Federal Preemption And Bank Securities: Was The Commissioner's Order Really Necessary?

September 16, 2011 by Keith Paul Bishop

The August 2011 Monthly Bulletin published by the Department of Financial Institutions recently arrived in my inbox. One article caught my eye and caused me to revisit the status of state regulation of the offer and sale of bank securities in light of the National Securities Markets Improvement Act of 1996.

The Small Business Lending Fund

First, I want to give a little background on the DFI's article. It discusses the Small Business Lending Fund, or SBLF. Congress created the SBLF as part of the Small Business Jobs Act of 2010. It is a $30 billion fund that encourages lending to small businesses by providing capital to qualified community banks with assets of less than $10 billion. The U.S. Treasury provides capital by by purchasing Tier 1-qualifying preferred stock or equivalents. In May of this year, the Commissioner of Financial Institutions issued this order exempting the offer and sale of securities to the SBLF by California state chartered banks from the application and permit process normally associated with those sales. For those banks that had previously issued preferred stock under the Troubled Asset Relief Program (TARP), the Treasury is now proposing to accept new SBLF preferred shares in exchange for the TARP shares. The DFI article explains that consistent with the Commissioner's May 31 order, no additional approvals from the DFI is required.

Bank Securities and the CSL

Qualification with the Department of Corporations is not an issue for the offer and sale of securities issued or guaranteed by and representing a direct interest in or a direct obligation of a national bank or a bank or trust company incorporated under the laws of California. Cal. Corp. Code § 25100(c). Section 350 of the Financial Code makes the qualification requirements of the Corporate Securities Law of 1968 inapplicable to the offer or sale of securities issued by and representing an interest in or a direct obligation of a bank or trust company incorporated under the laws of California provided the securities are offered and sold pursuant to authorization of the DFI or are exempt from such authorization pursuant to specified provisions of the Financial Code. Section 691 of the Financial Code generally prohibits a California bank from offering or selling any security issued by it without a permit from the Commissioner of Financial Institutions.

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The National Securities Markets Improvement Act of 1996

However, we can't stop with either the CSL and the Financial Code. Section 18(b)(4)(C) of the Securities Act of 1933 (as added by the NSMIA) provides that a security is a covered security with respect to a transaction that is exempt pursuant to Section 3(a) of that act. Section 3(a)(2) of the Securities exempts, among many other types of securities, "any security issued or guaranteed by any bank". The term "bank" means any national, bank or banking institution organized under the laws of any state, territory or the District of Columbia, and supervised by a state or territorial commission or similar official. However, a security issued or guaranteed by a bank does not include any interest or participation in any collective trust fund maintained by a bank. The NSMIA prohibits the states from requiring qualification or registration of the offer and sale of a covered security. Section 25102.1 of the Corporations Code recognizes this federal preemption.

Was the Commissioner's Order Surplusage?

In light of federal preemption under the NSMIA, one has to ask whether California's Financial Code Section 691 has any continuing application and whether the Commissioner needed to issue his May 31 order exempting offers and sales to the SBLF.

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