
AUDIT AND BANKING

Regulation of Banks By States

By: *Garland W. Binns, Jr.*

During 2004, the Office of the Comptroller of the Currency ("OCC") issued two final regulations regarding the preemption of state laws by federal law over national banks. The first regulation clarifies to the extend the operations of a national bank are subject to state laws and identifies the type of state laws that are preempted by federal law under the National Bank Act. The second regulation is directed toward the exclusive authority of the OCC under the National Bank Act to examine, supervise and regulate the affairs of a national bank.

Because of the controversial nature of these regulations as to state versus federal regulation of national banks, particularly in the area of corporate subsidiaries of national banks and the applicability of preemption of state law relating to these corporate subsidiaries, a number of lawsuits were filed by state regulatory authorities regarding the position taken by the OCC.

The most recent case decided is *Office of the Comptroller of the Currency v. Cuomo, No. 05-6001* and *The Clearing House Association, LLC v. Cuomo (2d Cir., December 4, 2007)*. In 2005, the New York State Attorney General, Andrew Cuomo, began investigating evidence of possible racial discrimination in the residential real estate lending practices of mortgage lenders, national banks and their operating subsidiaries. On the basis of these apparent racial disparities, the Attorney General sent letters of inquiry to mortgage lenders implicated by the data, including several national banks and their operating subsidiaries requesting that the lenders voluntarily produce certain non-public information regarding their mortgage policies and practices. Based on the regulations of the OCC, both the OCC and The Clearing House Association, a consortium of national banks, filed lawsuits seeking to enjoin the Attorney General's investigation and enforcement efforts.

In upholding the regulations issued by the OCC, the Court held that the regulations were a reasonable inter-

pretation of the National Bank Act.

Due Diligence

In the financial sector, due diligence is a term that has been used and defined in many ways, but the best meaning of it is the level of judgment, care, prudence, determination, and activity that a person would reasonably be expected to do under particular circumstances. Due diligence involves exercising the degree of care in investigating a matter by verifying facts in order to eliminate unknown risks.

The origin of the term due diligence came about following the passage of the federal Securities Act of 1933 which afforded a defense to persons selling securities when accused of inadequate disclosure of material information to investors. As a result, persons selling securities to the general public, such as broker/dealers, instituted a standard practice of conducting due diligence investigations into the company having a stock offering in order to protect themselves from nondisclosure of material information. Although the term was originally limited to public offerings of stock, it has now become associated with all types of investigations.

The purpose of exercising due diligence is to cut down the risk to a manageably small level. A considerable measure or judgment is involved, not only in deciding what to do, but in determining the level of investigation into a particular matter. Due diligence investigations frequently arise in a number of different contexts. These include (i) acquiring a company, (ii) loaning monies to a company, and (iii) marketing a new product. For instance, in the acquisition of a company, a careful analysis of the target company would involve an analysis of financial statements, environmental reports on real estate, existing contracts, pending litigation and regulatory proceedings and a review of contingent liabilities not reflected on the financial statements. In Loaning money to a company, due diligence would involve reviewing the business plan of the company, analysis of financial statements, possible environmental issues if real estate is involved, and making sure that the lender is the first lienholder on any collateral for the loan. Due diligence in marketing a new product may involve

such things as whether the product would infringe upon the rights of other similar products and whether a patent or trade mark is available for the new product. In connection with the issuance of stock by a company, due diligence is a requirement on the part of the company as the issuer to insure that the offering does not misstate or omit material information to a prospective purchaser of its securities.

To some degree, due diligence is involved in the day-to-day activities of everyone as they relate to a purchase of a car or home such as obtaining an appraisal, inspections and making sure that everything works. In more complicated transactions, the due diligence will take place between the time of the signing of an agreement outlining the terms of the transaction, sometimes referred to as a letter of intent, and the execution of a definitive agreement which sets forth, among other things, the representations and warranties of the parties to the transaction.

Due diligence reduces the risks by ensuring the creditability and accuracy of information.

Cumulative Preferred Stock

In Interpretive Letter No. 1086, the Office of the Comptroller of the Currency ("OCC") confirmed the authority of a national bank to purchase and hold shares of fixed-rate cumulative preferred stock based in part on reliable estimates [12 C.F.R. § 1.3(i)] that the issuer of the security would be able to satisfy its obligations under the security, and that the bank would be able to sell the security with reasonable promptness at a price that corresponds reasonably to the fair value of the security.

12 C.F.R. § 1.3(i) limits all securities in a bank's portfolio acquired on the basis of reliable estimates to no more than five percent of the bank's capital and surplus. The OCC concluded that cumulative preferred stock is similar to debt instruments in that the securities do not confer voting rights on the holder so long as the yield is current and the issuer is not attempting to alter the holder's rights under the security. The OCC also noted that dividend payments were cumulative, similar to a typical debt instrument, and that the securities were callable by the issuer.

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ASCPA Banking Liaison Meeting January 31, 2008

The third Banking Liaison Meeting was hosted by the Arkansas Society of CPAs for its members who perform both internal and external bank audits. The purpose of the meeting was to update CPAs, bankers, and regulators on key issues facing the banking industry today.

The liaison meeting was led by a host of speakers from the Arkansas State Bank Department, Federal

Reserve Bank, and FDIC. The speakers included: **Candace A. Franks**, Commissioner, Arkansas State Bank Department; **Bill Coffey**, Supervisory Examiner Consumer Affairs Unit, Federal Reserve Bank of St. Louis, Little Rock Branch; **Michael Wallace**, Senior Examiner Consumer Affairs Unit, Federal Reserve Bank of St. Louis, Little Rock Branch; **Susannah Marshall**, Deputy Bank Commissioner, Arkansas State Bank Department; **John Ashby**, Financial Analyst Supervisor, Arkansas State Bank Department; **Wayne Nichols**, Assistant Regional Director, Federal Deposit Insurance Corporation in Memphis, TN; and **Danita Sprague**,

Regional Accounting Specialist, Federal Deposit Insurance Corporation in Dallas, TX.

The leaders discussed some of the latest developments and issues in the banking industry concerning: various Financial Accounting Standards (FAS), regulatory accounting issues, self-examination issues, disaster planning, disclosures, guidance and compliance issues.

Approximately 100 people were in attendance for this free event. Participants in attendance received four CPE Credit hours. Please join us next year for this insightful meeting.

FASB Releases Accounting Standards...

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(e) Become the authoritative source of literature for the completed XBRL taxonomy.

The FASB is exposing the Codification for a verification period of a year. During that time, interested parties may use the Codification Research System free of charge to research accounting issues and provide feedback. They may register to review the Codification at <http://asc.fasb.org>.

"We wholeheartedly support the FASB's Codification project," said Barry Melancon, AICPA president and CEO. "For a long time, many users have said that GAAP is confusing. The Codification represents a simplification of the enormous body of accounting standards. It renders GAAP more understandable and accessible for research."

The Codification affects preparers, auditors, tax practitioners, financial statement users, academics and students, Melancon said. "We're encouraging all our members to take the time to use the Codification in the course of their daily work during the verification period and offer their feedback to FASB."

The Institute will develop professional development courses to help educate its members about the Codification. These will include webcasts, self-study and group-study courses.

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Fixed-rate cumulative preferred stock is an excellent vehicle for maintaining shareholder ownership, funding acquisitions, stock repurchases and providing funds for internal growth.

About the Editor

Garland W. Binns, Jr. is an attorney with the firm of Dover Dixon Horne PLLC in Little Rock, Arkansas. He practices with an emphasis on corporate, commercial, banking, mergers, acquisitions, divestitures, complex banking products, bank holding company formations, de novo bank formations, and securities matters. Mr. Binns is available to meet with your organization or group relating to shareholder issues, increasing capital, regulatory and compliance, areas of profitability, marketing, and management responsibilities. He is a frequent speaker on matters regarding mergers, acquisitions, commercial law, securities, and banking law. Prior to entering the private practice of law, Mr. Binns was an accountant practicing with an emphasis on securities regulation and regulatory compliance. He has extensive experience representing organizations before federal and state banking and securities agencies. In addition to his business accomplishments, Mr. Binns is the 46th person in the world to be certified by the 50 States Marathon Club, a nonprofit organization dedicated

to the promotion of health and fitness, as having run a marathon (26.2 miles) in each of the 50 states in the United States.

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