

NY Regulator's Untenable Authority Over Confidential Info

By **Pinchus Raice** and **Dustin Nofziger**

Financial institutions and their legal counsel may be surprised to learn that the New York State Department of Financial Services (DFS) asserts that financial institutions are prohibited from disclosing confidential supervisory information (CSI), such as reports of examination, to their outside counsel absent DFS' prior written authorization. The reader may be even more surprised to learn that the source of DFS' proclaimed authority — Section 36.10 of the New York Banking Law — does not appear to support DFS' contention. Nor has DFS responded to the instant authors' recent requests to explain how Section 36.10 could possibly restrict a financial institution from confidentially disclosing CSI to outside counsel for the purpose of obtaining legal advice. As a result, DFS' interpretation of Section 36.10 appears to be ripe for judicial challenge. The language and history of Section 36.10 suggest that it was never meant to prevent financial institutions from confidentially disclosing CSI to their outside counsel.



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DFS' Assertion: Section 36.10 Provides Authority to Prohibit Financial Institutions From Disclosing CSI to Counsel

When a financial institution receives a report of examination from DFS, it is typically accompanied by the following statement:

This copy of the report is and shall remain the property of [DFS] and is furnished to the institution examined for its confidential use. Under no circumstances shall the institution or any of its directors/trustees, or officers or employees disclose or make public in any manner the report or any portion thereof without the permission of the Superintendent of Financial Services. This report is subject to the confidentiality restrictions of Section 36.10 of the New York Banking Law.



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The cover letter to the report of examination may also assert that "[u]nder no circumstances shall the [financial institution] or any of its Board members, officers or employees disclose in any manner the [r]eport or any of its portions. The [r]eport, including the composite and component ratings, is subject to the confidentiality restrictions of Section 36.10 of the New York Banking Law."

This sweeping language — "disclose in any manner" — could be read to prohibit a financial institution from confidentially disclosing a report of examination to its outside counsel. In fact, this is the exact position taken by DFS. In our recent interactions with DFS, it has asserted that it is necessary for DFS to grant a financial institution a "limited waiver" from the requirements of Section 36.10 before the institution may disclose CSI to the institution's own counsel — even where counsel have been hired to represent the institution before DFS and federal financial regulatory agencies.

The Plain Meaning of Section 36.10 Contradicts DFS' Assertion

The source of DFS' declared authority — Section 36.10 of the New York Banking Law — does not suggest that a financial institution requires DFS' permission before "disclosing" reports of examination to outside counsel on a confidential basis. For that matter, Section 36.10 does not even utilize the word "disclose." Rather, Section 36.10 provides in relevant part:

All reports of examinations and investigations, correspondence and memoranda concerning or arising out of such examination and investigations ... in the possession of any [financial institution] ... shall be confidential communications, shall not be subject to subpoena and shall not be made public unless, in the judgment of the superintendent, the ends of justice and the public advantage will be subserved by the publication thereof, in which event the superintendent may publish or authorize the publication of a copy of any such report or any part thereof in such manner as may be deemed proper or unless such laws specifically authorize such disclosure.

Thus, by Section 36.10's terms, a financial institution may not make CSI "public" or produce it in response to a subpoena without DFS' authorization.

Could Section 36.10's prohibition against making CSI "public" prohibit a financial institution from confidentially disclosing CSI to its outside counsel? The ordinary meaning of "public" suggests not. Merriam-Webster defines "public" as "exposed to general view"; "of, relating to, or affecting all the people or the whole area of a nation or state"; or "of or relating to people in general." Each of these definitions has to do with exposure to a general or entire class of people. None suggests that disclosing CSI to outside counsel, on a confidential basis, in order to obtain legal advice could possibly be deemed to be making the CSI "public."

The Legislative History of Section 36.10 Does Not Support DFS' Assertion

The legislative history of Section 36.10 also does not support DFS' assertion. The original, 1914 version of Section 36.10 (then Section 41) directed examiners to make a written report on oath to the superintendent of DFS' predecessor agency, the New York State Banking Department, and provided that the superintendent could make those reports of examination "public" by publishing them in a newspaper. The use of "public" in the original version of Section 36.10 was thus entirely consistent with the ordinary

meaning of “public” as “exposed to general view.”

It was not until 1945 that an amendment was made to Section 36.10 to provide that the phrase “[a]ll reports” of examination “includ[ed] any duly authorized copy ... in the possession of any [financial institution].”

There is no indication in the 1945 legislative history that this amendment was intended to prohibit financial institutions from disclosing CSI, on a confidential basis, to their own counsel in order to obtain legal advice. Rather, the intent of the 1945 amendment, if anything, appears to have been to prevent private litigants from subpoenaing reports of examination in a financial institution’s possession.

Prior to 1945, language had been added to Section 36.10 to provide that reports of examination in the Banking Department’s possession “shall not be subject to subpoena” unless approved by the superintendent. Meanwhile, however, the Banking Department had been providing financial institutions with copies of its reports of examination for many years. The 1945 legislative history reveals that the Banking Department supported amending the statute to extend to copies of reports of examination in financial institutions’ possession because “[i]f the confidential nature of these reports is to be preserved, it is necessary that the privilege against disclosure clearly extend to copies of the reports in the possession of the institutions examined.”

The only “privilege against disclosure” that existed in 1945 was the Banking Department’s privilege against disclosure in response to a subpoena. Then, as now, this privilege clearly had no relevance to an institution’s confidential disclosure of CSI to its outside counsel — who would never subpoena the financial institution for documents, and, as the financial institution’s agents, would enjoy any protections against discovery applicable to the financial institution. (In fact, when DFS does authorize financial institutions to disclose CSI to outside counsel, it is the instant authors’ experience that DFS specifies that counsel should “notify DFS, promptly and in writing, of any demand for the [CSI] and agree to assert on behalf of DFS all such legal privileges and exemptions as DFS may request.”)

Problems Caused by DFS’ Untenable Interpretation of Section 36.10

DFS’ untenable interpretation of Section 36.10 can present significant problems for financial institutions and their outside counsel. In particular, these problems may arise where a federal agency and DFS have issued a joint report of examination, and the institution seeks counsel’s assistance in evaluating the merits of an intra-agency appeal of the report of examination through the federal agency’s intra-agency appeals process — a process that the primary federal financial regulatory agencies are required to make available to financial institutions by Section 309 of the Riegle Community Development and Regulatory Improvement Act of 1994.

Consider the following examples, which are loosely based on recent experience.

Example 1. A financial institution jointly regulated by a federal agency and DFS retains outside regulatory counsel in anticipation of possible formal or informal enforcement actions by the agencies. The federal agency’s regulations allow the financial institution to disclose the federal agency’s most recent report of examination to counsel as a matter of right. But the report is a joint federal-state report, and DFS contends that the financial institution must obtain DFS’ authorization before disclosing the joint report to counsel. Meanwhile, the federal agency’s intra-agency appeal guidelines do not discuss the possibility of extensions of its intra-agency appeal deadlines, and the federal agency also takes the position that extensions are not permitted under its guidelines.

Although the financial institution makes a timely request to DFS for authorization to disclose the joint report of examination and related CSI to counsel, DFS does not grant the request until after the federal regulator’s intra-agency appeals deadline has elapsed. Upon finally receiving the requested report of examination, counsel concludes that the financial institution would have had a strong case to appeal certain material supervisory determinations through the federal agency’s intra-agency appeals process. The intra-agency appeal deadline has passed, however, and the federal agency refuses to extend it. DFS’ foot-dragging, combined with the federal agency’s cramped view of its powers, have prevented the financial institution from taking advantage of the intra-agency appeals process that the federal agency is mandated to make available to it by the federal Riegle Act.

Example 2. A financial institution jointly regulated by a federal agency and DFS receives a joint report of examination from those agencies, triggering a 60-day time frame to submit an intra-agency appeal under the federal agency’s intra-agency appeals guidelines. The institution promptly makes a request to the federal agency for authorization to disclose the joint report of examination and “related” materials to outside regulatory counsel. The federal agency promptly grants the institution’s request, but conditions its approval on DFS’ agreement. DFS then refuses to allow the institution to share “related” materials with counsel for unspecified reasons. The institution seeks (and receives) an extension of the federal agency’s 60-day intra-agency appeal deadline while attempting to resolve the dispute with DFS. DFS eventually agrees to provide the requested authorization if an extremely granular list of the “related” materials sought is provided to it, but never responds with the promised authorization after the granular list is provided. As the federal agency’s extended deadline for an intra-agency appeal approaches, the institution, which had all along been “on the fence” about submitting an intra-agency appeal, decides not to pursue it, having never received the fully informed advice of counsel as a result of DFS’ intransigence.

Implications

Although the instant authors have twice this year sought explanation from DFS regarding how Section 36.10 could possibly be read to restrict a financial institution from confidentially disclosing CSI to outside counsel, none has been forthcoming. Nor has DFS published an interpretative letter or memorandum explaining the basis for its expansive (and by all appearances unwarranted) interpretation of Section 36.10. Absent such an explanation, it would appear to be appropriate for outside counsel to advise clients that although DFS makes ipse dixit assertions that its authorization is required before an institution may share CSI with counsel, those assertions appear to be without legitimate basis.

If financial institutions do decide to continue to request authorization from DFS prior to disclosing CSI to counsel, they should keep in mind that, in the event of a denial or a delay, DFS’ interpretation of Section 36.10 appears to be highly vulnerable to legal

challenge. In addition, financial institutions considering potential intra-agency appeals through the federal agencies' intra-agency appeals processes should request extensions from those agencies, where possible, while awaiting CSI authorization from DFS. If a federal agency declines to provide a requested extension, the financial institution should consider challenging the denial in federal court, including on the basis that the federal agency has denied the financial institution its statutory right to an intra-agency appeal under the Riegle Act.

Given DFS' disregard of the plain meaning and history of Section 36.10, industry groups and bar associations should lobby the New York State Legislature to insert a provision in Section 36.10 explicitly stating that it does not restrict financial institutions from disclosing reports of examination and other CSI to their counsel on a confidential basis. New York would not be the first state to modernize its financial regulatory statutes in this fashion. Illinois, for example, explicitly provides in statute that financial institutions may confidentially disclose reports of examination and other CSI to their attorneys — without the need to first obtain permission from the Illinois Department of Financial and Professional Regulation.

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