Old Wine in New Bottles: Bank Investments in Fintech Companies

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I. Introduction

We are again in the midst of another wave of banking organization investments in technology companies. There has been a great deal of publicity surrounding new nonbank firms creating innovative bitcoin and blockchain technology, marketplace lenders, roboadvisors and innovative security, authentication, and payments technologies. Without digging too deeply, one would think that these financial technology (fintech) firms are going to take over the business of banking, putting the lumbering dinosaurs out of their collective misery. Yet as you dig a bit, you find that banking organizations are active participants in this technology revolution. They are investors, early adopters, users and partners.

Fintech has always been tied to banking organizations—from the laying of the first transatlantic cable in 1866, to the launch of the ATM in 1967 and so on.[2] In fact, the term fintech can be traced back to Citigroup's Financial Services Technology Consortium," a project in the early 1990s to facilitate technological cooperation efforts.[3] Since the 1990s, the financial services industry, including banking organizations, has been the largest purchaser of IT services.[4] As noted in a recent law article describing waves of fintech investment by the financial services sector, "Since the late 1980s, finance has been an industry based upon transmission and manipulation of digital

[2] *See* Douglas Arner, Janos Barberis and Ross Buckley, *The Evolution of Fintech: A New Post-Crisis Paradigm?*, UNSW Law Research Paper No. 2015/047, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2676553.

[3] *Id.* at 4.

[4] *Id.* at 41.

information."[5] One third of the more than 30,000 employees of Goldman Sachs are engineers.[6]

It is easy to see why banking organizations are participants in the current wave of fintech. Banking organizations are burdened by legacy systems that are costly, cumbersome, clunky and inefficient. Compliance costs have soared. Branch banking is becoming less and less relevant, yet is costly to maintain and there is a regulatory bias towards maintaining branches. Margins are compressed. There is much hoopla about how technology companies are going to cannibalize the business of the banks through greater efficiency and ease of access. Both fear and opportunity seem to be driving banking organizations in this current wave of fintech interest.

A couple of data points: Global investments in the fintech industry are estimated to have grown from $4.05 billion in 2013 to $12.21 billion in 2014 to $22.3 billion in 2015, a 450% increase.[7] Such investments through third quarter of 2016 reached $18 billion.[8] Banking organizations alone have invested $7 billion in fintech startups from 2010 to 2015 and in the last five quarters Banco Santander, Goldman Sachs and

[5] *Id.* at 6.

[6] *Id.* at 11.

[7] Accenture, *The Future of Fintech and Banking: Digitally Disrupted or Reimagined?* (2015), https://www.accenture.com/_acnmedia/Accenture/Conversion-Assets/DotCom/Documents/Global/PDF/Dualpub_11/Accenture-Future-Fintech-Banking.pdf#zoom=50; Accenture, *Global Fintech Investment Growth Continues in 2016 Driven by Europe and Asia, Accenture Study Finds* (Apr. 13, 2016), https://newsroom.accenture.com/news/global-fintech-investment-growth-continues-in-2016-driven-by-europe-and-asia-accenture-study-finds.htm.

[8] *Id*; KPMG, *The Pulse of Fintech Q2 2016: Global Analysis of Fintech Venture Funding* (Aug. 17, 2016), https://assets.kpmg.com/content/dam/kpmg/xx/pdf/2016/08/the-pulse-of-fintech-q2-report.pdf; KPMG, *The Pulse of Fintech Q3 2016: Global Analysis of Fintech Venture Funding* (Nov. 16, 2016), https://assets.kpmg.com/content/dam/kpmg/xx/pdf/2016/11/the-pulse-of-fintech-q3-report.pdf.

Citigroup have each completed seven or more fintech deals.[9] As a result of the emergence of well-funded fintech firms such as Betterment,[10] Symphony[11] and Motif Investing,[12] legal services providers and consulting firms have taken note. Many prominent law firms have responded to the growth of the fintech sector by emphasizing

[9] Richard Lumb, Fintech: If You Can't Beat Them, Join Them, Institutional Investor (June 19, 2016), http://www.institutionalinvestor.com/blogarticle/3563039/fintech-if-you-cant-beat-them-join-them/banking-and-capital-markets-trading-and-technology.html#.WHb3vWIrLIU; Daniel Huang, *Banks and Fintech Firms' Relationship Status: It's Complicated*, Wall St. J., Nov. 18, 2015, http://www.wsj.com/articles/banks-and-fintech-firms-relationship-status-its-complicated-1447842603. Additionally, in 2015, firms such as American Express, Bain Capital, Goldman Sachs, MasterCard, New York Life and the New York Stock Exchange invested $1 billion in blockchain related startups. Jose Pagliery, *Record $1 billion Invested in Bitcoin So Far*, CNN Money, Nov. 3, 2015, http://money.cnn.com/2015/11/02/technology/bitcoin-1-billion invested/?utm_source=November+Newsletter&utm_campaign=ADCCA&utm_medium=email; KPMG, *The Pulse of Fintech Q3 2016: Global Analysis of Fintech Venture Funding* (Nov. 16, 2016), https://assets.kpmg.com/content/dam/kpmg/xx/pdf/2016/11/the-pulse-of-fintech-q3-report.pdf.

[10] Betterment is a robo-advisor platform that manages portfolios, for a sliding fee, that are designed to fit investor's goals and risk tolerance. Samantha Sharf, *The Fintech 50: The Complete List 2016*, Forbes (Nov. 7, 2016), http://www.forbes.com/sites/samanthasharf/2016/11/07/the-fintech-50-the-complete-list-2016/#3c697c5d10f7. In its last two rounds of funding—the most recent being last spring—the fintech firm has raised $205 million. Erin Griffith, *Robo-advisor" Betterment raises $100 million*, Fortune (Mar. 29, 2016), http://fortune.com/2016/03/29/betterment-funding/. Telis Demos, *Betterment Valued At Nearly $500 Million In New Round*, WSJ (Feb. 19, 2015), http://blogs.wsj.com/moneybeat/2015/02/19/betterment-valued-at-nearly-500-million-in-new-round/.

[11] Symphony is a platform through which users can access data, analytics, news and other sources of information. Justin Baer, *Goldman Backed Symphony Communication In Talks to Raise 100 million*, WSJ (Oct. 5, 2016), http://www.wsj.com/articles/goldman-backed-symphony-communication-in-talks-to-raise-100-million-1475694280. The company is backed by a number of banking organizations including Bank of America, BNY Mellon, Citi, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JPMorgan, and Morgan Stanley. Ron Miller, *Wall Street-Backed Symphony Wants To Revolutionize Financial Services Communication*, Techcrunch (Feb. 21, 2015), https://techcrunch.com/2015/02/21/wall-street-backed-symphony-wants-to-revolutionize-financial-services-communication/. The company has raised $170 million so far. Samantha Sharf, *The Fintech 50: The Complete List 2016*, Forbes (Nov. 7, 2016), http://www.forbes.com/sites/samanthasharf/2016/11/07/the-fintech-50-the-complete-list-2016/#3c697c5d10f7.

[12] Motif Investing allows users to create, share, and invest baskets of stocks around common themes. Each basket costs $10. Douglas Macmillan, *Renren Backs Motif Investing in Latest Financial Tech Bet*, WSJ (Jan. 20, 2015). Motif Investing has raised $126 million in funding from investors such as Goldman Sachs and JPMorgan Chase. Samantha Sharf, *Motif Investin: Everything Is Thematic*, Forbes (Dec. 25, 2015), http://www.forbes.com/sites/samanthasharf/2015/12/09/motif-investing-everything-is-thematic/#c3f7df424786l.

the strengths of their fintech practice groups.[13] Likewise, large consulting firms have begun to market to these clients through papers, reports and studies on fintech.[14]

Some fintechs, instead of being bought by or merely partnering with banks, could seek to become full service banks or limited purpose banks. Green Dot Bank, for example, was a nonbank prepaid card company that partnered with issuing banks until 2011, when it acquired a small community bank and became a bank holding company.[15] New York start has granted non-depository trust bank charters to two bitcoin exchanges, Gemini and itBit.[16] More recently, on December 2, 2016 the OCC announced a proposed framework for granting special purpose national bank charters to companies, including fintechs, that are involved in one of three core banking activities: accepting deposits,

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[13] *See generally* DAVIS POLK & WARDWELL LLP, FINTECH, http://www.davispolk.com/practices/corporate/FinTech/ (last visited Nov. 17, 2015); CLEARY GOTTLIEB STEEN & HAMILTON LLP, FINANCIAL TECHNOLOGY, http://www.cgsh.com/financial-technology/ (last visited Nov. 17, 2015); WILMER CUTLER PICKERING HALE AND DORR LLP, FINTECH, https://www.wilmerhale.com/fintech/ (last visited Nov. 17, 2015); REED SMITH LLP, FINTECH, http://www.reedsmith.com/FinTech-Practices/ (last visited Nov. 17, 2015); DECHERT LLP, FINTECH, https://www.dechert.com/FinTech/ (last visited Nov. 17, 2015).

[14] *See* Accenture, The Future of Fintech and Banking: Digitally Disrupted or Reimagined?, *supra* note 2; Deloitte, Financial Technology Software and Services, http://www2.deloitte.com/us/en/pages/risk/solutions/financial-technology-software-and-services.html (last visited Nov. 17, 2015); EY, Fintech: Are banks responding appropriately?, http://www.ey.com/CN/en/Industries/Financial-Services/Banking---Capital-Markets/EY-fintech-are-banks-responding-appropriately (last visited Nov. 18, 2015); Oliver Wyman et al., The Fintech 2.0 Paper: Rebooting Financial Services, http://www.oliverwyman.com/content/dam/oliver-wyman/global/en/2015/jun/The_Fintech_2_0_Paper_Final_PV.pdf (last visited Nov. 24, 2015); PricewaterhouseCoopers, Money is no object: Understanding the Evolving Cryptocurrency Market, https://www.pwc.com/us/en/financial-services/publications/assets/pwc-cryptocurrency-evolution.pdf (last visited Nov. 18, 2015).

[15] Deborah Crowe, Green Dot Completes Bank Acquisition, L.A. Business Journal (Dec. 9, 2011), http://labusinessjournal.com/news/2011/dec/09/green-dot-completes-bank-acquisition/.

[16] Nathaniel Popper, *Bitcoin Exchange Receives First License in New York State*, N.Y. Times (May 7, 2015), https://www.nytimes.com/2015/05/08/business/dealbook/bitcoin-exchange-receives-first-license-in-new-york-state.html.; NYDFS, *NYDFS GRANTS CHARTER TO "GEMINI" BITCOIN EXCHANGE FOUNDED BY CAMERON AND TYLER WINKLEVOS* (Oct. 5, 2015), http://www.dfs.ny.gov/about/press/pr1510051.htm.

making loans, or paying checks (i.e. payments activities).[17] A number of groups, including the ABA, ICBA, Conference of State Bank Supervisors, consumer advocacy groups and democratic senators, have strongly criticized the proposal on various grounds, including blurring the traditional line between banking and commerce.[18]

Even accounting for this blurring line between banks and fintechs there are a number of factors pointing to why banking organizations will ultimately survive and thrive notwithstanding the technological onslaught. First, they have capital and almost unparalleled access to funding, something that all but a handful of new entrants lack. They have longstanding and large customer bases that have shown remarkable loyalty to their institutions. The combination of providing a safe haven for funds and a ready source of credit creates a very tight relationship with the customer base. Finally, not to be discounted, the banking world is regulated "from cradle to grave," creating barriers and obstacles to nonbank outsiders that are formidable. Fintechs themselves see these benefits and end up seeking to partner with banking organizations.

To survive and thrive, however, banking organizations must be able to take advantage of the opportunities presented. That formidable thicket of laws and regulations preventing others from getting into the business of banking also creates obstacles

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[17] Fannie Chen, John L. Douglas, Reuben Grinberg and Margaret E. Tahyar, *OCC Releases Long-Awaited Limited Purpose National Bank Charters For Fintechs*, Beyond Sandbox (Dec. 2, 2016), http://www.beyondsandbox.com/single-post/2016/12/02/OCC-Releases-Long-Awaited-Limited-Purpose-National-Bank-Charters-For-Fintechs; Davis Polk, *Beyond FinTech: The OCC's Special Purpose National Bank Charter* (Dec. 9, 2016), https://www.davispolk.com/publications/beyond-fintech-occs-special-purpose-national-bank-charter/.

[18] Rachel Witkowski, *Democratic Senators Criticize Fintech-Charter Plan*, WSJ (Jan. 9, 2017), http://www.wsj.com/articles/democratic-senators-criticize-fintech-charter-plan-1483996432; ICBA, *ICBA Expresses Grave Concerns About Proposed FinTech Federal Charter*, (Dec. 2, 2016), http://www.icba.org/news-events/press-releases/2016/12/02/icba-fintech-charter-should-ensure-level-regulatory-standards; Conference of State Bank Supervisors, *State Regulators Oppose OCC Fintech Charter* (Nov. 14, 2016), https://www.csbs.org/news/press-releases/pr2016/Pages/111416.aspx.

preventing banking organizations from straying too far outside what the regulators consider the business of banking.

Obviously, there are an almost innumerable manner of ways in which relationships between banking organizations and technology companies can be structured. On one end, the banking organization can simply purchase or license needed technology; on the other, the bank can acquire the technology company.

It would be impossible to explore all of the possible permutations of how a relationship might be structured in a short article. Accordingly, this article will focus on those relationships where the banking organization is investing by taking some form of equity interest either directly in the technology company or in a new company where the technology company is a co-investor or participant.

The purpose of this article is to examine how banking organizations may utilize the existing framework of laws and regulations to take advantage of investment opportunities in the technology space. Every investment, partnership or joint venture must navigate the sometimes confusing restrictions of the Bank Holding Company Act, the National Bank Act, the Volcker Rule or any number of other laws that could apply.

A brief organizational note: this article begins by addressing investments by bank holding companies out of their "nonbank chains" by the holding company or one of its subsidiaries other than its chartered bank subsidiaries. These nonbank chain investments provide substantial flexibility for certain types of investments. The article continues by addressing investments by banks (i.e., national or state banks, whether insured or not) and by exploring the parameters of the National Bank Act, and how banks can exploit the flexibility of the OCC's approach to the business of banking in structuring investments and activities. Because most states have wild-card statutes permitting state banks to engage in activities permissible for national banks, and because the Federal Deposit Insurance Act generally limits state banks to activities as principal that are permissible for national banks, state bank powers in the fintech area generally parallel those of national banks. The article then discusses the restrictions of the Volcker Rule, provides a summary of various investment alternatives and associated considerations, and provides a conclusion.

II. The Opportunities and Constraints of the BHCA

The Bank Holding Company Act (BHCA) provides the basic framework for investments in companies by companies that control banks, known as bank holding companies.[19] Since the framework also applies to an investment made by a subsidiary of a bank holding company, except for investments made by a subsidiary that is a bank or its subsidiaries, it can be helpful to think of these restrictions as applying to the nonbank chain of the holding company. Investments made instead by banks and their subsidiaries are discussed in Section III. In its simplest form, the BHCA will allow bank holding companies to own or control companies that are engaged in banking and other activities that are so closely related to the business of banking or of managing or controlling banks as to be a proper incident thereto.[20] If the target company doesn't fall within the "banking" or "closely related" buckets, the bank holding company is precluded from making a controlling investment.

[19] 12 U.S.C. § 1841, et seq.

[20] 12 U.S.C. § 1843(c)(8).

Embedded in that simple statement are a number of important concepts. What is "control?" What activities are so closely related that controlling investments are permissible? How do I structure an investment in a company to avoid control? Are there reasons to avoid control, even in companies that engage in permissible activities?

A. Non-Controlling Investments

This section addresses the parameters and nuances of control in more detail below, but the basic concept is that the ownership level must be low enough, and there must be no contractual or other powers, that would allow the investor to exercise a controlling influence over the management or policies of the target. The investment need not be totally passive, but the target must retain the power to make business and policy decisions.

Many investments by banking organizations into technology companies are structured to be non-controlling. In some, the activities fall outside the parameters of permissibility, and any investment by a bank holding company in a company engaged in impermissible activities must be limited to a non-controlling investment. In others instances the banking organization is unclear which direction the company will take, and having to monitor the target company at all times to assure that it is only engaging in permissible activities is sometimes viewed as unnecessarily intrusive, and perhaps inhibiting the creative development of the desired technology or application. Finally, a banking organization may elect to make a non-controlling investment (and the target may have a strong preference for a non-controlling investment), so that the target will not be or be deemed a subsidiary of the banking organization and thus subject to regulation, supervision and examination by the investor's banking supervisor.

For example, Ripple, a fintech that uses blockchain technology to move funds, last Series B $55 million investment round in the fall of 2016, included investments from Santander and Siam Commercial Bank.[21] Though the details on each of these investments were not made public, one imagines that each banking organization likely has a non-controlling investment in this platform.

The definition of control determines much of the applicability of the BHCA. A company that controls a bank is a bank holding company. Companies controlled by another company are subsidiaries of that company. Shares of companies controlled by subsidiaries of a company are deemed to be controlled by the parent. Affiliates are companies that control, are controlled by or are under common control with another company. A qualified family limited partnership may only control a single bank holding company.

Control (or lack thereof) determines whether or not the activities of the target must conform to the activity limitations of the BHCA. If controlling, the activity must be permissible; if not, no such limitations apply. Control also determines the nature of the Federal Reserve's jurisdiction to supervise, examine and regulate. A controlled investment is a subsidiary, within the Federal Reserve's regulatory jurisdiction; a non-controlling investment (absent more) would generally be beyond the Federal Reserve's supervisory reach.

Control for BHCA purposes is set at an intentionally low threshold. A company is deemed to control another if owns, controls or has the power to vote 25% or more of

[21] Martin Arnold, *StanChart invests in blockchain startup Ripple*, Financial Times (Sep. 15, 2016), https://www.ft.com/content/8bc258e2-8463-3fa5-a1f7-7aacf6993c4d.

any class of voting securities, has the power to elect a majority of the directors, or has the power to exercise a controlling influence over the management or policies of the company, as determined by the Federal Reserve after notice and opportunity for hearing.[22]

Whenever a company owns, controls or has the power to vote less than 5% of any class of voting securities of a company, the first company is presumed not to have control over the second.[23]

There is, of course, a bit of a gap between the 25% threshold, where one has control, and the less than 5% level, where one is presumed not to have control.

For years, that gap was subject to a lot of uncertainty. In 1982, and more importantly, in 2008, the Federal Reserve issued policy statements providing much needed guidance around controlling and non-controlling investments.[24] The 1982 statement was prompted by a series of aggressive investments by bank holding companies in other banking organizations at a time when interstate banking was virtually nonexistent. The 2008 policy statement was prompted by significant investments by nonbanking companies into banking organizations. In each case, the investing party wanted to avoid triggering the application and approval requirements of the BHCA which, in the first circumstance, would have precluded the investment completely, and in the second, resulted in the investing company being subject to the full panoply of activity

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[22] *See*, Donald N. Lamson et al., *Nonbanking Activities of Foreign Banks*, § 10.3(1)(a)-(b), in *Regulation of Foreign Banks & Affiliates in the United States* (8th ed. 2014); 12 U.S.C. § 1841, et seq; 12 CFR Part 225.

[23] *Id.* at § 10.3(1)(d).

[24] Federal Reserve, *Policy Statement on Nonvoting Equity Investments by Bank Holding Companies* (July 1982) (codified at 12 CFR § 225.143); Federal Reserve, Policy Statement on Equity Investments in Banks and Bank Holding Companies (Sep. 2008) (codified at 12 CFR § 225.144).

and other restrictions of the BHCA. The principles in the policy statements regarding control are applicable to investments by banking organizations in nonbanking companies.

Without attempting to address all of the nuances of the policy statements, a company will not be presumed to exercise a controlling influence over another as follows:

i. *Director representation.* The Federal Reserve indicated that a company is unlikely to exercise control if the investor has a single representative on the board of directors, or potentially two members if the representation is proportionate to the investment, does not exceed 25% of the voting members and there is another controlling shareholder that is a bank holding company. The representative of a minority investor may serve on a committee, but may not serve as chair of the committee, may not occupy more than 25% of the seats on the committee, and the committee may not make (or block the making of) policy or other decisions that bind the board or management.

ii. *Total equity.* The Federal Reserve indicated that it would not expect a minority investor to exercise control if it owned a combination of voting and non-voting shares that, when aggregated, represented less than one-third of the total equity, and less than one-third of any class of voting equity assuming conversion of all non-voting shares held by the investor, and its ownership did not exceed 15% of any class of voting securities. The non-voting shares may not be convertible in the hands of the investor. They may, however, be converted into voting shares in the hands of a third party, but only if the investor transfers the shares in a widespread public distribution, in transfers where no transferee (or group of related transferees) would receive 2% or more of any class of voting securities, or to a transferee that would control 50% or more of the voting securities of the banking organization without any transfer of shares from the investor.

iii. *Consultation with management.* The minority investor will be permitted to communicate with the banking organization and advocate for changes in polices and operations, including changes in management, dividend policies, the need for additional debt or equity, and advocating mergers, acquisitions, sales or divestitures. However, the decisions must rest with the organization's shareholders as a group, its board or management, and the investor must limit its participation to voting its shares or exercising its rights as a director. It may not launch a proxy context (although may grant another (independent) shareholder its proxy), and may not threaten to dispose of its shares if its desires are not acted upon.

iv. *Business relationships.* The Federal Reserve indicated that business relationships that were "quantitatively limited and qualitatively nonmaterial" could be permissible, particularly in situations where the investor's voting securities percentage is closer to 10% than 25%. Generally, the Federal Reserve stated that it would evaluate such relationships on a case-by-case basis, and would pay attention to whether the relationship was on market terms, non-exclusive and terminable without penalty to the target.

v. *Covenants.* The Federal Reserve continues to be sensitive to covenants that limit management's discretion over major policies and decisions. These

> would include covenants that require consent for management changes and compensation, changes in business lines or operations, raising debt or equity, or engaging in mergers, acquisitions, sales or divestitures. The Federal Reserve does allow covenants that basically protect the nature of the investment. For example, covenants that prohibit the issuance of senior securities modifying the terms of the investment or liquidating the organization. The Federal Reserve acknowledges that covenants regarding access to limited financial information or requiring consultation would not normally indicate control.

The limitation on business relationships can often be an impediment to non-controlling fintech deals. Startups that receive investment from a banking organization may receive almost all of their revenues from the banking organization, which would typically lead the banking organization to control the startup if it owns at least 5% of the voting equity of the startup. In our experience, this risk is significantly reduced if there is a plan to rapidly—within a year or two—significantly shrink the proportion of revenues coming from the banking organization. For example, consider a hypothetical relationship between a roboadvisor and a banking organization investor. The banking organization makes what it hopes is a non-controlling investment, purchasing 10% of the robo-advisor's voting equity. At the same time, they agree to a pilot with a small number of the banking organization's customers. Although the pilot is insignificant to the banking organization, to the small robo-advisor the deal will mean that 90% of its revenue over the next year may come from its pilot with the banking organization. There is a significant danger that the banking organization may be found to control the robo-advisor, but this danger can be mitigated if the robo-advisor has a plan in place to expand to other potential clients and revenue streams and quickly bring down the share of its revenue from the banking organization down to say, 15%.

Similarly interesting issues arise in consortium deals involving many banking organizations investing into a fintech that will provide a product or platform for the banking organizations. Thus far the Federal Reserve has seemingly allowed these investments to not constitute control if each bank makes an equal minority investment and the revenues attributable to each are on a roughly equal basis as well. One potential example of this is the recent Deutsche Bank, HSBC, KBC, Natixtis, Rabobank, Société Générale and UniCredit investment in Digital Trade Chain, a prototype blockchain trade finance tool.[25] The banks signed a Memorandum of Understanding to build Digital Trade Chain and will be equal investors in the newly formed consortium.[26] One can hypothesize the formation of this consortium and the banks' investments could have relied on the non-control consortium principles laid out above. Banking organizations must keep in mind thatif the Federal Reserve finds that they acted in concert with one another their ownership interests will be aggregated together for the purposes of a control analysis. Whether or not the banking organizations are deemed to be acting in concert will likely depend on the facts and circumstances of the particular deal or investment.

B. Permissible BHCA Activities and Controlling Investments

[25] Oscar Williams-Grut, *Deutsche Bank, HSBC, and Five Other Big Banks Are Collaborating on a Blockchain Project*, Business Insider (Jan. 16, 2017), http://www.businessinsider.com/deutsche-bank-hsbc-kbc-natixis-rabobank-socit-gnrale-and-unicredit-work-on-digital-trade-chain-dtc-2017-1; Ian Allison, Deutsche Bank, *HSBC and Five Other Big Banks Form 'Digital Trade Chain' Consortium*, International Business Times (Jan. 16, 2017), http://www.ibtimes.co.uk/deutsche-bank-hsbc-five-other-big-banks-form-digital-trade-chain-consortium-1601259.

[26] *Id.*

Besides engaging in non-controlling investments, bank holding companies are permitted to engage in a variety of activities and controlling investments, all of which directly relate to the business of banking. Relevant for fintech investments are provisions that allow bank holding companies to own shares of companies engaged in furnishing services to or performing services for the bank holding company and its subsidiaries,[27] "shares of companies of the kinds and amounts eligible for investment by national banking associations,"[28] and "shares of any company the activities of which have been determined by the Board by regulation or order . . . to be so closely related to banking as to be a proper incident thereto."[29] Under the latter authority, there is a large laundry list of permissible activities, including all forms of lending and credit services, trust and fiduciary activities, investment advisory activities, certain securities and limited insurance activities, certain consulting services and data processing.

1. *Permissible Closely Related Activities*

Over the years the Federal Reserve has approved a wide variety of activities as being so closely related to banking or the business of managing or controlling banks as to be a proper incident thereto. Investments in companies engaged in such activities are permissible under 12 U.S.C. § 1843(c)(8), and the laundry list of permissible activities is found in Regulation Y at 12 C.F.R. § 225.28.

[27] 12 U.S.C. § 1843(c)(1).

[28] 12 U.S.C. § 1843(c)(5).

[29] 12 U.S.C. § 1843(c)(8).

Certain of the permissible activities are part of the core business of banking, including extending credit, servicing loans and other activities related to extending credit. Trust and fiduciary activities are permissible, as are many securities brokerage activities.

The laundry list also includes management consulting and data processing, which, although each comes with certain limitations, are important. Investments in fintech companies that engage in such activities or offer support for the foregoing activities are generally permissible. As much of technology relates to the capture and manipulation of data, the data processing area is quite important. Importantly, the exception mandates a strong link to financial data, for in order to satisfy the "closely related" standard, the bank may engage in:

> [p]roviding data processing, data storage and data transmission services, facilities (including data processing, data storage and data transmission hardware, software, documentation, or operating personnel), databases, advice, and access to such services, facilities, or data-bases by any technological means, if: [t]he data to be processed, stored or furnished are financial, banking or economic . . . .[30]

Although most fintech deals focus on companies that provide software and services, the companies may provide hardware only in conjunction with "software designed and marketed for the processing, storage and transmission of financial, banking, or economic data, and where the general purpose hardware does not constitute more than 30 percent of the cost of any packaged offering." And while in connection with providing the permissible financial data processing activities the company may also engage in "impermissible" or non-financial data processing, "the total annual revenue

[30] 12 C.F.R. § 225.28(b)(14)(i).

derived from those activities [must] not exceed 49 percent of the company's total annual revenues derived from data processing, data storage and data transmission activities."

The OCC however has generally shown greater flexibility in interpreting the limits of the permissible data processing activities (for national banks) than the Federal Reserve.

There is a clear intent in the BHCA implementing regulations to tie all permissible activities to banking and bank-related activities, supporting one of the purposes of the BHCA to separate banking and commerce.[31] In the management consulting area, a bank holding company may provide management consulting advice "on any matter" to another unaffiliated banking organization.[32] However, to the extent it provides management consulting to other nonbanking organizations, its advice must be limited to "financial, economic, accounting, or audit" matters.[33] There is a 30% limit for any consulting activities that fall outside the permissible parameters.[34]

The laundry list will cover much in the fintech area, including consumer-financing nonbank fintechs. Within this space are such companies as the marketplace lenders (Lending Club, for example), payments companies (Venmo), robo-advisors (betterment.com) and personal financial management tools (Mint), all of whom perform services that banks commonly perform, and all of whom could permissibly be owned, controlled and operated by banking organizations.

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[31] John Krainer, The Separation of Banking and Commerce, The Federal Reserve Bank of San Francisco (July 3, 1998), http://www.frbsf.org/economic-research/publications/economic-letter/1998/july/separation-banking-commerce/.

[32] 12 C.F.R. § 225.28 (9)(i)(A)(1).

[33] *Id.* at (9)(i)(A)(2).

[34] *Id.* at (9)(i)(C).

Digital currency activities would be permissible as a payments or funding activity within the scope of the business of banking. Blockchain technology, which is being tested in a variety of areas, can be viewed as a data processing activity or as part of the core lending, trust and fiduciary, and payments areas traditionally within the scope of banking.

There are some challenges with using the laundry list to make controlling investments in fintech companies. First, there may be some form of application and approval requirement (or after the fact notification requirement) depending upon the bank and its condition.[35] The notice and approval requirement can be somewhat time consuming, and there may be various reasons why a banking organization may wish to avoid having to seek regulatory approval for an investment or activity. Second, the target must continue to assure that its activities fall within the permissible boundaries set forth in the regulations and interpretations. This may limit some of the flexibility a fintech may wish to have in order to respond to changing conditions. Third, if the investment is controlling, the target will be an affiliate for the purposes of Sections 23A and 23B as well as the Federal Reserve's Regulation W, which will govern transactions between the banking organization's chartered bank subsidiaries and the target company. Finally, the Federal Reserve will have the right to examine the target, which may be viewed as intrusive by the target. For all of these reasons, even if the activity is permissible, the bank holding company may wish to make a non-controlling investment, discussed in Section II.A above.

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[35] 12 U.S.C. § 1843(j).

2. *Shares of the Kinds Eligible for Investment by National Banks*

The Federal Reserve takes a very restrictive view of this provision, generally limiting it to the investments deemed permissible for national banks under 12 U.S.C. § 24 (Seventh), which permits investments in various government and agency securities.[36] However, because under the Small Business Company Investment Act national banks (and state banks) may invest in Small Business Investment Companies (SBICs), parallel investment authority is available for bank holding companies.[37]

3. *The Services Exemption*

The services exemption is quite important.[38] The business of banking includes much more than simply accepting deposits and making loans. Necessary and essential to carry on the business of banking are such mundane activities as counting and transporting money, engaging in customer identification, processing and sorting checks, creating, printing and delivering statements, compliance, fraud detection, internet security, developing, modifying and maintaining software, maintain, furnishing and operating bank premises, maintaining and storing records, designing signs, logos and other materials, advertising, communicating with customers, and thousands upon thousands of other activities. Banks and bank holding companies do not perform all those services themselves, although they certainly could do so.

The Federal Reserve permits a bank holding company to establish or acquire a company that engages solely in servicing activities for the bank holding company or its

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[36] 12 C.F.R. § 225.111.

[37] *Id.*

[38] 12 C.F.R. § 225.22.

subsidiaries in connection with lawful activities, including services necessary to fulfill commitments entered into by the subsidiaries with third parties, so long as the company does not act as principal in dealing with third parties. It also permits such investments in companies engaged solely in servicing activities for the internal operations of the bank holding company or its subsidiary, including such things as accounting, auditing, appraising, advertising and public relations, data processing and transmission, personnel services, courier services and insurance services.

Note that while the list of permissible activities is quite large, the structure of the services exemption is such that the company performing the services must essentially limit its activities to providing services for the bank holding company and its subsidiaries. To the extent it offers those services outside the bank holding company—even to other bank holding companies—it must find another authority to do so.[39]

The rationale for this limitation is fairly straightforward. Just because a bank needs to print statements doesn't mean that it can go in the printing business any more than it can go in the lawn maintenance business simply because it must maintain its banking premises.

Fortunately, to the extent that the services go to the core financial operations or processes of the bank, they are likely to be found to be permissible under other authority. A simple example: because banking organizations need to assure online security for their customers as they transact business, investing in companies that will develop and enhance online security is certainly permissible. In that vein, numerous companies are trying to enhance the efficiency of various back office operations of banking

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[39] *See Id.* at (b).

organizations. Much of this is invisible to customers, but critically important to banking organizations. The same is true for many activities that are necessary in connection with lending, deposit taking, financial data processing and the like. Banking organizations can invest in companies providing these services under the services exception. However the Federal Reserve has specifically determined that many of these activities are so closely related to the business of banking as to be proper incidents thereto and thus permissible for bank holding companies. This allows the bank holding company to invest even though the target may be performing services for nonbanking institutions. For example, in August of 2016, Bank of America partnered with the fintech startup Viewpost, which is a payment platform designed for businesses, particularly small businesses, and streamlines payment processes and is involved in nonbank partnerships such as with Comdata, a credit card issuer for MasterCard.[40] Bank of America customers will be able to use their Bank of America credentials to link their bank accounts to the Viewpost network, from which they can manage and conduct their electronic payments activities.[41] Since Viewpost provides services to companies other than Bank of America and its affiliates, Bank of America is unlikely to be relying upon the services exception as its authority for investment into Viewpost.

C. Financial Holding Companies

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[40] *See* Grace Noto, *Bank of America-Viewpost Partnership Brings Digital Payments to SMEs*, Bank Innovation (Aug. 25, 2016), http://bankinnovation.net/2016/08/bank-of-america-viewpost-partnership-brings-digital-payments-to-smes/. *See also Viewpost Inks Partnership with Bank of America*, PYMTS (Aug. 23, 2016), http://www.pymnts.com/news/partnerships-acquisitions/2016/viewpost-bank-of-america-partnership/; Business Wire, Viewpost and Comdata Team Up to Streamline Secure ePayables (Nov. 13, 2016), http://www.businesswire.com/news/home/20161213005451/en/Viewpost-Comdata-Team-Streamline-Secure-ePayables.

[41] *Id.*

Qualifying bank holding companies may elect to become financial holding companies as a result of the Gramm-Leach-Bliley Act, and as such are permitted to engage in activities that are "financial in nature" or are "incidental to financial activities" over and above those permissible for bank holding companies under the BHCA.[42] In addition, they are permitted to engage in merchant banking activities. Indeed, virtually all large bank holding companies have elected to become financial holding companies.[43] The additional authorities available to FHCs hold promise for a broader range of fintech investments, although as we shall shortly see, those promises are largely illusory.

1. *Qualifying as an FHC*

In order to qualify as a financial holding company, both the holding company and all of its depository subsidiaries must be well capitalized and well managed. It must file a declaration with the Federal Reserve affirmatively electing to be a financial holding company. If it fails to maintain the well-capitalized and well-managed standards, the Federal Reserve will impose limitations on further use of the financial holding company provisions and may, if the condition persists, require divestiture of any subsidiary depository institution; alternatively, the company may elect to cease all activities other than those permissible for bank holding companies. If one of the insured depository institution subsidiaries of the financial holding company fails to maintain at least satisfactory CRA records, the Federal Reserve may preclude new activities or further acquisitions using the financial holding company powers.

[42] 12 U.S.C. § 1843(4)(k).

[43] Dafna Avraham, Patricia Selvaggi and James Vickery, *A Structural View of U.S. Bank Holding Companies*, FRBNY Economic Policy Review (July 2012), https://www.newyorkfed.org/medialibrary/media/research/epr/12v18n2/1207avra.pdf.

2. *Financial in Nature or Complementary to Financial Activities*

It was clear that Congress intended that activities that were financial in nature would be a broader category of activities than the banking and closely related to banking activities permissible for bank holding companies. As elucidated in the statute and implementing regulation, a broad range of insurance and securities activities were deemed to be financial in nature, as well as activities permissible for bank holding companies outside the United States.[44]

However, the Federal Reserve has been quite reluctant to extend the parameters of "financial in nature" beyond the stated regulatory limitations.[45] Wishes that broader data processing, software or other technological activities would be deemed permissible have been unfulfilled. Accordingly, the limitations of permissibility described above for bank holding companies seem to define the outer boundaries for financial holding companies.

3. *Merchant Banking Activities*

A financial holding company with a securities affiliate (a registered broker-dealer or municipal securities dealer) or a controlled insurance company with a registered investment adviser providing advice to an insurance company may engage in merchant banking activities.[46] Through the merchant banking powers, a financial holding company may acquire virtually any type of debt or equity investment in any company, regardless of the activities of the company, whether voting or non-voting. While it is clear that the

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[44] 12 U.S.C. § 1843; 12 C.F.R. 248; 12 C.F.R. § 380.8.

[45] Michael S. Barr, Howell E. Jackson and Margaret E. Tahyar, *Financial Regulation: Law and Policy* (2016), 676 ("To date, most of the Federal Reserve Board's determinations regarding activities that are 'complementary' relate to FHC physical commodities activities.").

[46] 12 U.S.C. § 1843(4)(k); 12 CFR Parts 217 and 225.

financial holding company may control any portfolio company it acquires under the merchant banking authority, it may not "routinely manage or operate" the company. This severely limits day-to-day involvement with the company, except in those instances where necessary to protect the investment. There are certain cross-marketing restrictions that apply to the portfolio company and any bank or bank subsidiary of the financial holding company. Further, if the financial holding company owns or controls more than 15% of the total equity of the portfolio company, there is a rebuttable presumption that the restrictions of Sections 23A and 23B of the Federal Reserve Act limiting transactions with affiliates will apply to transactions with the portfolio company.

Many banking organizations make strategic investments in fintechs, hoping for a more fruitful relationship than just a mere economic return from increase in share price and hope to provide strategic direction and advice that may be incompatible with the limitations on day-to-day involvement. Thus, as a result of the restrictions imposed on relationships between the financial holding company and any portfolio company acquired under the merchant banking authority, while the merchant banking authority offers a theoretical avenue for fintech investments, its practical use is somewhat limited.

III. The National Bank Act and the Business of Banking

A. The Scope of Permissible Activities Using the National Bank Charter

Instead of investing out of the nonbank chain, a banking organization can have its bank subsidiary make the investment. Most U.S. banks are owned by BHCs[47], and many

[47] Dafna Avraham, Patricia Selvaggi, and James Vickery, *A Structural View of U.S. Bank Holding Companies*, FRBNY Economic Policy Review (July, 2012), https://www.newyorkfed.org/medialibrary/media/research/epr/12v18n2/1207avra.pdf.

banks are national banks chartered by the OCC. The national bank charter provides surprising flexibility with respect to investments in the fintech area. The OCC has a long tradition of viewing the charter as flexible and adaptable to changing economic and market conditions.

The National Bank Act provides that national banks shall have the power:

> [T]o exercise . . . all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes . . .[48]

The OCC has taken the position that the five enumerated powers do not limit the broad grant of power that authorizes banks to engage in the business of banking.[49] It uses a three-part test as to whether an activity is a permissible component of the business of banking: It is functionally equivalent to or a logical outgrowth of a recognized banking activity; would it respond to customer needs or otherwise benefit the bank or its customers; and would it involve risks similar to those already assumed by banks.[50] If banks have traditionally engaged in the activity as part of their business, that business is entitled to evolve and grow as times change. The OCC recognizes that banks are justified in taking advantage of technological developments to conduct and expand their businesses.

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[48] 12 U.S.C. § 24 (Seventh).

[49] Michael S. Barr, Howell E. Jackson and Margaret E. Tahyar, Financial Regulation: Law and Policy (2016), 192.

[50] *See*, *e.g.*, 12 C.F.R. § 7.5001(c).

The OCC also places great importance on the introductory phrase in 12 U.S.C. § 24 (Seventh) that national banks are entitled to exercise "all such incidental powers as shall be necessary to carry on the business of banking." The OCC has taken a broad view of the incidental powers, a view that has been upheld in various court decisions. In 1972, the First Circuit Court of Appeals defined an incidental power as one that is "convenient or useful in connection with the performance of one of the bank's express powers under the National Bank Act.[51] In the *VALIC* decision, the Supreme Court went even further, holding that incidental activities include those that were convenient or useful to the business of banking itself, and were not limited to those incidental to the five enumerated or express powers set forth in the National Bank Act. [52]

In 1996, the OCC issued a very provocative decision relating to the authority of a national bank to serve as an internet service provider to both customers and non-customers.[53] Although the precedent is somewhat old, it is illustrative to examine how the OCC has dealt with and expanded the basic concept of the business of banking, and how it interprets the incidental powers. A national bank sought approval to provide home banking services to its customers via a direct Internet connection to the bank's home banking system, and in connection therewith, provide Internet access to both customers and non-customers in the bank's service area. As a preliminary matter, the OCC determined that providing facilities to provide banking services to its customers is simply the use of electronic technology to provide recognized banking services. It is both the

[51] *Arnold Tours, Inc. v Camp*, 472 F.2d 427 (1st Cir. 1972).

[52] *NationsBank of North Carolina, N.A. v Variable Life Annuity Co.*, 115 S. Ct. 819 (1995).

[53] OCC Interpretive Letter 742 (Aug. 19, 1996).

functional equivalent of recognized banking activities, it is convenient and beneficial for the bank and its customers and involves risks similar to those already assumed by banks. It then termed the provision of Internet access as a permissible incidental activity, as providing the mechanisms for its customers to conduct the business of banking. It saw no problem with the bank owning those means or mechanisms, and was not troubled that customers might use the Internet access provided for other nonbanking purposes. Its rationale mentioned that it was impractical to separate the banking from the nonbanking services, that providing full service Internet access added virtually nothing to the cost of providing the internet service, and that the offering of full internet access did not "dominate" the bank's home banking package. The OCC also noted that providing full Internet access created a package designed to satisfy customer demand and to enable the bank to market its services. Finally it noted that the bank would be justified in offering full Internet access as a permissible use of excess capacity acquired in good faith.

Of perhaps more interest is the OCC's justification for allowing the bank to offer Internet access to non-customers as an incidental power. It considered it to be a form of marketing and advertisement, promoting its reputation as a good corporate citizen in the community. It also used the "excess capacity" rationale to justify providing the service to non-customers.

The OCC interpretive letter approving acting as an internet service provider was issued over 20 years ago. The themes and rationales used in the letter, however, have a wonderfully broad applicability to a variety of very interesting activities.

Using these guidelines, the OCC has approved such diverse activities as acting as a certification authority for digital signatures, dispensing transportation and event tickets, offering electronic data interchange services, commercial web site hosting for retailers, creating and operating an electronic marketplace, providing electronic storage and safekeeping of documents or information, providing internet access to customers, and selling excess capacity to non-customers, and selling web site editing software as part of web hosting services for customers.[54]

The OCC has also taken a flexible and broad approach to the parameters of electronic activities of national banks. OCC precedents, for example, authorize banks to provide advice with respect to data processing and data transmission services; has given greater flexibility to the sale of software to purchasers if it is part of the business of banking (a determination made by a twelve-factor list); [55] and electronic activity is authorized as incidental to the business of banking if that activity is useful or convenient to a specifically authorized activity for banks.[56]

The Federal Reserve also permits bank holding companies to engage in data processing (including data storage, and data transmission hardware, software, documentation or operating personnel) activities as discussed above in Section B.[57] But the Federal Reserve has neither been as flexible or as broad in their interpretations of the data processing activities closely related to the business of banking as the OCC has regarding the electronic activities of national banks through its line of precedents.

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[54] *See* http://www.occ.gov/topics/bank-operations/bit/opinions-and-letters.html for various OCC interpretations and approvals dealing with electronic banking activities.

[55] *See* 12 C.F.R. § 7.5001(c) for the 12 factors.

[56] *See* OCC Corporate Decision #2002-11 (Jul. 2002); OCC Corporate Decision #2003-6 (Apr. 2003); 12 C.F.R. § 7.5001(d).

[57] 12 C.F.R. § 225.28(b)(14).

As one can see from the above discussion, the OCC appears to have a broad perspective on the parameters of the business of banking and permissible incidental activities relating to that business. In many respects the OCC's view of the business of banking is broader than the Federal Reserve's view of activities that are so closely related to the business of banking as to be permissible incidents thereto.[58]

B. The Structural Flexibility of the National Bank Charter

The OCC permits broad flexibility in structuring investments, permitting both controlling and non-controlling investments. There are four types of subsidiaries applicable to fintech investments or acquisitions: non-controlling investments; financial subsidiaries controlled by the bank; bank service companies, authorized by the Bank Service Company Act (BSC Act); and operating subsidiaries controlled by the bank.[59] In addition, national banks may invest in small business investment companies (SBICs) under provisions of the Small Business Investment Company Act.[60]

1. *Bank Service Companies*

Bank service companies are entities—wholly owned by one or more insured depository institutions—subject to regulation by the OCC to the same extent as the national bank which engage in a variety of specified internal functions for other depository institutions such as accounting or statistical function.

[58] This difference in approach seems somewhat ironic, as one would presume that if an activity is conducted in a bank or a subsidiary of a bank it would present more risk than if conducted in a holding company subsidiary outside the bank chain.

[59] [The OCC also permits subsidiaries to hold bank premises and subsidiaries to hold …][**DPW Internal: this footnote was never completed.**]

[60] 15 U.S.C. § 631 et seq.

Banks are limited by statute to investing no more than ten percent of their capital and surplus in any single bank service company, and no more than five percent of their total assets in all bank service companies.[61] Banks may also only invest in service companies at locations that the investing depository institution could perform the same contract service.[62] There is also a procedure for a national bank to invest in a company engaged in activities permissible for a bank holding company under Section 4(c)(8) of the BHCA.[63] Such authority could theoretically provide both broader activity powers and greater geographic flexibility, for activities under this provision are not solely limited to locations where the investing bank could perform those services.

OCC regulation can also extend to bank vendors that are not bank services companies in the traditional sense, i.e., companies that are not owned by the bank.[64] For example, third-party technology service providers, depending on the nature of their services to the bank, could be subject to the same regulatory regime as a bank service company.[65] The number and type of activities that fall within the regulatory umbrella are not clear from the BSC Act, but it seems that the more critical the function that the third-party technology service provider provides for the bank or the more it interfaces with the bank's customers then the higher the chance the company will be subject to OCC regulation.

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[61] 12 U.S.C § 1862.

[62] However, this restriction tends to be of little practical import as branching limitations do not apply to activities other than the acceptance of deposits or the approval of loans.

[63] 12 U.S.C. § 1843(4)(c)(8).

[64] *See* OCC, *Bulletin 2013-29 Third Party Relationships: Risk Management Guidance* (Oct. 30, 2013).

[65] *Id.*

2. *Minority Investments*

Through a series of regulatory interpretations that date back approximately 20 years, the OCC expanded the scope of a national bank's investment authority by permitting minority, non-controlling investments.[66] These investments must also be limited to bank permissible activities. They must also be "convenient and useful to the bank in carrying out its business, and not a mere passive investment unrelated to the bank's banking business." The bank's loss exposure must be limited as a legal matter, and the bank may not have unlimited liability for the obligations of the enterprise. The bank must also have the power to assure that the entity only engages in bank permissible activities or must otherwise have the ability to withdraw its investment. As with the other target entities, the enterprise into which the bank invests must agree to be subject to OCC supervision and examination.

The minority investment is particularly useful for ventures between banks and technology companies. The shareholders need not be banks (as with bank service companies) and the bank need not control the company (as with operating subsidiaries). This creates substantial flexibility in crafting the ownership structure. The requirement that activities be limited to only those permissible for national banks, and the resulting OCC supervision and examination, may be drawbacks however, as the target company may want greater flexibility in its business operations, and may be uncertain as to whether it wishes that sort of scrutiny by the OCC.

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[66] *See, Appendix B: Noncontrolling Investment Guidelines* in OCC, *Comptroller's Licensing Manual: Investment in Subsidiaries and Equities* (July 2008).

3. *Financial Subsidiaries*

The authority to acquire a financial subsidiary was added by the Gramm-Leach-Bliley Act in 1998, and was intended to grant additional flexibility to engage in "financial" activities, similar to those available to financial holding companies.[67] To acquire a financial subsidiary, the bank must be well-capitalized, well managed and, if it is one of the one hundred largest insured banks, have at least one issue of outstanding debt that meets specified creditworthiness standards. The bank must also have at least a satisfactory CRA rating. The aggregate amount of investments in financial subsidiaries may not exceed 45% of the consolidated total assets of the parent bank or $50 billion, whichever is less, although these numbers are indexed by the Federal Reserve and the Treasury.

For national banks, the authority is intended to parallel the authority granted to financial holding companies to engage in financial activities.[68] For the national bank, however, these are primarily limited to the securities activities, as the insurance, real estate and merchant banking authorities are off limits for financial subsidiaries of national banks. Further, to the extent that there are 4(c)(8) activities beyond those otherwise permissible for national banks, or activities permissible for U.S. banks abroad beyond those otherwise permissible for national banks, these also may be conducted through financial subsidiaries.

[67] 15 U.S.C. §§ 6801-6809, §§ 6821-6827.

[68] The use of financial subsidiaries by financial holding companies is discussed below. Both bank financial subsidiaries and bank holding company financial subsidiaries were intended to provide broader flexibility to engage in activities than that afforded under the National Bank Act or the Bank Holding Company Act. In practice, other than securities activities (for both national banks and bank holding companies), insurance activities, real estate activities, and merchant banking activities, the authority has not proven to be particularly valuable or useful for investments in the fintech area.

There are some additional drawbacks for financial subsidiaries. The assets of the financial subsidiary may not be consolidated with those of the bank for the purpose of determining regulatory capital, and the investment in the subsidiary, plus all retained earnings, must be deducted from regulatory capital. Federal Reserve Act Sections 23A and 23B will generally apply to transactions between the bank and any financial subsidiary. And if the bank fails to maintain qualifications to invest in financial subsidiaries, the OCC may impose limitations upon the bank or the subsidiary and may under certain circumstances require divestiture of control of the subsidiary.

As a result, while the use of financial subsidiaries by a national bank would seem to open up substantial additional flexibility in both the nature and structure of permissible fintech investments, in actual practice it is a bit of a disappointment. Though that is not to say it has been without use. Capital One, N.A. acquired the price tracking service Paribus in the fall of 2016, which helps online shoppers get automatic refunds when the price drops on items that have purchased.[69] Paribus's staff and the fintech itself will be merged into Capital One, though it will not shut down after doing so but work with Capital One to expand into new areas of Capital One's business.[70] Though the exact deals, or price, of the deal were not disclosed, one can see how this authority is likely the one that allowed Capital One to complete the deal.

4. *SBICs*

[69] Sarah Perez, Capital One Acquires Online Price Tracker Paribus, TechCrunch (Oct. 6, 2016), https://techcrunch.com/2016/10/06/capital-one-acquires-online-price-tracker-paribus/; Capital One, *Capital One Bank Welcomes Paribus*, http://press.capitalone.com/phoenix.zhtml?c=251626&p=irol-headline4 (last accessed Jan. 19, 2017)

[70] *Id.*

Banks have authority under the Small Business Investment Act of 1958 (as amended) to invest in one or more SBICs, or any entity established to invest solely in SBICs. SBICs are privately owned and managed investment funds licensed and regulated by the U.S. Small Business Administration (SBA). SBICs raise private capital and can, if they choose to, supplement it with additional capital borrowed at lower cost using SBA-guaranteed securities to make investments in qualifying small businesses and smaller enterprises as defined by SBA regulations. Under this authority, total investments in SBICs by any one bank may not exceed 5 percent of the institution's capital and surplus.

By regulation, SBICs may invest only in small businesses and must allocate a minimum of 25 percent of their capital to smaller enterprises. A small business is a business, including its affiliates, that has a tangible net worth not in excess of $19.5 million, and average net income after federal income taxes (excluding any carry-over losses) for the preceding two completed fiscal years not in excess of $6.5 million.[71] A business may also be deemed "small" using the SBA's North American Industry Classification System (NAICS) codes.[72] A smaller enterprise is a small business that (1) together with its affiliates, and, by itself, meets the NAICS size standard at the time of financing; or (2) together with its affiliates has a net worth of not more than $6 million

[71] 13 CFR § 121.301(c). The size standards have been adjusted for inflation in 2014, according to the interim final rule in 79 Fed. Reg. 113 (June 12, 2014).

[72] 13 CFR § 121.201.

and average net income after federal income taxes (excluding any carry-over losses) for the preceding two years no greater than $2 million.[73]

Typically, SBICs invest in small businesses with $10 million to $50 million in annual revenues, but still fulfill the regulatory small business size requirements. On average, SBICs invest between $1 million and $10 million in each small business in its portfolio, although some SBICs go outside this range.

There are other regulatory limitations on SBICs besides small business size. For example, an SBIC may not invest an amount greater than 10 percent of its total capital (private and SBA leverage), and 30 percent of its private capital, in any single portfolio company. The SBIC may not invest in businesses with more than 49 percent of their employees located outside the United States, or in industry sectors deemed contrary to the public interest. SBICs are also prohibited from investing in project finance, real estate, or financial intermediaries. Finally, SBICs may not control small businesses for longer than seven years without first obtaining approval from the SBA.[74]

One example of an SBIC investment might be the BBVA deal with Propel.[75] In February 2016, BBVA announced that it was shutting down its in-house venture arm and becoming a limited partner in—and taking its venture capital portfolio to—Propel Venture Partners.[76] Propel is a fintech VC which will focus on credit, payments,

[73] 13 C.F.R. § 107.710.

[74] *See* 12 C.F.R. § 107.50.

[75] Ingrid Lunden, *BBVA Shuts In-House Venture Arm, Pours $250M Into New Fintech VC Propel Venture Partners*, TechCrunch (Feb. 11, 2016), https://techcrunch.com/2016/02/11/bbva-shuts-in-house-venture-arm-pours-250m-into-new-fintech-vc-propel-venture-partners/.

[76] *Id.*

insurance, wealth management, e-commerce, security and compliance.[77] The move of BBVA's portfolio to Propel Ventures allows BBVA to structure the fund as a SBIC which BBVA states "will give them flexibility in stake size," as previously the fund, while it was within BBVA, could only invest up to 5% in a funding round.[78]

SBICs may make both debt and equity investments in qualifying small businesses. To the extent a fintech company meets the qualification, using an SBIC can provide a useful vehicle for national bank investments.[79]

C. The Limitations of Using the National Bank

For all of its advantages, there are certain limitations associated with using the national bank as a vehicle for fintech investments (with the possible exception of using an SBIC).[80] First, the activities must be bank permissible, regardless of the amount of the investment. So long as the bank remains an investor, the company must limit its activities to those that are bank permissible, inhibiting the company's flexibility to respond to changing business or market conditions or opportunities. While the OCC has shown great flexibility in connection with expanding its definition of the business of

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[77] *Id.*

[78] *Id.*

[79] Another advantage of the SBIC is that while in some respects it can operate as an investment fund, it is exempt from the Volcker Rule as the rule specifically excludes SBICs from the definition of covered fund. *See* 12 C.F.R. § 44.10(c)(11).

[80] Although relatively few banks have used the SBIC vehicle for fintech investments, it does avoid the two major problems discussed in this section, that of having to limit the activities of the target to those that are national-bank permissible, and that of being subject to OCC examination and supervision.

banking and of permissible incidental activities, that flexibility is not unlimited. As discussed in Section II.A, above, when a bank holding company makes a non-controlling investment, there are no activity limitations associated with such investment.

Second, the target will be subject to OCC supervision and examination, again, regardless of the size of the investment. Non-controlling investments of bank holding companies do not carry with them the requirement of Federal Reserve examination (although the Federal Reserve may certainly do so). The prospect of national bank examiners evaluating a target's business and activities can be somewhat unattractive for many technology companies.

IV. State Banks

States have the power to define the permissible activities for their banks, and many have used this power to authorize activities and investments for their banks that are beyond those authorized for national banks. Many states, for instance, authorized insurance brokerage powers for their banks, and some even permitted broad real estate development powers. Most states, however, have enabling statutes for their banks that are roughly parallel to those afforded national banks. Indeed, a common element in many statutes is a "wild card" provision, allowing state banks to engage in any activity determined to be permissible for national banks.[81]

As a result of the savings and loan crisis of the late 1980s, however, Congress imposed limitations on how far a state could go in empowering its banks. Section 24 of the Federal Deposit Insurance Act provides that a state-chartered bank may engage as

[81] *See, e.g.*, the New York State "Wild Card" section, NYSBL § 12-a.

principal only in those activities that are permissible for national banks, and those approved by the FDIC under procedures set forth in its regulations.[82] As a general proposition, investments in other entities are treated as "principal" rather than agency activities. Thus presuming the state statute empowers the bank to make the investment in the first instance, the investment must conform to that permissible for a national bank as described above. The FDIC has the power to authorize investments by a state chartered bank beyond those imposed on national banks, but banks do not appear to have used this procedure for technology investments.[83]

We should note that state-chartered banks have the power to invest in bank service companies and in financial subsidiaries under the same terms and conditions as are applicable to national banks. The state statute must grant them the investment power; the federal statutes authorizing these investments provide the contours. And the Small Business Investment Company Act extends to state banks the power to invest in SBICs and use them as a vehicle for additional fintech investments.

V. The Volcker Rule

Added as part of the Dodd-Frank Act in 2009, the Volcker Rule has two primary prongs.[84] It prevents banking organizations from engaging in proprietary trading and prevents them from sponsoring, controlling or investing in hedge funds or private equity funds (i.e., certain funds excluded from the definition of investment company under the

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[82] 12 U.S.C.§ 1831a.

[83] The FDIC's decisions on Section 24 applications are compiled at https://www.fdic.gov/regulations/laws/bankdecisions/InvestActivity.

[84] 12 U.S.C. § 1851.

Investment Company Act of 1940). While described as a rule to prohibit banks from investing using insured deposits, the rule is much broader, and applies to any institution controlling, controlled by or under common control with an insured depository institution, and reaches subsidiaries and affiliates of each of these entities. Control uses the bank holding company test described above. Hence the reach is far broader than perhaps expected.

It is not the intent of this article to explore all the nuances of the Volcker Rule. After all, the final implementing regulation, with its introductory commentary, ran close to 1,000 pages.[85] While compliance with the Volcker Rule generally should not be a problem in the fintech investment area, Volcker Rule issues do pop up from time to time in strange places, so it is critical to be aware of the proscriptions. Careful attention to the requirements will avoid unintended, and potentially disastrous consequences. At the same time, the recently elected U.S. President Donald Trump has vowed to dismantle Dodd-Frank, with one of the likely vehicles for reform, the Financial CHOICE Act, repealing the Volcker Rule completely and with Trump's treasury secretary nominee, Steven Mnuchin, testifying in his nomination hearings that he preferred fixes to the rule instead.[86]

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[85] The Volcker Rule is contained in Section 13 of the Bank Holding Company Act, 12 U.S.C. § 1851 (2012) and *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds*, 12 C.F.R. §§ 44, 248, 351, 17 C.F.R. § 255.

[86] *See* H.R. 5983, 114th Congress (2016); Davis Polk, *Trump Transition: Financial CHOICE Act – Only the Beginning*, FinRegReform (Nov. 17, 2016), http://www.finregreform.com/single-post/2016/11/17/Trump-Transition-Financial-CHOICE-Act---Only-the-Beginning; Elizabeth Gurdus, *Parts of Dodd-Frank affecting small businesses will be rolled back under Trump, Steve Mnuchin says*, CNBC (Nov.

A. Proprietary Trading

Entities covered by the Volcker Rule may not engage in proprietary trading, defined as engaging as principal in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, derivative, future or option on any such security, derivative or future, principally for the purpose of short-term resale, benefitting from short-term price movements, realizing short-term arbitrage profits, or hedging one of those positions. There is a presumption that any security, derivative or future held for less than 60 days involves proprietary trading. There are a number of exceptions for such things as market making, hedging, underwriting, trading on behalf of customers or trading solely outside the United States.

It would be the rare investment by a banking organization in the fintech area that would trigger the proprietary trading prohibition. These are generally long-term investments, made for the intent of taking advantage of the underlying technology, not a short-term play for profits. However, recall that the definition of entities covered by the prohibitions of the Volcker Rule includes companies controlled by the bank or bank holding company, and that control is the regulatory definition of control, having only a slight relationship with whether actual control exists. And while trading is unlikely to be the primary business of the target investment, the bank investor must be sure, if it controls the target company, that the target itself is not engaged in purchasing or selling securities on a short term basis.

B. Funds

The funds prohibition is somewhat more difficult. Under the rule, banking entities are precluded from sponsoring or acquiring an interest in covered funds.

Important for the purposes of fintech investments is the definition of a covered fund, which is any issuer that would be an investment company as defined in the Investment Company Act of 1940, but for the exemptions found in sections 3(c)(1) or 3(c)(7) of that Act. It also includes issuers organized outside the United States that would be a covered fund if organized in the United States or offered to United States residents.

The definition of covered fund certainly covers most hedge funds and private equity funds, as they rely on the 3(c)(1) (100 investors) or 3(c)(7) (all investors are "qualified purchasers") exemptions. It likely includes most other venture capital funds and certain types of special purpose vehicles. Importantly, it will include inadvertent investment companies that must rely on the 3(c)(1) or 3(c)(7) exemptions to avoid being so characterized. It is this last point that may inadvertently catch a fintech investment. These are typically privately held, when funded may hold a substantial amount of cash, and if not careful as to how the funds are invested, may need to rely on the exemptions to be characterized as an investment company. If so characterized, a banking organization cannot invest. Additionally, a fintech controlled by a banking organization cannot itself violate the funds prohibition of the Volcker Rule.

VI. Investment Structuring Alternatives

The discussion above indicates that while the range of permissible activities for banking organizations is somewhat constrained, the regulatory structure provides a framework where banking organizations can invest in a company engaged in virtually any (legal) activity. There may be limitations around the amount of the investment (for example, if the target company is engaging in activities that aren't permissible for a bank or the bank holding company), the banking organization may not control the target, either through ownership of voting securities, the total amount of its equity investment, or contractual or other restrictions. The following chart is an attempt to summarize the various structural alternatives:

	Type	Nature of Investors	Degree of Control	Type of Activities	Other Limitations
Bank Holding Company / Nonbank Chain	**BHC Permissible investment**	No restriction	Any	Must be banking, services to banks, or permissible incidents to business of banking	May require approval or notice to the FRB for the acquisition
	BHC Impermissible	No restriction	May not control	No limitation	Must avoid control
	FHC Certain Investments	No restriction	Any	Must be financial in nature or complementary to financial activities	BHC must meet and maintain FHC qualification; subject to FRB supervision
	FHC Merchant Banking	No restriction	May control, but may not be involved in day-to-day decision-making	No limitation	Limited investment horizon (10-15 years)
Bank Investments	**Bank Service Company**	All must be depository institutions	Any	Services for depository institutions and other bank permissible activities	Subject to examination as are owners. Geographically limited to perform activities only at locations where the shareholders could engage in the activities
	Bank Operating Subsidiary	No restriction, although the bank must	Required	Any bank permissible activity	Subject to examination as is bank

	Type	Nature of Investors	Degree of Control	Type of Activities	Other Limitations
		control			
	Non-Controlling Investment	No restriction	Any	Any bank permissible activity	Subject to examination as is bank; must limit activities
	Financial Subsidiary	No restriction	Any	Financial activities, similar to activities permissible for a financial holding company	Subject to examination; no merchant banking, real estate or insurance as principal (with limited exceptions)
	SBIC	No restriction	Permitted for up to seven years (with extension possible)	No limitation, although must be a "Small Business" and 25% of investments must be in "Smaller Enterprises"	Limited investment horizon

VII. Summary

Despite all of the publicity about the fintech companies devouring the lumbering bank dinosaurs, the reality is a bit more complex. Banking organizations have customers, capital, existing distribution systems, and an inherent advantage over outsiders in that they have successfully navigated the regulatory environment that both hems them in and keeps others out. There are, and will continue to be, technology companies that become very successful by skirting around the edges of the bank regulatory world – think PayPal or First Data – but by and large the major banks that were under siege by technology companies twenty years ago remain firmly in their place as the primary customer interface for a majority of Americans as they obtain and use financial services.[87] However, these banking organizations have a desperate need to remain firmly connected to those customers, to cut costs, improve efficiencies and enhance their services. Technology holds the key to achieving those objective. The seven billion dollars we have seen in bank investments in the fintech space is merely the beginning of a process that will surely go on for many years, as fintech continues to evolve.

As banking organizations ponder how to structure their investments in fintechs, the key decision making drivers appear to be (i) is the activity likely to be – and remain – permissible; (ii) do I want to subject the company to bank regulation and supervision; (iii) do I need to control the company from an operational or business perspective; (iv) who are the other investors and how might they be structuring their investments; and (v) will

[87] That is not to say that there haven't been changes over the last twenty years in the banking industry, many of which were prompted by technology.

the structure trigger a regulatory approval that might be difficult or time consuming to obtain. For many organizations, the non-controlling investment through the bank holding company or nonbank subsidiary of the holding company provides the easiest and quickest path to closing.