Davis Polk

April 30, 2018

*By electronic submission to regs.comments@federalreserve.gov*

Ms. Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, D.C. 20551

**Re: Comment Letter on Proposed Amendments to Guidelines on an Internal Appeals Process for Institutions Wishing to Appeal an Adverse Material Supervisory Determination (Docket No. OP-1597)**

Ladies and Gentlemen:

Davis Polk & Wardwell LLP ("**Davis Polk**") welcomes the opportunity to comment on the notice issued by the Board of Governors of the Federal Reserve System (the "**Federal Reserve**" or the "**Board**") entitled *Internal Appeals Process for Material Supervisory Determinations and Policy Statement Regarding the Ombudsman for the Federal Reserve System*, published in the Federal Register on February 27, 2018 (the "**Proposal**").[1]

We commend the Board's Proposal and appreciate the Federal Reserve's willingness to revise its guidelines[2] based on its experience and feedback from supervised institutions.[3] The Proposal seeks to streamline the review process and to make it more efficient and transparent,[4] each laudable goals, and each consistent with broader themes supported by the leadership of the Federal Reserve.[5] At the same time, we believe that there are changes that should be made to the Proposal to support greater consistency in the appeals process and to better align the Federal Reserve's internal appeals process for material supervisory determinations with the principles of

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[1] Federal Reserve, *Internal Appeals Process for Material Supervisory Determinations and Policy Statement Regarding the Ombudsman for the Federal Reserve System*, 83 Fed. Reg. 8391 (Feb. 27, 2018) [hereinafter, Proposal].

[2] Federal Reserve, *Internal Appeals Process*, 60 Fed. Reg. 16470 (Mar. 30, 1995) (the "**1995 Guidelines**").

[3] Proposal at 8391.

[4] Id. at 8392.

[5] *See* Vice Chairman for Supervision Randal K. Quarles, Early Observations on Improving the Effectiveness of Post-Crisis Regulation (Jan. 19, 2018) ("I believe that we have an opportunity to improve the efficiency, transparency, and simplicity of regulation.").

transparency and accountability. By doing so, the Federal Reserve would build on actions it has already taken to strengthen the rule of law within the supervisory functions of the Federal Reserve.

While we understand, of course, that discretion is a necessary element of supervision, our concern is with discretion that is insufficiently accountable, involves legal interpretation more often than is realized and takes place behind the curtain of confidential supervisory information. In our view, this realm of secret legal interpretation should be more limited, transparent and accountable.[6]

The Proposal's key feature is simplifying the levels of review for appeals of material supervisory determinations from three levels to two levels.[7] This simplification is a welcome development. The Proposal would also establish guidelines for the appointment and functioning of an Initial Review Panel and a Final Review Panel.

The Initial Review Panel would be made up of three Reserve Bank employees with relevant experience to contribute to the review of the material supervisory determination.[8] In reviewing the appeal, the Initial Review Panel would be required to "make its own supervisory determination" and would not be permitted to "defer to the judgment of the Reserve Bank staff."[9] The Initial Review Panel's decision would be required to consider whether the material supervisory determination under review was supported by the record and was "consistent with" both the Board's policies and applicable laws and regulations.[10] The decision of the Initial Review Panel, as well as

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[6] *See* Margaret E. Tahyar, *Are Bank Examiners Special?*, The Clearing House Banking Perspectives 22 (Quarter 1 2018) (examining the current state of bank supervision and offering proposals to improve transparency, accountability and the rule of law).

[7] A material supervisory determination "includes, but is not limited to, any material determination relating to examination or inspection composite ratings, material examination or inspection component ratings, the adequacy of loan loss reserves and/or capital, significant loan classification, accounting interpretation, and Community Reinvestment Act (including component ratings) and consumer compliance rating." Proposal at 8392.

[8] Id. at 8393. In addition, members of the Initial Review Panel must not have been substantively involved in any material supervisory determination at issue in the appeal, must not directly or indirectly report to any person(s) who made the material supervisory determination, and must not be employed by the Reserve Bank that made the material supervisory determination. The Proposal does not require that the members of the Initial Review Panel be attorneys, but does direct that an attorney be appointed to advise the Initial Review Panel in the exercise of its responsibilities. Id.

[9] Id.

[10] Id.

the record of the appeal and any materials submitted in connection with any subsequent final review would be considered confidential supervisory information.[11]

Within fourteen days of receiving notice of an Initial Review Panel decision, a supervised institution could appeal that decision to a three-member Final Review Panel. At least two of the Final Review Panel's three members would be required to be Board employees, and at least one of those members would be required to be an officer of the Board at the level of associate director or higher.[12]

The Final Review Panel's standard of review would be deferential, requiring the Final Review Panel to determine only whether the Initial Review Panel's decision was "reasonable."[13] In making its determination, the Final Review Panel would be directed to consider, among other things, "whether there has been a clear error of judgment and whether the decision is supported by a preponderance of the evidence."[14] The Final Review Panel would be permitted to affirm the decision of the initial review panel even if it were possible to draw a contrary conclusion from the record presented on appeal.[15] The Federal Reserve would publish a copy of the Final Review Panel's decision, redacted to avoid disclosure of exempt information.[16]

The Federal Reserve has requested comment on all aspects of the Proposal, and while we offer here only two comments in support of the rule of law and increased transparency, we note our general agreement with those comments made in letters submitted to the Board by the American Bankers Association, The Clearing House Association L.L.C. and the Financial Services Roundtable.

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[11] Id.

[12] Id. at 8394. Members of the Final Review Panel must not be employed by the Reserve Bank that made the material supervisory determination, must not have been members of the Initial Review Panel, must not have been personally consulted regarding the issue being determined or provided guidance regarding how it should be resolved, and must not directly or indirectly report to the person(s) who made the material supervisory determination. The Board's General Counsel must appoint an attorney to advise the Final Review Panel in the exercise of its responsibilities. Id.

[13] Id.

[14] Id.

[15] Id.

[16] Id.

## I. The Final Review Panel's Standard of Review for Questions of Law Should be De Novo

The 1995 Guidelines were put in place to implement Section 309 of the Riegle Community Development and Regulatory Improvement Act of 1994 ("**Riegle Act**").[17] Congress determined that Section 309 was necessary because "material differences in examiner determinations have the potential to result in unfair differences in regulatory treatment of institutions."[18]

Under the 1995 Guidelines, each Reserve Bank is permitted to establish its own standard of review for internal appeals of material supervisory determinations. As a result, current standards of review vary significantly among the Reserve Banks.[19] In this sense then, the Proposal's establishment of a single standard of review to be used by each of the Reserve Banks marks a step toward greater uniformity, consistent with the Riegle Act's goal of decreasing unfair differences in regulatory treatment of supervised institutions.

Even so, the Proposal's proposed standards of review can be clarified and improved in two ways. First, the Federal Reserve should make clear that the standard of review to be applied by the Initial Review Panel is to be a *de novo* standard of review. We believe that this is implicit in the Board's statement that the Initial Review Panel "shall not defer" to the judgment of the Reserve Bank staff that made the material supervisory determination under review, [20] but the Board should state this explicitly in order to avoid continued inconsistency in the standards of review applied in each appeal.

Second, the Proposal's reference to "the Board's policies" and "applicable laws and regulations," while a common formulation by the Federal Reserve, perpetuates the mistaken notion that "laws" and "regulations" are separate, distinct concepts. Regulations are, in fact, legally binding laws, as are statutes. There is a hierarchical

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[17] Codified at 12 U.S.C. § 4806. Section 309 requires each appropriate federal banking agency and the National Credit Union Administration Board to establish an independent intra-agency appeals process.

[18] S. Rep. No. 103–169 at 52 (1993).

[19] *Compare* Federal Reserve Bank of New York, *Procedures for Appeals of Adverse Material Supervisory Determinations* ("The Review Panel will use a 'de novo' standard of review in reaching its decision.") *with* Federal Reserve Bank of Minneapolis, *Procedures for Appealing Material Supervisory Determinations* ("The standard for review will be whether the Reserve Bank's findings and conclusions were based on sufficient evidence and were consistent with FRS policy. A completely new (de novo) review will not be undertaken.").

[20] Proposal at 8393.

distinction between them but they are all "laws." Publicly issued guidance, supervisory letters, FAQs and other supervisory writings, such as matters requiring attention ("**MRAs**") and matters requiring immediate attention ("**MRIAs**"), exist within and are bound by the legal framework of statutes and regulations within which they reside as a lower hierarchical element. When bank examiners take a written or oral position during the examination process that relies on an interpretation of the elements of this legal framework or through MRAs and MRIAs, those examiners are engaging in an interpretation that is legal in nature, and, as a result, are owed much less deference than they are owed when, for example, making a purely fact-based determination about the activities of a supervised institution.

We realize that many, indeed most, material supervisory determinations will involve pure questions of fact. Determinations with respect to the adequacy of loan loss reserves or loan classifications fall within this category.[21] Other material supervisory determinations, however, will involve questions of law or mixed questions of law and fact. Based on the Federal Reserve's nonexclusive list of what constitutes a material supervisory determination, for example, we believe that many consumer, bank secrecy and anti-money laundering and other compliance examinations are likely to involve questions of law or mixed questions of law and fact, as are certain management component ratings.[22]

In addition, it is clear to us from our practical experience that some, though not all, MRAs and MRIAs will involve questions of law or mixed questions of law and fact. We note that the other federal banking regulators have stated explicitly that MRAs are subject to their internal appeals processes.[23] It would be surprising if the Federal Reserve took a different view in light of the material impact that MRAs and MRIAs can have on a supervised financial institution. Clarity on this point would also be better communication to the supervisory staff.

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[21] *See* Proposal at 8392 (material supervisory determinations include "the adequacy of loan loss reserves and/or capital" and "significant loan classification").

[22] *See* id. (material supervisory determinations include "material examination or inspection component ratings" and "consumer compliance rating").

[23] *See* OCC Bulletin 2013–15, Bank Appeals Process (June 7, 2013) ("a bank may appeal any agency supervisory decision or action . . . including but not limited to . . . material supervisory determinations such as matters requiring attention"); FDIC, Guidelines for Appeals of Materials Supervisory Determinations, 82 Fed. Reg. 34522, 34526 (July 25, 2017) ("Material supervisory determinations include . . . matters requiring board attention"). *See also* id. at 34523 ("The FDIC believes that [amending its guidelines to provide expressly that a matter requiring board attention is a material supervisory determination] clarifies institutions' opportunities for appeal and enhances consistency with the appellate processes used by other agencies.").

Given the above, certain material supervisory determinations that will come before the Final Review Panel are likely to involve questions of law or mixed questions of law and fact. Therefore, the Board should not adopt a standard of review for the Final Review Panel that does not distinguish between questions of fact, questions of law and mixed questions of law and fact. Instead, the Board should establish a *de novo* standard of review for those material supervisory determinations that are based on questions of law or mixed questions of law and fact, with legal interpretation, that is questions of law, properly understood to encompass not only statutes and regulations but also the nonbinding guidance, supervisory letters, FAQs and other supervisory writings which, though lower in the hierarchy, are nonetheless bound up within the legal framework.[24]

*De novo* review for questions of law or mixed questions of law and fact, as we have defined them here, at the Final Review Panel stage is necessary in order to ensure uniformity in material supervisory determinations across the Reserve Banks, thus establishing uniformity in the Board's expectations for supervised institutions no matter where those supervised institutions may be located. Such uniformity is necessary to ensure the "evenhandedness" that is required in order to "maintain confidence in our regulatory system."[25]

Arguments often offered, with some justification, in other contexts against a *de novo* standard of review for questions of law carry little weight here.[26] First, unlike in the Administrative Procedure Act context, Congress has not specified a deferential standard of review for internal appeals of material supervisory determinations.[27] Instead, Congress has left the decision to the federal banking regulators. Second, deference is often justified as a way to avoid fragmented, disharmonized results. With a *de novo* standard of review, it is argued, decision makers would apply one interpretation of the law in one jurisdiction while decision makers in another

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[24] We acknowledge that it may be appropriate for questions of fact to be reviewed with a more deferential posture.

[25] S. Rep. No. 103–169 at 52.

[26] For an in-depth examination of the typical justifications for deference and a more comprehensive explanation of why many of those arguments do not apply in the internal appeals context, *see* Julie Andersen Hill, *When Bank Examiners Get it Wrong: Financial Institution Appeals of Material Supervisory Determinations*, 92 Wash. U. L. Rev. 1101, 1178-80 (2015).

[27] *See* id. at 1178 ("[C]ourts defer to agencies because the Administrative Procedure Act, or some other relevant statute, has instructed that they defer. Congress has determined that statutory gaps should be filled by administrative agencies rather than courts. In contrast, Congress did not specify a standard of review for MSD appeals in either the Administrative Procedure Act or in the Riegle Community Development and Regulatory Improvement Act.") (footnotes omitted).

jurisdiction apply a different interpretation.[28] Here, just the opposite is true. A *de novo* standard of review would alleviate, rather than exacerbate, regulatory fragmentation by ensuring that law is applied consistently by examiners at each and every Reserve Bank by subjecting legal decisions made by those examiners to heightened review. Finally, because members of the Final Review Panel are quite likely to have more expertise than a given examiner in addressing questions of law,[29] any argument that a higher level of deference in these matters is justified based on the special expertise of the examiner is likewise unfounded.[30] Thus, any analogy to *Chevron*[31] or *Auer*[32] deference, which apply to interpretations or policy positions of the agency, is inapplicable when assessing an individual examiner or examination team's interpretation of the law, especially in light of the fact that those examiners or examination teams are not legally trained.

## II. The Federal Reserve Should, at a Minimum, Make Public Those Decisions Made by the Initial Review Panel That Concern Questions of Law or Mixed Questions of Law and Fact

As Vice Chairman for Supervision Quarles observed earlier this year, transparency is a "necessary precondition to the core democratic ideal of government accountability—the governed have a right to know the rules imposed on them by the government."[33] The Board's Proposal to publish redacted versions (or at least summaries) of Final Review Panel decisions is commendable and consistent with Vice Chairman Quarles' stated goals, and we offer our strong support. We believe, however, that the Proposal should go further and should provide for greater transparency at the Initial Review Panel stage as well.

In offering these comments, we acknowledge that, in certain cases, a desire for full transparency must yield to other important considerations such as the need for financial stability and the necessity of free and candid flows of information between supervised institutions and their supervisors. We also recognize that Congress is currently considering proposals that would take even more radical steps in favor of

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[28] *See* id. at 1179 (addressing this argument).

[29] *See* Proposal at 8394 (members of the Final Review Panel must "include at least two Board employees, at least one of whom must be an officer of the Board at the level of associate director or higher"). Members of the Final Review Panel will also be advised by an attorney appointed by the Board's General Counsel. Id.

[30] *See* Hill, *When Bank Examiners Get It Wrong*, 92 Wash U. L. Rev. at 1178.

[31] Chevron, U.S.A. Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837 (1984).

[32] Auer v. Robbins, 519 U.S. 452 (1997).

[33] Quarles, *supra* note 5.

transparency, including by subjecting decisions made in the examination process to review by outside panels. While we understand that the Federal Reserve may not be inclined to go so far as those Congressional proposals, we believe that the internal appeals process may nonetheless be made meaningfully more transparent.

By providing that the Initial Review Panel's determination will be considered confidential supervisory information, the Proposal falls short of the level of transparency required in order to enable supervised institutions to know the rules imposed on them by the Federal Reserve. All too often, bank examiners take written and oral positions that, though based on interpretations of statutes, regulations and other elements of the legal framework, remain shrouded in secrecy as confidential supervisory information.[34] The application of such "secret law" has real-world effects and yet may never be shared with other supervised institutions or other regulatory agencies, much less the public. This result is inconsistent with baseline principles of democratic accountability.

Therefore, we believe that, at a minimum, the Board should publicly release versions of Initial Review Panel decisions that concern questions of law or mixed questions of law and fact, with any confidential factual [or supervisory] information properly redacted. This public disclosure would serve not only the interests of supervised institutions, but, as importantly, would also serve to benefit the rule of law and the interests of the public as a whole. The current lack of transparency with respect to the material supervisory determination appeals process makes it difficult for the public, their representatives in Congress and other interested parties to evaluate the supervisory performance of the Federal Reserve and its Reserve Banks. The release of Initial Review Panel decisions concerning questions of law or mixed questions of law and fact, with any confidential factual [or supervisory] information redacted as appropriate,[35] would give the public a more complete picture of the Federal Reserve's supervisory activities and would provide for a heightened level of accountability by bringing some aspects of the secret law of bank supervision out of the shadows.

Finally, for those Initial Review Panel decisions that include purely questions of fact, the Board should, periodically and no less often than annually, release anonymized, aggregated statistics related to those questions of fact. These statistics should include an anonymized description of the facts and the type of material

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[34] *See* Tahyar, *supra* note 6 at 23 (quoting Kenneth Culp Davis's 1966 observation that the banking regulators "have long maintained systems of secret evidence, secret law, and secret policy"); *see also* id. at 26–28 (reviewing the creation and expansion of a "nonpublic, shadow regulatory system that is neither transparent nor subject to accountability").

[35] In some limited cases, it may be necessary to release a summary of an Initial Review Panel decision with respect to a question of law rather than a redacted copy of the decision.

supervisory determination at issue in the appeal, the results of the appeal, an identification of the Reserve Bank that made the initial material supervisory determination, and any other anonymized information deemed necessary by the Board in order to provide greater transparency to the institutions that it supervises.

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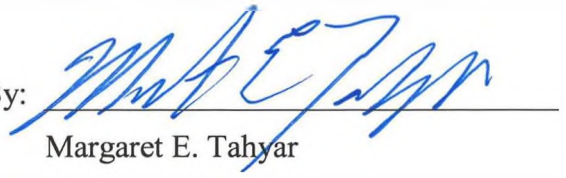
Davis Polk thanks the Federal Reserve for its consideration of our comments. If you have any questions, please do not hesitate to contact Margaret E. Tahyar at (212) 450-4379 or Randall D. Guynn at (212) 450-4239.

Yours sincerely,

DAVIS POLK & WARDWELL LLP

By: 

Margaret E. Tahyar