



STATE OF CALIFORNIA

Department of Business Oversight

GOVERNOR **Gavin Newsom** • COMMISSIONER **Manuel P. Alvarez**

IN REPLY REFER TO:

FILE NO: PRO 1/20

March 4, 2020

INVITATION FOR COMMENTS ON PROPOSED RULEMAKING **PUBLIC BANKING LAW: DEFINITIONS AND APPLICATION REQUIREMENTS (PRO 1/20)**

BACKGROUND

On October 2, 2019, Governor Newsom signed AB 857 (Chapter 442, Statutes of 2019). The bill established a process for a local agency to apply for a public bank charter from the Department of Business Oversight. The bill specified that a local agency would need to meet the same general requirements and approval criteria as existing law requires of a private sector applicant for a banking license, including obtaining deposit insurance provided by the Federal Deposit Insurance Corporation. The bill authorized the Commissioner of Business Oversight to promulgate regulations for the purpose of carrying out the Commissioner's duties under the new law.

INVITATION FOR COMMENTS

To expedite the rulemaking process, the Commissioner intends to issue regulations in phases. The first phase will focus on general definitions and application requirements. This will enable the Commissioner to provide guidance on those areas which are most immediately relevant to stakeholders and enable implementation of the new law as timely as possible.

Subsequent rulemaking phases will address areas that are specific to licensees, which may need clarification in the context of public banks, including examination and reporting requirements and collateralization of local agency deposits.

By this Invitation for Comments, therefore, the Commissioner specifically seeks input from stakeholders in developing regulations to clarify certain definitions and the application requirements to organize and establish a public bank pursuant to Financial Code section 1020. The Commissioner has identified various areas where rulemaking may be appropriate, desirable, or necessary. The Commissioner has formulated questions to assist interested parties in providing input on rulemaking. However, stakeholders are not limited in providing comments to the areas the Commissioner has identified and may comment on any potential area for rulemaking.

POTENTIAL TOPICS FOR RULEMAKING

Definitions

AB 857 introduced terms relating to public banking; however, not all of the new terms are defined. Are additional definitions needed? For the terms already defined, are any definitions unclear; and if so, why?

The Commissioner has identified the following terms for which feedback is particularly solicited.

1. "Jurisdiction of the public bank" (Govt. Code, § 57604)

Does "jurisdiction" refer to a geographically-defined boundary? For example, for a county bank, does it mean the boundary of the county, or a "primary service area," or something else?

2. "Local financial institution" (Govt. Code, § 57604)

Does the term "local" refer to a geographically-defined boundary? Is "local" relative to the jurisdiction of the public bank? If "local" is not relative to the jurisdiction of the public bank, please provide the rationale for such an interpretation in light of the fact that private banks are generally limited to servicing specific geographic areas.

3. "Compete," "offered and provided," and "financial products and services" (Govt. Code, § 57604)

- a. AB 857 prohibits a public bank from competing with local financial institutions. It further mandates that if a public bank conducts "retail activities," as defined, it must be in partnership with local financial institutions. But a public bank can engage in retail activities by itself if those retail activities are not "offered or provided" by local financial institutions.
- b. The central issue will be whether a financial product or service "competes" with one offered by a local financial institution. That determination is dependent on how "financial products or services" is defined. Is it defined by the actual product or service level, or is it by the terms level? An example of actual product level is the offering of a checking account. An example of terms level is the offering of a checking account at a particular interest rate. Generally, competition in private commercial banking is viewed at the actual

product level, not the terms level. Therefore, for any interpretations offered in support of “terms level,” please provide a rationale which addresses why a public bank should be treated differently than a private commercial bank.

4. “Governing board of a public bank” and “designated alternate member” (Govt. Code, §§ 54956.97, 54956.98)
 - a. AB 857 uses the term “governing board of a public bank.” However, the term is not defined. Private banks do not have a “governing board.” They only have a board of directors. Should “governing board” have a meaning other than board of directors?
 - b. AB 857 provides that a “designated alternate member of the governing board” may attend a meeting of the governing board in lieu of the regularly-appointed member. Private banks do not have alternate board members. Non-board members are not permitted to attend board meetings. How should “designated alternate member” be defined?
5. “Organizers” (Fin. Code, § 1022; 10 C.C.R. § 10.151)

Financial Code section 1022 requires the Commissioner to examine the fitness of the organizers of a public bank. Existing regulations define “organizers” to mean “any person who, alone or in conjunction with one or more other persons, directly or indirectly takes the initiative in founding and organizing the business or enterprise of the corporation or other organization.”¹ In the context of a public bank, should “organizers” be defined as members of the governing body of the local agency tasked with deciding whether to move forward with an application for a public bank charter?

Application Requirements

AB 857 requires that a local agency seeking to establish a public bank must submit an application pursuant to Financial Code section 1020. When processing an application, the Commissioner is required to make determinations on several factors. Some factors in existing law may or may not be readily applicable to public banks. Are there any factors that are unclear or that should be modified in the context of public banks? If so, why?

The Commissioner has identified the following factors for which feedback is particularly solicited.

¹ Cal. Code Regs., tit. 10, § 10.151.

1. Character of organizers

- a. Under Financial Code section 1022, upon the filing of an application, the Commissioner is required to make a careful investigation and examination into, among other things, the character, reputation, and financial standing of the “organizers or incorporators” of the proposed bank. Existing regulations define “organizer” to mean “any person who, alone or in conjunction with one or more other persons, directly or indirectly takes the initiative in founding and organizing the business or enterprise of the corporation or other organization.”²
- b. When processing a private bank application, the Commissioner carefully examines the background of organizers who are integral to the establishment of a bank. These persons are central to creating the business plan, selecting management, finding directors, and determining the capitalization plan for the bank. In the context of a public bank, organizers perform the same types of functions as organizers of private banks, but they have the added responsibility of being fiduciaries of taxpayer funds. Assuming that organizers of public banks should be subject to the same scrutiny as organizers of private banks, is any clarification needed to existing law or regulations as they relate to the examination of organizers?

2. Reasonable promise of successful operation

Financial Code section 1023 requires, among other things, the Commissioner to ascertain that the proposed bank will have a reasonable promise of successful operation prior to approving an application for a license. How should this factor be interpreted in the context of a public bank?

3. Viability study

AB 857 requires a local agency to conduct a viability study, which must include several elements. The Commissioner is contemplating promulgating regulations for the following elements:

- i. Government Code section 57606, subdivision (a)(3) – estimate of initial amount of capital.

1. The Commissioner is considering requiring this element to include the information required in Section 10.3167 of the existing

² Cal. Code Regs., tit. 10, § 10.151.

banking regulations. Is there any reason that such information should not be required as part of the viability study?

2. Existing regulations require that, at the time when a subject institution commences business, the shareholders' equity be not less than 10% of the estimated total deposits of the subject institution as of the end of the third year of business.³ Is there any reason why this regulation should not be applicable to a public bank?

ii. Government Code section 57606, subdivision (a)(4) – financial projections. The Commissioner is considering requiring this element to also include the information required in Section 10.3168 of the existing banking regulations. Is there any reason that such information should not be required as part of the viability study?

iii. Government Code section 57606, subdivision (a)(6) – corporate governance. The Commissioner is considering requiring this element to include a proposed policy against self-dealing, insider transactions, and conflict of interests. Is there any reason that such information should not be required as part of the viability study?

4. Control persons

- a. AB 857 specifies that for the purposes of Financial Code section 1280, “any person or entity, including a local agency, that owns, controls, or holds an ownership interest in a public bank is not a bank holding company by reason of that ownership interest.”⁴ While AB 857 precludes a determination of a local agency owner being a bank holding company, it does not preclude the applicability of the control statutes in Financial Code section 1250 et seq. Section 1250 defines “control” to mean possession, direct or indirect, of the power: (1) to vote 25 percent or more of any class of the voting securities issued by a corporation or (2) to direct or cause the direction of the management and policies of a corporation.
- b. Existing regulations require a bank applicant to submit certain information about proposed control persons.⁵

³ Cal. Code Regs., tit. 10, § 10.3302.

⁴ Govt. Code, § 57605.

⁵ Cal. Code Regs., tit. 10, § 10.3162.

- c. Government Code section 57600 defines a “public bank” to mean a nonprofit corporation that is “wholly owned by a local agency, local agencies, or a joint powers authority.”
- d. Based on the statutory definition of “control,” a local agency would be a control person of a public bank. Existing regulations, therefore, would require the Commissioner to evaluate the proposed control person.⁶ Is there any reason why this regulation should not be applicable to a public bank?

5. Corporate structure

“Member” and “shareholder”

- i. AB 857 requires that a public bank be organized as either a nonprofit mutual benefit corporation or a nonprofit public benefit corporation.⁷
- ii. AB 857 added Section 1008 to the Financial Code. That section specifies that in the context of a public bank, references to “share, shareholder, or stockholder” means “membership or member in the public bank.”
- iii. Private banks have shareholders, not members. Private bank shareholders have an ownership in the bank that is directly proportional to the number of shares that they own. Private bank shareholders generally have the right to vote the shares they own. For example, a bank has 100 shares issued and outstanding. Shareholder A owns 40 shares, Shareholder B owns 25 shares, Shareholder C owns 20 shares, Shareholder D owns 10 shares and Shareholder E owns 5 shares. Therefore, Shareholder A has 40 votes, B has 25 votes, C has 20 votes, D has 10 votes, and E has 5 votes. Assuming Shareholders B, C, D, and E are not acting in concert, Shareholder A, through its voting power, will be able to control the bank and direct the management and policies of the bank because it is the largest shareholder. A private bank can add capital by issuing and selling more shares. Those shareholders that have “contributed” the most capital through the purchase of shares of a bank have more power to influence the management and policies of the bank.
- iv. A nonprofit corporation does not have shareholders, but it can have members. A nonprofit does not issue and sell shares to capitalize itself.

⁶ Cal. Code Regs., tit. 10, § 10.3162.

⁷ Govt. Code, § 57600, subd. (b)(1).

1. In the case of a nonprofit public benefit corporation, such a corporation may provide in its articles or bylaws that it shall have members or no members.⁸ In the case of a corporation which has no members, only approval of the board is required.⁹ If a corporation has members, the corporation can issue memberships having different rights, privileges, or restrictions (e.g., voting or nonvoting).¹⁰ A corporation may serve or assist persons who are not members within the meaning of Corporations Code section 5056.¹¹
 2. For a nonprofit mutual benefit corporation, the same rules generally apply. A corporation may provide in its articles or bylaws that it shall have members or no members.¹² In the case of a corporation which has no members, only approval of the board is required.¹³ If a corporation has members, the corporation can issue memberships having different rights, privileges, or restrictions (e.g., voting or nonvoting).¹⁴ A corporation may serve or assist persons who are not members within the meaning of Corporations Code section 5056.¹⁵
- v. If a public bank is organized with no members, how should be the term “shareholder” be applied to a public bank – given that AB 857 requires that references to “share, shareholder, or stockholder” means “membership or member in the public bank”? Or, should it be clarified that a public bank must be organized with members?
 - vi. Assume a local agency (“Local Agency A”) establishes a public bank as a nonprofit mutual benefit corporation with the option of having members. Local agencies (“Local Agencies B and C”) place deposits in the public bank and become members. Should such membership be restricted (e.g., non-voting)? What if instead of placing deposits in the public bank, Local Agencies B and C want to invest capital in the bank? How would that process work? Would Local Agencies B and C become members of the bank with an equal right to vote as Local Agency A – even though Local

⁸ Corp. Code, § 5310.

⁹ *Id.*

¹⁰ Corp. Code, § 5330.

¹¹ Corp. Code, § 5332.

¹² Corp. Code, § 7310.

¹³ *Id.*

¹⁴ Corp. Code, § 7330.

¹⁵ Corp. Code, § 7333.

Agency A may have contributed the most capital? Would that pose any acquisition of control issues for Local Agencies B and C because they would each have the power to vote 33.33 percent, respectively, of the three member votes?

- vii. Are there any concerns with a nonprofit ownership structure and the implications it has on the management of a public bank? Do the terms “member” or “shareholder,” or any other term related to the corporate organization of a public bank need clarification?

TIME FOR COMMENTS

The Commissioner invites interested parties to submit comments by **April 4, 2020**.

WHERE TO SUBMIT COMMENTS

You may submit comments by the following means:

Electronic Mail

Comments may be submitted electronically to regulations@dbo.ca.gov. Include “PRO 1/20” in the subject line with copy to Jennifer Rumberger at Jennifer.Rumberger@dbo.ca.gov.

U.S. Mail

Department of Business Oversight
Attn: Regulations Coordinator
1515 K Street, Suite 200
Sacramento, California 95814-4052

CONTACT PERSONS

Questions regarding this invitation for comments may be directed to Jennifer Rumberger, Senior Counsel for the Commissioner, at (415) 263-8528.