ALERT MEMORANDUM

June 12, 2020

OCC Looks to Expand Digital Banking and Proposes Updates to Bank Activity Regulations:
Codification, Clarification and Additional Flexibility

On June 4, the Office of the Comptroller of the Currency published a Proposal to update rules applicable to the **activities and operations** of national banks and Federal savings associations. Comments on the Proposal are due August 3. Simultaneously with the Proposal, the OCC released an Advance Notice of Proposed Rulemaking requesting comment on expanding, updating and improving the regulations and interpretations on **digital and electronic activities**. The ANPR is quite open-ended, and we anticipate that comments are likely to take many forms, from direct responses to white papers and research analyses. Comments on the ANPR are also requested by August 3.

The Proposal would **clarify and codify several long-standing OCC interpretations** (or series of interpretations)—most notably covering **derivative activities, tax equity finance transactions and payment systems memberships**—and update or eliminate certain outdated regulatory requirements. On balance, we expect the Proposal would provide greater certainty and transparency in these areas, particularly as the codifications tend to be relatively short and compact in comparison to the varying conditions and requirements that appear through years of interpretive letters. If the Proposal is finalized, it could relieve some longstanding practical difficulties, stemming in part from the highly fact-dependent or case-by-case nature of the OCC's historic approach and the occasionally conflicting views of supervisory staff as to whether a new or modified interpretation would be necessary to address a bank's particular activity proposal. Furthermore, the Proposal would follow a recent general trend among the U.S. banking agencies to reduce "enforcement" based on nonbinding guidance, but to increase clarity and permanence through promulgation of binding regulation.

The Proposal would also **more clearly delineate roles for OCC examination staff and legal staff**. Under prior requirements to obtain examination staff non-objections, the line between examination staff review of the bank's ability to conduct the activity in a safe and sound manner, and the activity's legal permissibility, often became blurred. The conservative path in the face of these ambiguities was often to seek additional interpretations from OCC legal staff, even if the activity was, or was an outgrowth of an activity, deemed permissible in prior interpretations. Several provisions in the Proposal would require only notice to a bank's supervisory team, rather than a request for approval or non-objection.

Furthermore, the Proposal seeks to make the activity and governance regulations more relevant and flexible for **national banks that may be considering simplification of their structures**, and particularly those that have eliminated, or that may follow a market trend in considering shedding, a holding company structure (thus making the bank the top-tier entity).

Finally, the Proposal would **integrate some regulations for national banks and Federal savings associations**, continuing the post-Dodd-Frank Act efforts to harmonize the thrift and national bank charters. Nevertheless, several differences would remain, either at the discretion of the OCC or based on each charter's governing statutory framework.

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I. DERIVATIVES

In the Proposal,[1] the OCC would clarify and codify decades of interpretations related to the derivatives powers of national banks through a relatively compact authorization regulation. Commenters, however, may question whether the regulatory text in several spots actually captures all of the nuances and embedded authorizations appearing in prior interpretations.

SUMMARY OF PROPOSAL:

- The Proposal would clarify that all national banks **may engage in derivatives activities** of the following types:
  - On underlying reference assets that a national bank is permitted to **purchase directly as an investment** (including interest rates, foreign exchange and currency, credit, precious metals and investment securities);
  - On any underlying reference asset, in order to **hedge risks arising from bank-permissible activities**; and
  - As **financial intermediary** with any underlying reference asset, and **either perfectly matched or portfolio hedged**, provided that the derivative is customer-driven—these derivatives may be conducted in any of three different ways:
    - Cash settled,
    - Physically settled by transitory title transfer, or
    - Physically settled (other than by transitory title transfer) and/or physically hedged.
- **Notice would be required** to a national bank's examiner-in-charge ("EIC") at least 30 days prior to commencing either of the following activities:
  - engaging in any derivatives transactions based on underlying reference assets that a national bank is not permitted to purchase directly as an investment, or
  - expanding any of such activities to include a "new category" of underlying reference assets for derivatives transactions.
- The Proposal would codify a number of conditions to engaging in **physical hedging activities**:
  - Solely to hedge risks arising from **customer-driven** derivatives transactions;
  - Only if physical hedging offers a **cost-effective** means to hedge risks;
  - **No anticipatory or residual positions**, except as necessary for the orderly establishment or unwinding of a hedging position;
  - **Equity securities** for hedging purposes may **not constitute more than 5% of a class** of voting securities of any issuer; and
  - With respect to physical hedging involving **commodities**:

[1] "Activities and Operations of National Banks and Federal Savings Associations" (June 4, 2020) (the "Proposal"), https://www.occ.gov/news-issuances/news-releases/2020/nr-occ-2020-76b.pdf.

- A physical position in a particular commodity (including, as applicable, delivery point, purity, grade, chemical composition, weight, and size) must **not be more than 5% of the gross notional value** of the bank's derivatives (1) on that particular physical commodity and (2) that allow for physical settlement within 30 days (but commodities acquired and immediately sold through transitory title transfer do not count against this limit);
- The physical position must **more effectively reduce risk than a cash-settled hedge** referencing the same commodity; and
- Receipt of physical quantities of the commodity on **bank premises is not permitted**.

OBSERVATIONS:

- *Certain historical burdens on derivative activities*. The OCC offers two significant clarifications that are likely to make undertaking derivative activities more efficient and less burdensome:
  - First, the OCC would put to rest the ongoing debate as to whether engaging in certain types of derivative activities requires repeated authorization with regard to *legal permissibility*. By authorizing "any" underlying reference asset, and indicating that all may be conducted in perfectly matched, portfolio hedged, cash and/or physically settled form, the OCC would reduce the proliferation of interpretive letters on a reference-asset-by-reference-asset basis and on a hedging-style basis.[2]
  - Second, the OCC would clarify that no derivative activities would require *prior approval*—instead, the regulation would constitute prior approval to engage in the activities. The preamble to the Proposal is clear that any prior notice to the national bank's EIC is merely a notice and not an approval requirement,[3] and is designed to keep the EIC apprised of the bank's activities and allow the EIC to incorporate these new activities in the cycle of examinations.[4]
  - Related to both these points, the Proposal should also cure the historical conflation of *legal permissibility* and *risk management*. From time to time, national banks looking for an examiner non-objection (as required by many prior interpretive letters) from a safety and soundness or risk management perspective would be informed that a non-objection also required a legal sign-off, even if a prior interpretive letter was directly on point. The Proposal specifically provides the legal authorization in the regulatory text, and specifically indicates that review of a national bank's risk

[2] *See, e.g.*, OCC Interpretive Letter No. 1056 (Mar. 29, 2006) (clarifying that (1) linear low density polyethylene and polypropylene are permissible underlying reference assets when OCC Interpretive Letter No. 1039 (Sept. 13, 2005) ("Interpretive Letter 1039") had mentioned only high density polyethylene, and (2) frozen orange juice is a permissible underlying reference asset when Interpretive Letter 1039 had mentioned only "orange juice"); OCC Interpretive Letter No. 1060 (Apr. 26, 2006) (permitting portfolio hedging for coal derivatives when prior Interpretive Letters had described only perfectly matched coal derivatives).

Through 2005's Interpretive Letter 1039, the OCC commenced a period of significant uncertainty for national banks, as it was not completely clear why small differences in the underlying reference asset mattered for purposes of determining *legal permissibility*, and therefore why separate interpretive or approval letters were needed for each.

[3] *See* Proposal at 53-4.

[4] *See* OCC Interpretive Letter No. 1160 (Aug. 22, 2018) ("Interpretive Letter 1060") (providing for EIC notice and ongoing monitoring requirements instead of an EIC prior non-objection determination).

management with regard to derivatives activity is separate and should be undertaken in the normal exam cycle.[5]

- *Notice when adding a new "category" of underlying reference assets*. Nevertheless, the Proposal could potentially continue some of the confusion regarding case-by-case review. The Proposal requires a notice to a national bank's EIC, if the bank proposes to expand certain (previously noticed) derivatives activities "to include any new category of underlyings". The Proposal requests comment on whether the concept of "new category" is clear and whether "categories" should be listed in the regulation. To illustrate the categories, the preamble cross-references a list of interpretive letters.[6]
  - The cross-referenced interpretive letters are likely to be viewed as too granular, and derived from an era when the OCC was approving every particular commodity or security reference asset. In addition, the referenced letters include only commodities, but similar proliferation of equity hedging letters occurred after the OCC's initial approval of hedging with equity securities in 2000.[7]
  - Therefore, commenters on the Proposal may want to recommend a less granular division of "categories". Categories could be as broad as "equities", "non-investment-grade debt", "commodities" and "real estate", or could have a few subcategories of commodities, without requiring a specific reference-asset-by-reference-asset notice as the list of letters in the preamble implies.
  - Helpfully, however, the "category" concept would apply to a prior notice requirement that the OCC clarified is meant to be solely a notice, as discussed above. Therefore, if a granular category-by-category notice requirement were retained, it still would not be as burdensome as the prior non-objection procedures in pre-Interpretive Letter 1160 guidance.
- *Physical hedging authority*:
  - The Proposal would provide clear authority to hedge with physical commodities, without obtaining prior approval.[8] However, the Proposal would not relax the OCC's interpretation requiring that physical commodity hedging activities be only "a nominal percentage of a bank's risk management activities". In OCC Bulletin 2015-35 (Aug. 4, 2015), the OCC set forth a formula for determining a "nominal percentage" of risk management activities, concluding that the value (short or long) of "each commodity" held could not be greater than 5% of the gross notional value of the derivatives for which physical settlement in that commodity was permitted over the next 30 days. This formula would be adopted in the Proposal. Therefore:
    - Subject to delta hedging potentially requiring a lower amount, a national bank must hedge a significant portion of its physically settled commodity derivative obligations with either transitory title, back-to-back derivatives or through some other means, and

[5] Indeed, the OCC notes that the notice to a national bank's EIC need not reference any OCC interpretive letter as a basis for legal permissibility of the activity. Proposal at 53.

[6] While the preamble cross-references footnote 27, we believe that the cross-reference should be to the list of interpretive letters in footnote 87 of the preamble.

[7] *See, e.g.*, OCC Interpretive Letter No. 1090 (Oct. 25, 2007) (listing a number of different types of equity securities that would be permissible to hold under the equity hedging authority).

[8] OCC Banking Circular No. BC-277, "Risk Management of Financial Derivatives" (Oct. 27, 1993), required OCC approval of a "detailed plan" before a bank could commence hedging with physical commodities.

- A national bank may not take into account for physical hedge purposes any of its physically settled commodity derivatives that do not mature or require delivery within the next 30 days, thus leaving longer maturity contracts potentially to be hedged in another manner.

  - The OCC requests comment on whether any of the physical hedges (commodities or securities) should be subject to a liquidity requirement. There are several reasons why a liquidity requirement may not be beneficial and may, in fact, reduce flexibility that national banks believe they already have under existing interpretations:

    - Liquidity requirements are inherently subjective and highly dependent on facts, circumstances, geographies, relationships and a host of additional factors. Addition of a liquidity element would likely cause an increase in interpretations needed from the OCC, contrary to the main thrust of the entire Proposal to reduce the need for additional guidance across a number of areas (including areas outside of derivatives authority).

    - In many cases, the physical hedge will either be delivered to the counterparty in physical settlement or the payment to or from the counterparty may incorporate some elements of recent price transparency or liquidity (*e.g.*, pricing based on sale of the hedge over a period of time).

- *Limitation on physical settlement?* Notwithstanding the general permission in the Proposal to physically settle a derivative, the OCC has defined "customer driven" as a transaction that "is entered into for a customer's valid and independent business purpose (and a customer-driven transaction *does not include a transaction the principal purpose of which is to deliver to a national bank assets that the national bank could not invest in directly*)" (emphasis added). The provision appears to have an anti-evasion purpose, but there are likely better ways to accomplish that purpose than the ambiguous language inserted into the definition of "customer-driven". There are a number of valid and non-evasive reasons why a national bank may enter into a physically settled transaction designed to deliver to the bank assets that it could not invest in directly, including reasons embedded directly in the Proposal (e.g., to obtain a back-to-back, perfectly matched and physically settled derivative in order to be able to deliver on another customer derivative in its portfolio). While the Proposal may suggest that this example involves hedging, which is not subject to the "customer-driven" requirement, the language still raises significant ambiguity.

II. TAX EQUITY FINANCING

The Proposal would codify, and make more flexible, a bank's ability to invest in projects for which investors are expected to receive tax credits (such as the New Markets Tax Credit, Solar Investment Tax Credit, Energy Production Tax Credit and Business Energy Investment Tax Credit, among others), notwithstanding that (1) these projects usually require that the investment be in equity (typically impermissible for banks) and (2) the project company engages in activities that are not part of the business of banking.[9]

SUMMARY OF PROPOSAL:

- A national bank or Federal savings association may engage in tax equity finance ("TEF") transactions that are the "**functional equivalent of a loan**".

  - In these transactions, a bank provides equity financing to fund a project that generates tax credits and

[9] The Proposal does not address or modify other authorities under which a national bank may invest in tax credit projects, including community development and public welfare investment authorities under 12 U.S.C. 24(Eleventh) and 12 C.F.R. Part 24.

other tax benefits, and the use of an **equity-based structure** allows the transfer of those credits and benefits to the bank.

- **Conditions** to engaging in TEF transactions:
  - The structure of the transaction is **necessary** for making the tax credits and other tax benefits available to the bank;
  - The transaction is of **limited tenure** and is not indefinite;
  - The investment is **repaid**, and the implied rate of return is provided, **from the tax benefits** and other payments received from the transaction; repayment or returns **do not rely on appreciation** of value in the project or property rights underlying the project;
  - The bank uses approval standards that are **substantially equivalent to the underwriting and credit approval criteria and standards** used for a traditional commercial loan;
  - The bank is a **passive investor** in the transaction, unable to direct the affairs of the project, and the bank cannot control the sale of energy, if any, from the project;
  - The bank **appropriately accounts for the transaction** initially and on an ongoing basis and has documented contemporaneously its accounting assessment and conclusion;
  - The bank **limits the total dollar amount** of tax equity finance transactions to **no more than 5%** of its capital and surplus, but the bank may request that **the OCC approve an amount up to 15%** of the bank's capital and surplus;
  - The national bank or Federal savings association provides **written notification** to the OCC prior to engaging in **each** TEF transaction;
  - The bank has **appropriate risk management capabilities** to identify, measure, monitor, and control the associated risks of its TEF transactions individually and as a whole on an ongoing basis; and
  - The transactions must be subject to a bank's **legal lending limits** and, if applicable, **any limits under Sections 23A and 23B** of the Federal Reserve Act and Regulation W.

OBSERVATIONS:

- *Clarifying, and offering more flexibility than, prior interpretations*. By narrowing the conditions to engaging in a TEF transaction to certain essential factors at the core of the OCC's prior interpretations, the Proposal would standardize the review by banks of TEF transactions and remove ambiguity generated by differing standards over several prior interpretive letters.
  - In the most clear change from precedent, the OCC would permit the total amount of TEF transactions to constitute up to 5% of a bank's capital and surplus, with the possibility of requesting that the OCC provide a limit up to 15%—a 2013 interpretive letter had placed a 3% cap on TEF transactions.[10]
    - Nevertheless, we expect that this limit will generate comments to the OCC, as it is not clear why (and the OCC does not offer a specific reason other than general safety and soundness for why) an aggregate limit is required in relation to loan-equivalent transactions. Indeed, Interpretive Letter 1139 was the cause of some ambiguity in the TEF transaction space, because letters

[10] *See* OCC Interpretive Letter No. 1139 (Nov. 13, 2013) ("Interpretive Letter 1139").

permitting TEF transactions prior to 2013 did not contain this limitation.[11]

- Depending on how one reads some of the prior interpretive letters on TEF transactions, a number of "facts" or "representations" provided by the bank requesting the interpretation could be read as requirements or conditions to the conduct of TEF transactions. For example, in Interpretive Letter 1139, the requesting bank had "represented" that neither it nor any of its U.S. affiliates engaged in electricity or energy trading activities. If read as a requirement, a large number of U.S. banks with affiliates engaged in complementary energy trading activities[12] would not have been permitted to make TEF investments. Other similar examples exist in the prior TEF interpretive letters.[13] The proposed regulation would limit the conditions to only those listed above.

- *Real estate*. We note that prior interpretive letters[14] provided significant analysis of whether a TEF transaction might result in the ownership of an interest in real estate in contravention of 12 U.S.C. § 29 (limitations on national bank ownership of real estate). The conditions in the proposed regulatory text do not discuss the real estate aspects of TEF transactions. Instead, the OCC relies on its past interpretations and in the preamble states definitively that "wind turbines, solar panels, and other ancillary equipment are not considered real property under 12 U.S.C. 29, and acquisition of interests in real estate incidental to the provision of financing is not inconsistent with 12 U.S.C. 29".[15] This definitive statement is a signal that the debate over the real estate elements of these transactions has, from the OCC's perspective, ended.[16]

- *Notification*. We expect that commenters may still find the notice requirement for "each" TEF transaction to be burdensome, particularly if the bank's aggregate TEF transactions are still under the regulatory (or OCC-assigned) limit. We also note that the preamble does not clarify the meaning of "written notification", but if it is interpreted similarly to the notice requirements for, *e.g.*, derivatives activities, then the requirement would not be as burdensome as requesting an EIC non-objection or prior approval.

- *Limited tenure*. The preamble clarifies that the OCC intends this requirement to be more concrete than it may appear, including that the OCC expects (subject to tax law requirements) there to be a definitive date upon which the bank's involvement terminates, perhaps through an option of another investor/sponsor to buy the bank out or requirement of the bank to put the investment to another party. This is consistent with several of the prior interpretive letters on TEF transactions.

- *Bank underwriting procedures*. Similarly, although not explicit in the regulatory text, the proposed provision requiring a bank to use its standard credit underwriting procedures is intended by the OCC to also include a requirement from the prior letters that documents governing the transaction contain terms and conditions equivalent to those found in documents governing typical lending relationships and transactions.

[11] *See* OCC Interpretive Letter No. 1048 (Dec. 21, 2005) ("Interpretive Letter 1048"); OCC Interpretive Letter No. 1048a (Feb. 27, 2006); OCC Interpretive Letter No. 1053 (Jan. 31, 2006) ("Interpretive Letter 1053").

[12] *See, e.g., Citigroup Inc.*, Federal Reserve Board Order dated Oct. 2, 2003; *The Royal Bank of Scotland Group plc*, Federal Reserve Board Order dated Mar. 27, 2008 (long-term electricity supply contracts)

[13] *See, e.g.,* Interpretive Letter 1139 (the requesting bank represented that "it would not provide financing until the Facility is ready to be 'placed into service.' As a result, the Bank would not take on any construction risk.").

[14] *See* Interpretive Letter 1048; Interpretive Letter 1053; Interpretive Letter 1139.

[15] Proposal at 24.

[16] The OCC had spent significant time defending its decision on the real estate elements of TEF and other transactions. *See* Interpretive Letter 1053.

- In addition, the OCC requested comment on whether a bank should have other contractual remedies, such as the option to replace the sponsor or manager of a project under certain conditions or an indemnification or guarantee from a project sponsor.

- *Accounting*. While the bank must treat the transaction as a loan for credit analysis/underwriting, documentation, legal lending limit and Regulation W purposes, the OCC acknowledges that the accounting treatment may not be as a loan. Indeed, it is likely that the tax analysis of a TEF transaction could be negatively affected if it were required by the OCC to be booked as a loan or extension of credit for balance sheet purposes.

- *Requests for comment*. The OCC fashions the TEF transaction authority as a form of commercial or industrial lending. Nevertheless, it requested comment on whether other structures should be specifically contemplated by a final regulation, including:
  - residential installation projects, not involving utility-scale standalone power-generation facilities;
  - other projects involving detached single-family residences, multi-family residences, or non-utility commercial buildings; and
  - participation in TEF transactions through fund-based structures.

III. PAYMENT SYSTEM MEMBERSHIP

The Proposal would codify a line of OCC approvals and interpretations regarding the process for national banks and Federal savings associations to join payment systems.

SUMMARY OF PROPOSAL:

- Payment systems would be **defined as "financial market utilities"**[17] meaning "any person that manages or operates a multilateral system for the purpose of transferring, clearing, or settling payments, securities, or other financial transactions among financial institutions or between financial institutions and the person".
  - U.S. and non-U.S. **derivatives clearing organizations** and **securities clearing agencies** would be **excluded** from the definition.
- If membership in a payment system would expose a bank to **open-ended liability,** then **prior notice** of 30 days would be required; if not, then **after-the-fact notice** of 30 days would be required.
  - **Open-ended liability** would refer to liability for **operational losses that is not capped** under the rules of the payment system and includes indemnifications provided to third parties as a condition of membership in the payment system.
    - If a bank believes that, notwithstanding the open-ended nature of the payment system's rules, its liability is otherwise limited (*e.g.*, by law or contract), prior to joining it should **obtain an independent legal opinion** that describes how the payment system allocates liability for operational losses, contains a conclusion that liability is in fact limited, and that describes how any potential liability does not exceed the lower of the bank's lending limit or the limit for the institution set by the OCC.

[17] 12 U.S.C. 5462(6).

  - o **Operational loss** would mean a charge resulting from **sources other than defaults** by other members of the payment system.
- Joining a payment system would be subject to **safety and soundness procedures.**
  - o **Prior to and on a continual basis after joining**, the bank must identify and evaluate the risks posed by membership in the payment system (taking into account whether the liability is limited), and measure, monitor, and control those risks.
  - o **After joining,** the bank would need to notify the OCC if its ongoing risk management identifies a safety and soundness concern, such as a material change to the bank's liability or indemnification responsibilities, as soon as that concern is identified, and the bank would be required to take appropriate actions to address and remediate the concern.

OBSERVATIONS:

- Codification of the process described in OCC Interpretive Letter No. 1157 (Nov. 12, 2017) ("Interpretive Letter 1157") (including its notice, rather than no-objection, procedure) is likely to assist in streamlining and making the conditions to joining payment systems more accessible to a greater number of banks. This approach mirrors other aspects of the Proposal, such as derivatives, where the OCC has proposed to eliminate approval or no-objection requirements, instead favoring an approach built around providing notice coupled with risk management and safety/soundness undertakings.
- However, there are a number of unanswered questions, including in relation to why the OCC did not propose to make the payment systems regulation more comprehensive by covering several similar interpretations that the OCC has provided over time. We discuss those issues below.
  - o *Payment systems definition.* Payment systems include financial market utilities,[18] but exclude U.S. and non-U.S. derivatives clearing organizations and securities clearing agencies. The OCC did not provide a rationale for these exclusions, but has requested comment on whether they are appropriate.
    - Parallel with its payment systems membership precedents, the OCC has approved a long line of requests by banks to become members of derivative clearinghouses, commodities central counterparties and securities clearing agencies, both domestically and abroad.[19]
    - These interpretations generally follow an analysis and conclusion similar to those for payment systems memberships, although the OCC has not determined that a mere notice to a bank's EIC would be sufficient in the case of derivatives and securities clearinghouses, in contrast to its conclusions in the Proposal and in Interpretive Letter 1157 for payment systems. Therefore,

[18] 12 U.S.C. § 5462(6) (defining "financial market utility" to mean "any person that manages or operates a multilateral system for the purpose of transferring, clearing, or settling payments, securities, or other financial transactions among financial institutions or between financial institutions and the person.").

[19] *See, e.g.,* OCC Interpretive Letter No. 929 (Feb. 11, 2002) ("Interpretive Letter 929") (London branch membership in LCH SwapClear); OCC Interpretive Letter No. 1014 (Jan. 10, 2005) (membership in loss allocation system of the Government Securities Division of the Fixed Income Clearing Corporation); OCC Interpretive Letter No. 1071 (Sept. 6, 2006) (membership in independent system operators or regional transmission organizations for physical and derivative electricity trading); OCC Interpretive Letter No. 1102 (Oct. 14, 2008) ("Interpretive Letter 1102") (membership in an India securities clearinghouse); OCC Interpretive Letter No. 1113 (March 4, 2009) (membership in ICE Trust credit derivative clearinghouse); OCC Interpretive Letter No. 1122 (July 30, 2009) ("Interpretive Letter 1122") (membership in ICE Clear Europe derivative clearinghouse).

primarily for risk exposure reasons, a bank seeking membership in a derivatives or securities clearinghouse generally must obtain a no-objection determination from its EIC.

- Nevertheless, the Proposal could have been broader to cover more multilateral clearing systems.

- *Operational losses.* The Proposal provides for authority to become a member of a payment system, even if there is "open-ended liability" for "operational losses". Operational losses are "charge[s] resulting from sources other than defaults by other members of the payment system".[20]
  - The Proposal appears to be too narrow in relation to the authority already granted by a series of OCC precedents on joining payment systems and clearinghouses. While the Proposal states that "OCC legal precedent only has addressed whether a national bank may assume open-ended liability for operational losses at the payment system" and therefore "the OCC is proposing to define 'operational loss' as a charge resulting from sources other than defaults by other members of the payment system",[21] the OCC has a number of significant and important precedents where banks have been permitted to join clearinghouses even if the rules of the clearinghouse would impose potential liability for the credit risk and default of other members.
  - In particular, Banking Circular 235, as early as 1989, indicated that banks participating in payment systems must control for the credit, counterparty and settlement risks inherent in these systems, including through potential default of other members, and operational risks were relegated to the last page of the Banking Circular.
  - A series of OCC precedents regarding membership in derivatives or securities clearinghouses specifically took on the questions of both theoretically limited[22] and open-ended/unlimited[23] liability allocated by the clearinghouse in the event of a default of another member, and approved both subject to EIC non-objection and the ability to monitor the risks of the clearinghouse to keep projected liability within a bank's legal lending limit.

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[20] OCC Banking Circular BC-235, "International Payment Systems Risks" (May 10, 1989) ("Banking Circular 235"), defined operational risks as including: "(a) system failure - caused by a breakdown in the hardware and/or software supporting the system. This may result from design defects, insufficient system capacity to handle transaction volumes, or mechanical breakdown, including telecommunications. (b) system disruption - the system is unavailable to process transactions. This may be caused by system failure, destruction of the facility (natural disasters, fires, terrorism), or operation shutdown (employee actions, business failure, or government action). (c) system compromise - resulting from fraud, malicious damage to data, or error." The Proposal and OCC Interpretive Letter No. 1140 (Jan. 13, 2014) ("Interpretive Letter 1140") also provide examples of operational loss, including "losses that are due to: employee misconduct, fraud, misjudgment, or human error; management failure; information systems failures; disruptions from internal or external events that result in the degradation or failure of services provided by the payment system; or payment or settlement delays, constrained liquidity, contagious disruptions, and resulting litigation." Proposal at 30.

[21] Proposed § 7.1026(b)(4).

[22] *See, e.g.,* Interpretive Letter 929 (theoretical cap on liability because bank may resign membership and limit its loss allocation to its original default fund contribution).

[23] *See, e.g.,* Interpretive Letter 1102. Indeed, in footnote 2 of Interpretive Letter 1102, the OCC contrasted the required procedure for clearinghouses with theoretically limited liability (certification to the EIC that liability is limited and is within the bank's legal lending limit) and situations with potential allocation of unlimited liability from defaulting members (EIC non-objection and continuous review and monitoring of exposure to ensure that projected exposure is within the bank's legal lending limit).

    - Therefore, the OCC could have written a more comprehensive regulation to encompass all financial market utilities (including derivatives and securities clearinghouses) and even those situations where fellow clearing member default is allocated to a bank (rather than just operational losses).

  - *Application of legal lending limits.* Greater clarity is likely necessary with regard to the application of legal lending limits to memberships in financial market utilities.

    - The OCC's legal lending limits provide calculation methodologies for banks that face clearinghouses on cleared transactions. First, the exposure amount of non-credit-default transactions is to be calculated using one of four methodologies (the current exposure methodology, a model methodology, a conversion factor matrix methodology or the standardized approach to counterparty credit risk).[24] For exposures to clearinghouses, the bank must also add any initial margin posted to the clearinghouse and (for banks that are members) any contribution to the clearinghouse's default guarantee fund.[25]

    - The OCC interpretive letters relied on for the Proposal's new provisions on payment systems describe requirements to monitor exposure to the payment system and manage that exposure within "predetermined risk limits". The bank must also have an "ability to monitor and report aggregate risk exposures and measurement against risk limits both at the sponsoring business line level and the total exposure organizationally".[26] However, these letters to not mention maintaining exposure levels within the bank's legal lending limits.

    - The Proposal states that a bank should certify to its EIC in its after-the-fact notice that its exposure to a payment system with capped liability for operational losses is within its legal lending limit or such lower limit established for the bank by the OCC (or that the payment system rules do not impose liability for operational losses).[27] In contrast, the prior notice for membership in a payment system with open-ended liability requires that the bank only be able to monitor and measure its exposure to the payment system, but does not refer to maintaining the exposure within its legal lending limit.[28]

    - OCC interpretive letters on the subject of exposure to derivatives or securities clearinghouses generally require that a bank analyze any liabilities allocated to the bank from operational losses or from the default of other members, and be able to model and monitor that exposure (whether it is capped or open-ended/unlimited) to confirm that it is within a bank's legal lending limits (or such other smaller limit set by a bank's EIC).[29]

- *Independent legal opinion*. We note that the option in proposed § 7.1026(e)(4) for obtaining an independent legal opinion that a bank's liability for operational losses is not, in fact, open-ended appears to assist a bank in its risk management procedures under subparagraph (e). However, commenters should consider whether it could be more appropriately applied to the notice requirement so that a bank may benefit from the after-the-fact notice rather than the prior notice. A few additional tweaks in the notice

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[24] 12 C.F.R. § 32.9(b)(1).

[25] 12 C.F.R. § 32.9(b)(3).

[26] *See* Interpretive Letter No. 1140 (Jan. 13, 2014). *See also* Interpretive Letter 1157.

[27] *See* proposed §§ 7.1026(c)(2) and (d)(2).

[28] *See* proposed §§ 7.1026(c)(1), (d)(1) and (e)(1)-(3).

[29] *See* Interpretive Letters 1102 and 1122.

sections and in the definition of "open-ended liability" along the same lines could likely make the proposed provision much more beneficial and widen the scope of payment systems that could qualify for after-the-fact notice, without increasing perceived risks.

IV. Branching

The Proposal would generally provide national banks the ability to provide a **greater range of services** at locations **without having to characterize them as branches**.

Summary of Proposal:

- The Proposal would codify an OCC interpretation[30] that a national bank **may distribute loan proceeds directly to a borrower in person at an office of an operating subsidiary**, without turning that office into a branch, if the operating subsidiary provides similar services on substantially similar terms and conditions to customers of unaffiliated entities, including unaffiliated banks. Under these circumstances "money" would not be deemed to be "lent" from that office.
- The Proposal would codify an interpretation that **"remote service units"** ("RSUs") also include non-automated and unstaffed facilities, such as **drop-boxes for payments or deposits**.[31] RSUs are **not treated as branches**.[32] A location at which a bank operates a combined loan production office, deposit production office and an RSU would also continue not to be treated as a "branch", and the Proposal clarifies that an RSU at a **combined location** "must be primarily operated by the customer with at most delimited assistance from bank personnel".[33]
- In addition, in an effort to clarify that prior regulations were not intended to be rigid, the Proposal would make more general the **loan production office authority** to provide that a national bank may solicit loan customers, market loan products, assist potential borrowers in completing documentation, make credit decisions and offer other loan information such as applications, provided that (1) "money" is not "lent" at that site and (2) the office does not accept deposits or pay withdrawals.
- The Proposal would also codify an OCC interpretation[34] regarding when premises of a third party at which a national bank participates in a **financial literacy program is not a branch**.
  - The key requirement that a bank not "establish and operate" the premises or facility would remain unchanged.
  - The OCC would still review these programs and their premises on a case-by-case basis, but would propose to apply the safe harbor for third-party messenger services[35] to financial literacy program locations. Generally, the safe harbor should be met if a bank's participation is limited to managing or

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[30] OCC Interpretive Letter No. 814 (Nov. 3, 1997) ("Interpretive Letter 814").

[31] OCC Interpretive Letter No. 1165 (June 28, 2019).

[32] 12 U.S.C. § 36(j).

[33] *See also* OCC Conditional Approval No. 313 (July 9, 1999) (Bank personnel who are physically present will not be considered to be staffing the facility provided that "withdrawals undertaken . . . will be accomplished by depositors, not by bank personnel" and bank personnel "cannot operate the [facility] on behalf of a [c]ustomer.").

[34] OCC Interpretive Letter No. 839 (Aug. 3, 1998).

[35] *See* 12 C.F.R. § 7.012(c)(2).

conducting activities, while the third-party organization retains control over the program and the premises or facilities.

- Finally, while it would remain in the definition of "financial literacy program", the concept that the "principal purpose" of the program be educational would no longer be part of the determination of permissibility of the location and whether the premises or facility is a branch.

- The Proposal would replace the anachronistic authority to "operate a postal substation" on banking premises with the more general power to "provide postal services".

OBSERVATIONS:

- *Branching functions.* The Proposal clarifies and modestly expands the scope of activities that may be conducted at a location of a bank or its operating subsidiary without rendering that location a branch. Because establishing a new branch requires OCC approval, this aspect of the Proposal is likely to reduce administrative burdens associated with expansion and, when combined with an updated set of digital activity regulations, potentially allow greater delivery of services electronically even at brick-and-mortar non-branch locations.

- *Distribution of loan proceeds from an operating subsidiary.* Allowing distribution of loan proceeds at certain operating subsidiaries that provide similar services to others appears to be a broad example of the OCC's position that locations that offer no competitive advantage to the national bank should not be deemed branches.[36]

  - The OCC interpretation on which the codification is based involved a bank operating a loan disbursement office where the bank was (1) "actively engaged" in soliciting and providing services to nonaffiliated entities and their customers (2) on "substantially similar terms and conditions" as those offered to bank customers and (3) less than 10 percent of the business arose from loans made by the bank and its subsidiaries. However, the Proposal would codify only the second condition, which appears to provide additional flexibility to operate a loan disbursement office without potentially managing other compliance metrics.[37]

- *Scope of "financial literacy".* The revised permission to participate in a financial literacy program on a third party's premises without turning those premises into a branch could have been simplified further and could have eliminated OCC review on a case-by-case basis (as the Proposal does in other areas). Applying the messenger service regulation safe harbor also seems inapposite because, if a messenger service is established by a bank, the service could transfer deposits or withdrawals at many locations, therefore raising branching issues, but it is unlikely that a financial literacy program operated by a bank at, for example, a conference center (*even if* established by the bank) would be engaging in branching functions (*i.e.*, making loans, paying checks or allowing withdrawals).

- *RSUs.* OCC interpretations have recognized that whether a location is a "branch" may turn on the nature of the *interaction* between a customer and bank personnel, rather than the *underlying service* that is being provided. For example, a location at which deposits are taken by an automated teller machine ("ATM") is not a branch, whereas a location at which deposits are received in person by a teller would be. That distinction would generally continue to be employed by the OCC even with regard to drop boxes

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[36] *See, e.g.*, Interpretive Letter No. 635 (July 23, 1993) (describing that a facility must provide convenience to bank customers that gives the bank a competitive advantage in obtaining customers).

[37] Interpretive Letter No. 814.

(although they were formerly deemed “branches”) and other RSUs at combined locations, provided that any interaction between customers and bank personnel is limited and the customer operates any electronic devices provided by the bank at the location.

- *Removal of references to a “postal substation”.* While this may seem like a minor modification, this change would provide flexibility for a branch to engage in activities in any manner that the U.S. Postal Service believes may be appropriate, without implying that the branch has to operate an entity or a location that may resemble a postal office.

V. CORPORATE GOVERNANCE

The Proposal would make several changes to corporate governance procedures, defined as those involving the operation and mechanics of a national bank’s **internal organization**, including relations among owners-investors, directors, and officers.[38]

Among the several corporate governance proposals, below we focus on two selected modifications in the Proposal: (1) the ability to elect certain State law corporate governance procedures, and (2) the ability to adopt anti-takeover measures.

SUMMARY OF PROPOSAL:

- *State corporate governance procedures.* In addition to being able to elect the corporate governance procedures of the law of the State in which the **main office** of the bank is located, the law of the State in which **the holding company** of the bank is incorporated, Delaware General Corporate Law, or the Model Business Corporation Act, national banks would also be authorized to elect the corporate governance provisions of a wider set of States—specifically the law of:
  - **any State** in which **any branch** of the bank is located;
  - **a State** where **any holding company** of the bank is incorporated; or
  - the State where its holding company is incorporated **even if the holding company is later eliminated** or no longer controls the bank, and the national bank is not located in that State.

  The election would be permitted only if not inconsistent with Federal law and bank safety and soundness.
- *Anti-takeover measures.* National banks would be permitted to adopt **anti-takeover measures** included in State law, if those provisions are **not inconsistent with Federal law** and **not inconsistent with bank safety and soundness**. The OCC has determined that the following anti-takeover measures are not inconsistent with Federal law and therefore **would be permissible** for a national bank to adopt:
  - Restrictions on business combinations with interested shareholders;
  - Poison pills;
  - Requiring all shareholder actions to occur at a meeting, and not by written consent;
  - Limits on shareholders’ ability to call special meetings; and
  - Shareholders’ removal of directors only for cause.

[38] Proposal at 57. Corporate governance procedures do not include requirements that relate to the banking powers or activities or relationships between a national bank and customers or third parties.

Anti-takeover measures that the OCC believes are **inconsistent with Federal law**, and therefore **would not be permissible** to adopt, are: (1) supermajority voting requirements and (2) restrictions on a shareholder's right to vote all the shares it owns.

Any State corporate governance provision, including anti-takeover provisions, that would **render more difficult or discourage a capital injection** by purchase of bank stock, a merger, the acquisition of the bank, a tender offer, a proxy contest, the assumption of control by a holder of a large block of the bank's stock, or the removal of the incumbent board of directors or management **would be inconsistent with bank safety and soundness** if:

- the bank is less than adequately capitalized;
- the bank is in troubled condition;
- grounds for the appointment of a receiver are present; or
- the bank is otherwise in less than satisfactory condition, as determined by the OCC;

except, a bank that adopts an anti-takeover measure is not in violation if, at the time it adopts the provision, the national bank: (1) is not subject to any of the foregoing conditions and (2) includes along with the provision a limitation that the provision is not effective if one or more of the foregoing conditions occur or if the OCC otherwise directs the bank not to follow the provision for supervisory reasons.

On a case-by-case basis, the OCC could object to a national bank adopting one of these measures as **inconsistent with Federal banking law or safety and soundness**.

OBSERVATIONS:

- *National banks with a holding company.* The Proposal's flexibility to permit a national bank to choose its corporate law based on the locus of its operations is likely to be of limited utility to most national banks. Most national banks are subsidiaries of holding companies, for historical bank regulatory, securities law and corporate governance reasons. We therefore expect most national banks would continue with their current choice of corporate governance law, which is often that of the state of incorporation of its holding company.
- *National banks without a holding company.* National banks that are the top-tier entity within a group (or are considering a restructuring to shed their holding company) would receive the greatest potential benefits from the corporate governance-related changes in the Proposal.
  - These national banks would have new flexibility to choose to adopt the corporate governance law of the state in which branches may be concentrated (if different from the state of the "main" office) or a state with well-developed corporate governance law (in addition to Delaware, which national banks may choose under current OCC rules).
  - A national bank considering whether to shed its holding company would also receive marginal benefits through the permission to retain the law of its former holding company, thereby potentially avoiding disruption to previous corporate governance choices of the bank. This aspect of the Proposal may make the OCC a more attractive primary federal regulator and may signal the OCC's willingness to continue granting approvals for this type of restructuring.[39] While national banks of all sizes could

[39] *See* OCC Conditional Approval No. 1200 (July 6, 2018) (merger of Zions Bancorporation, a holding company, down into its subsidiary national bank to create Zions Bancorporation, N.A.).

realize managerial, operational and administrative benefits by streamlining their corporate structures,[40] recent forms of relief by the OCC and the other banking agencies (*i.e.*, increasing the thresholds at which the Federal Reserve's enhanced prudential standards apply) may obviate some of the regulatory benefits that had previously motivated at least one larger banking organization to pursue this course.

- *Anti-takeover defenses.* Although national banks are often subsidiaries of publicly traded holding companies, the OCC has recognized that the value of the national bank charter could be enhanced with greater flexibility to adopt anti-takeover defenses—thus, allowing national banks to consider independence from a holding company and to maintain that independence. In conjunction with the greater flexibility offered by the Proposal with regard to banking activities and with the potential for expansion of digital activities under the ANPR, there may be further opportunities for non-traditional bankers to establish a national bank as a platform for financial services.

VI. Other Issues

Summary:

- *Electronic activities*. The current regulations contain two separate rules regarding "finder" activities: one that includes a non-exclusive list of permissible general finder activities, and another that includes a list of permissible electronic finder activities. The Proposal would cross reference the electronic activities list in the general activities list, thus clarifying the broad scope of this useful authority. Separately, the OCC would also modify its rule for determining permissible activities generally, by clarifying that the same criteria apply to digital and electronic activities as apply to other activities.
- *Perfection of security interests*. The Proposal would clarify that national banks may perfect security interests in any manner permitted under state law and the Uniform Commercial Code, removing older provisions indicating that a bank could transfer collateral into its name as nominee.
- *Small Business Investment Company ("SBIC")*. The Proposal would codify interpretations that a national bank may invest in an already organized SBIC or one that is in the process of organization.
- *Additional corporate governance items*, several of which are also aimed at national banks that may not have, or that may have shed their, holding company, include:
  - Requiring that the person with the function of the **president** (regardless of title) of a national bank must be a member of its board of directors, but need not be chairman of the board;
  - Clarifying that a bank may **indemnify an institution-affiliated party** ("IAP") in accordance with the State law it has chosen to apply to its corporate governance procedures. A bank may indemnify an IAP for administrative proceedings or civil actions brought by a Federal banking agency, but only if the indemnity is reasonable and consistent with the requirements of certain provisions of the Federal Deposit Insurance Act and their implementing regulations;

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[40] *See* Bank of the Ozarks, Annual Report (Form 10-K) (Mar. 1, 2017); Zions Bancorporation, N.A. "2018 Year in Review" (no date) ("It had become increasingly evident in recent years that, given the increased powers available under our national bank charter, and considering the straight-forward traditional banking business we conduct, the need for a bank holding company had become superfluous. Virtually every aspect of our business was conducted — and could be conducted — with a national bank charter alone, without the need for a holding company.").

  - Requiring an IAP to reimburse the bank for **any portion of the bank's advancement of funds that the IAP is not entitled to**, except to the extent the bank is reimbursed by insurance or a fidelity bond; and
  - Removing and updating regulations related to **physical stock certificates and stock transfers** that are outdated, removing regulations related to treasury stock as superseded by legislation, and codifying interpretations to provide flexibility to engage in **capital stock-related activities**, such as providing for and issuing preferred stock and shareholder approval procedures for share repurchase programs.[41]
- *Separate proposals or final rules*. The OCC has also recently proposed or made a number of additional changes to related bank activities and governance regulations, including:
  - The so-called "*Madden* fix", "clarifying and reaffirming [in a regulation] the longstanding understanding that a bank may transfer a loan without affecting the permissible interest term".[42]
  - An interim final rule allowing institutions to permit telephonic and electronic participation at all board of directors, shareholder, and as applicable, member, meetings.[43]
  - A proposal to update its rules on, among other procedures, organization and establishment of banks, branches and subsidiaries.[44]

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[41] *See* OCC Interpretive Letter No. 1162 (July 6, 2018).

[42] "Permissible Interest on Loans That Are Sold, Assigned, or Otherwise Transferred: Final Rule", 85 Fed. Reg. 33530 (June 2, 2020).

[43] "Director, Shareholder, and Member Meetings: Interim final rule and request for comment", 85 Fed. Reg. 31943 (May 28, 2020).

[44] "Licensing Amendments", 85 Fed. Reg. 18728 (Apr. 2, 2020).

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