The OCC's Part 7 Final Rule: **Five Things To Know**

On November 23, 2020, the Office of the Comptroller of the Currency ("OCC") issued a final rule amending its regulations under 12 C.F.R. Part 7 relating to the activities and operations of national banks and federal savings associations ("FSAs"). The final rule, which becomes effective on April 1, 2021, governs a range of topics, including permissible derivatives activities, payment system memberships, tax equity finance transactions, and corporate governance, and is intended to clarify and codify recent OCC interpretations, integrate certain regulations for national banks and FSAs, and update or eliminate outdated regulatory requirements that no longer reflect the modern financial system. We have prepared a blackline of the changes in the final rule compared to the current OCC part 7 regulations.

1 The final rule incorporates and streamlines the framework established by OCC interpretive letters regarding bank-permissible derivatives activities.

The final rule codifies into formal regulation the complex legal analysis of bank-permissible derivatives activities that has been established over several decades of interpretive letters, thereby clarifying and formalizing the substantive elements of this framework and promoting consistency and efficiency in its application. The final rule generally incorporates definitions and requirements that are substantially similar to those used in prior OCC interpretive letters and bulletins. In streamlining this framework, the final rule establishes different categories of bank-permissible derivatives activities and specifies applicable procedural and substantive requirements for each:

- *Derivatives referencing underlyings in which a national bank may invest directly.* The final rule permits national banks to engage in derivatives transactions based on underlyings that the national bank is permitted to purchase directly as an investment. A national bank is not required to provide notice to its OCC Examiner-in-Chief ("EIC") before engaging in this category of derivatives activity.
- *Hedging bank-permissible activities with derivatives.* After providing at least 30 days' prior notice to its EIC, a national bank may engage in derivatives transactions with any underlying to hedge the risks arising from bank-permissible activities. A national bank also must provide prior notice to its EIC if it plans to expand these hedging activities to include a new category of underlying.
- *Derivatives intermediation for customers.* The final rule permits customer-driven derivatives transactions, based on any underlying, that are either (i) cash-settled and either perfectly-matched or portfolio-hedged; (ii) physically-settled by transitory title transfer, and either perfectly-matched or portfolio-hedged; or (iii) physically-hedged, and either portfolio-hedged or hedged on a transaction-by-transaction basis. A national bank must provide at least 30 days' prior notice to its EIC before engaging in any of these activities for the first time; for example, a bank must provide EIC notice if it has only previously engaged in cash-settled transactions based on a particular underlying and intends to begin physically-settling transactions based on the same underlying. A national bank also must provide prior notice to its EIC before expanding any of these derivatives activities to include a new category of underlying.
    - *Limits on physical hedging.* Derivatives transactions that are physically-settled (other than by transitory title transfer) are subject to additional restrictions – for example, a national bank may not take physical delivery of any commodity by receipt of physical quantities of the commodity on bank premises, the underlying must be held solely to hedge risks arising from customer-driven derivatives transactions, and the national bank may not acquire equity securities for hedging purposes that constitute more than five percent of a class of voting securities of any issuer.

- *Limits on physical hedging involving commodities.* The final rule also incorporates specific restrictions on physical hedging involving commodities. First, a national bank may not hold a physical position in a particular physical commodity of more than five percent of the gross notional value of the national bank's derivatives that are in that same particular commodity and allow for physical settlement within 30 days. Second, a national bank may not employ a physical hedge if a cash-settled hedge involving the same commodity would more effectively reduce risk. Third, the physical position must hedge one or more physically-settled customer-driven derivative transactions.

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2 The final rule adds a new section to part 7 codifying the process for national banks and FSAs to join a payment system.

As with permissible derivatives activities, the final rule incorporates into formal regulation a process for joining payment systems that was previously articulated in OCC interpretive letters. The final rule defines "payment system" as a financial market utility as defined by section 5462(6) of the Dodd-Frank Act, which includes a range of U.S. and international retail and wholesale payment systems but excludes registered U.S. derivatives clearing organizations, registered U.S. clearing agencies, and foreign organizations that would be considered either of the former if they were operating in the United States.

The final rule requires a national bank or FSA to provide 30 days' prior notice to the appropriate OCC supervisory office before joining a payment system that would expose the institution to open-ended liability, and to provide after-the-fact notice within 30 days of joining a payment system that does not expose it to open-ended liability. The rule defines "open-ended liability" as liability for operational losses that is not capped under the rules of the payment system, and includes indemnifications of third parties provided as a condition of membership in the payment system. A national bank or FSA that believes open-ended liability is otherwise limited may obtain a written legal opinion to that effect, which would enable the institution to treat its liability as limited for purposes of the rule. The written legal opinion may be obtained from in-house or external counsel.

The final rule also outlines the safety and soundness considerations that national banks and FSAs should evaluate both before and after joining a payment system.

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3 The final rule codifies and streamlines OCC interpretations permitting a national bank or FSA to engage in tax equity finance ("TEF") transactions.

Consistent with prior OCC interpretive letters, the final rule permits national banks and FSAs to engage in TEF transactions if the transaction is the functional equivalent of a loan and satisfies certain other conditions. The OCC defines "TEF transaction" as a transaction in which a national bank or FSA provides equity financing to fund a project or projects that generate tax credits or other tax benefits and the use of an equity-based structure allows the transfer of those credits and other tax benefits to the national bank or FSA.

A TEF transaction must meet seven criteria to be considered the functional equivalent of a loan, including that the structure of the transaction is necessary for making the tax credits or other tax benefits available and the national bank or FSA is a passive investor in the transaction. A TEF transaction is also subject to the substantive legal requirements of a loan, such as legal lending limits and affiliate transactions restrictions.

The national bank or FSA also (i) must not be able to control the sale of energy, if any, from the project; (ii) must limit the total dollar amount of TEF transactions undertaken pursuant to part 7 to no more than five percent of its capital and surplus, unless the OCC authorizes a higher cap in response to a written request; (iii) must provide written notice, including a description of applicable risk management, to the OCC before each TEF transaction; (iv) must be

able to manage the risks associated with individual TEF transactions and its TEF portfolio generally; and (v) must obtain a legal opinion from external or in-house counsel or otherwise have a good faith, reasoned basis for making a determination that tax credits or other tax benefits will be available.

Finally, the final rule generally permits national banks and FSAs to engage in a range of TEF transactions, including for residential projects and through fund-based structures. The final rule affirms that, as is the case with loans and leases, the legal permissibility of a TEF transaction does not depend on the end-user segment and underlying asset.

4 The final rule updates and modernizes the regulatory framework for national bank corporate governance.

The final rule updates the corporate governance section of part 7 to reduce burden, provide greater clarity, modernize the national bank charter with respect to corporate governance provisions, and address anomalous results that may arise when a national bank eliminates its holding company. The OCC has not substantively changed this section since its adoption in 1996. Key changes include:

- *Flexibility in choice of state law.* The final rule increases a national bank's flexibility to choose which corporate governance provisions to follow. In addition to the existing set of options[1], the final rule authorizes a national bank to follow the corporate governance provisions of (i) the law of any state in which any branch of the national bank is located; (ii) the law of the state where one holding company of the bank is incorporated; or (iii) the law of 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 final rule also prescribes a process for seeking OCC views on the permissibility of a given state corporate governance law and makes corresponding changes to the corporate governance provisions for FSAs in the OCC's part 5 regulations.
- *Anti-takeover provisions.* In addition, the final rule codifies the OCC's views on which types of anti-takeover provisions are inconsistent with federal banking law and safety and soundness. Under the final rule, restrictions on business combinations with interested shareholders, poison pills, requirements that all shareholder actions be taken at a meeting, limits on shareholders' authority to call special meetings, and shareholder removal of a director only for cause are not inconsistent with federal banking law; on the other hand, supermajority voting requirements and restrictions on a shareholder's right to vote all the shares it owns are inconsistent with federal banking law and may not be adopted. Moreover, the final rule provides that national banks may not adopt anti-takeover provisions under certain circumstances in which doing so may affect safety and soundness by discouraging necessary injections of capital into the bank.
- *Electronic and telephonic participation in meetings.* The final rule codifies relief that the OCC provided to national banks and FSAs in May 2020 in response to the COVID-19 pandemic. Under the final rule, national banks may provide for telephonic or electronic participation at shareholder and board of directors meetings.
- *President as director of national bank.* The final rule better aligns with the corresponding statutory requirement by requiring that the person serving as, or in the function of, president of a national bank, regardless of title, must be a member of the board of directors.
- *Indemnification of institution-affiliated parties ("IAPs").* The final rule reorganizes and revises the OCC's regulations on indemnification of IAPs for national banks and FSAs. Among other changes, the final rule clarifies the application of state law to indemnification proceedings by providing that a national bank or FSA may indemnify an IAP for damages and expenses, including the advancement of expenses and legal fees, in accordance with the law of the state the national bank or FSA has designated for its corporate governance.

[1] Existing options are the corporate governance provisions of the state in which the main office of the national bank is located, the state in which the bank's holding company is located, the Delaware General Corporation Law, and the Model Business Corporation Act.

5 The final rule amends a range of other provisions affecting national bank and FSA activities and operations.

These changes to other sections of part 7 include the following:

- *Increased flexibility to distribute loan proceeds at operating subsidiary offices.* The final rule codifies an OCC interpretation that a national bank operating subsidiary facility is not a branch if it provides similar services on substantially similar terms and conditions to customers of unaffiliated entities, including unaffiliated banks. Accordingly, a national bank operating subsidiary may distribute loan proceeds from its own funds or bank funds directly to borrowers in person at offices of the operating subsidiary, if it performs similar services on similar terms and conditions to customers of non-affiliates.

- *Increased flexibility to invest in Small Business Investment Companies ("SBICs").* The final rule codifies OCC interpretive letters allowing investment in a SBIC during its organization phase and, consistent with the Volcker Rule implementing regulations, allows national banks and FSAs to retain an interest in a SBIC during its wind-down period.

- *Expanded authority for financial literacy programs.* The final rule allows national banks and FSAs to provide financial literacy programs to community-based organizations, such as non-profit organizations, in addition to schools. The final rule also clarifies the conditions under which the premises where these programs are conducted will not be considered a branch of the participating national bank or FSA.

- *Expanded definition of remote service unit ("RSU").* An RSU is a non-branch facility, such as an ATM, that is not subject to state geographic or operational restrictions or licensing laws. The final rule amends the definition of RSU to include a drop box and an automated or unstaffed facility.

- *Codification of OCC interpretations relating to capital stock issuances and repurchases.* The final rule codifies OCC interpretations that a national bank's board of directors may issue common stock without obtaining additional shareholder approval at the time of the issuance if the issuance does not exceed the amount of common stock previously approved and authorized by shareholders. The final rule also codifies OCC interpretations allowing national banks to issue preferred stock through blank check procedures[2] and to implement share repurchase programs, each following the necessary shareholder vote and corporate governance procedures.

- *Expanded flexibility to declare a legal holiday under emergency conditions.* Among other changes, the final rule updates and expands the types of emergency conditions that may result in a legal holiday, authorizes the Comptroller to declare a legal holiday in advance of an emergency condition, and allows a national bank or FSA to temporarily close its offices in response to an emergency condition even in the absence of the Comptroller's declaration of a legal holiday.

[2] The board of directors is empowered to issue, and determine the terms of, this type of preferred stock.

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