WILMER, CUTLER & PICKERING

Financial Institutions Group Newsletter

MAY 17, 2002

NEW OCC ELECTRONIC BANKING RULE

Today, the Office of the Comptroller of the Currency ("OCC") published a final E-banking rule. 67 Fed. Reg. 34,922, 35,005 (May 17, 2002) (to be codified at 12 C.F.R. 7.5002(c)).[1] While it has not received much notice, the OCC's E-banking rule is a significant expansion of the national bank charter. The three most noteworthy sections of the E-banking rule are (1) preemption of state law, (2) codification of the OCC's major opinions on electronic banking powers, and (3) expansion of data processing authority. Below, we address those provisions in detail, and then provide a section-by-section summary of the entire rule.

Major Developments

Preemption

The most significant feature of the E-banking rule is the provision on state law preemption, which states (with emphasis added):

> …State law is not applicable to a national bank's conduct of an authorized activity through electronic means or facilities if the State law, as applied to the activity, would be preempted pursuant to traditional principles of Federal preemption derived from the Supremacy Clause of the U.S. Constitution and applicable judicial precedent. Accordingly, *state laws that stand as an obstacle to the ability of national banks to exercise uniformly their Federally authorized powers through electronic means or facilities, are not applicable to national banks.*

This language is a substantial departure from the proposed rule and OCC practice.

The phrase "stand as an obstacle" was used by the Supreme Court in Barnett and earlier opinions, and is consistent with the frustration of purpose/conflict analysis that the OCC has traditionally employed — as opposed to the "occupy the field" analysis favored by the OTS. The rule preempts, however, not just state laws that stand as an obstacle to a national bank's exercising its powers, but those that stand as an obstacle to the bank's exercising its powers "*uniformly*." Because *any* state law arguably stands as an obstacle to a national bank's *uniform* exercise of its powers, this preemption could be quite broad indeed.

[1] The E-banking Rule is available at http://www.occ.treas.gov/ftp/release/2002-44b.pdf

Furthermore, the fact that the OCC placed explicit preemption language in the rule is itself significant. Previously, the OCC generally has relied on case-by-case opinions, disdaining the OTS's regulatory, occupy-the-field approach. The E-banking rule continues to use the OCC's traditional "conflict" analysis approach, but does so through regulation. While the OCC has recently taken some steps in this direction — for example, with respect to operating subsidiaries — this is its most significant such action to date. Here, it appears that the OCC is effectively saying that any state law conflicts with the National Bank Act to the extent it prevents the uniform delivery of electronic services. Depending on their appetite for risk, national banks can now choose to rely on that rule without seeking an opinion from the OCC.

The preamble indicates that the OCC does intend its new "obstacle to uniformity" standard to permit broader preemption than its predecessors. The justification for the rule is lengthy, but the most significant portions are set forth below:

> "*In general*, the application of State law to activities conducted by national banks through electronic means presents issues of preemption that are determined under traditional principles of Federal preemption derived from the Supremacy Clause of the United States Constitution and applicable judicial precedent. . . . *However, when the activity is being conducted by electronic means, and thus is potentially geographically boundless, a consideration unique to the purpose and characteristics of the national bank charter becomes an element of this preemption analysis*. Through the national bank charter, Congress established a banking system intended to be nationwide in scope, and authorized the creation of national banks, whose powers were intended to be uniform, as established by Federal law, regardless of where in the nation they conducted their business. . . .
>
> *Thus in analyzing the potential for State laws to be applicable to activities conducted by national banks via electronic means, it is also necessary to recognize in the preemption analysis that application of a multiplicity of State requirements in itself is an important factor in the analysis.* Particularly where an activity is conducted via electronic means and is potentially accessible to a customer without any necessary connection to where the customer is physically located, *application of multiple State law standards to that particular activity conflicts with the uniformity of standards under which national banks were designed to operate.*

Id. at 34,996-97 (emphasis added). In sum, the OCC appears to be stating that the case for preemption is stronger on-line than off-line. While "in general" preemption opinions will be based on established precedent, the OCC believes that the need for a uniform legal environment is a new and important factor in deciding on-line preemption cases. Accordingly, it has preempted by regulation any state law that stands as an obstacle to electronic activities.

Powers

Since the mid-1990s, the OCC has issued approval orders permitting national banks to engage in many electronic banking and related activities deemed part of or incidental to the business of banking. The new OCC E-banking rule not only codifies those letters but also the analytic framework the OCC uses to determine whether an activity is permissible for national banks. This codification of the OCC bank powers framework will help ensure that all future OCC bank powers interpretations receive the greatest judicial deference possible, if challenged.

Under Chevron v. N.R.D.C. and its progeny, a court must defer to a regulatory agency's reasonable interpretation of an ambiguous provision in a statute administered by the agency.[2] After modifications to the Chevron doctrine made by the Supreme Court's recent decisions in Christensen v. Harris County[3], and United States v. Mead Corp., 121 S. Ct. 2164 (2001)[4], agency interpretations are much more likely to receive Chevron deference when they are the product of a notice and comment rulemaking. By interpreting national banks' powers through an E-banking regulation, the OCC has ensured that its views will enjoy the same Chevron-style deference they did in the past.

Data processing

The E-banking rule allows national banks to provide data processing and related activities with respect to banking, financial or economic data, as part of the business of banking. 67 Fed. Reg. 34,992, 35,006 (to be codified at 12 CFR 7.5006(a)). The OCC had also sought comment on how much processing of *non-financial* data should be permissible, as an incidental activity. (The Federal Reserve allows bank holding company affiliates to perform up to 30 percent of their data processing on non-financial data, and has proposed raising that figure to 49 percent.) The final rule allows such data processing, conditioned on a requirement that the bank's data processing revenue be derived "predominantly" from banking, financial, or economic data.

As the Supreme Court observed about an earlier term with a special place in the banking laws — the "engaged principally" test of Glass-Steagall's section 20 — the word "predominant" is "intrinsically ambiguous." One must assume that the OCC chose it for that very reason. The OCC considered comments suggesting a non-financial revenue limit of 30 percent or 49 percent, but rejected any bright line test, noting only that "in light of the rapidly evolving nature of bank data processing and data processing markets in which banks compete, a fixed percentage would be inappropriately rigid." The question is, by using "predominant," does the OCC leave open the possibility that more than 50 percent of data processing revenue can come from non-financial data? Stay tuned.

Section-by-Section Analysis

The E-banking rule is generally divided into three categories, national bank powers, location, and safety and soundness.

I. National Bank Powers

National bank finder authority (12 C.F.R. § 7.1002)

National banks have long been permitted to engage in finder activities. The E-banking rule states explicitly that finder activities are a part of the business of banking and gives several examples of finder activities. With finder activities determined to be "part of the business of banking" the OCC can now approve activities that are "convenient or useful" to being a finder as incidental activities. This could permit national banks to engage in a broad range of commercial activities.

The E-banking rule notes that banks may, in acting as a finder, bring together parties other than a buyer and seller to the transaction such as service providers, consultants, software developers, and regulatory authorities. The transactions to which national banks act as finders do not need to involve financial products.

---

[2] Chevron v. N.R.D.C., 467 U.S. 837 (1984).

[3] Christensen v. Harris County, 529 U.S. 576 (2000).

[4] United States v. Mead Corp., 121 S. Ct. 2164 (2001). The Mead opinion suggested the OCC's statutory interpretations may continue to receive Chevron deference even when expressed in an opinion letter rather than a regulation. Id. at footnote 13.

Among approved finder activities noted in the E-banking rule are operating an Internet mall via a web page, posting hyperlinks on the bank's website to third-party providers' websites, providing links from smart phone banking services to non-bank service providers, and providing a means of electronic communications for securities transactions. Several commenters to the proposed rule urged the OCC to include additional permissible finder activities, but the OCC declined, preferring to review additional activities on a case-by-case basis.

The finder section preserves the distinction between a finder and broker by stating that the authority to act as a finder does not enable a national bank to engage in brokerage activities that have not been found to be permissible for national banks.

Electronic banking activities that are part of, or incidental to the business of banking (12 C.F.R. §7.5001)

Section 7.5001 sets out the framework the OCC will use in determining whether new activities by national banks are part of or incidental to the business of banking.

A. Activities Part of the Business of Banking

The section codifies the OCC test for determining whether a new electronic activity is part of the business of banking. The first three elements of this test are the factors the OCC has traditionally used, while the fourth — whether the activity is permissible for state banks — is a new development. Under 7.5001, the OCC will consider:

1. "Whether the activity is the functional equivalent to, or a logical outgrowth of, a recognized banking activity;"

2. "Whether the activity strengthens the bank by benefiting its customers or its business;"

   The OCC states that examples of such benefits would include "those where the activity increases service, convenience, or options for bank customers or lowers the cost to banks of providing a product or service."

3. "Whether the activity involves risks similar in nature to those already assumed by banks;" and

4. "Whether the activity is authorized for state-chartered banks."

   The preamble states that whether an electronic activity is permissible under state law is "at least a relevant factor in determining whether an electronic activity is part of the business of banking."

Significantly, a proposed activity does not need to satisfy all of the above factors to be deemed part of the business of banking. The OCC's preamble notes that "[o]ne or more of these factors may be sufficient, depending on the specific facts and circumstances presented." 67 Fed. Reg. 34,992, 34,994.

B. Activities Incidental to the Business of Banking

The OCC also explains that "an activity is incidental to the business of banking if it is convenient or useful to an activity that is specifically authorized for national banks or to an activity that is otherwise part of the business of banking." Id. at 35,004. To determine whether a new electronic activity would be incidental to the business of banking, the OCC considers the following two factors:

1. "Whether the activity facilitates the production or delivery of a bank's products or services, enhances the bank's ability to sell or market its products or services, or improves the effectiveness or efficiency of the bank's operations, in light of risks presented, innovations, strategies, techniques and new technologies for producing and delivering financial products and services."

According to the preamble, examples of this type of incidental activity may include "hiring employees, issuing stock to raise capital, owning or renting equipment, borrowing money for operations, purchasing the assets and assuming the liabilities of other financial institutions, and operating through optimal corporate structures, such as subsidiary corporations or joint ventures." Id. at 34,995.

2. "Whether the activity enables the bank to use capacity acquired for its banking operations or otherwise avoid economic loss or waste."

   Under this authority, banks are able to engage in nonbanking activities in order to realize a gain or avoid a loss from activities part of or necessary to banking. One example of such authority is the utilization of excess bank physical space or capacity.

Again, a proposed activity does not need to satisfy both factors to be deemed incidental to the business of banking.

While the criteria set forth above apply, under the terms of 7.5001, only to "electronic activities," one might expect the OCC at some point to codify these criteria for off-line activities as well.

Furnishing of products or services by electronic means and facilities (12 C.F.R. § 7.5002)

The "transparency doctrine" provides that a bank may use electronic means to provide any permissible function, product or service. Under the transparency doctrine, the OCC looks through the means of delivery of a product to see whether the offered product is permissible. Section 7.5002 also provides examples of permissible activities, including web site hosting, providing a "virtual mall" for products and services, electronic billing and collection services, and storage of electronic encryption keys as a safekeeping function. Activities permissible under this section are still subject to the same regulatory requirements as if the activities were conducted without electronic means.

As discussed in detail above, Section 7.5002 also clarifies that state law will apply to new electronic activities by national banks if state law would govern the banks' activity if not conducted through electronic means. State law may apply to a national bank's electronic banking activities in one of two ways, federal statutes may direct that state laws apply or state law may apply directly, subject to preemption (as discussed above).

Composite authority to engage in electronic banking activities (12 C.F.R. § 7.5003)

This section codifies the approach taken from earlier OCC approval letters regarding the authorization of complex proposed electronic activities in Section 7.5003. If each of the component activities has previously been deemed permissible, then the more complex aggregation of these activities will also be permissible.

Excess electronic capacity (12 C.F.R. § 7.5004)

National banks have long used the "excess capacity doctrine" to benefit from otherwise underutilized resources such as real estate. The advent of electronic banking has created a new opportunity. The E-banking rule states that the bank may in certain circumstances market and sell electronic capacities "legitimately acquired or developed by the bank for its banking business." This standard appears somewhat broader than the capacity "acquired in good faith for banking purposes" standard initially proposed. See 66 Fed. Reg. 34,855, 34,863 (July 2, 2001). The section also includes some examples of permissible uses of excess capacity, but cautions that each excess capacity determination is a fact sensitive determination and banks considering use of this power should consult with the agency.

The OCC next codifies its "by-product theory" which allows a national bank to sell by-products of its banking business such as software.

The OCC stresses that this section is independent from the changes to national banks' data processing powers and that this authority remains unchanged. The rule gives two examples of permissible by-products: "[s]oftware acquired (not merely licensed) or developed by the bank for banking purposes or to support its banking business; and … [e]lectronic databases, records, or media (such as electronic images) developed by the bank for or during the performance of its permissible data processing activities."

National bank acting as digital certification authority (12 C.F.R. § 7.5005)

The OCC restates its position that national banks may act as a digital certification authority "to verify any attribute for which verification is part of or incidental to the business of banking." To promote future expansion of banks' digital certification activities, the OCC also states that the activity is part of, rather than incidental to, the business of banking (thereby allowing for the approval of future, incidental, authorities). The rule expressly permits banks to verify 1) the identity of persons associated with a particular public/private key pair, and 2) attributes, including some financial attributes such as account balance as of a particular date, lines of credit as of a particular date, past financial performance of the customer, and verification of customer relationship with the bank as of a particular date, of persons associated with a particular public/private key pair. Banks are also permitted, with case-by-case OCC authorization, to issue "system-linked certificates" where the verified information resides in the linked bank system. Such system-linked information would be updated as bank data is updated allowing the certified information to remain valid for a longer time period.

Data processing (12 C.F.R. § 7.5006)

As described above, section 7.5006 codifies existing OCC precedent allowing national banks to perform certain data financial and economic processing and related services for itself and its customers. Economic data, in turn, is defined extremely broadly to include "anything of value in banking and financial decisions." This section also permits, as an incidental activity, a limited amount of nonfinancial data processing.

Correspondent services (12 C.F.R. § 7.5007)

Again codifying existing precedent, the OCC states that national banks may perform for its affiliates or other financial institutions corporate or banking services that the national bank could perform for itself. Correspondent services are further deemed part of the business of banking.

II. Location

Location of a national bank conducting electronic banking activities (12 C.F.R. § 7.5008)

Section 7.5008 clarifies issues relating to the location of national banks' electronic operations. The section provides that a bank will not be deemed to be located in a state solely because the bank maintains technological operations, such as a server or automated loan center, in the state. A bank also will not be considered located in a state because the banks' services are accessed electronically by customers in the state.

Location of Internet-only bank under 12 U.S.C. 85 (12 C.F.R. § 7.5009)

The lack of a physical presence for some banks may create difficulties in determining the bank's home state for purposes of interest rate exportation under 12 U.S.C. 85. The OCC therefore prescribes in § 7.5009 that Internet-only banks are deemed to be located in the state where the bank's main office is located unless legally relocated.

III. Safety and Soundness

Shared electronic space (12 C.F.R. § 7.5010)

In Section 7.5010, the OCC applies the same rules applicable to banks sharing physical

space under 7.3001(c) for when banks share electronic space with subsidiaries or third parties. Under Section 7.3001(c), a bank sharing physical space must take reasonable steps to segregate its operations from those of others and minimize the potential for customer confusion.

The preamble explains that where a bank shares electronic space, even with affiliated or subsidiary institutions, the bank must "take reasonable steps to clearly, conspicuously, and understandably distinguish between products and services offered by the bank and those offered by the bank's subsidiary, affiliate, or the third-party." 67 Fed. Reg. 34,992, 35,002. This same treatment also applies to other electronic operations such as co-branded websites.

* * *

If you would like more information on the OCC's E-banking rule, please contact:

Gregory Baer (202) 663-6859
gbaer@wilmer.com

Franca Harris Gutierrez (202) 663-6557
fgutierrez@wilmer.com