



# Office of the Comptroller of the Currency

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## Interpretive Letter #737, Part 2

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### *a. Functions Relating to Stored Value*

The primary function of the LLC relating to stored value will be to provide for the collection, processing, and settlement of payments in the stored value system. Clearly, these activities are part of the business of banking.

When acting for merchants in the collection and settlement of stored value transactions, the LLC will be performing a recognized banking activity. The Supreme Court has established that 12 U.S.C. 24(Seventh) permits a national bank to "do those acts and occupy those relations which are usual or necessary in making collections of commercial paper and other evidences of debt" for its customers. *Miller v. King*, 223 U.S. 505, 510 (1912) (finding that a national bank may collect a judgment for its customer, and may also sue the bank's attorney in order to recover misused proceeds of the judgment). *See also*, OCC Interpretive Letter No. 731 (July 1, 1996) (national banks may enter into a contract with a public authority to operate on behalf of the authority an electronic toll collection system); OCC Interpretive Letter No. 732 (May 10, 1996) (national banks may provide electronic data interchange services that, among other things, provide for payments by EFT); and OCC Interpretive Letter No. 419, *reprinted in* [1988-1989 Transfer Binder] Fed. Banking Law. Rep. (CCH) 85,643 (national bank may provide a service that facilitates settlement and payment of health claims using EFT technology).

Similarly, when the LLC dispenses stored value to cardholders on behalf of the issuer, it will be performing the established banking functions of bill payment and dispensing of third party payment instruments. *See* OCC Interpretive Letter No. 718 (March 14, 1996) (national banks may dispense "alternative media" from their CBCT branches, including public transportation tickets, event tickets, gift certificates, and prepaid phone cards). *See also*, *Arnold Tours, Inc. v. Camp*, 472 F.2d 427, 438 (1st Cir. 1972) (national banks may sell travelers checks).

A secondary function of the LLC will be to provide record keeping services on the stored value transactions. This is also a function that is clearly part of the business of banking. An earlier version of 12 C.F.R. 7.1019 states that "as part of its banking business and incidental thereto, a national bank may collect, transcribe, process, analyze, and store for itself and others, banking, financial, or related economic data." Interpretive Ruling 7.3500, 39 Fed. Reg. 14195 (Apr. 22, 1974). Although in its 1984 revision of the ruling the OCC deleted this statement because it believed that "specific examples [of permissible electronic activities] are inappropriate given the imprecision of terms and rapid pace of change in the data processing industry", 49 Fed. Reg. 11157 (Mar. 26, 1984), the "analytical framework" embodied in the ruling remained the same, *id.* There was no intent to narrow or restrict the substantive effect of the rule. OCC Interpretive Letter No. 677, *supra*. *See also*, OCC Interpretive Letter No. 653 *reprinted in* [1994-1995 Transfer Binder] Fed. Banking L. Rep. (CCH) 83,601 (national bank may maintain records when acting as an informational and payments interface between insurance underwriters and general insurance agents); OCC Letter No. 346 [1985-1987] Transfer Binder] Fed. Banking Law.

Rep. (CCH) 85,516 (national banks may maintain records on commodities transactions).

In connection with these payments and record keeping functions, the LLC will also provide system participants with certain hardware and software that will be used for the stored value functions. The LLC will provide System Customers with preprogrammed smart cards and card readers for payment sites (e.g., at campus copy machines or laundromats). Participating merchants will receive card readers and associated software and hardware that will allow them to acquire and present stored value for settlement.

In analyzing the extent to which national banks may provide hardware and software, the OCC has distinguished between limited purpose and general purpose items:

When the hardware is such that it is not to be used for uses beyond the [bank services], it may well be considered literally an indistinguishable part of the [banking services]. Accordingly, a national bank's sale of such hardware is permissible as a part of the [service] permitted under 12 U.S.C. 24(7), just as the bank's sale of checkbooks to its customers is a permissible part of offering checking accounts.

OCC Interpretive Letter No. 345, *reprinted in*, [1985-1987] Transfer Binder] Fed. Banking Law. Rep. (CCH) 85,515.

The hardware and software the LLC will provide to the merchants can only be used to support the stored value function and, thus, it is permissible as part of the business of banking. The hardware and software being provided to System Customers can serve a dual function of supporting the stored value system and also the information related functions and, thus, will be discussed below in connection with those functions.

*b. Functions Relating to Other Information*

As noted, the LLC will have a very limited role in the information related functions of the smart card systems. The LLC will provide certain hardware and software capacities so that System Customers will be able to use the smart card system to support certain ancillary information processing as well as a stored value function. For purposes of this letter, we will assume, without deciding, that the ancillary information could be characterized as not banking, financial, or related economic data that would fall within the business of banking. Nevertheless, we conclude that the LLC's limited role in the information function is a permissible exercise of a national bank's incidental powers. There are two reasons for this conclusion.

First, while this is a determination that must be made on a case-by-case basis, the multi-function capacity that the LLC will provide Service Customers appears to be necessary for the banking services provided (*i.e.*, stored value system support) and not to be an excessive amount of the total stored value service package. The test was well summarized in OCC Interpretive letter No. 345, *supra*:

[Unlike hardware limited to banking purposes,] hardware which can be used for purposes beyond the [banking] services is no longer merely part of the permitted services. The sale of such hardware ... as part of its services package is permissible for national banks as incidental to the permitted services when the inclusion of the hardware is necessary, convenient, or useful to providing the permitted services in the package taken as a whole. The determination that hardware is subordinate within the total package can only be done on a case-by-case basis, taking into consideration factors such as cost, expected revenues, and the expected life of the hardware relative to other aspects of the package. Regulation Y's standard that the cost of the hardware 'not constitute more than 30 percent of the cost of any packaged offering,' *see* 12 C.F.R.

225.25(b)(7)(iii), is one means of demonstrating that the sale of the hardware is incidental to the permitted banking service. There may be other means as well.

*See also*, Letter from Michael J. O'Keefe, District Counsel, Midwestern District dated July 13, 1987 (unpublished) (distribution of software and hardware to banks permissible if full function hardware does not "dominate" permissible data processing services involved); OCC Interpretive Letter No. 516, *reprinted in* [1990-1991 Transfer Binder] Fed. Banking L. Rep. (CCH) 83,220 (hardware permissible when necessary and convenient to information services and where sale of such incidental hardware does not exceed 30% of total cost of the package). *Cf.*, *Association of Data Processing v. Board of Governors*, 745 F.2d 677 (D.C. Cir. 1984).

Here, as noted, the LLC will provide no manipulation or processing of the System Customer's non-banking data. Further, a substantial portion of the system hardware and software (specifically, that provided to the merchants and that provided to System Customers which will be used exclusively for payments purposes) is limited to banking functions. The Bank states that the manufacturing cost of the multi-function smart cards is small and not a significant economic factor in relation to the total stored value system. Thus, it appears that the "multi-function" hardware and software the LLC will provide System Customers will not be an excessive part of the entire package. Moreover, the LLC has committed in the LLC Operating Agreement to engage only in activities that are permissible for national banks and, thus, to operate the "multi-function" aspects of its program in conformance with the standard described above.

Second, under the facts of this case, the providing of multi-function smart cards and card readers is incidental to the business of banking because it enables the LLC to create a package of related services required to satisfy customer needs and to market successfully its stored value system. National banks under their incidental powers may provide ancillary non-banking services when those ancillary services are needed to successfully package and to promote other permissible banking services. OCC Interpretive Letter No. 611, *reprinted in* [1992-1993 Transfer Binder] Fed. Banking L. Rep. (CCH) 83,449 (national banks selling home banking service may also provide customer access to non-banking services "to increase the customer base and the usage of the program"); OCC Interpretive Letter No. 653, *supra* (national banks may offer non-banking products as part of larger product or service when necessary, convenient and useful to bank permissible activities).

Here, the LLC needs to provide hardware and software related to the information functions to market successfully its stored value smart card system to institutions such as universities that need to use the cards for multiple purposes, some of which may not involve banking, financial, or economic data that national banks may process as part of the "business of banking." Smart cards are essentially mini-computers that can perform many useful data storage functions beyond just stored value systems. Systems Customers will undoubtedly be reluctant to purchase smart card systems from national banks (or the LLC) if those systems must be limited to performing only stored value functions. As one authority has noted:

While stored value is likely to be a popular smart card application and of great interest to bankers, the extraordinary data storage and processing capabilities of modern microchip technology allow multiple applications to be provided on the same card. For example, a smart card could store personal information such as medical insurance data, health records, and financial data. The cardholder could use the same card in a consumer loyalty program.

Wright, "Smart Cards: Legal and Regulatory Challenges," *Bankers Magazine*, March/April 1996 at p. 24.

*See, generally, Fancher, "Smart Cards," Scientific American, August 1996.* In many cases, bank-provided smart card systems will need to permit their system customers to utilize and enjoy this multi-functionality potential of smart card systems.

Where, as here, the System users purchase the smart cards from LLC, <NOTE: If the LLC retained ownership of the cards, there might be an argument that the additional information functions could be provided under an "excess capacity" theory. In most smart card stored value systems, the stored value function is not expected to consume the entire programming and data capacity of the smart cards. As recognized in 12 C.F.R. 7.1019, "[a] national bank may also, in order to optimize the use of the bank's resources, market and sell to third parties electronic capacities acquired or developed by the bank in good faith for banking purposes." However, this theory does not apply where, as here, the bank does not retain ownership of excess capacity. > they will want to be able to make full use of the cards and, thus, will need to have the cards programmed to permit the System users to perform additional non-banking functions using the cards. Similarly, System Customers will need to have card readers connected to their data systems so that the readers can be used for both banking and non-banking functions. The additional card programming and reader connections needed to permit these non-banking functions are ancillary and incidental to the primary stored value function being provided by the LLC and, thus, permissible.

*2. The Bank must be able to prevent the LLC from engaging in activities that do not meet the foregoing standard.*

This is an obvious corollary to the first standard. It is not sufficient that the LLC's activities are permissible at the time the bank initially purchases LLC membership shares; they must also remain permissible for as long as the bank retains an ownership interest in the LLC.

Section 2.3 of the LLC's Operating Agreement provides that the LLC will only engage in activities permissible for national banks. In addition, the consent of all members through their representatives on the Board of Managers will be required before the LLC may engage in any new activities. Thus, Bank can prevent proposed new activities not permissible for national banks. Also, any amendment to the LLC Operating Agreement to change the LLC's purposes or permissible activities or to change any of the voting or consent requirements would require Bank's consent. As a result, Bank will be able, on an ongoing basis, to prevent the LLC from engaging in new activities that may be impermissible for national banks.

*3. The Bank's loss exposure must be limited, as a legal and accounting matter, and the Bank must not have open-ended liability for the obligations of the enterprise.*

*a. Loss exposure from a legal standpoint*

A primary concern of the OCC is that national banks should not be subjected to undue risk. Where an investing bank will not control the operations of the entity in which the bank holds an interest, it is important that a bank's investment not expose it to unlimited liability. This is the case here. <NOTE: As noted, this opinion does not address any *direct* activities of the Bank with regard to the stored value systems. See footnote 3, supra. Such direct activities could, of course, involve exposure of the bank in other aspects and, accordingly, will be subject to OCC monitoring and review even during the pilot program.> As a legal matter, investors in a Delaware LLC will not incur liability beyond their investment in the LLC because of being a member or manager of the LLC -- even if they actively participate in the management or control of the business. Del. Code Ann. Tit. 6, 18-303(a) (1994). Additionally, the LLC Operating Agreement does not expose the Bank to unlimited liability due to its investment in the LLC.

*b. Loss exposure from an accounting standpoint*

In assessing a bank's loss exposure as an accounting matter, the OCC has previously noted that the

appropriate accounting treatment for a bank's 20-50 percent ownership share or investment in an LLC is to report it as an unconsolidated entity under the equity method of accounting. Under this method, unless the bank has extended a loan to the entity, guaranteed any of its liabilities or has other financial obligations to the entity, losses generally are limited to the amount of the investment shown on the investor's books. *See generally*, Accounting Principles Board, Op. 18 19 (1971) (equity method of accounting for investments in common stock). Interpretive Letter 692, *supra*. Bank's investment will amount to a one-third ownership interest in the LLC; therefore, it may rely on the equity method.

*4. The investment must be convenient or useful to the Bank in carrying out its business and not a mere passive investment unrelated to that Bank's banking business.*

A national bank's investment in an enterprise or entity that is not an operating subsidiary of the bank also must satisfy the requirement that the investment have a beneficial connection to the *bank's* business, i.e., be convenient or useful to the investing bank's business activities, and not be a mere passive investment unrelated to that bank's business activities, "Necessary" has been judicially construed to mean "convenient or useful." *See Arnold Tours, Inc. v. Camp, supra*, 472 F.2d at 432. The provision in 12 U.S.C. 24(Seventh) relating to the purchase of stock, derived from section 16 of the Glass-Steagall Act, was only intended to make it clear that section 16 did not authorize speculative investments in stock. *See OCC Interpretive Letter No. 697, reprinted in [Current Transfer Binder] Fed. Banking L. Rep. (CCH) 81-102*. Therefore, a consistent thread running through our precedents concerning stock ownership is that it must be convenient or useful to the bank in conducting that bank's banking business. The investment must benefit or facilitate that business and cannot be a mere passive or speculative investment.

That requirement is met in this case. Bank is actively engaged in many aspects of electronic banking and has become known as an innovator in the field. The basic function of the LLC is to effectuate transfers of financial value, and this will provide opportunities, particularly within Bank's market area, for Bank to provide account services for the holders of smart cards. In fact, Bank may serve as the issuer of the stored value used in the LLC's system. As has been shown in the discussion set forth above, the investment by Bank in LLC is designed to contribute to customer convenience in using the system for cashless payments; expand Bank's customer base; permit better use of Bank's data processing capacity and technical personnel; expand the number of Bank's contacts with universities and other entities using the system, with the potential for offering additional cash management and deposit processing services; and expand the Bank's merchant customer base as vendor capabilities. Additionally, existing customers of Bank's core banking and other services, who can use a stored value system, are increasingly looking to Bank to provide such a system and the ability of Bank to provide such a system to such customers will be a factor in Bank's being able to retain these existing customers for core banking and other services. Finally, the use of a joint venture vehicle to develop the stored value system gives the Bank access to technology owned by Battelle and Sallie Mae that might otherwise be unavailable to the Bank.

### *C. Conclusion*

Based upon the information and representations you have provided, and for the reasons discussed above, Bank's investment in the LLC satisfies the four standards for a national bank's majority and minority, noncontrolling investment in a LLC. Therefore, the investment is approved subject to the following conditions:

1. the LLCs may engage only in activities that are part of or incidental to the business of banking;
2. the Bank will have veto power over any activities and major decisions of the LLC that are inconsistent with condition number one, or will withdraw from the LLC in the event its engages in

- an activity that is inconsistent with condition number one;
3. the Bank will account for the investment in the LLC under the equity method of accounting; and
  4. the LLC will be subject to OCC supervision, regulation, and examination. <NOTE:In the future, the nature and scope of the LLC's activities might be so substantially enhanced that the methodology the OCC uses to compute the Bank's assessment will need to be adjusted to cover adequately the expense of supervising and examining the LLC. >

Please be advised that all conditions of this approval are "conditions imposed in writing by the agency in connection with the granting of any application or other request" within the meaning of 12 U.S.C. 1818.

Sincerely,

/s/

Julie L. Williams  
Chief Counsel