



# BANKING LEGISLATION & POLICY

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## Recent Developments

### **OCC Orders a Bank Involved in a Late-Day Trading Scheme to Dissolve**

The Office of the Comptroller of the Currency (OCC) issued an order on November 25 requiring Security Trust Company, Phoenix, Arizona, to prepare to dissolve by

March 31, 2004. The bank had allegedly facilitated a late-day trading scheme between Canary Capital Partners LLC and Canary Investment Management LLC. The OCC issued an order in October requiring Security Trust to cease and desist from assisting or participating in a number

of activities involving late trading or market timing. The order also prohibited the bank from paying any dividends or making any other capital distributions, and from paying bonuses, commissions, severance benefits, golden parachutes, and excessive compensation without the OCC's approval. In the modified order, the OCC required the bank to take steps to ensure that the trust accounts and investment plans it administers experience the least possible disruption when the bank dissolves. The bank's assets were frozen previously, and they will be used to protect the interests of the bank's client investment funds and trust account holders.

### **President George W. Bush Signs the Fair and Accurate Credit Transactions Act**

On December 4 President George W. Bush signed the Fair and Accurate Credit Transactions Act, making it Public Law No. 108-159. The act makes permanent

provisions of the Fair Credit Reporting Act (FCRA) that prevented states from enforcing new credit reporting laws that were more restrictive than the FCRA. In addition, the bill addresses the problem of identity theft and offers a series of new protections for consumers. The bill also includes provisions that deal with information sharing among affiliates, consumers' access to free credit reports, and the sharing of medical information (see *Summary of Federal Legislation* section). In the next year, the Federal Trade Commission (FTC) and the federal banking regulators will be issuing many regulations to implement the act. At the end of the quarter the FTC and the Board of Governors of the Federal Reserve System issued an interim final rule and a notice of proposed rulemaking to establish effective dates for provisions of the act for which effective dates were not specified (see *Summary of Federal Regulations* section).

## **SUMMARY OF FEDERAL LEGISLATION**

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### *New Legislation*

**1. Predatory Lending Consumer Protection Act of 2003 (S. 1928).** Introduced by Sen. Sarbanes (D-MD) on November 21, 2003.

Status: Referred to the Senate Committee on Banking, Housing, and Urban Affairs.

This bill aims to protect consumers against predatory lending practices associated with high-cost mortgage transactions. High-cost mortgage transactions are defined by this bill as either: 1) a first mortgage credit transaction with an annual percentage rate (APR) that exceeds the rate on Treasury securities with comparable maturities by more than six percentage points; 2) a junior mortgage credit transaction with an APR that exceeds the rate on Treasury securities with comparable maturities by more than eight percentage points; or 3) a transaction that charges total points and fees that are either more than \$1,000 or more than 5 percent of the total loan amount, whichever is greater.

Creditors will be required to assess a consumer's ability to repay the loan on a case-by-case basis, evaluating the consumer's income, other obligations, employment status, and other financial resources. The creditor cannot just rely on the information provided by the consumer and will be required to verify independently that the consumer will be able to make the scheduled payments.

Creditors making high-cost mortgage loans will be required to make additional disclosures to consumers. The disclosures will point out that the interest rate on the

loan is much higher than what most people pay, that lower interest rates might be available, and that even though the loan may have lower monthly payments than other loans, if there are more monthly payments, the debtor might be paying more in the end. Creditors will also be required to give customers a written statement that encourages them to seek credit counseling. The statement should contain the names, addresses, and phone numbers of Department of Housing and Urban Development-approved counseling agencies.

The bill defines a prepayment penalty as a monetary penalty imposed on a consumer for paying all or part of the principal before the date on which the principal is due. Lenders would be permitted to charge a prepayment penalty on a high-cost mortgage only within the first 24 months of the loan. If the debtor financed points and fees exceeding more than 3 percent of the total loan amount, prepayment penalties may never be assessed. The bill also bans all balloon payments in high-cost mortgage credit transactions. A balloon payment is a large payment due at the end of a loan term to pay off the loan's principal.

Lenders will be prohibited from charging a consumer for modifying or renewing a high-cost mortgage loan or for deferring payments. Exceptions exist when the change benefits the consumer, the charge does not exceed 0.5 percent of the total loan amount, or when the total loan amount is less than \$60,000 and the charge does not exceed \$300. Also, high-cost mortgage loan terms may not require borrowers to resolve disputes via arbitration.

**2. Interest on Business Checking Act of 2003 (S. 1967).** Introduced by Sen. Hagel (R-NE) on November 25, 2003.

Status: Referred to the Senate Committee on Banking, Housing, and Urban Affairs.

This bill would permit banks and savings associations to pay interest on business checking accounts. Businesses will also be allowed to make up to 24 transfers each month from interest-bearing transaction accounts into other accounts held by the same owner at the same bank. In addition, each Federal Reserve Bank will be required to pay interest on reserves that are held by depository institutions at a Federal Reserve Bank. Interest will be paid at least once each calendar quarter at an interest rate no greater than the general level of short-term interest rates. The bill also gives the Federal Reserve Board greater flexibility in setting reserve requirements.

**3. Preserving Independence of Financial Institution Examinations Act of 2003. (S. 1947)** Introduced by Sen. Leahy (D-VT) on November 24, 2003.

Status: Referred to the House Committee on the Judiciary.

This bill would restrict financial institutions from offering credit to financial examiners assigned to monitor the institution. This bill does not apply to credit unions, Federal Reserve Banks, federal home loan banks, or depository institution holding companies. This bill does not preclude financial institutions from offering credit card accounts or home mortgage loans to examiners as long as the terms of these loans are the same as those of loans offered to all other customers. Bank employees, officers, or directors who violate this law will be fined and imprisoned for up to a year. Examiners who accept a prohibited offer of credit will be fined and imprisoned for up to a year, fined again a sum equal to the amount of the loan, and disqualified from being an examiner.

*Pending Legislation*

**1. FHA Multifamily Loan Limit Adjustment Act of 2003 (H.R. 1985).** Introduced by Rep. Miller (R-CA) on May 6, 2003.

Status: Passed the House. Referred to the Senate Committee on Banking, Housing, and Urban Affairs.

This bill will increase Federal Housing Administration (FHA)-insured mortgage loan limits for multi-family properties in high-cost areas. Currently, the FHA can exceed the base loan limits by 110 percent for these properties. This bill will increase the limit to 170 percent.

**2 Mutual Funds Integrity and Fee Transparency Act of 2003 (H.R. 2420).** Introduced by Rep. Baker (R-LA) on June 11, 2003.

Status: Passed the House. Referred to the Senate Committee on Banking, Housing, and Urban Affairs.

This bill will require the Securities and Exchange Commission to revise regulations to improve companies' disclosures about mutual funds. The new disclosures should include: 1) how much of a company's operating expenses are borne by shareholders; 2) the method used to determine the portfolio manager's compensation and ownership interest in the company; 3) the portfolio's turnover rate (displayed in such a way that it can be compared easily to that of other investment companies); 4) a description of the implications of high turnover rates in terms of a portfolio's transaction costs and performance; and 5) a description of the company's policy for paying brokers' and dealers' commissions. Companies will be required to make the disclosures in quarterly (or other periodic) shareholder reports. Investment companies will also be required to issue a statement informing shareholders that they have paid fees on their investments and explaining how to get more information about the fees.

Investment advisers will be required to report to the investment company's board of directors annually about "soft-dollar arrangements." The report should include information about payments made to promote the sale of the company's shares and services provided to the company by brokers or dealers in exchange for directing business to the broker or dealer. Brokers will be required to reveal any financial incentives they might have to sell a particular fund. The bill will require that two-thirds of a fund's board of directors be independent, and the board will review the investment adviser's annual report and ensure the fund's integrity. In addition, the board's votes will be made public. Investment companies will also be required to establish a code of ethics and disclose the code to shareholders in quarterly reports. Companies will appoint a chief compliance officer, to be approved by the board, who will ensure compliance with the code.

Investment advisers will be prohibited from managing SEC-registered mutual funds and hedge funds while also managing unregistered funds at the same time. The bill will also prohibit short-term trading in an investment company's fund by people affiliated with the investment company and prohibit after-hours trading at a price determined before the trade was executed.

*Enacted Legislation*

**1 Check Clearing for the 21st Century Act (H.R. 1474).** Introduced by Rep. Hart (R-PA) on March 27, 2003.

Status: Signed into law by President George W. Bush on October 10 and became Public Law No. 108-100.

This law allows banks to transmit electronic checks for payments instead of using paper checks. To be a valid substitute, an electronic check must have all of the information on the front and back of the original check and state that it

is a copy. This act will not require banks to use electronic checks instead of paper checks. For more information, see *Banking Legislation and Policy*, January-March 2003.

A controversial provision was added to the bill just prior to its enactment. The provision requires the Board of Governors of the Federal Reserve System (the Board) to include in its next 10 annual reports the operating costs and imputed revenues associated with transporting commercial checks between Federal Reserve Bank check processing centers.

## **2. Fair and Accurate Credit Transactions Act of 2003 (H.R. 2622).** Introduced by Rep. Bachus (R-AL) on June 26, 2003.

Status: Signed into law by President George W. Bush on December 4 and became Public Law No. 108-159.

This law permanently extends provisions of the Fair Credit Reporting Act (FCRA) and offers consumers a series of protections against identity theft. The existing FCRA contained provisions preventing states from enforcing credit reporting laws that were more restrictive than the FCRA. Those provisions were set to expire on January 1, 2004. This law removes the sunset provision, and states are now permanently prohibited from enforcing laws stricter than the FCRA that regulate: 1) the prescreening of consumer reports; 2) the time within which credit bureaus must respond to consumer disputes; 3) the duties of users of credit bureau information; 4) the information contained in credit reports; 5) the duties of information providers; and 6) the exchange of credit information between affiliates. The act did not specifically set an effective date for this provision, and federal regulators scrambled to establish one before the end of the year. The regulators set the effective date of these preemptions to December 31, 2003 (see *Summary of Federal Regulations* section).

The act also establishes several other preemptions concerning: 1) how often consumers can obtain free copies of their credit reports; 2) the disclosure of credit scores used for credit decisions; 3) consumers' opt-out process for exchanges of information (that would otherwise be treated as a credit report) among affiliates; and 4) the duty of lenders to notify consumers that information contained in their credit reports resulted in their receiving credit on less than the most favorable terms.

**Identity Theft:** Other provisions of the bill address the problem of identity theft. Consumers will be able to initiate fraud alerts when they suspect they are a victim of fraud or identity theft. They can do this by contacting one of the national consumer reporting agencies (CRAs), which will be required to include the alert in the consumer's file, provide the consumer with a free credit report, and alert all of the other national CRAs. For at least 90 days after the alert is made, the CRAs will also include the alert with any credit score generated for the individual. Consumers can request an extended fraud alert, which would require

CRAs to include the alert with all credit scores generated for the consumer for seven years following the alert. Lenders may not extend lines of credit (other than open-ended credit card accounts), increase credit limits, or issue additional credit cards to consumers who have a fraud alert attached to their credit scores unless the issuers take reasonable means to verify that they know the true identity of the requester.

Financial regulators will be required to develop rules to help banks and creditors recognize or prevent potential cases of identity theft. One rule will prohibit credit card issuers from sending an additional card to a consumer who has also requested a change of address within the same 30-day period, unless the issuer notifies the cardholder of those requests at his or her former address. Another rule permits consumers to request that CRAs exclude from their credit reports the first five digits of their social security numbers. In addition, businesses that accept credit and debit cards will be prohibited from electronically printing more than the last five digits of a card number or the card's expiration date on the cardholder's receipt.

CRAs will be required to block any information from an individual's file that the individual claims was a result of identity theft. To make a claim, a consumer will file a police report and submit an affidavit of identity theft. The CRA will then be required to notify its source that the information could be the result of identity theft and that an identity theft report has been filed. Resellers of information are exempted from this provision if they are not currently reselling a file that contains the information that the consumer wants blocked. However, if the reseller does have this file, the reseller will be prohibited from redistributing this information. Consumers will be permitted to dispute credit information directly with the furnishers of information, and if a furnisher of information has reason to believe that information might have resulted from identity theft, the furnisher will be prohibited from later sending it to a CRA.

**Credit Reports and Scores:** The act requires lenders to notify consumers within 30 days of providing negative information about the consumer to a CRA. Consumers will also be entitled to receive from a CRA one free credit report in a 12-month period. The CRA will be required to provide the report within 15 days of the consumer's requesting it. If the consumer requests a reinvestigation after reviewing the report, the CRA will be required to comply within 45 days of receiving the request. CRAs will be prohibited from restructuring as another business organization to circumvent this law. Consumers may request a credit score instead of or in addition to a credit report, and CRAs will be required to provide the credit score (for a reasonable fee) and make several disclosures, including the range of scores that could have been derived using the same model and all of the factors that adversely affected the score.

If a consumer's credit score causes a credit issuer to extend credit at terms less favorable than what might

have been offered otherwise, the credit issuer is required to notify the consumer orally, electronically, or in writing. The lender will notify the consumer either during the application for credit or when the application is approved. The notice should include: 1) a statement informing the consumer that the terms offered to the consumer are based on information from a consumer report; 2) the name of the CRA that furnished the report; 3) a statement informing the consumer that he or she may obtain a copy of his or her report from that CRA; and 4) the contact information specified by that CRA for obtaining consumer reports.

**Affiliate Sharing:** Information that is ordinarily considered a credit report is not subject to the FCRA's limitations on disclosure when it is shared with affiliates. Credit report information (other than medical information) may be shared among affiliates in order to make offers, as long as consumers are given the opportunity to opt out of receiving solicitations about products or services offered by an affiliate of a company with which the consumer does business. The opt-out period will last for five years, at which time the consumer must be notified that the period has expired and be given the chance to renew it. This does not apply to affiliates with which the consumer has a pre-existing business relationship. Examples of pre-existing relationships include financial contracts currently in effect, a transaction between a consumer and a firm that occurred within the last 18 months, or an inquiry initiated by the consumer within the last three months.

**Medical Information:** The law also protects the confidentiality of consumers' private medical information. The act defines medical information as information related to a person's past, present, or future physical, mental, or behavioral health; the provision of health care to an individual; or the payment for such care. Unless a consumer expressly permits it, medical information cannot be furnished in connection with insurance transactions or for employment purposes. The law also places restrictions on businesses sharing medical information with affiliates. Medical information may be shared with affiliates for transactions or debts arising from medical treatment as long as this information does not convey the nature of the product or services obtained. Providers of medical services and products that share information with CRAs are required to notify the CRAs that they are

engaged in this line of business. The CRAs will then code their information so that medical information is not inadvertently disclosed. The FTC will issue guidelines regarding medical information coding.

**Employee Screening:** The act amends the FCRA to permit employers to obtain credit reports on their existing workers, without obtaining their prior consent, for the purpose of investigating suspected employee misconduct or to comply with federal, state, or local law, or rules promulgated by a self-regulatory organization. If the employer takes an adverse action against the employee on the basis of information obtained in a credit report, it must inform the employee that the reason for the action was due, at least in part, to information contained in his or her credit report.

### **3. American Dream Downpayment Act (S. 811).** Introduced by Sen. Allard (R-CO) on March 13, 2003.

Status: Signed into law by President George W. Bush on December 16 and became Public Law No. 108-186.  
Related Bills: H.R. 1276, H.R. 1614

This bill will permit the Secretary of the Department of Housing and Urban Development to grant \$200 million for qualifying families to use as down-payment assistance in fiscal years 2004 through 2007. The secretary will give the grants to eligible jurisdictions that apply for the money, and the jurisdiction will provide the money to qualifying families in the jurisdiction. To receive a grant, a jurisdiction must describe how the grant money will be used. The jurisdiction will also have to show how it will reach out to residents and tenants of public housing and mobile home communities to ensure that the grant money will provide down-payment assistance to these residents. A family may be eligible for down-payment assistance if it is a low-income family and a first-time homebuyer. Up to 20 percent of the grant funds can be awarded to eligible families for home repairs. Assistance can be awarded for either \$10,000 or 6 percent of the purchase price of a single family housing unit, whichever is greater. The secretary will develop a formula to help decide how to allocate the funds.

## **SUMMARY OF FEDERAL REGULATIONS**

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### **Board of Governors of the Federal Reserve System**

*Basel Accord (10/27)*

The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift

Supervision (together, "the agencies") are proposing to change the internal ratings-based (IRB) approach to evaluating credit risk in the New Basel Capital Accord. The new accord implements international bank capital requirements (see *Banking Legislation and Policy*, July-September 2003).

The agencies issued an advanced notice of proposed rulemaking in August that addressed the framework for implementing the new accord in the United States. In that notice, the agencies proposed to require users of the IRB approach to hold capital for expected and unexpected losses when evaluating credit risk. However, after receiving public comments, the agencies are now proposing to separate expected losses and unexpected losses within the IRB approach. Under the new framework, banks would not include expected losses in their measurements of risk-weighted assets. The IRB capital requirement will be derived solely from the unexpected losses portion of the IRB calculations.

Expected losses will be subject to a separate treatment under which banks will be required to make provisions for the expected losses and compare the provisions with the IRB measurement for expected losses. If a bank's provisions are found to be less than the IRB measurement of its expected losses, the bank will be said to be experiencing a shortfall. On the other hand, if a bank's IRB measurement of expected losses is greater than its provisions, the bank will be experiencing an excess. Shortfall amounts would be deducted from the bank's capital, with 50 percent being taken from tier one capital and 50 percent from tier two capital. Excess amounts can be considered an eligible element of tier two capital, as long as it doesn't account for more than 20 percent of tier two capital.

Comments on this proposed modification were due December 31, 2003. More information can be found on the Board's web site at [www.federalreserve.gov/boarddocs/press/bcreg/2003/20031030/default.htm](http://www.federalreserve.gov/boarddocs/press/bcreg/2003/20031030/default.htm).

#### *Fair and Accurate Credit Transactions (12/16)*

The Board of Governors of the Federal Reserve System and the Federal Trade Commission (the agencies) issued a joint notice of proposed rulemaking and joint interim final rules to establish effective dates for provisions of the recently enacted Fair and Accurate Credit Transactions Act of 2003 (see *Summary of Federal Legislation*). In the joint interim final rules, the agencies established December 31, 2003, as the effective date for provisions of the act that govern the relationship between the Fair Credit Reporting Act (FCRA) and state laws. The FCRA contains provisions that prevent states from enforcing certain credit reporting laws that are more restrictive than the FCRA, but those provisions were set to expire on January 1. By enacting the FACT Act, Congress removed the sunset provision but did not give an effective date. Therefore, the agencies established December 31 as the effective date.

In the joint notice of proposed rulemaking, the agencies established March 31, 2004, as the effective date for all other provisions of the act that do not contain specific effective dates. The agencies also established December 1, 2004, as the effective date for provisions of the act that will require changes in systems, disclosure forms, or practices.

Comments on the joint interim final rule and notice

of proposed rulemaking were due January 12, 2004. For more information, see 68 *Federal Register*, pp. 74467-9 and 74529-32, respectively.

#### *Substitute Checks (12/22)*

The Board of Governors of the Federal Reserve System (the Board) issued a proposed rule to add a new subpart to Regulation CC, which governs the availability of funds deposited in checking accounts and the collection and return of checks. The revisions would accommodate the recently enacted Check Clearing for the 21st Century Act (see *Summary of Federal Legislation*) by making the regulation applicable to substitute checks. The new subpart will outline endorsement standards for substitute checks, requirements that a substitute check must meet to be the legal equivalent of an original check, duties of reconverting banks (a bank that creates the substitute check or, if the substitute check was created by an entity other than a bank, the first bank to transfer it), the warranties and indemnity associated with substitute checks, and consumers' and banks' procedures for expedited recredit.

The proposed rule defines new places on substitute checks where reconverting banks must endorse the substitute. The rule also requires all endorsements on substitute checks to be printed in black ink. The Board proposes to permit but not require a depository bank to include its name and location in its substitute check endorsement. A paying bank that is also a reconverting bank will be required to identify itself as such by placing its nine-digit routing number and an asterisk at the end of each number on the back of the substitute check. The Board also clarified that reconverting banks will assume liability for losses related to substitute checks' being used instead of original checks.

Reconverting banks are responsible for preserving all previously applied endorsements, but they are not responsible for obtaining endorsements that should have been applied but were not. A reconverting bank's endorsement and identification will be set off by asterisks and a truncating bank's identification will be set off by brackets.

Substitute checks will be considered to be the legal equivalent of original checks as long as the bank providing the substitute makes two warranties. First, the bank must verify that the substitute checks meet the requirement by bearing the legal equivalence legend and by accurately representing the information on the front and back of the original check. Second, no depository bank, drawee, drawer, or endorser will be asked to make payment based on a check that they have already paid.

The rule provides that indemnity covers losses suffered directly owing to the receipt of a substitute check instead of the original check. The amount of indemnity is the amount of any loss, including interest and fees, caused by a breach of the substitute check warranties. Indemnity can be reduced in proportion to the amount of the claiming party's negligence or bad faith. The claiming party must also comply with an indemnifying bank's reasonable

requests for assistance with respect to the claim.

A consumer may make a claim for expedited recredit for several reasons, including a mischarge to his or her account due to the use of a substitute check and a resulting loss. The consumer will have 40 days after the bank mails his or her periodic statement to file a claim; however, a bank will be required to make exceptions when the consumer is physically unable to file within that period. The claim must include a description of the occurrence, the reason for any loss and the amount of loss suffered, the reason an original check must be presented to settle the claim, and enough information to help the bank investigate the claim. Consumers must make claims in writing and will be permitted, but not required, to make claims electronically.

The indemnifying bank will be required to recredit the consumer by the end of the banking day after it determines the claim is valid or by the end of the 10th business day after the consumer made the claim, whichever is sooner, provided the amount of recredit does not exceed \$2,500. For amounts exceeding \$2,500, banks will be required to recredit the consumer within 45 calendar days. If the consumer's account is new or frequently overdrawn, or if the bank suspects fraud, the bank can further delay the recredit.

Procedures for bank expedited recredit claims are very similar to those for consumer recredit claims. However, a claimant bank may bring a claim against an indemnifying bank within 120 days of the transaction that gave rise to the claim, and the indemnifying bank must respond within 10 days of receiving the claim.

Comments on this proposed rule are due March 14, 2004. For more information, see 68 *Federal Register*, pp. 1469-1501.

#### *Disclosures (12/10)*

The Board of Governors of the Federal Reserve System (the Board) issued proposed rules to amend Regulations B, E, M, Z, and DD as they pertain to disclosures under the Equal Credit Opportunity Act, Electronic Fund Transfers Act, Consumer Leasing Act, Truth in Lending Act, and Truth in Savings Act, respectively. The proposed rule will make uniform the Board's "clear and conspicuous" standard for disclosures required under the five consumer protection regulations. For Regulation B, E, M, Z, and DD disclosures, the Board is proposing to define clear and conspicuous to mean "reasonably understandable and designed to call attention to the nature and significance of the information in the disclosure." The Board is also proposing to adopt guidance regarding type sizes that meet the clear and conspicuous standard and type sizes that would be too small. However, the Board is not proposing to add specific type-size requirements.

In its proposal to amend Regulation Z, the Board also proposed to specify that the word "amount," where used in disclosure requirements, refers to a numerical amount. This interpretation comes closely after a judicial ruling

(*Carmichael v. The Payment Center Inc.*) that an amount does not have to be a specific dollar figure but can be given as a narrative description of an amount (see *Banking Legislation and Policy*, July-September 2003).

Comments on these proposed rules were due by January 30, 2004. For more information, see 68 *Federal Register*, pp. 68786-802.

#### *Nonfinancial Data (12/9)*

The Board of Governors of the Federal Reserve System (the Board) issued this final regulation to expand bank holding companies' ability to process, store, and transmit nonfinancial data in connection with their financial data processing, storage, and transmission activities. Regulation Y currently permits bank holding companies (BHCs), including financial holding companies (FHCs), to provide data processing services if the data to be processed are financial, banking, or economic in nature. This allows BHCs to provide customers with a range of services, including bill preparation and bill payment, tax planning, and loan processing. Regulation Y also currently permits BHCs engaged in financial data processing activities to process nonfinancial data as long as the annual revenue derived from nonfinancial data processing does not account for more than 30 percent of the company's total annual data processing revenues. In the final regulation, the Board increased this limit to 49 percent.

Previously the Board requested comment on whether to adopt a rule permitting FHCs to invest in companies that provide: 1) data storage services for nonfinancial data without regard to the revenue limitations discussed above, as long as the company provided data storage services for some financial data; 2) data processing services for nonfinancial data, as long as the company derived at least 20 percent of its total revenues from processing financial data, processing data for depository institutions, or the sale of other financial products or services; or 3) electronic information portal services. The Board concluded that because of the varying kinds of potential proposals, it was premature to make a final rule regarding investments in these types of companies. Instead, the Board will review proposals to invest in these companies on a case-by-case basis.

This final rule became effective January 8, 2004. For more information, see 68 *Federal Register*, pp. 68493-9.

#### *Cash Policy (10/14)*

The Board of Governors of the Federal Reserve System (the Board) is proposing a new currency recirculation plan to encourage banks to recirculate cash to their customers instead of relying on the Federal Reserve Banks to supply new notes. Reserve Banks remove unfit notes (meaning they are unacceptable for circulation) from circulation and accept deposits of fit notes when banks have surpluses. Conversely, when banks have shortages of fit notes, the Reserve Banks provide currency. Recently, however, banks with large cash businesses have been ordering cur-

rency directly from Reserve Banks to fill their customers' orders, and they have been depositing notes received from customers directly with the Reserve Banks. This practice is known as cross-shipping, which the Board prohibits. The Board's policy is that if a bank deposits fit currency with the Reserve Banks, the bank cannot order currency of the same denomination within five days before or after making the deposit. However, the Board does not currently have a clear way to enforce this policy. The Board is proposing to introduce two elements to its policy to help return banks to their original role of recirculating cash among customers.

First, the Board is proposing to institute a custodial inventory program to provide an incentive to banks to hold currency in their vaults to meet customer demand. A custodial inventory is currency owned by a Reserve Bank but located within a bank's secured facility and segregated from the bank's currency. To be eligible to hold a custodial inventory, a bank must be capable of recirculating substantial amounts of currency in the \$5 through \$20 denominations. Banks will not be able to transfer more than 25 percent of the value of their total holdings in the \$5 to \$20 denominations to a custodial inventory. The Board has authorized this program to begin in 2004.

The Board also proposes to begin assessing a recirculation fee on bundles of cross-shipped currency (a bundle is a standard package of 1,000 notes). Banks will be required to pay between \$5 and \$6 per bundle of notes it cross ships. The fee will not be assessed when notes are unfit or when a bank is depositing a surplus of fit currency. The Board estimates that the recirculation fee would affect 100 of the Reserve Banks' largest cash customers. One dollar, \$50, and \$100 notes would be excluded from the recirculation policy. Banks will not pay a recirculation fee for the first 1,000 bundles of cross-shipped currency each quarter.

Comments on this proposal were due by January 15, 2004. For more information, see 68 *Federal Register*, pp. 59176-82.

#### *Commodity Trading (10/3)*

Citigroup Inc., a financial holding company (FHC), requested permission from the Board of Governors of the Federal Reserve System (the Board) to retain all of the voting shares of Phibro, a company that engages in a variety of commodity-related activities, including trading in physical commodities. The Board permits FHCs to engage in commodity dealing when the commodity is an item that state member banks are permitted to own or when the FHC takes and makes delivery of the commodity on an instantaneous, pass-through basis. Beyond these circumstances, FHCs have not been permitted to take or make delivery of nonfinancial commodities. Under the Gramm-Leach-Bliley Act, the Board can make other exceptions for activities that the Board determines are financial in nature or complementary to financial activities.

In this case, the Board determined that these activi-

ties are complementary to financial activities and therefore permissible as long as safety and soundness concerns are considered. The Board also decided that approval of the proposal would benefit Citigroup's customers by allowing Citigroup to offer a full range of commodity-related services. In addition, Citigroup will be able to compete more effectively with companies that do not have similar regulatory restrictions. For these reasons, the Board approved Citigroup's proposal, conditioned on Citigroup's compliance with a number of commitments, including ensuring safe transport and storage of the commodities, possessing proper insurance, and performing safety tests. The Board limited Citigroup's commodity trading activities to no more than 5 percent of Citigroup's tier one capital.

For more information, see the Board's press release at [www.federalreserve.gov/boarddocs/press/orders/2003/20031002/default.htm](http://www.federalreserve.gov/boarddocs/press/orders/2003/20031002/default.htm).

#### **Office of Thrift Supervision**

##### *Federal Preemption (10/6)*

The Office of Thrift Supervision issued a legal opinion that federal law preempts a New York law requiring savings associations to pay interest on escrow accounts established in connection with mortgage loan agreements. In the specific mortgage document discussed, the terms included a choice of law provision that referenced both federal law and New York law. The OTS determined that by referencing both laws, the document did not establish a contractual agreement to pay interest on escrow accounts. "The reference to state law does not nullify or negate the preemptive effect of federal law," the OTS said.

##### *Affiliate Transactions (10/7)*

The Office of Thrift Supervision (OTS) issued a final rule to conform its regulations for transactions between savings associations and their affiliates with similar regulations issued by the Board of Governors of the Federal Reserve System (the Board). In December 2002, the Board issued Regulation W, which implements sections 23A and 23B of the Federal Reserve Act. The rule governs transactions between Federal Reserve System member banks and their affiliates, setting limits for covered transactions. Covered transactions include loans or extensions of credit to an affiliate, purchases of or investments in securities issued by an affiliate, purchases of assets from an affiliate, acceptance of securities issued by an affiliate as collateral security for a loan or extension of credit to any person or company, and issuance of a guarantee, acceptance, or letter of credit on behalf of an affiliate.

The Board limited the amount of covered transactions with any single affiliate to no more than 10 percent of the member bank's capital stock and surplus. Further, covered transactions with all affiliates are limited to no more than 20 percent of the member bank's capital stock and surplus. All covered transactions must be safe and sound, and member banks are prohibited from purchasing

low quality assets from an affiliate. Extensions of credit to a member bank's affiliate must be collateralized. Transactions between member banks and affiliates must occur on terms that are as favorable as those for transactions with unaffiliated companies.

The Home Owners Loan Act stipulates that savings associations' transactions with affiliates should be governed the same as transactions between Federal Reserve System member banks and their affiliates. The OTS issued this proposed rule so that savings associations are subject to the same restrictions as member banks. The OTS also added two other restrictions that apply specifically to savings associations. First, savings associations are prohibited from making a loan or extending credit to an affiliate unless the affiliate engages only in activities in which a bank holding company may participate. Second, thrifts are prohibited from purchasing or investing in securities issued by an affiliate, except for purchasing shares of an affiliate's subsidiary.

This final rule became effective November 6, 2003. For more information, see 68 *Federal Register*, pp. 57790-9.

## The Securities and Exchange Commission

### *Late Trading (12/3)*

The Securities and Exchange Commission (SEC) issued a proposed rule to help curb late-day trading in investment company fund shares. Currently, trades made past 4 pm are not permitted to receive that day's price. However, because investors can make trade orders until 4 pm, fund intermediaries often don't submit them to the fund until mid-evening. This process allows the rule to be circumvented, and some investors are able to make late trades. Therefore, the SEC is proposing to require fund intermediaries, such as banks, broker-dealers, and administrators of retirement plans, to submit trade orders to the fund before 4 pm in order for their customers to receive that day's price. Orders received later would receive the next day's price. To satisfy the requirement, an order must be received by the fund itself, the fund's designated transfer agent, or a clearing agency registered with the SEC. Exceptions would be made if orders could not be transmitted because of a power failure, hurricane, or other emergency.

## SUMMARY OF JUDICIAL DEVELOPMENTS

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### **Sixth Circuit Court of Appeals Rejects Tying Claims**

The U.S. Court of Appeals for the Sixth Circuit rejected tying claims alleging that a national bank extended a loan conditioned upon the borrower's purchasing stock in the bank's holding company (*Highland Capital Inc. v. Franklin National Bank*, No. 00-00832). In 1998 Highland Capital was controlled by its principal shareholder, Steve Morriss. Morriss, on behalf of Highland, approached an executive vice president for Franklin National Bank and expressed Highland's interest in obtaining stock in the bank's holding company, Franklin Financial Corporation. Soon after, Highland also sought a loan from the bank for \$610,000. The bank approved Highland's loan on November 10, 1998, and on the same day Highland deposited \$499,777 into a fund to purchase 69,400 shares of stock in the bank's holding company. In July 2000, Morriss lost control of Highland, and the new management alleged that the bank conditioned the loan on the stock purchase, thereby violating anti-tying provisions of the Bank Holding Company Act.

Highland offered as evidence that the loan did not adhere to the bank's typical lending policies (the bank did not require a written loan application, submission of the borrower's financial statement, or Morriss's personal guarantee). Highland also offered a banking expert's opinion that the loan should not have been made in the normal course of banking business. The bank offered in defense the affidavits of everyone involved in making the

loan, and all testified that Highland's stock purchase was not a requirement for obtaining the loan.

The court ruled that Highland would have had to show that the stock purchase was a mandatory condition or requirement of obtaining the loan, and Highland fell considerably short of proving the tying claim. The court said that "the procedure that led to the loan's approval, although perhaps out of the ordinary, did not demonstrate that a tying condition was imposed."

### **TILA and FDCPA Do Not Apply to Buyers of Delinquent Credit Card Accounts**

Nathan Neff and Robert Robb held delinquent credit card accounts years ago but thought their accounts had been settled. Then, years later, they discovered their accounts had been sold by their original issuers and had accumulated interest at a high rate. Neff and Robb brought suit against the account purchasers, Capital One and Capital Acquisitions and Management Company, charging violations of the Truth in Lending Act (TILA) and the Fair Debt Collection Practices Act (FDCPA). The plaintiffs alleged that the account purchasers failed to send statements or any other notification that would have alerted them to the still open accounts and the accruing interest charges. Further, the plaintiffs claimed that they had settled the accounts long ago. The U.S. Court of Appeals for the Seventh Circuit affirmed a district court's decision and ruled that the plaintiffs could not

seek relief under the TILA because the act does not apply to purchasers of credit accounts, since the purchasers were not “creditors” and did not extend the plaintiffs credit or allow them to incur debt. Also, the defendants, by purchasing the delinquent accounts, were not considered debt collectors and therefore were not subject to the FDCPA (*Neff v. Capital Acquisitions and Management Co., No. 02-4186*).

**Settlement Service Markups Do Not Violate RESPA If They Are Not Shared or Split**

The U.S. District Court for the Eastern District of Pennsylvania ruled that GMAC Mortgage Group Inc. did not violate the Real Estate Settlement Procedures Act (RESPA) by marking up fees for real estate settlement

services that were performed by third parties (*Santiago v. GMAC Mortgage Group Inc., No. 02-CV-04048*). The plaintiff, Francis Santiago, obtained a home mortgage from GMAC in January 2002. In connection with that mortgage, GMAC charged the plaintiff fees for settlement services, some of which were performed by third parties. GMAC charged the plaintiff what the third parties charged GMAC plus a markup, and the defendant retained the markup as a profit. The plaintiff alleges that by retaining this markup on services they did not perform, GMAC violated RESPA. The court ruled that RESPA prohibits markups when they are split between two parties. Since GMAC retained the overcharges and did not split them with the third parties, the court decided that GMAC did not violate RESPA and dismissed the charges.

**SUMMARY OF THIRD DISTRICT DEVELOPMENTS**

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**Pennsylvania**

Attorney General Mike Fisher has taken action against a Philadelphia-based mortgage and financial company that violated Pennsylvania’s do-not-call law, the Telemarketer Registration Act and Consumer Protection Law (TRACPL). The attorney general’s office announced through a press release that Liberty One Financial Inc. will pay \$13,000 in civil penalties after contacting 51 Pennsylvania residents

whose names were on the no-call list. According to a lawsuit, Liberty One had never purchased the state’s no-call registry and had never removed the no-call registrants from its calling data. In addition to paying civil penalties, the company has agreed to settle the lawsuit by immediately beginning to comply with the TRACPL and paying \$500 for Pennsylvania’s investigation costs.

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