Study B-400 August 18, 2004

Memorandum 2004-37

Financial Privacy (Comments on Tentative Recommendation)

This spring and summer the Commission circulated for public comment its Tentative Recommendation on *Financial Privacy* (April 2004) (available at www.clrc.ca.gov). The due date for comments was July 31, 2004.

We have received no comments on the tentative recommendation. That is not surprising, considering that the main event in the development of California financial privacy law — enactment of the California Financial Information Privacy Act (SB 1) — has already occurred. At this point we are in cleanup mode.

This memorandum reviews developments that have occurred since issuance of the tentative recommendation. The staff will update the recommendation to reflect the developments. **As so updated, the staff suggests that the Commission adopt the tentative recommendation as its final recommendation.**

The staff raises two questions in this memorandum — whether the Commission should recommend continuing study of this matter, and whether to finalize the recommendation now or wait until November. These questions are addressed at the end of the memorandum.

SUMMARY OF TENTATIVE RECOMMENDATION

The tentative recommendation analyzes Senate Bill 1 (Speier) — the California Financial Information Privacy Act, operative July 1, 2004. It concludes that the new law largely achieves the objectives of the Legislature. Although clarification or improvement is possible, the tentative recommendation does not propose revision of the new law before there is experience under it.

The tentative recommendation notes that the preemptive effect of federal law on the California Financial Information Privacy Act is not yet clear. It concludes that it is premature to amend the new law to accommodate federal preemption.

The tentative recommendation proposes statutory revisions to integrate the California Financial Information Privacy Act with existing California privacy statutes. It addresses major privacy statutes, but notes that numerous other statutes may also require adjustment.

The tentative recommendation concludes that further legislative work is necessary with respect to federal preemption and coordination with existing state privacy statutes. It notes that the Commission is not in a position to do the required work due to diminished resources and a heavy workload of other projects. A budget augmentation and staffing increase, as well as an extension of the report deadline, would be necessary to enable the Commission to accomplish the additional work.

PRIVACY PRACTICES OF FINANCIAL INSTITUTIONS

The Gramm-Leach-Bliley Act requires the Secretary of Treasury to study and report on information sharing practices of financial institutions and the risks and benefits of those practices. The report was due January 1, 2002; it has now been released. See Department of Treasury, *Security of Personal Financial Information* (June 2004). The 56-page report is primarily a compilation of the views of interested persons and organizations on the issues.

The report draws five general conclusions:

- Financial institutions and consumers have an interest in protecting the security of personal financial information.
- Financial information sharing has given consumers better access to financial products at lower cost.
- Identity theft is a problem.
- It is important to have national standards for information sharing.
- Consumers need to understand better the information sharing practices of financial institutions and how to exercise their rights.

The report recommends the following actions to help enhance the security and accuracy of personal financial information while at the same time encouraging robust financial markets that are more accessible to all Americans:

- Develop easy to read, easy to use, privacy notices.
- Fight identity theft by giving consumers better access to credit reports and by encouraging financial institutions to be more proactive.

The Secretary of Treasury notes that regulatory action is underway to improve the quality of privacy notices under the Gramm-Leach-Bliley Act. Also the Fair Credit Reporting Act has been amended to enhance the security and

accuracy of personal financial information and promote access by all Americans to U.S. credit and other financial services.

BALLOT INITIATIVE

The tentative recommendation notes ballot initiatives being circulated with the intent to deal comprehensively with the subject of financial privacy. None have qualified for the ballot. The staff will delete this discussion from the recommendation.

CALIFORNIA FINANCIAL INFORMATION PRIVACY ACT

Civil Remedies and Administrative and Civil Penalties

The synopsis of SB 1 in the tentative recommendation notes that SB 1 provides only one remedy for its violation — a civil penalty recoverable in an action by the Attorney General or by the financial institution's functional regulator, in the name of the People of the State.

At least one commentator suggests that "given the broad scope of California's existing Unfair Practices Act, Business and Professions Code section 17200 et seq., one may readily envision consumers seeking restitution for violations of the Act, perhaps by way of class actions." Dayanim & Togni, *California's "Privacy Revolution" — Take Notice or Take the Penalties*, Business Law News 3, 20 (No. 1, 2004). See also Coombs & Milner, *New California Identity Theft Legislation*, 27-Aug. L.A. Law. 21 (2004) ("Although this application of the law has yet to be proven ... businesses could face expensive class action lawsuits for violating the new laws even if the new laws do not specifically provide for these actions.")

It is true that, while the new law provides a civil penalty for its violation "irrespective of the amount of damages suffered by the consumer", it does not specifically preclude other relief. Fin. Code § 4057. It may be an overstatement to suggest, as the tentative recommendation does, that the civil penalty is the "exclusive" remedy for violation of the statute. Moreover, there may be common law causes of action for privacy violation that overlap the statutory restrictions.

Resolution of these issues will require judicial interpretation of legislative intent. The staff thinks this issue is worth flagging in the recommendation. We would not attempt to clarify the law on the matter. (Our initial staff draft of a

financial privacy statute, before enactment of SB 1, would have expressly precluded 17200 relief, while providing other remedies.)

The staff notes that pending legislation — SB 1451 (Figueroa) — would provide that if an entity governed by SB 1 transfers protected information to a person to whom SB 1 is not otherwise applicable (e.g., a person located outside California), the recipient is bound by the same limitations on sharing or otherwise disclosing the information that the transferring entity is bound by. A recipient of information who violates this prohibition:

> shall be liable in an action for civil damages under this section in the courts of this state, brought by a resident of this state who has been harmed by a violation of this subdivision, regardless of where the violation occurs. For purposes of this paragraph, that person shall be deemed to consent to jurisdiction in the courts of this state.

Proposed Civil Code § 1798.98(b)(2).

Assessment

The tentative recommendation's assessment of the new law includes the observation that there are questions concerning its implementation and operation. However, the Commission has declined to recommend corrective legislation before there is experience under operation of the new law.

One issue that has recently been highlighted is a provision of the new law that enables a financial institution to offer an incentive or discount to encourage a consumer to opt in to information sharing. "The Act does not attempt to identify when a 'discount' or 'incentive' becomes a de facto barrier to non-consenting consumers." Dayanim & Togni, *California's "Privacy Revolution" — Take Notice or Take the Penalties*, Business Law News 3, 20 (No. 1, 2004). The staff would note this issue along with others noted in the tentative recommendation.

RELATION OF CALIFORNIA FINANCIAL INFORMATION PRIVACY ACT TO FEDERAL LAW

Fair Credit Reporting Act Preemption

The Fair Credit Reporting Act (FCRA) preempts state laws that affect "the exchange of information among persons affiliated by common ownership or common corporate control".

Privacy Notice

While the FCRA preemption provision is broadly phrased, it would not seem to affect provisions of the California Financial Information Privacy Act that require a financial institution to provide notification to its customers of its information sharing practices.

Or so we thought. But Dayanim and Togni remark that, "Although the preemption provision is not entirely clear, it is likely that the federal bill will also preempt the California Act's notice requirements." Business Law News at 4 (No. 1, 2004). The authors do not elaborate the basis for their conclusion.

The staff does not see the need to flag this issue in the recommendation. Our position is that the extent of preemption is unclear and needs to play out in the courts before we can sensibly make any needed adjustments to the statute.

Affiliate Sharing

The tentative recommendation observes that the scope of affiliate sharing preemption by FCRA is unknown and potentially broad. Whether FCRA will ultimately be determined to preempt the affiliate sharing limitations of SB 1 remains unclear. A number of recent developments have occurred on this issue.

Some evidence of the extent of FCRA preemption may be gleaned from regulations issued under FCRA. As a result of the Fair and Accurate Credit Transactions Act of 2003, FCRA now regulates use of information shared among affiliates for marketing purposes. See FCRA § 624. The Federal Trade Commission has issued proposed implementing regulations, with a comment deadline of August 16. See 69 Fed. Regis. 33324 (June 15, 2004); 69 Fed. Regis. 43546 (July 21, 2004). While the proposed regulations do not address the FCRA preemption clause, they do indicate that the Federal Trade Commission reads the affiliate information sharing provisions of FCRA broadly, not limited to affiliates within the credit reporting industry.

There have also been significant case law developments.

The United States Court of Appeals for the Ninth Circuit has vacated the judgment of the federal district court and dismissed the appeal from *Bank of America, N.A. v. City of Daly City*, 279 F. Supp. 2d 118 (N.D. Cal. 2003). That case involved the issue of FCRA preemption of local ordinances that limited affiliate information sharing among financial institution. The federal district court for the Northern District of California had concluded that FCRA preempts the local

ordinances. During the pendency of the appeal, SB 1 was enacted, preempting the local ordinances. The court of appeals dismissed the appeal as moot.

In *American Bankers Association v. Lockyer*, 2004 WL 1490432, Civ. S 04-0778 (E.D. Cal. June 30, 2004), the federal district court for the Eastern District of California held that FCRA does not preempt the affiliate information sharing limitations of SB 1. The American Bankers Association, the Financial Services Roundtable, and the Consumer Bankers Association had brought suit seeking declaratory and injunctive relief to preclude the affiliate sharing provisions of SB 1 from becoming operative on July 1, 2004. The court read the FCRA preemption clause as narrowly limited to the credit reporting context, and granted summary judgment for the state. The court explained that:

> [T]he only reasonable reading of the FCRA preemption provision is that it prevents states from enacting laws that prohibit or restrict the sharing of consumer reports among affiliates. This comports with the stated purpose of the FCRA as regulating consumer reporting agencies to ensure the accuracy and fairness of credit reports. 15 U.S.C. § 1681. Contrary to the position espoused by Plaintiffs, the FCRA preemption provision does not broadly preempt all state laws regulating information sharing by affiliates, whatever the purpose or context. [Fn. omitted.]

The financial organizations have appealed the decision to the United States Court of Appeals for the Ninth Circuit (04-16344). To date the following trade groups have filed amicus briefs arguing for FCRA preemption:

America's Community Bankers
American Council of Life Insurers
American Insurance Association
Citizens for a Sound Economy
Clearinghouse Association
Investment Company Institute
Investment Counsel Association of America
National Business Coalition on E-Commerce
Securities Industry Association

The following federal financial institution regulatory agencies have also filed an amicus brief arguing for preemption:

Federal Deposit Insurance Corporation
Federal Reserve Board
Federal Trade Commission
National Credit Union Administration
Office of Comptroller of Currency

Office of Thrift Supervision

In the staff's opinion, these developments support the Commission's wait and see attitude. The staff will revise the discussion of this issue in the text of the recommendation to note the recent developments.

National Bank Act and Other Federal Functional Regulatory Laws

The tentative recommendation describes the expansive interpretation given by the Office of Comptroller of the Currency to National Bank Act preemption of state regulation. See pp. 20-22.

The California Legislature has adopted Senate Joint Resolution 20 (Florez) as 2004 res. ch. 107 (June 28, 2004). The resolution takes issue with the OCC position, noting that it would prevent the application of state consumer protections to federally chartered financial institutions and frustrate the efforts of state regulators and legislators to extend those projections to all citizens. The resolution requests Congress to disapprove the OCC rule and if necessary consider legislation that will prevent unilateral expansion of jurisdiction over financial institutions by federal regulators without the specific endorsement of Congress.

CONTINUING STUDY AND RECOMMENDATIONS

The tentative recommendation envisions continuing work by the Commission, contingent on funding being provided for that purpose. The Legislative Counsel has provided us with appropriation language that is more technically accurate for this purpose than that included in the tentative recommendation:

> **Uncodified (added). Continuing study and recommendations**
>
> (a) The California Law Revision Commission shall study the law governing sharing and disclosure of a consumer's nonpublic personal information by a financial institution and shall from time to time make recommendations to the Governor and the Legislature for any revisions of California law necessary for any of the following purposes:
>
> (1) The proper implementation and operation of the California Financial Information Privacy Act, Division 1.2 (commencing with Section 4050) of the Financial Code.
>
> (2) To adjust California statutes to the extent necessary to recognize any federal preemption, and any further revisions

necessary to balance the rights and interests of interested persons adversely affected by federal preemption.

(3) To coordinate California statutes with each other.

(b) This section applies ~~only~~ to the extent ~~and so long as~~ that the California Law Revision Commission is provided funding and staffing adequate to accomplish the purposes of this section.

~~(c) The appropriation for the California Law Revision Commission in the 2005-2006 Budget Act is augmented in the amount of $80,000 for the purpose of implementing this section, and the number of positions authorized for the California Law Revision Commission in the 2005-2006 Budget Act is increased by one for the purpose of implementation of this section. It is the intent of the Legislature that this augmentation and increase be continuing.~~

(c) It is the intent of the Legislature that, for purposes of implementing this section, the amount appropriated in Item 8830-001-0001 of Section 2.00 of the Budget Act for the 2005-06 fiscal year reflect an increase, from the amount appropriated to the California Law Revision Commission for the 2004-05 fiscal year, in the amount of $80,000, and that the number of positions authorized for the California Law Revision Commission in the Budget Act for the 2005-06 fiscal year be increased by one. It is the intent of the Legislature that this augmentation and increase be included in the Budget Act for the 2006-07 fiscal year and each subsequent fiscal year.

The staff has two concerns about this provision. First, given the continuing tight budget situation, and the Governor's line item veto of a similar augmentation for the Commission in the 2004-05 budget, does it make any sense to propose this? Second, given the lack of comment on the Commission's tentative recommendation, do stakeholders see a need for continuing work by the Commission in this area? With all the other major projects languishing on the Commission's calendar of topics, perhaps this cleanup effort should be left to a more desultory fate.

Does the Commission have a sense of where it wants to go on this one? If the Commission's decision is to persevere with an ongoing Commission study, the staff would put that proposal in a separate bill, so that any veto by the Governor would not affect the Commission's substantive recommendations on the matter.

FINAL RECOMMENDATION OF THE COMMISSION

The resolution that authorized this study directed that the Commission submit its report on the matter to the Legislature by January 1, 2005. We are in a position to finalize the recommendation now.

We have one more meeting scheduled before the January 1, 2005, deadline — November 19, 2004. A reason to wait before finalizing the recommendation is to incorporate any new developments that may occur over the next few months.

The staff favors finalizing the recommendation and reporting back to the Legislature now. As a practical matter, while there will be ongoing developments, we do not expect anything definitive to occur between now and then. Nor do we expect to be able to devote much time to it, given the other more pressing demands on the Commission's resources. We would wrap up work now and move on to other things.

Respectfully submitted,

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Executive Secretary