

March 17, 2000

Subgroup on Legal Barriers to Electronic Commerce
U.S. Department of Commerce
14th Street and Constitution Avenue, N.W.
Room 2815
Washington, DC 20230

Re: Request for Comment on Legal Barriers to Electronic Commerce

Dear Sir or Madam:

The Electronic Financial Services Council (the "EFSC") appreciates this opportunity to respond to the Department of Commerce's request for public comment on laws and regulations that pose barriers to electronic commerce.

The EFSC is an organization representing many of the leading companies offering financial services over the Internet. The Council's mission is to update laws and regulations to facilitate the electronic delivery of financial services (including mortgages, insurance, real estate, on-line banking services, and securities). Members include: Countrywide Home Loans, Inc., Intuit Inc., GE Capital Mortgage, Microsoft Corporation, Cendant Mortgage, Chase Manhattan Mortgage, Citigroup Mortgage, Inc., E-Loan, The First American Financial Corporation, Freddie Mac, GMAC Mortgage Corporation, Lender Services, Inc., Lending Tree, The Principal Financial Group, United Guaranty, and Wells Fargo/Norwest, Xpede, Creditland and Esurance. Additional information about the EFSC is available on the Internet at www.efscouncil.org.

The EFSC commends the Department of Commerce and the Administration for undertaking this process to identify, and hopefully revise, laws and regulations that stand as impediments to the further development of electronic commerce. The members of the EFSC have experienced significant expense, delay and frustration in their efforts to offer their products to consumers via the Internet as a result of a variety of "legacy" laws and regulations designed to facilitate face-to-face, paper-based transactions, but which now stand as barriers to the fulfillment of the opportunities available through electronic commerce. The EFSC welcomes the opportunity to work with the Department of Commerce and the Administration to better facilitate the use of electronic commerce as a medium delivering financial services to consumers more efficiently and economically.

As a general proposition, the EFSC believes that the Internet, and the electronic commerce revolution currently underway, represent the purest manifestation of interstate commerce that could have been envisioned by the drafters of Constitution in granting to Congress the authority "to regulate commerce . . . among the several states." The Internet is a borderless, paperless medium uniquely suited to facilitate commerce among the states and with other nations. Although the federal system of government by which the various states retain authority to regulate local activities is and will continue to be a principal source of law and regulation governing commercial activities in this nation, there must be some recognition by the states and the federal government of the need for clear, consistent and certain national standards for regulating commerce in this electronic era. While the EFSC supports an appropriate role for the states in the regulation of electronic commerce, we suggest that the federal government has a unique responsibility, and indeed the Congress has a Constitutional obligation, to reduce or eliminate those elements of state and local regulation that unduly burden interstate commerce and provide the sound legal framework necessary to facilitate the free flow of interstate commerce through the Internet and other channels of electronic commerce.

Although the Department of Commerce's request for public comment is clearly directed at identifying federal barriers to electronic commerce, it includes the following note:

Note concerning State or local laws and regulations: Barriers to electronic commerce may arise from a lack of uniformity in policies, laws, standards or codes among different jurisdictions. Although we do not

request comments about individual state or local laws, respondents may wish to identify general areas in which barriers to electronic commerce result from State or local policies, laws, or practices; or from differing State and federal policies, laws, licensing requirements, standards or other practices. Respondents also may wish to comment on whether increased coordination is needed between the Federal and State governments to avoid unnecessary impediments to electronic commerce.

While we acknowledge that a host of federal laws and regulations exist which hamper the use of the Internet, including for example, requirements in federal consumer protection statutes that various notices and disclosures be provided "in writing" without clear authority for such records to be transmitted electronically, the focus of our comments is on state law barriers to electronic commerce in the financial services industry. We are hopeful that the legislation currently under consideration by Congress, H.R. 1714, the "Electronic Signatures in Global and National Commerce Act," will be enacted shortly, thereby addressing many of the federal and state barriers to electronic commerce with respect to these issues.

With respect to state barriers, specifically, we will address: (i) the complex and often inconsistent process for obtaining licenses and other regulatory approvals to operate on a nationwide basis; (ii) state laws mandating the operation of in-state offices and the use of local agents; and (iii) the need for uniformity in rules governing the formation of contracts, the validity of electronic signatures, and the permissible use of electronic records as substitutes for statutorily mandated writings.

The Need for Uniformity of Licensing Requirements

By transmitting information over the Internet, a company may, from a single location, enter into a consumer transaction in any and every state and even internationally. A threshold question is whether the transaction occurs in the state in which the consumer is located, or at the location from which the electronic message originated (which may not necessarily be where the company transmitting the message is physically located and licensed). Most states that we have encountered believe that the transaction is deemed to occur in the state where the consumer is located. Also, in some cases, such as residential mortgage loan transactions, state jurisdiction follows from the situs of the property securing the loan, even if neither the borrower nor the lender are residents of the situs state. As a result, insurance companies, mortgage brokers, mortgage lenders, and real estate brokers are typically required to obtain separate licenses or other regulatory approvals in each state in which they do business.

While the difficulties associated with 50 or more different licensing laws predate the existence of the Internet or the conduct of business by electronic means, the ease of access to a nationwide market made possible by new technologies such as the Internet, heightens the need for greater uniformity in the licensure and regulation of financial service providers. The Gramm Leach Bliley Act of 1999 was an important step towards the elimination of unduly burdensome and unnecessary regulatory barriers for the banking, securities, and to a lesser degree, insurance sectors of the financial industry. The EFSC believes similar progress must be achieved in the mortgage, insurance and real estate industries.

The regulations governing the brokering, making, and servicing of residential mortgage loans, home equity loans and consumer loans vary significantly from state to state. Each state has at least one, and in some cases two or more licensing laws applicable to the mortgage business. There is no consistency of definitions of the activities subject to licensing or the categories of companies eligible for exemption from licensing. A company doing business on the Internet seeking to become licensed to offer first and second mortgage loans in all 50 states and the District of Columbia must complete 50 to 75 separate license applications, obtain multiple surety bonds, provide similar corporate, personal and financial information on its officers, directors, and investors on separate forms for each state, and undergo extensive and repetitive background investigations. Although each state reviews roughly the same information when considering license applications, there is no uniformity with respect to how the information is gathered, processed or analyzed, nor is there an effective system by which states can access the information obtained by other states to reduce the redundancies of the current system.

As a result of the inefficiencies of the multi-state licensing process, a company seeking national lending authority may require up to a year or more to obtain all the licenses required to operate. The direct cost of this process is significant as well, running as much as \$500,000 or more in terms of state filing fees, bond premiums, auditors' fees, registered agent expenses, and legal fees. The indirect costs associated with the current multi-state licensing system, such as the diversion of extensive corporate and administrative resources and the opportunity costs resulting from the lengthy time to obtain nationwide authority to conduct business, are more difficult to quantify, but are undoubtedly significant as well. Corporate officers, directors and investors can expect to be called upon repeatedly to provide detailed personal, business and financial information, and to provide fingerprints for multiple criminal background investigations. In addition, once licenses are obtained, companies must incur significant costs and devote substantial administrative resources for functions related to the upkeep of licenses, including annual license renewal procedures, the completion of annual reports of lending activity and financial results, general regulatory compliance and management of state examinations, and the payment of annual fees and assessments.

The EFSC would urge the Department of Commerce and other relevant federal agencies, such as the Department of Treasury, to review the possibility of a national licensing law for lenders and brokers offering residential mortgage loans and other consumer loans. For example, the Home Ownership Loan Act could be amended to provide for the chartering of non-depository financial institutions which are authorized to make residential mortgage loans under the same lending regulations currently applicable to federal savings associations.

Alternatively, legislation could be enacted to encourage states to adopt, within a specified time period, uniform licensing laws or a system of reciprocity under which a licence issued in one state is recognized in other states, provided that the laws applicable in the "home state" of the licensee meet a minimum threshold standard of regulation and oversight. Unless a significant majority of states adopt either a uniform licensing law or provide reciprocity for licenses issued in other states, it would be appropriate for a federal licensing system to be implemented to ameliorate the significant barriers to electronic commerce resulting from the current multi-state licensing system.

A precedent has been set in the insurance industry for a mechanism to encourage states to adopt a uniform, national licensing system for persons who sell or solicit the purchase of insurance. The Gramm-Leach-Bliley Act contains provisions (see Sections 321-336) that require states to act within three years either to adopt uniform licensing laws or to enact reciprocity laws governing the licensing of nonresident insurance agents. If a majority of states fail to act within three years, a national registration scheme, known as the National Association of Registered Agents and Brokers ("NARAB"), will be implemented. An insurance agent who registers with NARAB would be able to be licensed in any state without regard to state residency requirements so long as the agent pays the requisite license fees and meets applicable bonding requirements. The EFSC suggests that consideration be given to extending the NARAB model to other segments of the financial services industry, such as mortgages and real estate, that are plagued by similar licensing inefficiencies inherent in the current non-uniform multi-state licensing system.

While we understand that the role of the federal government in insurance sales practices has been limited in the past due to the McCarran Ferguson Act, the advent of the Internet with its "borderless" nature, make it an appropriate time to comment on the barriers to electronic commerce with respect to insurance laws and regulations.

Many insurance agent licensing requirements are currently not compatible with electronic commerce. For example, existing regulatory guidance in many states does not clearly identify and distinguish licensable from non-licensable activities. These ambiguities create regulatory uncertainty for the industry, which inhibits the legitimate use of the Internet and/or result in unnecessary costs associated with the 50 state licensing process.

The National Association of Insurance Commissioners (the "NAIC") has been active in assessing the state barriers to delivery of insurance through electronic commerce. The NAIC has appointed various working groups to, among other things, draft model agent licensing laws, design standardized non-resident agent license applications, and review the producer licensing infrastructure to maximize the effectiveness and efficiencies of the producer licensing process, including the Producer Information Network for the electronic appointment and termination of producers.

Although the NAIC is addressing these issues, and may continue to produce model laws promoting uniformity and reciprocity, particularly in light of the NARAB provisions of the Gramm Leach Bliley Act, these model laws will still have to be enacted by the 50 states and the District of Columbia. The EFSC requests that the Department of Commerce monitor the progress of state implementation of the NAIC's model laws promoting uniformity and reciprocity and review the feasibility of the NARAB system if a majority of states fail to act within the three year period provided by the Gramm Leach Bliley Act. Moreover, we would suggest that the Department consider the feasibility of alternative approaches to insurance licensure and regulation which might achieve more quickly the goal of uniformity.

In-State "Bricks and Mortar" Office Requirements are Unconstitutional and Clear Barriers to Electronic Commerce

In several segments of the financial services industry, a host of state laws exist which require financial service providers to maintain offices in state or employ local residents as employees or agents. While some of these laws are legacies of an era where it was valid to assume a transaction would occur in person, others were clearly intended to relieve local companies from the pressures of out-of-state competition. The EFSC believes it is appropriate for the federal government to exercise its authority to regulate interstate commerce and block enforcement of these state laws that unduly burden commerce among the states and which are antithetical to the concept of the Internet as an electronic marketplace free of the expense and inconvenience of physical places of business.

In the mortgage industry, approximately 30% of states require companies that make, broker or service first or second lien, residential mortgage loans to maintain some form of in-state office as a condition for becoming licensed. Among the states with these so called "bricks and mortar" requirements are Arizona, California, Georgia, New Jersey, Ohio, Pennsylvania, and South Carolina. In-state office requirements no longer serve any legitimate public policy object, such as consumer protection, and impose an undue burden on interstate commerce in the mortgage industry. Requirements for companies to maintain offices or employees in a particular state cannot be justified by business necessity and are out of sync with new technologies and business models that permit the accurate, convenient, and efficient communication of information to consumers via the Internet, centralized call centers and express mail.

Without discussing the specific bricks and mortar rules for each state, it is useful to consider the requirements in South Carolina's mortgage broker statute as an example of the burden these requirements impose on all mortgage companies operating nationally from centralized locations, using the Internet or other communications media. South Carolina law requires that a licensed mortgage broker maintain a physical place of business in the state, which, at a minimum, is staffed by at least one employee with authority to contract on behalf of the licensee and to accept service of process on the broker. The office must be open during regular business hours, which are defined as at least 30 hours a week from Monday through Friday. The state regulator must be notified of the licensee's hours of operations if the licensee's office is not open for business from at least 8:30 am to 5:00 pm, Monday through Friday.

While requirements in other states are not as well defined or onerous, the mere necessity of a physical presence in a state is a significant burden for companies doing business through electronic commerce. Companies are forced to either incur the cost of leasing offices, hiring employees and paying for equipment that they do not need and would not use but for the fact of the bricks and mortar requirement, or elect not to do business in that state. Either way, consumers are the ones that ultimately suffer as there are fewer sources of capital and less competition among lenders; and those out-of-state lenders that elect to do business in the state must incur greater expenses, which are likely to be passed on to consumers.

Unfortunately, in many states, the bricks and mortar requirements are not merely a case of old laws needing to be brought up to date. In the past two years, five states, Georgia, Kansas, Ohio, Texas and Wisconsin, have adopted some form of in-state office requirement for mortgage companies. In many cases, these laws are the result

of lobbying efforts by local mortgage companies with the express purpose of limiting competition from lenders and brokers operating on the Internet or otherwise from out of state.

With respect to insurance sales, many states still require that a resident agent countersign policies issued by agents or insurers not domiciled in the state. Some states also have laws or other requirements that specify that a nonresident agent or producer must be accompanied by a resident producer to solicit insurance. Countersignature requirements and resident-nonresident "hand holding" requirements clearly impede the sale of insurance through electronic means and serve only as a protection of resident agent commissions.

In addition to the fact that there is no reasonable business or public policy justification to support the continuation of in-state office or resident agent requirements, a compelling legal case may be made that a state law mandating that a company operate an office in state or employ a state resident as a condition of becoming licensed violates the Commerce Clause of the Constitution of the United States.

It is well settled that a state law that discriminates on its face or in its effect by treating in-state and out-of-state commerce or competitors differently is per se invalid under the Commerce Clause. *Hughes v. Oklahoma*, 441 U.S. 322, 336 (1979); *New Energy Co. of Indiana v. Limbach*, 486 U.S. 269, 274 (1988). A state law that discriminates in favor of local interests to the detriment of out-of-state businesses "invokes the strictest scrutiny of any purported legitimate local purpose, and of the absence of nondiscriminatory alternatives" and will generally be upheld only if it is the least restrictive means available to achieve a legitimate local government objective. *Hughes v. Oklahoma*, 441 U.S. at 337.

Federal courts considering the validity of in-state office requirements in connection with professional licenses have consistently struck down requirements that companies maintain an office in the subject state as a condition for holding a license. See, e.g. *Codar, Inc. v. Arizona*, No. 94-16902, 1996 U.S. App. LEXIS 21356 (9th Cir. 1996) (collection agencies); *Georgia Association of Realtors v. Alabama Real Estate Commission*, 748 F.Supp. 1487 (M.D. Ala. 1990) (real estate brokers); *Underhill Assoc., Inc. v. Coleman*, 504 F.Supp. 1147 (E.D. Va. 1981) (securities dealers). Indeed, the Supreme Court has noted that state laws requiring business operations to be performed in-state that could be performed more efficiently elsewhere are virtually per se illegal. See, e.g., *Pike v. Bruce Church*, 397 U.S. 137, 145 (1970).

The EFSC calls upon the Department of Commerce, the Administration and Congress to eliminate these unconstitutional, protectionist barriers to electronic commerce and enact federal legislation that will expressly preempt state requirements for in-state office or resident agent requirements for mortgage companies, insurance companies and other financial services providers.

The Need for Uniformity in Rules Governing the Formation of Contracts, the Validity of Electronic Signatures, and the Permissible Use of Electronic Records as Substitutes for Statutorily Mandated Writings

The commercial world has long relied on paper documents to record transactions, and memorialize agreements. The laws regulating commerce frequently assume, or require, the existence of these paper records. In order to fully utilize the electronic medium to provide financial services, it will be necessary to ensure that electronic signatures and disclosures will be legally enforceable in the same manner as their paper counterparts.

There are numerous statutory and regulatory references requiring entities offering financial services to "furnish," "provide," "deliver," or "mail" information to consumers. It is not clear whether the electronic communication of state and federally mandated disclosures would satisfy the delivery requirements set forth above. With respect to signatures, many types of documents are not legally enforceable unless they are signed, such as promissory notes or insurance policies.

Although many states have enacted legislation addressing the use of electronic records (notices and disclosures) and signatures in commerce, these laws are generally anything but uniform. The problem with a state

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by state approach to electronic records and signatures is that it creates a patchwork of regulation and clearly is an impediment to conducting business over the Internet.

We urge the Commerce Department to support the passage of H.R. 1714 in a form that provides for a strong national standard for the use of electronic records and signatures.

The EFSC appreciates this opportunity to comment on the most significant legal barriers to the growth of electronic commerce in the financial services industry. We look forward to working with the Department of Commerce and the Administration in the months ahead to overcome these and other impediments to electronic commerce.

Sincerely,

Jeremiah S. Buckley
Executive Director