit against Linda Watters in her official capacity as chairperson of the Michigan Office of Insurance and Financial Services, claiming that the NBA itself and the OCC's regulations preempt certain of Michigan's bank regulatory statutes.[82] Originally, Wachovia Mortgage was subject to Michigan statutes in connection with its mortgage business in Michigan.[83] In 2003, Wachovia Mortgage became a wholly owned operating subsidiary of Wachovia Bank, a national bank, and took the position that it was no longer bound by Michigan's registration and inspection requirements.[84] Watters responded by informing Wachovia Mortgage that refusal to comply with the relevant state regulations would preclude it from conducting mortgage lending activities in Michigan.[85] The Supreme Court, however, affirmed and held that Michigan laws have no authority to oversee the mortgage activities of the operating subsidiaries of national banks which are under the umbrella of the OCC.[86]

---

[78] National City Bank v. Turnbaugh, 463 F.3d 325 (4th Cir. 2006); Wachovia Bank, N.A. v. Burke, 414 F.3d 305 (2d Cir. 2005); Wells Fargo Bank N.A. v. Boutris, 419 F.3d 949 (9th Cir. 2005).

[79] Wachovia Bank v. Watters, 334 F. Supp. 2d 957 (W.D. Mich. 2004), *aff'd*, 431 F.3d 556 (6th Cir. 2005).

[80] Watters v. Wachovia Bank, N.A., 127 S. Ct. 1559 (2007). Unlike other preemption cases involving banking laws, which were decided unanimously, the opinions of the Justices in *Watters* were sharply divided.

[81] *Id.* at 1565, 1573.

[82] *Id.* at 1565.

[83] *Id.*

[84] *Id.*

[85] *Id.*

[86] *Id.*

C. Review of the OCC's Regulatory Scheme for Operating Subsidiaries and the Supreme Court's Decision in Watters v. Wachovia Bank

In preempting state laws pertaining to operating subsidiaries, the OCC effectively connected incidental powers to preemptive authority. First, the OCC has interpreted that national banks can use operating subsidiaries in conducting banking activities as "a department of national banks" pursuant to incidental powers under the NBA. Second, the OCC argued that such incidental power logically leads to a conclusion that the OCC regulates the operating subsidiary to the same extent as it does its parent banks. Finally, the OCC concluded that, because it has the same regulatory authority over operating subsidiaries as it does over parent national banks, its regulations preempt state laws over operating subsidiaries to the same extent as over their parent banks. As a consequence, the OCC declared that operating subsidiaries, like their national parent banks, are subject to the OCC's exclusive visitorial powers. The Supreme Court in *Watters* endorsed the OCC's construction.

1. Incidental Power to Use Operating Subsidiaries

The national bank's "incidental powers" played a paramount role in the Supreme Court's decision in *Watters*.[87] The Court noted twice that Watters did not contest the incidental power of national banks to "do business through operating subsidiaries."[88] Because of the central role the OCC's interpretation of incidental powers played in the Court's decision, that interpretation will be examined in detail.

Under § 24(7) of the NBA, a national bank is authorized to exercise "incidental powers as shall be necessary to carry on the business of banking . . ."[89] Since the enactment of the NBA, courts and commentators have construed the concept of incidental powers as flexible and expansive.[90] A national bank's activity is interpreted as an

---

[87] *See Boutris*, 419 F.3d at 959 (stating that the incidental powers clause is "central to our analysis here, as it is the basis for the OCC's permission to national banks to create and operate banking functions, through subsidiaries"); *see also* James R. Smoot, *Bank Operating Subsidiaries: Free at Last or More of Same?*, 46 DEPAUL L. REV. 651, 673 (1997) (explaining that, while there is no specific ground provision to support the authority to use operating subsidiaries, the national bank's incidental power "seems too well established to be successfully challenged now").

[88] *Watters*, 127 S. Ct. at 1569-70. The State of Michigan did not challenge the concept of incidental powers itself. *See* also Brief for the Petitioner, at 21, Watters v. Wachovia Bank, N.A., 127 S. Ct. 1559 (2007) (No. 05-1342) (stating that "no one disputes that 12 USC [§] 24 (Seventh) authorizes national banks to use nonbank operating subsidiaries"). Instead, Watters insisted the OCC erroneously extended the scope of incidental powers to the visitorial powers over a subsidiary, contrary to the congressional intent expressed in §§ 481 and 484(a) in detail. *See id.* at 12-17.

[89] 12 U.S.C. § 24 (Seventh).

[90] *See* Arnold Tours, Inc. v. Camp, 472 F.2d 427, 431 (1st Cir. 1972) (quoting Curtis v.

incidental power if it is "convenient and useful" in connection with the business of banking[91] and it is "not limited to the enumerated powers in § 24 seventh."[92] Just as the concept of the "business of banking" has expanded in scope to keep up with the banking market's emerging customer needs, new technologies, and increased competition, incidental powers have also expanded over time.[93] The OCC is authorized to interpret the scope of incidental powers on the grounds that it is charged with surveillance of the business of banking under the NBA.[94] The scope of incidental powers, however, is not unlimited. The Court held that the exercise of the OCC's discretionary authority "must be kept within reasonable bounds," noting that "[v]entures distant from dealing in financial investment instruments—for example, operating a general travel agency—may exceed those bounds."[95]

Under the rubric of incidental powers, the OCC has authorized national banks to use operating subsidiaries to conduct banking business.[96] The OCC has recognized the operating subsidiary as an alternative way for national banks to engage in banking activities.[97] Therefore, an operating subsidiary may engage in virtually the same scope of activities as is permissible for its national bank parent,[98] with

---

Leavitt, 15 N.Y. 9, 64 (1857) (explaining that "necessity is a word of flexible meaning")). *See also* M & M Leasing Corp. v. Seattle First Nat. Bank, 563 F.2d 1377, 1382 (9th Cir. 1977) (holding that incidental powers should be construed to "permit the use of new ways of conducting the very old business of banking"); Julie L. Williams & James F.E. Gillespie Jr., *The Business of Banking: Looking to the Future—Part II*, 52 BUS. LAW. 1279 (1997) (maintaining that incidental powers should be interpreted broadly and flexibly to accommodate the development of new banking services).

[91] *Arnold Tours*, 472 F.2d at 432 (holding that an activity is authorized as an incidental power if it is "convenient or useful" in connection with the performance of an express power of the NBA); *see also M & M Leasing Corp.*, 563 F.2d at 1382 (agreeing with *Arnold Tours* that to be an incidental power, it must be "convenient or useful").

[92] NationsBank of N.C., N.A. v. Variable Annuity Life Ins. Co., 513 U.S. 251, 258 n.2 (1995) [hereinafter "*VALIC*"]. In *VALIC*, the Court "expressly [held] that the 'business of banking' is not limited to the enumerated powers in § 24 Seventh" and concluded that selling annuities as an agency is incidental to brokering financial investment instruments—a banking business not enumerated in § 24(7). Accordingly, the incidental powers are not limited to activities incidental to enumerated powers but include those incidental to non-expressed business.

[93] *See* OCC, ACTIVITIES PERMISSIBLE FOR A NATIONAL BANK 1 (June 2008) (explaining that "[t]he business of banking is an evolving concept and the permissible activities of national banks similarly evolve over time"); *see also* Julie L. Williams & James F.E. Gillespie Jr., *supra* note 90, at 1280-81, 1299 (arguing that as the business of banking evolves, incidental powers must "also evolve with the business of banking").

[94] *See VALIC*, 513 U.S. at 256 (reaffirmed the interpretive authority of the OCC, citing that the OCC is responsible for the surveillance of a national bank's exercise of incidental powers and the business of banking) (quoting Clarke v. Sec. Indus. Ass'n, 479 U.S. 388, 403-04 (1987)).

[95] *Id.* at 258 n. 2.

[96] *See* Acquisition of Controlling Stock Interest in Subsidiary Operations Corporation, 31 Fed. Reg. 11,459 (Aug. 31, 1966) [hereinafter "1966 Regulation"].

[97] 1966 Regulation, 31 Fed. Reg. at 11,460; Preemption Regulations, 69 Fed. Reg. at 1900 (interpreting the operating subsidiary as a "Federally-authorized and Federally-licensed means by which a national bank may conduct Federally-authorized activities").

[98] 12 C.F.R. § 5.34(e)(1) provides :

> (1) Authorized activities: A national bank may conduct in an operating subsidiary activities that are permissible for a national bank to engage in directly either as part

the exception of taking deposits.[99] The OCC argues that such incidental power to use operating subsidiaries was recognized in the GLBA in 1999.[100] In *Watters,* the Supreme Court also observes that "[t]he GLBA simply demonstrates Congress' formal recognition that national banks have incidental power to do business through operating subsidiaries."[101]

The OCC's policy determination grants national banks the authority to utilize operating subsidiaries as a "convenient and useful form for conducting banking activities."[102] The OCC has considered operating subsidiaries a desirable way to meet rapid changes in the banking industry.[103] The operating subsidiary structure has facilitated new product and service offerings and allowed banks to restructure their businesses.[104] Importantly, the subsidiary structure protects national banks from the liability of the subsidiary and thus maintains their safety and soundness.[105] Since an operating subsidiary is a separate state-chartered corporation and not a chartered bank, fundamental principles of corporate law that limit liability apply to the parent bank-operating subsidiary relationship.[106]

Furthermore, the OCC construes incidental powers as a legal authorization for national banks to exercise banking activities indirectly. Even if an operating subsidiary—a separate legal entity—conducts those activities, the OCC deems them to be activities of the parent bank because the operating subsidiary is merely an alternative

---

of, or incidental to, the business of banking, as determined by the OCC, or otherwise under the other statutory authority, including: (i) Providing authorized products as principal; and (ii) Providing title insurance as principal....

[99] *See, e.g.,* RISSA L. BROOME & JERRY W. MARKHAM, REGULATION OF BANK FINANCIAL SERVICE ACTIVITIES 247 (2d ed. 2004).

[100] *See* Preemption Regulations, 69 Fed. Reg. at 1901 (explaining that the OCC's regulations "reflect express Congressional recognition in section 121 of the GLBA that national banks may own subsidiaries that engage 'solely in activities that national banks are permitted to engage in directly'").

[101] *Watters,* 127 S. Ct. at 1572 n.12.

[102] *See* Investment Securities; Bank Activities and Operations; Leasing, 66 Fed. Reg. 34,784, 34,788 (July 2, 2001) (codified at 12 C.F.R. § 7.4006) ("For decades national banks have been authorized to use the operating subsidiary as a convenient and useful corporate form for conducting activities that the parent bank could conduct directly.").

[103] *See* 1966 Regulation, 31 Fed. Reg. at 11,460 (observing that the use of a subsidiary is a significant option that could extend banking products and services functionally and geographically and permit banks to reorganize to control operating costs, improve the effectiveness of supervision, and decentralize management decisions).

[104] *Id.*

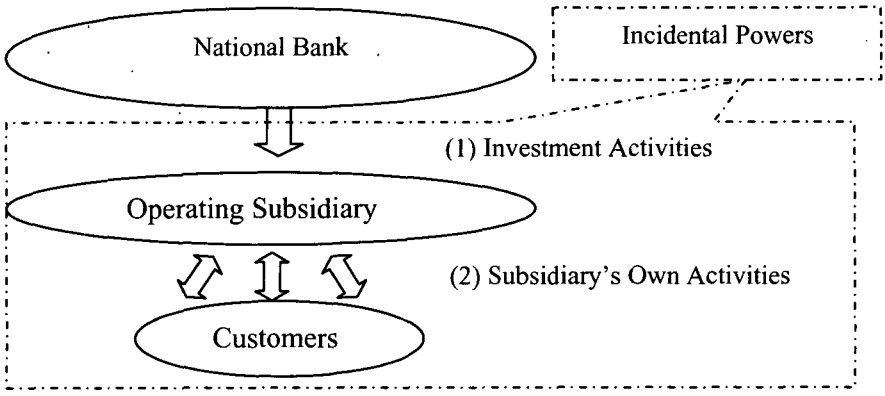
[105] National banks have established operating subsidiaries basically to insulate themselves from the effect of the failure of the subsidiaries and thereby could maintain their safety and soundness. *See* Rules, Policies and Procedures for Corporate Activities, 61 Fed. Reg. 60,342, 60,354 (Nov. 27, 1996) [hereinafter "1996 Regulation"] (explaining that a separate subsidiary structure can reduce risks of new activities by distinguishing the subsidiary's activities from those of the parent bank as a legal matter) (citation omitted).

[106] *See, e.g., Watters,* 127 S. Ct. at 1585 (Stevens, J., dissenting) (explaining that "the primary advantage of maintaining an operating subsidiary as a separate corporation is that it shields the national bank from the operating subsidiaries' liabilities) (citing United States v. Bestfoods, 524 U.S. 51, 61 (1998)).

tool of the parent bank with respect to that activity.[107] The OCC supports its conclusions as follows:

> Courts have consistently treated operating subsidiaries as equivalent to national banks in determining their power and status under Federal law, unless Federal law requires otherwise. Operating subsidiaries are consolidated with—that is, their assets and liabilities are indistinguishable from—the parent bank for accounting purposes, regulatory reporting purposes, and for purposes of applying many Federal statutory or regulatory limits. They are, in essence, no more than incorporated departments of the bank itself.[108]

The Supreme Court in *Watters* endorsed the OCC's interpretations. Citing *Barnett Bank of Marion Cty., N.A. v. Nelson*,[109] the Court held that it has concentrated on "the exercise of a national bank's *powers*, not on its corporate structure."[110] Also, the Court stated that it has treated operating subsidiaries as equivalent to national banks with respect to powers.[111] As a sample case, it suggested *VALIC*, which upheld the OCC's decision that the national bank has an incidental power to act as an agent in the sale of annuities, even though the activity is exercised by operating subsidiaries.[112] Indeed, the Supreme Court recognized that the operating subsidiary can exercise incidental powers under § 24(7) as its parent national bank does.



---

[107] *See supra* note 97 and accompanying text.

[108] Preemption Regulations, 69 Fed. Reg. at 1900; *see also* Investment Securities; Bank Activities and Operations; Leasing, 66 Fed. Reg. 34,784, 34,788 (July 2, 2001) (codified at 12 C.F.R. § 7.4006) (describing operating subsidiaries as "the equivalent of departments or divisions of their parent banks").

[109] Barnett Bank of Marion Cty., N.A. v. Nelson, 517 U.S. 25, 32 (1996).

[110] *Watters*, 127 S. Ct. at 1570.

[111] *Id.* at 1571.

[112] *Id.* The Court also cited Clarke v. Sec. Indus. Ass'n, 479 U.S. 388 (1987), which deals in part with activities of operating subsidiaries of national banks. For the critical analysis of the Court's reasoning, *see* discussion *infra* Part IV.B.2.

The OCC claims that the 1966 regulation first recognized a national bank's incidental authority "to use operating subsidiaries like a department of the parent bank."[113] However, the incidental power recognized in the 1966 regulation was rather to "purchase or acquire and hold stock" of operating subsidiaries.[114] Not until the OCC's 1969 interpretive ruling did it apply the concept of incidental powers to the *use* of an operating subsidiary and, thus, by implication declare its regulatory power over those subsidiaries.[115]

2. The OCC's Exclusive Oversight Power

Similar to incidental powers, the Supreme Court repeated that Michigan's commissioner did not dispute the OCC's authority to regulate operating subsidiaries to the same extent as the national bank.[116] Connecting Congress' recognition of the incidental power to use operating subsidiaries with the OCC's regulatory authority, the Supreme Court stated that "[f]or supervisory purposes, OCC treats national banks and their operating subsidiaries as a single economic enterprise."[117]

The OCC's regulation provides that "[a]n operating subsidiary conducts activities . . . pursuant to the same authorization, terms and conditions that apply to the conduct of such activities by its parent national bank."[118] Basically, the OCC claims that since the operating subsidiary is regarded as an incorporated division of the bank itself, the OCC has the same regulatory authority over the subsidiary as it has over the parent bank.[119] As grounds for this power, the OCC refers to incidental powers and its broad interpretive authority, citing the Ninth

---

[113] *See Watters*, 127 S. Ct. at 1562, 1569 (explaining that the OCC has made clear since 1966 that the national bank has the incidental authority to use an operating subsidiary). *See also Boutris*, 419 F.3d at 960; *Burke*, 414 F.3d at 317, 319.

[114] *See* 1966 Regulation, 31 Fed. Reg. at 11,459-60 ("[T]he authority of a national bank to purchase or otherwise acquire and hold stock of a subsidiary operation corporation may properly be founded among such incidental powers of the bank "as shall be necessary to carry on the business of banking" within the meaning of 12 U.S.C. 24(7)"); *Watters*, 127 S. Ct. at 1577 (Stevens, J., dissenting) (explaining that in 1966 the OCC took the position that "a national bank may acquire and hold the controlling stock interest in a subsidiary operations corporation"). *See also* Memorandum from Julie L. Williams, Chief Counsel to Eugene A. Ludwig, Comptroller of the Currency, *Legal Authority for Revised Operating Subsidiary Regulation*, at Section 4 (Nov. 18, 1996), *available at* http://www.occ.treas.gov/interp/part5.htm (last visited Nov. 13, 2008).

[115] *See* Memorandum from Julie L. Williams, *supra* note 114, at Section 5 (stating that the 1969 ruling provided that (i) national banks could engage in banking business by means of an operating subsidiary, (ii) a subsidiary could perform any business function that the parent bank could perform and (iii) federal banking laws applicable to a parent bank were equally applicable to its operating subsidiaries).

[116] *Watters*, 127 S. Ct. at 1569-70.

[117] *Id.* at 1570 ("OCC oversees both entities by reference to "business line," applying the same controls.") (citing the OCC, RELATED ORGANIZATIONS: COMPTROLLER'S HANDBOOK, at 64 (August 2004)) [hereinafter "COMPTROLLER'S HANDBOOK"].

[118] 12 C.F.R. § 5.34(e)(3) (2008).

[119] *See* Preemption Regulations, 69 Fed. Reg. at 1900.

Circuit's decision in *Boutris* which addresses the preemption of California law regulating the operating subsidiary.[120] In this case, the court explained that the authority to interpret the scope of incidental powers necessarily includes the ability to police the exercise of those powers.[121] Then, it concluded that Congress granted the OCC regulatory authority over the operating subsidiary under the incidental powers clause by reference when it granted the OCC power to permit such a subsidiary.[122]

This construction is supported on two grounds which were also expressed in *Watters*—consolidation supervision and the definition clause in the GLBA.[123] First, the OCC observed that it has combined the assets and liabilities of the operating subsidiary with the parent bank for regulatory purposes, creating consolidated supervision over the combined entity.[124] Second, the OCC relies on § 24a(g)(3)(A) of the GLBA, which defines an operating subsidiary as a subsidiary that "engages solely in activities that national banks are permitted to engage in directly and are conducted subject to the same terms and conditions that govern the conduct of such activities by national banks . . . ." The OCC has interpreted the phrase "terms and conditions" to include "how, and by whom, the operating subsidiary is examined and supervised."[125] In other words, the OCC regards Congress' definition in the GLBA as express grants of the incidental power to use an operating subsidiary and of the OCC's oversight power over the subsidiary's activities.[126]

3. Preemption of State Laws and Visitorial Powers

Under the assumption of the uncontested incidental power and the OCC's same regulatory authority under the GLBA, the OCC claimed that activities of the operating subsidiary have the same effect as those of the parent bank for preemption purposes and issued preemptive regulations in 2001,[127] providing that "[s]tate laws apply to national bank operating subsidiaries to the same extent that those laws apply to the parent national bank." Regardless of whether the parent

---

[120] *Id.* at 1901.

[121] *Boutris*, 419 F.3d at 961 (applying *M&M Leasing*'s logic that the OCC's authority "to regulate national banks' leasing activities is inherent in his authority to interpret the "incidental powers" provision to allow such leasing in the first place").

[122] *Id.*

[123] *Watters*, 127 S. Ct. at 1570.

[124] *See* Preemption Regulations, 69 Fed. Reg. at 1900; 12 C.F.R. § 5.34(e)(4)(i) (2008) (providing that "[p]ertinent book figures of the parent national bank and its operating subsidiary shall be combined for the purpose of applying statutory or regulatory limitations when combination is needed to effect the intent of the statute or regulation, e.g., for purposes of 12 U.S.C. 56, 60, 84, and 371d").

[125] *See* Preemption Regulations, 69 Fed. Reg. at 1901.

[126] *Id.*

[127] *See* Investment Securities; Bank Activities and Operations; Leasing, 66 Fed. Reg. 34,784, 34,788-89 (July 2, 2001) (codified at 12 C.F.R. § 7.4006).

bank or its operating subsidiary conducts an activity, the same preemption rules apply.[128] The OCC suggested that this regulation creates no new preemption doctrine, but simply reflects the conclusion that courts would reach based on federal statutes, OCC regulations and precedent case law.[129]

To demonstrate that state laws are applicable to the operating subsidiary to the same extent as they are to the national bank, the Supreme Court, as a first step, explained preemptive principles as applied to national banks. The Court emphasized the holding in *Barnett Bank* that both banks' enumerated and incidental powers constitute "grants of authority not normally limited by, but rather ordinarily pre-empting, contrary state law."[130] Moreover, state laws are preempted when preventing or significantly interfering "with the national bank's or the national bank regulator's exercise of its powers."[131]Additionally, the Court cited 12 U.S.C. § 371(a), providing that the national bank is authorized to engage in mortgage business subject to the OCC's regulation[132] and held that states' control over the mortgage lending business is preempted because a "state may not significantly burden a national bank's own exercise of its real estate lending power, just as it may not curtail or hinder a national bank's efficient exercise of any other power, incidental or enumerated under the NBA."[133] In particular, the Court underscored that "real estate lending, when conducted by a national bank, is immune from state visitorial control" pursuant to the visitorial powers of § 484(a)"[134]

Next, the Supreme Court extended such preemption principles applicable to the national bank to its operating subsidiary, reasoning that "just as duplicative state examination, supervision, and regulation would significantly burden mortgage lending when engaged in by national banks, so too would those state controls interfere with that same activity when engaged in by an operating subsidiary." [135] Preemptive regulation for operating subsidiaries is recognized as a "necessary consequence" of the statutory provisions of the NBA—§§ 24(7), 24a(g)(3)(A) and 371(a)—and of preemption principles. [136]

---

[128] *See id.*

[129] *See* Investment Securities; Bank Activities and Operations; Leasing, 66 Fed. Reg. at 34,790; *see also Burke*, 414 F.3d at 319-20 (arguing that the OCC's preemptive regulation clarifies the existing preemption of state laws).

[130] *See Watters*, 127 S. Ct. at 1567 (quoting *Barnett Bank*, 517 U.S. at 32).

[131] *Id.*

[132] *Id.* 12 U.S.C. § 371(a) provides that "any national banking association may make, arrange, purchase or sell loans or extensions of credit secured by liens on interests in real estate, subject to 1828*(o)* of this title and such restrictions and requirements as the Comptroller of the Currency may prescribe by regulation or order."

[133] *Watters*, 127 S. Ct. at 1567-68.

[134] *Id.* at 1568.

[135] *Id.* at 1570.

[136] *Id.* at 1572.

Therefore, the Court summarizes that preemption is just an effect of the NBA: "A national bank has the power to engage in real estate lending through an operating subsidiary, subject to the same terms and conditions that govern the national bank itself; that power cannot be significantly impaired or impeded by state law."[137] In other words, the OCC's authority to promulgate preemption regulation was justified by the NBA itself.

The preemption purview extended to operating subsidiaries justifies the OCC's exclusive exercise of visitorial powers over operating subsidiaries, just as it has over parent banks.[138] Under the NBA, national banks are not subject to state officers' examination, inspection of the bank's books and records, regulation and supervision of activities and enforcement of federal and state laws.[139] Since the subsidiary is treated as the national bank itself for regulatory purposes, the subsidiary should also enjoy immunity from the state's interventions. Therefore, the OCC maintained that it has exclusive authority to investigate operating subsidiaries regarding compliance with both federal and state laws and that it alone can seek the necessary enforcement measures,[140] even though § 484(a) clearly grants the OCC visitorial powers to the "national bank," not "operating subsidiaries." In *Watters,* the Supreme Court concluded that Wachovia Mortgage is immune from the state's visitorial powers because the operating subsidiary is subject to the OCC's exclusive visitorial powers under § 484(a) as is its parent bank.[141]

4. Rebutting Arguments of the State of Michigan in *Watters*

Watters contended that Congress unambiguously gave the OCC preemption power over state laws *only* with regard to national banks, and *not* their state-chartered operating subsidiaries under 12 U.S.C. § 484(a).[142] She focused on the fact that § 484(a) provides only that a

---

[137] *Id.*

[138] *See* Preemption Regulations, 69 Fed. Reg. at 1900 (stating that "under 12 U.S.C. 24 (Seventh) and 12 CFR 7.4006, the standards of section 484 apply to the national bank operating subsidiaries to the same extent as their national bank").

[139] 12 U.S.C. § 484(a) (providing that "[n]o national bank shall be subject to any visitorial powers except as authorized by Federal law" with some exceptions). Pursuant to 12 C.F.R. § 7.4000(a)(2), visitorial powers include examination of a bank, inspection of a bank's books and records, regulation and supervision of activities and enforcing compliance. The Court explained that "visitation" is "the act of a superior or superintending officer, who visits a corporation to examine into its manner of conducting business, and enforce an observance of its laws and regulations." *Watters*, 127 S. Ct. at 1568 (quoting Guthrie v. Harkness, 199 U.S. 148, 158 (1905)).

[140] Preemption Regulations, 69 Fed. Reg. at 1900-01.

[141] Watters, 127 S. Ct. at 1564-65 ("[W]e hold that Wachovia's mortgage business, whether conducted by the bank itself or through the bank's operating subsidiary, is subject to OCC's superintendence, and not to the licensing, reporting, and visitorial regimes of the several States in which the subsidiary operates.").

[142] *See* Reply Brief for the Petitioner, at 1-2, Watters v. Wachovia Bank, N.A. 127 S. Ct.

"national bank" is subject to exclusive visitorial powers of the OCC, rather than an "operating subsidiary."[143] She asserted that if Congress had intended to deny the state's visitorial powers over operating subsidiaries, it would have referenced not only the "national bank" but also "its affiliates" in § 484(a).[144]

To support this construction, Watters first argued that an operating subsidiary such as Wachovia Mortgage is an "affiliate" and is not itself a "national bank" under the NBA.[145] The operating subsidiary falls within the "affiliate" definition in 12 U.S.C. § 221a(b)[146] which includes any corporation controlled by a national bank.[147] Then, she maintained that Congress spoke directly to the OCC's authority over the bank's affiliates in 12 U.S.C. § 481 rather than § 484(a).[148] Under § 481, the OCC may examine the national bank's affiliates but only "as shall be necessary to disclose fully the relations between such bank and such affiliates and the effect of such relations upon the affairs of such bank."[149]

Pointing out that affiliates are not subject to the OCC's visitorial powers under § 481, Watters argued that the OCC has only limited and nonexclusive authority over affiliates.[150] Moreover, Watters contended that her construction was confirmed by the presumption against preemption; a basic preemption principle that "the historic police powers of the States were not to be superseded by the Federal Act unless that was the clear and manifest purpose of Congress."[151] She argued that because Congress did not demonstrate a clear and manifest purpose to preempt state laws under the NBA, the traditional state authority to protect consumers should not be preempted.[152] That is, "[t]he presumption against preemption bars any attempt to read operating subsidiaries by implication into § 484(a)."[153]

The Supreme Court, however, rejected Watters' contentions for two reasons. First, when §§ 481 and 484(a) were enacted and amended in 1864 and in 1933 respectively, Congress did not speak of the state's

---

1559 (2007) (No. 05-1342).

[143] *Id.*

[144] *Id.* at 4; *see also Watters*, 127 S. Ct. at 1571.

[145] *See* Reply Brief for the Petitioner, *supra* note 142, at 3.

[146] 12 U.S.C. § 221a(b) (providing that "the term "affiliate" shall include any corporation, business trust, association, or other similar organization" of which a bank "directly or indirectly, owns or controls" either a majority of the voting shares or more than 50% of the voting shares).

[147] *See* Reply Brief for the Petitioner, *supra* note 142, at 5.

[148] *Id.* at 3.

[149] *Id.*

[150] *Id.* at 3-4.

[151] Brief for the Petitioner, *supra* note 88, at 22-23 (quoting Rice v. Santa Fe Elevator Corp., 331 U.S. 218, 230 (1947)).

[152] *Id.* at 24-26.

[153] *Id.* at 26.

visitorial powers over operating subsidiaries.[154] Therefore, the Supreme Court stated that it could not find Congressional intent regarding the operating subsidiary from those provisions. [155] Second, the Court delineated the difference between "operating subsidiaries" and "affiliates" in § 221a(b) by pointing out that Congress distinguishes operating subsidiaries from other affiliates such as financial subsidiaries in the GLBA. [156] While an operating subsidiary may "engag[e] solely in activities that national banks are permitted to engage in directly," other affiliates may "engage in non-banking financial activities, e.g., securities and insurance" under state regulatory powers.[157] Accordingly, the Court refused to include the operating subsidiary within the general term "affiliates" under § 481, thereby denying it to be the ground of state's visitorial powers over operating subsidiaries.[158]

The application of *Chevron* deference was rejected by the Court because § 7.4006 is a mere clarification of proper interpretations of the NBA.[159] Additionally, the Court also rejected Watters' arguments that § 7.4006 violates the Tenth Amendment of the Constitution on the grounds that the preemptive regulation is "a prerogative of Congress under the Commerce and Necessary and Proper Clauses."[160]

D. Dissenting Opinion in Watters v. Wachovia Bank

The dissent shows no Congressional intent to preempt state laws, focusing instead on analyzing preemption principles rather than challenging incidental power itself and the OCC's oversight power. Absent congressional intent to do so, the dissent argues the dual banking system and state's interest to protect consumers cannot be set aside.

1. Views on Incidental Powers and Oversight Power

Contrary to the majority, which turns to unchallenged incidental powers, the dissent argues that Congress itself has never authorized or disavowed incidental power to use an operating

---

[154] *Watters*, 127 S. Ct. at 1571.
[155] *Id.*
[156] *Id.*
[157] *Id.* at 1571-72.
[158] *See id.*; *see also* Brief for the United States as Amicus Curiae Supporting Respondents, at 18, 127 S. Ct. 1559 (2007) (No. 05-1342) (arguing that § 481 "in no way signals a specific intention concerning treatment of an operating subsidiary").
[159] *Watters*, 127 S. Ct. at 1572.
[160] *Id.* at 1573 (citation omitted).

subsidiary,[161] nor has it authorized the power to license and regulate operating subsidiaries.[162] The dissent notes that notwithstanding the silence of Congress, the OCC has permitted the national bank's ownership of the operating subsidiary since 1966.[163] Also, it interprets the provisions of the GLBA as a "rejection of the OCC's position that an *operating* subsidiary could engage in activities that national banks could not engage in directly."[164] The dissent, however, does not completely reject the assertion that the OCC has oversight power over the operating subsidiary in its analysis of preemptive intent in the GLBA.[165]

The dissent argues that the statement "a department of a bank" is unreasonable in the context of *Chevron* because such a statement cannot be reconciled with the principle of corporate separateness under the state's corporate laws although it justifies the preemption of state laws. The dissent reasons that the parent banks cannot utilize insulation from the liability of operating subsidiaries because the corporate veil should be pierced if the operating subsidiary is acting like a part of the parent bank.[166]

2. No Intent of Congress to Preempt State Laws

The dissent, by examining the text of §§ 481 and 484(a) of the NBA, agrees with Watters that these provisions reflect Congress' intent not to preempt state laws governing operating subsidiaries.[167] The dissent explains that Congress has conferred on the OCC extensive supervisory power over affiliates, including operating subsidiaries under § 481, but it has never expanded the OCC's visitorial powers to "affiliates" under § 484(a).[168] Regarding the application of *Barnett Bank,* the dissent argues that preemptive regulation does not apply to this case where Congress has demonstrated a clear and manifest

---

[161] *Id.* at 1577 (Stevens, J., dissenting) (arguing that Congress "neither disavowed nor endorsed the Comptroller's position on national bank ownership of operating subsidiaries").

[162] *Id.* at 1578 (Stevens, J., dissenting) (arguing that Congress did not authorize the OCC to license any state-chartered entity).

[163] *Id.* at 1577 (Stevens, J., dissenting).

[164] *Watters,* 127 S. Ct. at 1577-78 (Stevens, J., dissenting).

[165] *Id.* at 1581 (Stevens, J., dissenting) (although the dissent contends that the GLBA does not demonstrate the "clear and manifest purpose of Congress" to preempt the state law at issue here, they reluctantly mentioned the "same terms and conditions" might reflect "an uncontroversial acknowledgement that operating subsidiaries of national banks are subject to the same federal oversight as their national bank parents.").

[166] *Watters,* 127 S. Ct. at 1585 (Stevens, J., dissenting) ("[The OCC's regulation] is about whether a state corporation can avoid complying with *state* regulations, yet nevertheless take advantage of *state* laws insulating its owners from liability."). *See* discussion *infra* Part IV.A.1.

[167] *Watters,* 127 S. Ct. at 1578-79 (Stevens, J., dissenting); *see also supra* notes 142-150 and accompanying text.

[168] *Watters,* 127 S. Ct. at 1578-79 (Stevens, J., dissenting).

purpose not to preempt state laws.[169] Moreover, the dissent notes that "four words" of the GLBA—"same terms and conditions"— does not represent the intent of Congress to preempt state laws.[170]

Alternatively, the dissent points out that the OCC lacks the authority to promulgate preemptive regulations.[171] Distinguishing "rules authorizing or regulating conduct" from "rules granting immunity from regulation," the dissent observes that incidental powers authorize or regulate the conduct of national banks.[172] For example, pursuant to incidental powers, the OCC has the authority to decide whether national banks can conduct the businesses of mortgage brokers, real estate brokers, or travel agencies directly, or through operating subsidiaries.[173] But such authority does not "imply the far greater power to immunize banks or their subsidiaries from state laws regulating the conduct of their competitors."[174]

Furthermore, although the agency's interpretation may be entitled to some weight,[175] the dissent contends that the OCC's regulation does not deserve *Chevron* deference for three reasons: first, unlike Congress, federal agencies do not represent the states' interests, so their determinations of the scope of preemption should not be entitled to deference;[176] second, the "same terms and conditions" of the GLBA cannot be incorporated into preemptive regulation because the use of that phrase "says nothing about preemption";[177] third, "a department of a bank" is inconsistent with the limited liability of parent banks under corporate laws.[178]

3. Concerns About Consumer Protection

The dissent expresses particular concerns about the dual banking system and consumer protection as a banking policy.[179] It points out that the OCC's preemption which modifies "competitive

---

[169] *Id.* at 1579-80 (Stevens, J., dissenting) ("The Court neglects to mention that *Barnett Bank* is quite clear that this interpretive rule applies only when Congress has failed (as it often does) to manifest an explicit preemptive intent.").

[170] *Id.* at 1581-82 (Stevens, J., dissenting) The dissent further argues that even assuming the relevance of the GLBA with preemption, state laws are in effect because those laws are basic legal rules governing the making of real estate loans, even if they encroach on the banking business. *Ibid.*

[171] *Id.* at 1582-85 (Stevens, J., dissenting).

[172] *Id.* at 1583 (Stevens, J., dissenting).

[173] *Id.* (Stevens, J., dissenting).

[174] *Watters,* 127 S. Ct. at 1583 (Stevens, J., dissenting).

[175] *Id.* at 1584 (Stevens, J., dissenting).

[176] *Id.* at 1584 (Stevens, J., dissenting) ("[W]hen an agency purports to decide the scope of federal preemption, a healthy respect for state sovereignty calls for something less than *Chevron* deference.").

[177] *Id.* at 1584-85 (Stevens, J., dissenting).

[178] *Id.* at 1585 (Stevens, J., dissenting).

[179] *Watters,* 127 S. Ct. at 1581, 1585 (Stevens, J., dissenting).

equality" between federal and state banks may drive operating subsidiaries to transfer federal charters, harming state-based competitors and "hamstring[ing] States' ability to regulate the affairs of state corporations."[180] In addition, the dissent criticizes the OCC's preemption of a state's ability to protect consumers because states have traditionally performed the role of consumer protection and their laws cannot be avoided without the "clear and manifest purpose of Congress."[181]

IV. CHALLENGING INCIDENTAL POWERS IN THE OCC'S OPERATING SUBSIDIARIES REGULATION AND *WATTERS V. WACHOVIA BANK*

As the Supreme Court points out, the preemption of Michigan laws is just a "necessary consequence" of incidental authority to use a subsidiary and the OCC's regulatory oversight over the subsidiary.[182] Nevertheless, this concept was not sufficiently disputed by Michigan or the dissenting opinion. This part of the paper challenges the OCC's construction of incidental powers and the OCC's regulatory powers for the first time. Then, it concludes that such a construction exceeds the OCC's delegated power under the NBA.

A. "A Department of a Bank" as a Rationale of Incidental Powers

1. Is It Policy Determination or Legal Authority?

For the purpose of applying corporate laws, "a department of a bank" respects the corporate separateness between the parent bank and its operating subsidiary. The OCC has long asserted that activities of operating subsidiaries be distinguished from those of the parent bank as a legal matter; and thus the corporate veil cannot be pierced in the national bank-operating subsidiary relationship.[183] Therefore, according

---

[180] *Id.* at 1585 (Stevens, J., dissenting).

[181] *Id.* at 1581 (Stevens, J., dissenting) ("It is especially troubling that the Court so blithely preempts Michigan laws designed to protect consumers. Consumer protection is quintessentially a "field which the States have traditionally occupied": the Court should therefore have been all the more reluctant to conclude that the "clear and manifest purpose of Congress" was to set aside the laws of a sovereign State.") (citation omitted).

[182] *Id.* at 1572; *see also* Brief for the United States as Amicus Curiae Supporting Respondents, *supra* note 158, at 20 (arguing that incidental power to use an operating subsidiary "bears a "close and logical" connection to" the preemption of state laws).

[183] *See* 1996 Regulation, 61 Fed. Reg. at 60,354 ("[T]he use of a separate subsidiary structure can enhance the safety and soundness of conducting new activities by distinguishing the subsidiary's activities from those of the parent bank (as a legal matter) and allowing more focused management and monitoring of its operations."); *see also Burke*, 414 F.3d at 319 (holding that "[t]he OCC is not disregarding any principle of corporate separateness" and "[s]ection 7.4006 reflects the OCC's policy judgment that national banks' use of operating subsidiaries as separately structured corporate entities is desirable and that it should not be hindered by state regulations"); Brief for the Respondents, at 44-45, Watters v. Wachovia Bank, N.A., 127 S. Ct. 1559 (2007) (No.

to the OCC, even a wholly-owned subsidiary of the parent bank does not warrant the conclusion that the subsidiary is a mere instrumentality.[184] To be consistent with this view, the OCC requires the parent bank to control the operating subsidiary effectively ("effective control"), not predominantly.[185]

In other words, the OCC describes "a department of a bank" as a reflection of its policy determination that a national bank can conduct banking business through a legally separated operating subsidiary that is not being controlled by the parent to an extent that would make it an internal organization.

The OCC's position described above is, however, different from its treatment of "a department of the bank" with respect to activities, powers and regulatory treatment. Arguing that "a department of a bank" signifies that the operating subsidiary is a replica of a national bank,[186] the OCC assumes that the national bank has far greater control over the subsidiary than a general corporation has over its subsidiaries. To be sure, the degree that the parent bank controls its operating subsidiaries exceeds the standard of "effective control" set forth by the OCC regulation.

The OCC legally determines that the activities of the operating subsidiary are equivalent to those of the parent bank because the subsidiary is essentially like "a department of a bank."[187] As explained above, the OCC construes incidental power as a legal authorization for national banks to exercise banking activities indirectly.[188] Even though the OCC argues that corporate separateness between the bank and its subsidiaries is strictly observed, the OCC determines that the

---

05-1342) (arguing that the OCC's operating subsidiaries regulation is "entirely consistent with basic tenets of corporate law, including the principle of corporate separateness").

[184] *See, e.g.*, Skouras v. Admiralty Enterprises, Inc., 386 A.2d 674, 681 (Del. Ch. 1978) ("Mere control and even total ownership of one corporation by another is not sufficient to warrant the disregard of a separate corporate entity."); S. Side Bank v. T.S.B. Corp., 419 N.E. 2d 477, 479 (Ill. App. Ct. 1981) ("Ownership of capital stock in one corporation by another does not, itself, create an identity of corporate interest between the two companies, nor render the stockholding company the owner of the property of the other nor create the relation of principal and agent, representative, or alter ego between the two.").

[185] *See* 12 C.F.R. § 5.34(e)(2) (2007) (providing that to qualify as an operating subsidiary, the national bank must own and control more than 50 percent of voting interest of the operating subsidiary or the bank must control the subsidiary and no other party controls more than 50 percent). In order to attract minor investors by allowing for the flexibility of an operating subsidiary structure and, at the same time, to avoid losing control of the subsidiary, the OCC in 1996 loosened the degree of ownership of operating subsidiaries from "at least 80%" to "more than 50%" or "when the bank otherwise controls the subsidiary." Also, the national bank must hold effective control over its operating subsidiaries. *See* 1996 Regulation, 61 Fed. Reg. at 60,349-50; Smoot, *supra* note 87, at 665, 686-90. Moreover, the OCC interpreted that the bank's ownership of 10% is sufficient to be a qualifying operating subsidiary. OCC Conditional Approval No. 646 at 1 (June 28, 2004); *see also* Brief for the National Association of Realtors(R) as Amicus Curiae in support of Petitioner, at 15 n.21, Watters v. Wachovia Bank, 127 S. Ct. 1559 (2007) (No. 05-1342).

[186] *See supra* notes 97, 107 and accompanying text.

[187] *See supra* notes 108-112 and accompanying text.

[188] *See supra* notes 107-108 and accompanying text.

subsidiary is no more than a mere agency of the parent bank. Also, "a department of a bank" is a legal ground for justifying the OCC's preemptive authority.[189] For regulatory purposes, the OCC has treated the operating subsidiary as a part of the parent bank, claiming that both are a single economic entity and, accordingly, are consolidated in applying the OCC's regulations.[190] By presupposing "a single entity," the OCC preempts state laws over operating subsidiaries.

The description by the OCC of "a department of a bank" serves two purposes at the same time: shielding a national bank from unlimited liability from its operating subsidiary's activities and extending the OCC's regulatory jurisdiction to operating subsidiaries. However, as the dissent points out, such construction is not reasonable because the statement of a "department of a bank" for preemption purposes is incompatible with corporate separateness under state corporation laws.[191] In addition, as discussed below, the OCC's construction must be rejected because it is contrary to the language of § 24(7) of the NBA, and Congress has not given the OCC exclusive oversight over operating subsidiaries given the structure of the NBA as "entity regulation."

B. Limitations of the Language of the Incidental Powers Clause

The national bank's ability to deem activities of the subsidiary as its own exceeds prescribed incidental powers. Given the language of § 24(7), incidental power is limited to the direct activity of the national bank to own and control operating subsidiaries. Applying this reasoning to *Watters*, Wachovia Bank has the power to own and control Wachovia Mortgage, whose permissible business is that of mortgage lending business. However, no longer does it have the ability to deem ordinary day-to-day mortgage lending activities of Wachovia Mortgage as those of Wachovia Bank.

1. National Bank Exercises Incidental Powers "By its Board"

As the Supreme Court has stated, "the 'plain purpose' of legislation...is determined in the first instance with reference to the plain language of the statute itself."[192] The language of the statute

---

[189] *See* Discussion, *supra* Part III. C.3.

[190] *See* Discussion, *supra* Part III. C.2.

[191] *See supra* notes 166, 178 and accompanying text.

[192] Bd. of Governors of Fed. Reserve Sys. v. Dimension Fin. Corp., 474 U.S. 361, 373 (1986); *see also* Lamie v. United States Tr., 540 U.S. 526, 534 (2004) (stating that "the starting point in discerning Congressional intent is the existing statutory context").

should be the first consideration.[193] Congressional intent to specify a list of the corporate powers of a national bank is indicated in 12 U.S.C. § 24, titled "Corporate powers of associations."[194] In particular, § 24(7) sets forth the national bank's authority to exercise incidental powers which "shall be necessary to carry on this business of banking."[195] In addition, § 24(7) provides that the national bank should exercise incidental powers "by its board of directors or duly authorized officers or agents, subject to law" (hereinafter "the board"). This language makes clear that the board, not the shareholders, is empowered to exercise incidental powers[196] and to delegate those powers to officers.[197]

Significantly, this provision indicates that incidental powers, as a part of corporate powers, should be within the board's authority under the NBA. The NBA generally authorizes the board to manage the affairs of the national bank.[198] Particularly, the NBA sets forth the board's powers, such as appointment and dismissal of officers, defining officers' duties,[199] and making bylaws that regulate the conduct of the general business of the national bank.[200] In addition, as banks are a form of corporation, the board can exercise corporate powers under state corporate laws.[201] Therefore, similar to non-banking corporations, the board can supervise the bank's affairs and adopt sound policies and

---

[193] *Dimension*, 474 U.S. at 368.

[194] 12 U.S.C. § 24 (2008), "Corporate powers of associations," is made up of eleven clauses specifying powers of the national bank.

[195] 12 U.S.C. § 24 (Seventh) provides that:

> To exercise by its board of directors or duly authorized officers or agents, subject to law, all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion....

[196] Reflecting state corporate law norms that day-to-day operations of business affairs are delegated to directors. *See, e.g.*, MACEY ET AL., *supra* note 18, at 266 ("The National Bank Act tracks language often found in state corporation laws when it provides that the "affairs of each [national bank] shall be managed" by a board of directors."); ROBERT W. HAMILTON, THE LAW OF CORPORATIONS IN A NUTSHELL 232 (5th ed. 2000) (explaining that "[t]he traditional language of business corporation statutes defining the role of the board of directors is that "business and affairs of a corporation shall be managed by the board of directors"). *Cf.* § 141(a) of the Delaware General Corporation Law provides that ordinary bylaws prescribe that the business and affairs of the corporation shall be managed under the direction of its board, except as otherwise permitted or provided in the certificate of incorporation.

[197] *See* MACEY ET AL., *supra* note 18, at 267 (explaining that "although the board has overall responsibility for managing the affairs of a depository institution, day-to-day decision making will nearly always be delegated to executive officers"); Merch. Bank v. State Bank, 77 U.S. 604, 619-20 (1871) (cashier's power to certify checks must be authorized through the action of the directors).

[198] 12 U.S.C. § 71 ("The affairs of each association shall be managed by not less than five directors...").

[199] 12 U.S.C. § 24 (Fifth) ("To elect or appoint directors, and by its board of directors to appoint a president, vice president, cashier, and other officers, define their duties...").

[200] 12 U.S.C. § 24 (Sixth) ("To prescribe, by its board of directors, bylaws not inconsistent with law, regulating the manner in which its stock shall be transferred,...its general business conducted...").

[201] *See* MACEY ET AL., *supra* note 18, at 263 (stating that "[b]anks are corporations and accordingly are subject to many of the principles of corporate law that govern business associations generally").

objectives in the areas of loan, investment, assets and liability management, capital planning, personnel policy, etc.[202]

This limitation of the language of incidental powers was highlighted in *Commercial Nat. Bank v. Weinhard.*[203] In this case, two shareholders of Commercial National Bank of Portland challenged the actions of its board in assessing and selling the bank's stocks without shareholder approval.[204] The Supreme Court held that assessing and selling stocks in the absence of the action of shareholders is beyond the directors' powers because the shareholders, not the directors, have the right to decide whether national banks must continue or be liquidated.[205] The Court explained that the corporate powers of directors conferred by 12 U.S.C. §§ 24(6) and 24(7) of the NBA are to "transact the usual and ordinary business of national banks."[206] This case shows the board can exercise authority pertaining to the usual and ordinary business of national banks.[207] To be clear, incidental powers should be within the granted authority of the board under the NBA.

As discussed in Part III.C.1, the OCC concluded that the national bank has the incidental authority not only to own and control operating subsidiaries, but also to deem activities of operating subsidiaries as those of the national bank by treating the operating subsidiary as equivalent to the national bank with respect to powers and status.[208] This interpretation, however, raises a question of whether the bank's board can exercise such incidental powers within its corporate powers. Specifically, can the bank legally exercise, through its board, the incidental power to deem the activities of the operating subsidiary to be those of the parent bank?

To be sure, the national bank has the power to own and control an operating subsidiary within the board's authority under § 24(7). At least, the GLBA acknowledged the national bank's authority to own and control an operating subsidiary whose activities are limited to those permissible for the national bank.[209] Also, the investment and control of

---

[202] OCC, DUTIES AND RESPONSIBILITIES OF DIRECTORS: COMPTROLLER'S HANDBOOK 2-4 (SECTION 501) (Jan. 1998) (In addition, the board must "avoid self-serving practices," "be informed of the bank's condition and management policies," "maintain reasonable capitalization," and "observe banking laws, rulings, and regulations"). However, the directors' powers do not include reorganization transactions, such as merger, consolidation and conversion which are required to be approved by shareholders. *See* 12 U.S.C. §§ 214a, 215 and 215a.

[203] Commercial Nat. Bank v. Weinhard, 192 U.S. 243 (1904).

[204] *Id.* at 243-44.

[205] *Id.* at 250-53.

[206] *Id.* at 248-49 (explaining that 12 U.S.C. §§ 71, 24 (Sixth) and 24(7) of the NBA are the grounds of the directors' authority to manage the ordinary business of the national banks).

[207] *Id.* at 249-52.

[208] Distinguishing the ownership of the national bank from the ability to deem indirect performance of banking activities is different from the OCC's position that has identified the ownership of the subsidiary with the power to use an operating subsidiary in conducting banking business.

[209] *See, e.g.*, 145 Cong. Rec. E2386-01 (Nov. 15, 1999) (the GLBA "would authorize national

the operating subsidiary may be exercisable by the board. The board may decide to own the operating subsidiary,[210] unless such activity causes a fundamental change in the corporation's structure which requires approval of the shareholders of the national bank.[211] In the parent-subsidiary structure, the national bank can exercise control of the operations of the subsidiary through its ownership since the parent bank is, in form, a "shareholder" of the subsidiary. For example, the national bank may elect the subsidiary's directors, vote on major issues, amend the articles of incorporation or bylaws, and inspect the subsidiary's books and records.[212] Normally, such control may be exercisable by the bank's board under almost all state corporation laws because they would fall within the power to manage the ordinary business of the bank, with the exception of certain powers reserved to the shareholders by statute or recognized by the common law.[213]

The national bank, however, does not have the incidental power, by its board, to deem activities of operating subsidiaries as those of its parent bank under the NBA. While the parent bank is entitled to own and control the subsidiary under § 24(7), it cannot influence the subsidiary's activities directly, but can only use its influence over the operations of the subsidiary indirectly, by changing the subsidiary's directors or recommending the subsidiary's operations, etc.[214] As a

---

banks to own or control a subsidiary only if the subsidiary engages solely in bank permissible activities") (statement of Rep. Tom Bliley). For a detailed discussion of whether the NBA permits a national bank to acquire or establish operating subsidiaries prior to the GLBA, *see* Smoot, *supra* note 87, at 672-86. This view is consistent with the OCC's position in the 1966 regulation which only discussed the permission of ownership of operating subsidiaries. *See supra notes* 113-114 and accompanying text.

[210] *See supra* notes 198-202 and accompanying text.

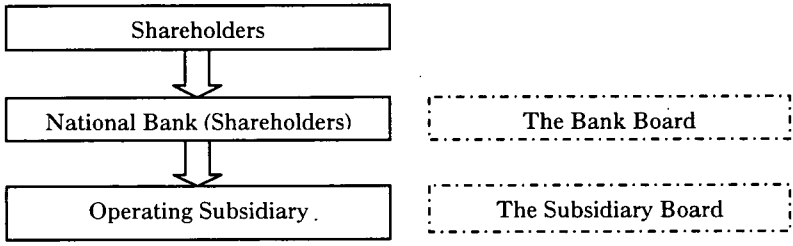
[211] *See supra* note 202 and accompanying text; *see also* CHARLES R.T. O'KELLEY & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS: CASES AND MATERIALS 137-38 (4th ed. 2003) (shareholders "approve fundamental changes in the corporation's governing rules or structure").

[212] *See, e.g.*, United States v. Bestfoods, 524 U.S. 51 (1998) (explaining that the parent corporation's powers as a shareholder include the election of the subsidiary's directors, the making of by-laws, the determination of capital stock, the inspection of the subsidiary's books and records, and doing all other incidental acts). It is consistent with the parents' investor status to monitor the subsidiary's performance, to supervise the subsidiary's financial and capital budget decisions, and to articulate general policies and procedures. *Id.* at 72.

[213] If a merger or a sale of substantially all of the assets of the subsidiaries constitutes merging or selling substantially all of the assets of the parent corporation, the vote of the shareholders of the parent corporation is required. *See, e.g.*, N. J. STAT. ANN § 14A: 10-11(1),(3); Hodge v. Cuba Co., 142 N.J. Eq. 340, 348, 60 A.2d 88, 93 (Ch. 1948) (the approval of stockholders is required if the directors exercise power as to change substantially the capital structure of the parent company). *See generally* Melvin Aron Eisenberg, *Megasubsidiaries: The Effect of Corporate Structure on Corporate Control*, 84 HARV. L. REV. 1577, 1589-1607 (1971).

[214] *See* HAMILTON, *supra* note 196 ("[T]he shareholders have only limited powers to participate in management and control: their principle function is to select other persons—the directors—to manage the business of the corporation for them.") It is the same even when parent banks can participate in and exert control over the daily decision-making of the operating subsidiary. *See Bestfoods*, 524 U.S. at 69-70 (a "well established principle [of corporate law] that directors and officers holding positions with a parent and its subsidiary can do and do 'change hats' to represent the two corporations separately, despite their common ownership") (quotation

shareholder of the operating subsidiary, the parent bank cannot manage the ordinary business or affairs of "its subsidiaries" because exercising those activities is entrusted to the "the board" of the subsidiary generally.[215] The board of the operating subsidiary, rather than the board of the national bank, has the legal authority to transact the usual and ordinary business of the subsidiary. The national bank's power to regard the activities of the subsidiary as the performance of the parent bank is equivalent to altering the legal characteristics of the subsidiary's activities. Accordingly, the incidental powers exercised by the national bank board's corporate powers do not encompass the authority to grant its subsidiary the same powers and status as the parent bank or to have its subsidiary exercise incidental powers under § 24(7).



2. The "Operating Subsidiary" Cannot Exercise Incidental Powers

The OCC and the Supreme Court in *Watters* posit that the "operating subsidiary" can exercise the same incidental powers under § 24(7) as the national bank.[216] Citing the *VALIC* decision, the Supreme Court held that operating subsidiaries may sell annuities pursuant to the incidental powers clause because the OCC has treated operating subsidiaries as equivalent to national banks with respect to powers and status.[217]

Such a holding, however, suffers from two problems. First, it is contrary to the plain language of § 24(7), which refers to "national banks" as entities having power to exercise incidental powers. Permitting operating subsidiaries to exercise incidental powers would lead to the untenable conclusion that a national bank, whose powers and status are granted by the NBA, may grant the same powers and status to its operating subsidiary pursuant to its own incidental

---

omitted).

[215] *See* Eisenberg, *supra* note 213, at 1603 (explaining that the parent's board has only the most limited powers within the subsidiary/parent structure and "it is the subsidiary's board, rather than the parent's, which will have the legal power to set business policy and make significant business decisions for the enterprise").

[216] *See supra* notes 108-112 and accompanying text.

[217] *Id.*

powers.[218] Most cases affirming incidental powers concern "direct activities that the national bank can exercise" in conducting banking business. For example, such incidental powers as "paying state taxes on depositors' accounts"[219] or "offering data processing services"[220] presuppose that the national bank could exercise those activities directly.[221]

Second, case law precedent does not support the holding in *Watters*. For example, *VALIC* did not rule on the matter of the legal treatment of the operating subsidiary, even though the issue there involved an insurance company's challenge to the OCC's permission to sell an annuity through the operating subsidiary.[222] The Court only determined whether the national bank's incidental powers include new activities—selling annuities as an agency based on the OCC's regulation, 12 C.F.R. § 5.34, providing that the operating subsidiary may conduct the same activities as the national bank.[223] In other words, since the OCC authorized the national bank to use operating subsidiaries in the late 1960s, long before the decision in *VALIC* in 1995, it does not matter whether the activities are exercised by national banks or by operating subsidiaries. Likewise, other cases on incidental powers have only focused on whether a new activity is an incidental power of the "national bank," not on the legal treatment of the operating subsidiary. Considering the text of § 24(7) and precedent cases, the Court in *Watters* gave great weight to the OCC's interpretation of precedent cases which were not intended to establish the legal status of operating subsidiaries.

C. The OCC's Regulatory Authority over Operating Subsidiaries

Traditionally, the federal government has heavily regulated banks because of the significant roles they play in the development and stability of the economy. Banks intermediate money supply in the financial marketplace and dominate the payment systems for the settlement of financial transactions. Banks' eligibility for federal deposit insurance further justifies oversight by bank regulators.

---

[218] This argument is consistent with the dissent's assertion that the incidental power is to authorize or regulate the conduct of the national bank. *See Watters*, 127 S. Ct. at 1582-83 (Stevens, J., dissenting); *see also supra* notes 172-174.

[219] Clement Nat. Bank v. Vermont, 231 U.S. 120, 140-41 (1913).

[220] National Retailers Corp. of Arizona v. Valley Nat. Bank, 411 F. Supp. 308 (D. Ariz. 1976), *aff'd*, 604 F.2d 32 (9th Cir. 1979).

[221] For a detailed discussion, *see infra* notes 250-257 and accompanying text.

[222] In *VALIC*, the Supreme Court mentions "the subsidiary" only once when introducing the facts of the case. *See VALIC*, 513 U.S. at 254 ("Petitioner NationsBank of North Carolina,...and its brokerage subsidiary sought permission from the Comptroller of the Currency, pursuant to 12 CFR § 5.34 (1994), for the brokerage subsidiary to act as an agent in the sale of annuities.").

[223] *Id.* The Court focused on whether the sale of annuities as an agent is an incidental power of national banks. Neither party challenged the OCC's regulation, 12 C.F.R. § 5.34, but, instead, they assumed it. 12 C.F.R. § 5.34 (1994) in *VALIC* provided that "a national bank may engage in activities which are a part of or incidental to the business of banking by means of an operating subsidiary operating."

However, does that oversight role extend to a mortgage service corporation, a state-chartered mortgage lender owned by a national bank? Can federal regulators subject a mortgage service corporation to the same regulatory treatment as the national bank, even though mortgage lenders do not conduct traditional banking activities?

In *Watters*, Michigan did not contest the OCC's general regulatory authority over the operating subsidiary.[224] Nor did the dissent take a clear position on this authority of the OCC.[225] The focus of this part of this paper is on whether Congress authorized the OCC to exclusively regulate the operating subsidiary. Close scrutiny of regulatory structure, the incidental powers clause and provisions of the GLBA shows that the OCC is not granted such broad regulatory oversight power.

1. The NBA as "Entity Regulation"

Fundamentally, each federal financial regulatory statute is based on "entity regulation," meaning a certain regulator has regulatory authority over a certain financial institution."[226] The same is true for the NBA, which states that the OCC licenses national banks and regulates their activities.[227] Almost all provisions of the NBA, including charters, safety and soundness regulations, examination and enforcement, reflect characteristics of "entity regulation" in order to regulate the "national bank." Even controversial provisions in this case—§§ 481 and 24a of the NBA—are understood within the framework of "entity regulation." The purpose of § 481, providing for the examination of affiliates of the national bank,[228] is to protect the safety and soundness of the national bank, not its affiliates.[229] Because affiliates may significantly threaten the financial condition of the national bank, § 481 allows the OCC to examine the affairs of all the bank's affiliates but only as shall be necessary to disclose the relations between the bank and its affiliates and the effect of such relations upon the bank.[230] The OCC's

---

[224] *Watters*, 127 S. Ct. at 1569-70. *See also supra* notes 88, 116 and accompanying text.

[225] *See supra* note 165 and accompanying text.

[226] *See* Elizabeth F. Brown, *E Pluribus Unum—Out of Many, One: Why the United States Needs a Single Financial Services Agency*, 14 U. MIAMI BUS. L. REV. 1, 11-12 (2005) ("U.S. financial regulation predominately was entity regulation."); BLUEPRINT, *supra* note 61, at 139 ("The current U.S. regulatory system, while often characterized as functional regulation, could more appropriately be characterized as an institutionally based functional system."). *See infra* notes 237-239 for a discussion of functional regulation.

[227] *See* Brown, *supra* note 226, at 14-15.

[228] 12 U.S.C. § 481 (prescribing the examination of affiliates).

[229] *See* BLUEPRINT, *supra* note 61, at 162-63 (describing the regulatory system for commercial banks as one that is based on the "principle that affiliates should not pose significant risks to a commercial bank" and further stating that the "ability to examine affiliate relationships" is one of the safeguards "designed to provide protection from affiliate relationships and limit the transfer of the safety net"); *see also* Reply Brief for the Petitioner, *supra* note 142, at 3 (asserting that the OCC has no authority to investigate affiliates in their own right, but may do so as an aid in making its full and detailed report on the condition of the national banks).

[230] *See* Reply Brief for the Petitioner, *supra* note 142, at 3.

examination of affiliates cannot be conceived solely to regulate the safety and soundness of the affiliates overall.[231]

Likewise, regulatory schemes for subsidiaries of a national bank, including financial subsidiaries and operating subsidiaries, also utilize "entity regulation" to maintain the safety and soundness of the national bank itself, not of its subsidiaries. To minimize the risk caused by the activities of subsidiaries, especially financial subsidiaries which engage in insurance and securities activities, § 24a commands the "national bank": (i) to meet statutory requirements to control a financial subsidiary;[232] (ii) to employ safeguards to separate itself from financial subsidiaries;[233] and (iii) to divest financial subsidiaries when the bank fails to comply with the laws.[234] Such strict scrutiny should be excluded only when a subsidiary does not expose a national bank to higher risks.[235] In sum, these provisions mean that "the national bank" should control its subsidiaries by adopting appropriate policies and procedures, not by governing activities of the financial subsidiary or the operating subsidiary directly. The OCC's authority should be interpreted to implement this statutory demand of Congress.[236]

Under this "entity regulation" framework, exceptions to "entity regulation"—where a regulator other than the OCC exercises regulatory powers over the national bank, or the OCC regulates entities other than the national bank—have been set forth with an explicit congressional intent to do so. For example, when Congress adopted the concept of "functional regulation" in the GLBA—that is, the same activities should be regulated by the same regulator, regardless of the kind of financial institution,[237] it clarified the alteration of a primary regulator. When a national bank or its functionally regulated affiliates engage in the securities or insurance business, the Securities Exchange Committee ("SEC") or the state insurance regulators has the

---

[231] *Id.*

[232] 12 U.S.C. § 24a(a)(2)-(3) (for example, requiring the national bank and each depository institution affiliate to be well-capitalized and well managed).

[233] 12 U.S.C. § 24a(d) (requiring the national bank to protect itself from risks of managing financial subsidiaries and to observe the corporate separateness and limited liability of the national banks).

[234] 12 U.S.C. § 24a(e) (requiring the national bank to "divest control of any financial subsidiary" pursuant to such terms and conditions imposed by the OCC).

[235] 12 U.S.C. § 24a(g)(3)(A). *See also* COMPTROLLER'S HANDBOOK, *supra* note 117, at 10-14 ("A financial subsidiary does not engage *solely* in activities in which a national bank may engage directly.").

[236] *See* 12 U.S.C. § 24a(a)(5) ("Before the end of the 270-day period beginning on November 12, 1999, the Comptroller of the Currency shall, by regulation, prescribe procedures to implement this section."). The OCC construed this clause as allowing its general regulatory authority over financial subsidiaries. *See* 12 C.F.R. § 5.39(k) (providing that "[a] financial subsidiary is subject to examination and supervision by the OCC, subject to the limitations and requirements of section 45 of the Federal Deposit Insurance Act (12 U.S.C. 1831v) and section 115 of the GLBA (12 U.S.C. § 1820a)").

[237] *See* Brown, *supra* note 226, at 12, 19 ("Functional regulation focuses on regulating based on the type of product being provided, instead of on the type of institution providing the product."); BROOME & MARKHAM, *supra* note 99, at 265 (for instance, the securities activities conducted by national banks would be subject to regulations of the SEC, including the registration as a broker-dealer).

responsibility to regulate those activities, respectively.[238] If there are no such provisions, even insurance businesses or securities activities which are conducted by the national bank are still regulated by the OCC.[239]

Another instance of "entity regulation" is the regulatory scheme for a "bank service company" ("BSC"), a corporation which is owned by a national bank and conducts parts of the banking business like an operating subsidiary.[240] Section 5 of the Bank Service Company Act squarely indicates the way in which Congress delegates regulatory authority to the OCC over entities other than national banks by setting forth a requirement that a BSC is subject to "examination and supervision" by the appropriate federal banking agency of its principle investor "to the same extent as its parent national bank."[241] The OCC is explicitly authorized to regulate a BSC by issuing regulations and orders.[242] Similarly, as to the federal branch of foreign banks, a statutory provision clearly states a branch of a foreign bank "shall be subject to all the same duties, restrictions, penalties, liabilities, conditions and limitations that would apply under the National Bank Act to a national bank."[243] Again, Congress expressly intended that these entities be subject to the rules, regulations, and orders of the OCC, and that they receive the same rights and privileges as a national bank at the same location under the NBA.[244] Given the structure of the NBA and other banking laws, it is obvious that if Congress had intended to grant the OCC regulatory power over the operating subsidiary, it would have expressly done so in the NBA.[245]

---

[238] 15 U.S.C. § 78c(a)(4)-(5) (repealing "the bank" exception from the definition of "broker" and "dealer" in the Securities Exchange Act of 1934); 15 U.S.C. § 6711 (insurance activities of a national bank are functionally regulated by the state insurance regulator); and 12 U.S.C. § 1844(c) (regulations for "functionally regulated subsidiaries," subsidiaries of bank holding companies, such as securities broker-dealers, investment advisors, future commission merchants, and insurance companies). *See also* COMPTROLLER'S HANDBOOK, *supra* note 117, at 53 (the GLBA "recognizes the roles of the Securities and Exchange Commission, the Commodities Futures Trading Commission, and state insurance commissioners as the primary regulators of securities, commodities, and insurance activities, respectively").

[239] The OCC regulates most securities activities, including private investment, asset-backed securities, derivatives and trust activities, while broker-dealer activities are regulated by the SEC. *See, e.g.*, Brown, *supra* note 226, at 19.

[240] A BSC may perform activities permissible for its shareholders or member banks to perform directly. 12 U.S.C. § 1863 provides that a BSC may perform services including "check and deposit sorting and posting, computation and posting of interest and other credits and charges, preparation and mailing of checks, statements, notices, and similar items, or any other clerical, bookkeeping, accounting, statistical, or similar functions performed for a depository institution." *See also* COMPTROLLER'S HANDBOOK, *supra* note 117, at 17.

[241] 12 U.S.C. § 1867(a) (providing that a BSC "shall be subject to examination and regulation by the appropriate Federal banking agency of its principal investor to the same extent as its principal investor"). Based on this provision, the preemption principle applicable to parent banks is applied to the BSC.

[242] *See* 12 U.S.C. § 1867(d) (providing that "the Board and the appropriate Federal banking agencies are authorized to issue such regulations and orders as may be necessary to enable them to administer and to carry out the purposes of this chapter and to prevent evasion thereof").

[243] 12 U.S.C. § 3102(b).

[244] *Id.*

[245] *Cf. Watters*, 127 S. Ct. at 1578 (Stevens, J., dissenting) (arguing that Congress has never authorized the OCC to "license" the operating subsidiary which is a state-chartered entity).

2. The Incidental Powers Clause

The OCC construes the incidental power to use operating subsidiaries as justifying the OCC's regulatory oversight.[246] However, it is unlikely that the incidental power indicates or implies the OCC's authority to regulate the operating subsidiary for two reasons. First, given the framework of the NBA as "entity regulation," the language of § 24(7) is too general and broad to support an interpretation that Congress' intent was to grant regulatory jurisdiction over a new entity or to preempt state laws. Congress "does not alter the fundamental details of a regulatory scheme in vague terms or ancillary provisions—it does not, one might say, hide elephants in mouseholes."[247]

Second, because § 24(7) is a rule authorizing or regulating the conduct of "national banks,"[248] the OCC's interpretive authority is limited to regulating the conduct of the parent bank in utilizing the operating subsidiary. The conduct of the operating subsidiary is not directly under the OCC's authority. Therefore, the conduct of the national bank subject to the OCC's regulation should include investment activities in, and supervision of, operating subsidiaries in order to prevent significant risks to the parent bank. For example, in *Watters,* the OCC may prescribe rules to govern Wachovia Bank's investment in, and supervision or management of Wachovia Mortgage. This approach is in accordance with limitations on incidental powers, grounded in the structure of the NBA to oversee the national bank.[249]

Case law also endorses this interpretation of incidental powers. Until *Watters*, precedent cases only determined whether a "specific activity of a national bank" was incidental to the "business of banking" and never granted a far greater authority to "regulate new entities." In earlier cases, the Supreme Court held that the national bank has incidental powers "to take corporate stocks in payment and satisfaction of debts"[250] and "to own and sell stocks which are acquired as collateral on a defaulted loan."[251] Incidental powers also encompass "paying state taxes on depositor's accounts,"[252] "operating a safe-deposit business"[253]

---

[246] *See supra* notes 117-122 and accompanying text.

[247] Gonzales v. Oregon, 546 U.S. 243, 267 (2006) (quoting Whitman v. American Trucking Assns., Inc., 531 U.S. 457, 468 (2001)).

[248] *Watters*, 127 S. Ct. at 1583 (Stevens, J., dissenting).

[249] *See* discussion *supra* Parts IV.B.1., C.1.

[250] First Nat. Bank v. National Exch. Bank, 92 U.S. 122, 128 (1875) ("[W]hile a bank is expressly prohibited...from loaning money upon or purchasing its own stock, special authority is given for the acceptance of its shares as security for, and in payment of, debts previously contracted in good faith.").

[251] California Nat. Bank v. Kennedy, 167 U.S. 362, 367 (1897) (holding that a national bank has an incidental power to take the stock of another corporation as collateral security).

[252] Clement Nat. Bank v. Vermont, 231 U.S. 120, 140-41 (1913) (holding that paying state taxes on deposit accounts is incidental to deposit taking because it promotes the convenience of the bank's business).

[253] Bank of Cal. v. Portland, 69 P.2d 273, 279 (Or. 1937), *cert. denied,* 302 U.S. 765 (1937) (holding that the operation of safe-deposit is within incidental powers of national banks as an

and "using the word 'saving' or 'savings' in advertising saving deposits."[254] In relatively recent cases, specific activities of national banks such as "selling annuities as an agency,"[255] "offering data processing services to retailers"[256] and "acting as an agent for the selling of credit life insurance"[257] were judicially established as falling within the incidental powers of the national banks.

An operating subsidiary's being supervised on a consolidated basis buttresses the same control of the OCC over the operating subsidiary.[258] The Supreme Court held that operating subsidiaries are consolidated with their parent "for purposes of applying statutory or regulatory limits, such as lending limits or dividend restrictions" and "for accounting and regulatory reporting purposes."[259] On the other hand, the Court stated that the financial subsidiary is not subject to the same OCC regulations because the OCC does not supervise financial subsidiaries on a consolidated basis.[260]

Consolidated supervision is, however, irrelevant as a ground for the general regulatory authority[261] over operating subsidiaries because combined supervision is basically a supervisory principle to regulate a banking group, including all the subsidiaries and affiliates of the bank. This is evident from a report of the Basel Committee on Banking Supervision. [262] The report observes that the reason to adopt consolidated supervision is to regulate all the risks from activities not only of the bank, but also of its affiliations—subsidiaries and

---

integral part of the business of banking); *see also* Colorado Nat. Bank v. Bedford, 310 U.S. 41 (1940) (explaining that safe-deposit must be considered a banking function).

[254] Franklin Nat. Bank of Franklin Square v. New York, 347 U.S. 373 (1954) (holding that a national bank's using the word 'saving' or 'savings' in advertising is incidental to saving deposits because advertising is one of the most "usual and useful ways" to engage in authorized deposit business).

[255] *VALIC*, 513 U.S. at 251.

[256] National Retailers Corp. of Arizona v. Valley Nat. Bank, 411 F. Supp, 308 (D.Ariz, 1976), *aff'd*, 604 F.2d 32 (9th Cir. 1979).

[257] Independent Bankers Ass'n of America v. Heimann, 613 F.2d 1164, 1170 (D.C. Cir. 1979), *cert. denied*, 449.U.S. 823 (1980) (explaining that credit life insurance is commonplace and essential to carry on the ordinary consumer credit of the national bank).

[258] *See supra* notes 123-124 and accompanying text.

[259] *Watters*, 127 S. Ct. at 1570 n.10 (stating that the assets and liabilities of both entities are combined for accounting and reporting purposes, and the lending limits or dividend restrictions of an operating subsidiary are also consolidated with the parent bank for supervisory purposes) (quoting COMPTROLLER'S HANDBOOK, *supra* note 117, at 64).

[260] *Id.* ("OCC treats financial subsidiaries differently. A national bank may not consolidate the assets and liabilities of a financial subsidiary with those of the bank.").

[261] General regulatory authority includes chartering, safety and soundness regulations, examinations, enforcements and liquidations.

[262] *See* BASEL COMM. ON BANKING SUPERVISION, *Core Principles Methodology* (October 2006), *available at* http://www.bis.org/publ/bcbs130.pdf (last visited Nov. 13, 2008) [hereinafter "*Core Principles Methodology*"]. *See also* BASEL COMM. ON BANKING SUPERVISION, *Core Principles for Effective Banking Supervision* (October 2006), *available at* http://www.bis.org/publ/bcbs129.pdf (last visited Nov. 13, 2008). The committee of banking supervisory authority is composed of representatives of banking regulators and central banks from 13 countries including the U.S. It was established by the central bank governors of the G10 countries in 1975. *See id.* at 1 n.1.

affiliates.[263] As the proliferation of the banking business through the banking group threatens the safety and soundness of the bank, a regulator is required to "supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide."[264] Under this regulatory principle, consolidated supervision does not distinguish subsidiaries from affiliates to the extent that it is appropriate to maintain the safety and soundness of the bank.[265] Consolidated prudential standards—such as capital adequacy, large exposures, exposures to related parties and lending limits—were utilized as a supervisory tool to regulate a banking group.[266] Consolidated accounting and financial information reporting also constitute essential parts of consolidated supervision that are applied to all relevant entities when appropriate.[267] In other words, not only operating subsidiaries but also financial subsidiaries may be subject to consolidated supervision, which is different from interpretations of the OCC and the Supreme Court.

Inconsistent with the Supreme Court and OCC's findings that a financial subsidiary is not subject to consolidated supervision, the NBA consolidates the financial subsidiary with the national bank in some provisions.[268] The national bank must prepare a consolidated financial statement which includes the financial subsidiary,[269] while the financial subsidiary is not consolidated for the purpose of calculating regulatory capital.[270] Also, the figures of all affiliates including operating subsidiaries and financial subsidiaries are consolidated in calculating investment limitations in bank premises.[271] These instances illustrate that the financial subsidiary is not excluded from consolidated supervision for specific regulatory purposes, a strong argument against the idea that only the operating subsidiary should be subjected to the

---

[263] *See Core Principles Methodology*, *supra* note 262, at 38 n.43 (explaining that a banking group includes "the bank and its office, subsidiaries, affiliates and joint ventures"); RONALD MACDONALD, CONSOLIDATED SUPERVISION OF BANKS, BANK OF ENGLAND HANDBOOKS IN CENTRAL BANKING No. 15. 5 (June 1998), *available at* http://www.bankofengland.co.uk/education/ccbs/ handbooks/pdf/ccbshb15.pdf (last visited Nov. 13, 2008) (consolidated supervision seeks to evaluate the safety and soundness of an entire group by considering the risks of a bank which are derived from banks or related entities).

[264] *See Core Principles Methodology*, *supra* note 262, at 38. In this regard, consolidated supervision maintains the characteristic of "entity regulation" to protect the bank in nature.

[265] *See id.* at 38 n.43.

[266] *See id.* at 39.

[267] *Id.*

[268] The NBA also embodies the concept of consolidated supervision not only for subsidiaries but also for affiliates of banking (or financial) holding companies—for example, 12 U.S.C. §§ 24a(c)(2) (consolidated reporting of financial statements), 161(c) (reports of affiliates) and 371d(a) (Investment in bank premises or stock of corporation holding premises).

[269] 12 U.S.C. § 24a(c)(2) (providing that "...in addition to providing information prepared in accordance with generally accepted accounting principles...."). *See also* MACEY ET AL., *supra* note 18, at 506.

[270] 12 U.S.C. § 24a(c).

[271] 12 U.S.C. § 371d(a) (requiring the national bank to include in its aggregate investment in bank premises any indebtedness incurred by corporations that are affiliates of the bank).

same OCC regulations under the consolidated supervision rationale. In addition, the argument of consolidated supervision has another drawback. The OCC exercised its discretion in applying consolidated supervision to the operating subsidiaries by selecting or excluding some provisions without reasonable explanations.[272]

Considering the irrelevance of consolidated supervision and supporting provisions of the NBA, it is manifest that the OCC's interpretation is arbitrary and contrary to law—not administrating a demand of Congress, but expressing the will of the OCC.[273]

3. "Same Terms and Conditions" in the GLBA

As discussed earlier, the OCC and the Supreme Court agreed that the "same terms and conditions" in § 24a(g)(3)(A) of the GLBA affirmed the OCC's oversight power over the subsidiary as tantamount to that over its parent bank.[274] However, such a view is not correct in light of the legislative history and Congress' purpose in enacting the GLBA, together with the structure of the NBA as "entity regulation."

Before the enactment of the GLBA in 1999, there had been contentious debates about whether the operating subsidiary could engage in a broad scope of activities that its parent bank could not engage in directly.[275] This issue was derived from the OCC's amended regulation in 1996 ("1996 regulation") which permitted operating subsidiaries to engage in new activities different from those permissible for national banks.[276] For instance, in 1997 the OCC allowed Zions First National Bank to underwrite municipal revenue bonds through operating subsidiaries even though Zions was not permitted to underwrite these bonds directly.[277] Following the language in the 1996

---

[272] 12 C.F.R. § 5.34(e)(4)(i) ("when combination is needed to effect the intent of the statute or regulation, e.g., for purposes of 12 U.S.C. §§ 56, 60, 84 and 371d."). In the case of other organizations, such as BSC, Congress authorized the OCC to issue regulations and orders for these companies "as may be necessary to enable them to administer and to carry out the purposes of this chapter..." *See supra* notes 240-242. In the absence of such a provision, the OCC's authority to select regulations is questionable.

[273] *See* Gonzales v. Oregon, 546 U.S. 243, 257 (2006) (holding that "the existence of a parroting regulation does not change the fact that the question here is not the meaning of the regulation but the meaning of the statute"); *cf. Watters*, 127 S. Ct. at 1584 (Stevens, J., dissenting) (arguing that the OCC's incorporation of "the same terms and conditions" of the GLBA into its regulation does not support the OCC's position because the GLBA says nothing about preemption).

[274] *See supra* notes 125-126 and accompanying text. The dissenting opinion also agreed that § 24a(g)(3)(A) may implicate the regulatory power of the OCC over operating subsidiaries together with state regulations. *See supra* note 165 and accompanying text.

[275] *See* 1996 Regulation, 61 Fed. Reg. at 60,350-52; 12 C.F.R. § 5.34(f) (1997) (providing that the operating subsidiary can engage in activities which are prohibited to its parent bank); BROOME & MARKHAM, *supra* note 99, at 825. *See generally* William T. McCuiston, Note, *National Bank Operating Subsidiaries: How Far Has the OCC Opened the Door to NonBanking Activities?*, 2 N.C. BANKING INST. 264 (1998).

[276] *See* 1996 Regulation, 61 Fed. Reg. at 60,350-52; McCuiston, *supra* note 275, at 264-66.

[277] *See* OCC Conditional Approval No. 262, Decision of the Comptroller of the Currency on

regulation, the OCC concluded that selling municipal revenue bonds was legally permissible as incidental to the business of banking.[278] At the same time, the OCC reviewed applications by NationsBank, a national bank, to engage in real estate development, which is another activity national banks could not conduct directly.[279]

In order to justify the 1996 regulation, the OCC created a new type of operating subsidiary ("1996 operating subsidiary") which it distinguished from typical operating subsidiaries. The 1996 operating subsidiary is a subsidiary which: (i) can conduct activities different from those permissible for national banks; and (ii) is subject to enhanced supervisory tools of the OCC.[280] First, to permit expanded activities, the OCC changed its policy that the operating subsidiary could only engage in the same banking business as the national banks could conduct directly because the subsidiary is, in essence, a department of a bank. The OCC argued that the description of "a department of a bank" did not represent "a legal determination that an operating subsidiary may never permissibly conduct activities different from those allowed its parent banks."[281] The OCC underestimated the value of its earlier language referring to the operating subsidiary as a convenient and useful way for a national bank to conduct banking business.[282]

Second, the OCC imposed additional supervisory scrutiny for the new 1996 operating subsidiary. In response to criticism that allowing new activities would jeopardize the bank's safety and soundness,[283] the OCC emphasized that it could modify its policies where a change was lawful and enhanced by proper supervisory tools.[284] As part of the enhanced oversight, this regulation imposed on the "1996 operating subsidiary" and its parent bank many additional conditions and safeguards, such as independent operations from parent banks and the compliance with safety and soundness regulation.[285] For example, the application of NationsBank in 1997 seeking permission to

---

the Application by Zions First National Bank, Salt Lake City, Utah to Commence New Activities in an Operating Subsidiary (Dec. 11, 1997), *available at* http://www.occ.treas.gov/interp/dec97/ca262.pdf (last visited Nov. 13, 2008).

[278] *See id.*

[279] *See* Operating Subsidiary Notice 97-07, 62 Fed. Reg. 16,213; *see also* McCuiston, *supra* note 275, at 274-79.

[280] *See* 1996 Regulation, 61 Fed. Reg. at 60,350-55.

[281] *Id.* at 60,352.

[282] *Id.*

[283] *Id.* at 60,353.

[284] *Id.* at 60,352-53 ("The OCC is not precluded from modifying its policies where the modification is lawful and where enhanced flexibility can be appropriately monitored and contained via the imposition of conditions as warranted and the availability of improved supervisory tools.").

[285] 12 C.F.R. § 5.34(f)(2) (1997); 1996 Regulation, 61 Fed. Reg. at 60,353-54. To justify the 1996 operating subsidiary, the OCC imposed "corporate requirements" such as corporate separateness and distinction, operations under different name, separate accounting and corporate records and the board of directors. Also, the bank's capital and total assets were reduced by the amount of the bank's equity investment in the subsidiary. And 12 U.S.C. §§ 371c and 371c-1 were applied to transactions between banks and their subsidiaries. *See id.*

conduct real estate development through operating subsidiaries[286] included these additional conditions and safeguards. NationsBank argued that the development of real estate by banks was permissible because it was incidental to the business of banking, though § 29 of the NBA restricted the national bank's ownership of real estate.[287] NationsBank asserted that such restrictions would not apply to real estate development activities through an operating subsidiary because the risks involved with real estate could be addressed by imposing conditions and safeguards created under the 1996 regulation, coupled with self-imposed conditions.[288] Indeed, the OCC's ability to impose additional terms and conditions was utilized by national banks to engage in new business, thereby avoiding restrictions on the activities of the parent bank.

However, the 1996 regulation was confronted by strong resistance from the Federal Reserve and several members of Congress, who questioned the OCC's authority to adopt the 1996 regulation as a means of expanding the scope of national bank subsidiary powers.[289] The opponents urged the OCC not to approve its 1996 regulation until Congress clarified the bounds of permissible activities of the 1966 operating subsidiary and the OCC's authority under § 24(7).[290]

Finally, Congress repealed the 1996 regulation by enacting the GLBA.[291] Instead of allowing the 1996 operating subsidiary to engage in extended activities, Congress created a new operating subsidiary—that is, the "financial subsidiary"—which can participate in a broad scope of securities, commercial, and other activities equivalent to those of affiliates of financial holding companies.[292] The GLBA contained a number of safeguards similar to those in the 1996 regulation to address concerns about the safety and soundness of these activities.[293] The difference between them is that a financial subsidiary is conceived and governed by statute, while the 1996 operating subsidiary is defined and governed by an OCC regulation.

---

[286] *See supra* note 275 and accompanying text.

[287] *See* McCuiston, *supra* note 275, at 274-75.

[288] *Id.* at 275-79, 288-89 ("NationsBank attempts to address...concern[s] by including a self-imposed limitation on its investment in real estate development activities to two percent of Tier 1 capital" and by selling any real estate which it developed as quickly as possible, in addition to the safeguards in § 5.34(f)).

[289] *See* McCuiston, *supra* note 275, at 264-65, 276-77; 1996 Regulation, 61 Fed. Reg. at 60,351-54.

[290] *See, e.g.*, 1996 Regulation, 61 Fed. Reg. at 60,350-51.

[291] *See, e.g.*, BROOME & MARKHAM, *supra* note 99, at 248 ("With the creation of financial subsidiaries in the [GLBA], the expanded authority for national bank operating subsidiaries was scaled back to the pre-1996 regime.").

[292] The financial subsidiary may engage in specific activities that are financial in nature and in activities that are incidental to financial activities if the bank and the subsidiary meet certain requirements and comply with stated safeguards. *See* BROOME & MARKHAM, *supra* note 99, at 251 (explaining that activities of a financial subsidiary include activities permissible for subsidiaries of the financial holding company except insurance underwriting, annuity issuance, merchant banking, real estate investment and development under 12 U.S.C. §§ 24a(a)(2)(A)-(B) and 1843(k)(7)(B)). *See generally* MACEY ET AL., *supra* note 18, at 490-507.

[293] *See supra* notes 232-234 and accompanying text.

Also, Congress sought to address the OCC's questionable interpretation that operating subsidiaries may engage in activities not permissible to national banks on the condition that those activities are subject to the OCC's discretionary enhanced supervisory tools. Congress defined operating subsidiary in § 24a(g)(3)(A) and excluded it from the heavy regulations applicable to financial subsidiaries only if the subsidiary satisfies two requirements: (i) it can engage solely in activities that the national bank can conduct directly; and (ii) the same terms and conditions that govern activities of the national bank are to be imposed on its activities.

A close examination of the legislative history and purpose of the GLBA demonstrates that two requirements of § 24a(g)(3)(A) should be restrictively construed as granting an operating subsidiary immunity from financial subsidiary regulation, rather than granting the OCC general regulatory authority over the operating subsidiary. Specifically, the first requirement codified for the first time the rule that an operating subsidiary cannot engage in activities that the national bank could not engage in directly.[294] The second requirement aims to prohibit the OCC from imposing additional terms and conditions which are not applicable to the national banks without statutory grounds. Contrary to the OCC's interpretation, the "same terms and conditions" should not be interpreted to mean that the operating subsidiary is subject to the same OCC regulatory jurisdiction. Rather, it means that operating subsidiaries can only avoid the financial subsidiary regulations if they conduct their business subject to the same terms and conditions applicable to activities of the national bank. The matters of who should regulate the operating subsidiary in general and whether the state maintains regulatory powers over the operating subsidiary were left intact.

This interpretation is supported by the bill passed by the House of Representatives,[295] providing that no provisions should be construed to allow the national bank's subsidiary to engage in activity that "is not permissible for a national bank to engage in directly," or "is conducted under terms or conditions other than those that would govern the conduct of such activity by a national bank."[296] This provision was slightly revised to match the current provision, but Congress has never altered its intention to prohibit the OCC's arbitrary construction of the NBA as it did in the 1996 regulation.

---

[294] *See Watters*, 127 S. Ct. at 1577-78 (Stevens, J., dissenting) (the GLBA "worked a rejection of the OCC's position that an *operating* subsidiary could engage in activities that national banks could not engage in directly").

[295] H.R.10, 106th Cong. (section 5136A(a)(1) provides that "no provision of section 5136...shall be construed as authorizing a subsidiary of a national bank to engage in, or own any share of or any other interest in any company engaged in, any activity that –(A) is not permissible for a national bank to engage in directly; or (B) is conducted under terms or conditions other than those that would govern the conduct of such activity by a national bank" unless such ownership or control is expressly authorized by the federal laws).

[296] *Id.*

Moreover, similar to the analysis of the incidental powers clause,[297] "the same terms and conditions" in a definitional context is not the way in which Congress delegates to the OCC regulatory authority over other entities. As discussed, Congress clearly expressed its intent when it conferred regulatory jurisdictions on the OCC.[298] The definitional provision cannot radically change the state's authority over national bank affiliates that has been in place for more than a century. [299] Presumably, the OCC recognized its problematic construction when it inserted the dubious words "the same authorization" in the regulation 12 C.F.R. § 5.34(e)(3), although the GLBA uses "the same terms and conditions."[300] The deviation from the literal language might reflect the OCC's difficulty in deriving its regulatory authority directly from the GLBA's definition clause.

V. CONCLUSION

While the concept of incidental powers is flexible and evolving, its limitations are founded upon the NBA. Approaching the scope of incidental powers in light of statutory language, regulatory structure and case law, this article highlighted the idea that the incidental power in *Watters* exceeds its bounds and the OCC is not authorized to oversee subprime mortgage corporations which do not engage in traditional banking activities. It is quite clear the Congress is aware of the difference between regulatory structure applicable to depository institutions and those that govern non-depository companies. This is evidenced by the regulatory reality over operating subsidiaries. Even though the OCC has maintained that it retains extensive oversight over operating subsidiaries, the OCC could not even provide a list of those operating subsidiaries in 2003. A list containing the names of more than 300 companies was not produced until June 2006.[301]

This article demonstrates that the OCC's interpretations must be motivated by its sole aim to expand its regulatory jurisdiction.[302] In the absence of Congressional intent, the OCC should not be permitted to construe the NBA so as to cripple the state's oversight function and, simultaneously, to extend its own regulatory jurisdiction to cover

---

[297] *See supra* note 247 and accompanying text.

[298] *See* discussion *supra* Part IV.C.1.

[299] *See supra* note 247; Reply Brief for the Petitioner, *supra* note 142, at 9 (arguing that Congress did not intend to radically change state's authority over national bank affiliates by adding a definition clause that only acknowledges the existence of operating subsidiaries).

[300] *See* Reply Brief for the Petitioner, *supra* note 142, at 11 n.8 (asserting that 12 C.F.R. § 5.34(e)(3) deviates from the NBA because the OCC added the term *"authorization"*, which is not included in § 24a(g)(3)(A), with no explanation). *See also supra* note 118 and accompanying text.

[301] *See* American Dream, *supra* note 10, at 1369-70.

[302] *Watters*, 127 S. Ct. at 1585-86 (Stevens, J., dissenting) ("Never before have we endorsed administrative action whose sole purpose was to preempt state law rather than to implement a statutory command.").

operating subsidiaries. Such aggressive constructions, coupled with judicial deference, may strip each state's important oversight function of protecting its consumers, as well as the dual banking system in the U.S. Considering that the recent subprime mortgage turbulence may be a "necessary consequence" of the OCC's preemption since 2001, restructuring the OCC's regulatory scheme for operating subsidiaries can contribute to addressing problems in the subprime mortgage market.