OLD WINE IN NEW BOTTLES: BANK INVESTMENTS IN FINTECH COMPANIES

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Abstract

Interest in and investment into FinTech firms is growing and investors, regulators, and consultants are increasingly focused on this area. Because banking organizations (i.e., bank holding companies and their subsidiaries) have customers, capital, and experience with financial regulation, on the one hand, and a need to compete in an evolving digital world, on the other, banking organizations and FinTech firms have and will continue to work together. This article discusses how banking organizations, including their bank subsidiaries, can structure investments in FinTech firms consistent with the requirements of the Bank Holding Company Act, National Bank Act, and the Volcker Rule. Though the bank regulatory landscape can be complex, its structure does not prohibit banking organizations from making investments in FinTech firms or from taking part in the ever-growing space where finance and technology collide.

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I. Introduction

We are again in the midst of a wave of banking organization investments in technology companies. A great deal of publicity has surrounded new nonbank firms creating innovative bitcoin and blockchain technology, marketplace lenders, robo-advisors and security, authentication, and payments technologies.[1] 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 digging deeper, one finds that banking organizations are active participants in this technology revolution. They are investors, early adopters, users, and partners.[2]

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.[3] In fact, the term FinTech can be traced back to Citigroup's "Financial Services Technology Consortium," an early-1990s project that facilitated technological cooperation efforts.[4] Since the 1990s, the financial services industry, including banking organizations, has been the largest purchaser of informational technology services.[5] As noted in a recent article describing waves of FinTech investment by the financial services sector, "[s]ince the late 1980s, finance has been an industry based upon transmission and manipulation of digital information."[6] One-third of the more than thirty thousand employees of Goldman Sachs are engineers.[7]

It is easy to see why banking organizations are participants in the current wave of FinTech. Banking organizations are burdened by

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[1] *See generally* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-17-361, FINANCIAL TECHNOLOGY: INFORMATION ON SUBSECTORS AND REGULATORY OVERSIGHT (2017), https://www.gao.gov/assets/690/684187.pdf [https://perma.cc/5EYZ-5RXM].

[2] *See Financial technology is proving less of a battleground than feared*, THE ECONOMIST (May 6, 2017), http://www.economist.com/news/special-report/21721505-relationship-between-banks-and-technology-companies-becoming-increasingly [https://perma.cc/S3TT-UB7R].

[3] *See generally* Douglas Arner et al., *The Evolution of Fintech: A New Post-Crisis Paradigm?*, 47 GEO. J. INT'L L. 1271 (2009).

[4] *Id.* at 1271.

[5] *Id.* at 1275.

[6] *Id.*

[7] *Id.* at 1291.

legacy systems that are costly, cumbersome, clunky, and inefficient.[8] Compliance costs have soared.[9] Although branch banking is becoming less and less relevant, it is nevertheless costly to maintain and there is a regulatory bias towards maintaining branches.[10] Margins are compressed.[11] As a result, there is much hoopla about how technology companies are going to cannibalize the business of the banks through greater efficiency and ease of access.[12] Both fear and opportunity seem to be driving banking organizations in this current wave of FinTech interest.

A few data points: Global investments in the FinTech industry are estimated to have grown from $4.05 billion in 2013 to $24.7 billion at the end of the fourth quarter in 2016.[13] Banking organizations

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[8] *See Cutting Through the FinTech Noise: Markers of Success, Imperatives For Banks*, MCKINSEY & CO. (Dec. 2015) http://www.mckinsey.com/industries/financial-services/our-insights/cutting-through-the-noise-around-financial-technology [https://perma.cc/965D-36TZ].

[9] DELOITTE, THE FUTURE OF REGULATORY PRODUCTIVITY, POWERED BY REGTECH 2 (2017), https://www2.deloitte.com/content/dam/Deloitte/us/Docments/ regulatory/us-regulatory-future-of-regulatory-productivity-powered-by-regtech.pdf [https://perma.cc/S99M-EBE8]; Drew Dahl et al., Bank Size, Compliance Costs, and Compliance Performance in Community Banking 2 (May 2016), https://www.communitybanking.org/documents/2016-Conference-Papers/Session2_Paper2_Neely.pdf [https://perma.cc/8C86-V84G].

[10] *Withering Away*, THE ECONOMIST (May 19, 2012) http://www.economist.com/node/21554746 [https://perma.cc/6L28-MKDQ].

[11] Francisco B. Covas et al., *Why Are Net Interest Margins of Large Banks So Compressed?*, FEDS NOTES (Oct. 5, 2015) https://www.federalreserve.gov/econresdata/notes/feds-notes/2015/why-are-net-interest-margins-of-large-banks-so-compressed-20151005.html [https://perma.cc/7S4C-WNLC].

[12] *See generally* MCKINSEY & COMPANY, FINTECHNICOLOR: THE NEW PICTURE IN FINANCE (2017), http://www.the-blockchain.com/docs/FinTechnicolor-The-New-Picture-in-Finance%20-%20Mckinsey.pdf [https://perma.cc/8MK5-4MS9].

[13] Press Release, 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 [https://perma.cc/9SD5-GJDV]; KPMG, THE PULSE OF FINTECH Q3 2016: GLOBAL ANALYSIS OF FINTECH VENTURE FUNDING 12 (2016), https://assets.kpmg.com/content/dam/kpmg/xx/pdf/2016/11/the-pulse-of-fintech-q3-report.pdf [https://perma.cc/9SD5-GJDV]; KPMG, THE PULSE OF FINTECH Q2 2016: GLOBAL ANALYSIS OF FINTECH VENTURE FUNDING 12 (2016), https://as-

alone have invested $7 billion in FinTech startups over the past seven years, and in 2015, 35 percent of investments in FinTechs were in collaborative technologies for financial institutions.[14] In the last six quarters, Banco Santander, Goldman Sachs, and Citigroup have each completed seven or more FinTech deals.[15] As a result of the emergence of well-funded FinTech firms and a growth of interest in the space, legal services providers and consulting firms have taken note. Many prominent law firms have responded to the growth of the FinTech sector by emphasizing the strengths of their FinTech practice groups.[16] Likewise, large consulting firms have begun to market to these clients through papers, reports, and studies on FinTech.[17]

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sets.kpmg.com/content/dam/kpmg/xx/pdf/2016/08/the-pulse-of-fintech-q2-report.pdf [https://perma.cc/PT6C-BJ3F] [hereinafter KPMG, THE PULSE OF FINTECH Q2 2016].

[14] Richard Lumb, *Fintech: If You Can't Beat Them, Join Them*, INST. INV. (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 [https://perma.cc/TA2M-K6H3]; 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 [https://perma.cc/YYD5-BB7G]; *How FinTech and Banks are Partnering*, JP MORGAN CHASE & CO. (Feb. 17, 2017), https://commercial.jpmorganchase.com/pages/commercial-banking/industry-expertise/technology/fintech-banks-partnering [https://perma.cc/9UPH-J55P]. 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 Firms So Far*, CNN MONEY (Nov. 3, 2015, 12:56 PM) http://money.cnn.com/2015/11/02/technology/bitcoin-1-billion-invested/ [https://perma.cc/56WV-A48Z]; *see also* KPMG, THE PULSE OF FINTECH Q2 2016, *supra* note 13.

[15] *See* Declan Harty & Ranvir Vala, *Citi jumps to top of Q1'17 fintech M&A league table*, SNL FIN., Apr. 10, 2017; Pagliery, *supra* note 14.

[16] *See, e.g.*, *FinTech*, DAVIS POLK & WARDWELL, http://www.davispolk.com/practices/corporate/FinTech/ [https://perma.cc/KX6V-TXHX]; *Financial Technology*, CLEARY GOTTLIEB STEEN & HAMILTON, http://www.cgsh.com/financial-technology/ [https://perma.cc/5H5W-K7G7]; *FinTech*, WILMER HALE, https://www.wilmerhale.com/fintech/ [https://perma.cc/N7XS-L5PC]; *FinTech*, REED SMITH, http://www.reedsmith.com/FinTech-Practices/ [https://perma.cc/9QMT-JQSY]; *FinTech*, DECHERT, https://www.dechert.com/FinTech/ [https://perma.cc/G3RM-ZZVM].

[17] *See, e.g.*, PWC, MONEY IS NO OBJECT: UNDERSTANDING THE EVOLVING CRYPTOCUR-

Some FinTechs, instead of being bought by or partnering with banks, may also become full service banks or limited purpose banks. Green Dot Corporation, 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.[18] New York has granted non-depository trust bank charters to two bitcoin exchanges: Gemini and itBit.[19] More recently, on December 2, 2016, the Office of the Comptroller of the Currency (OCC) announced a proposed framework for granting special purpose national bank charters to companies, including FinTechs, that are involved in making loans or payment activities.[20] A number

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RENCY MARKET, https://www.pwc.com/us/en/financial-services/publications/assets/pwc-cryptocurrency-evolution.pdf [https://perma.cc/97U8-NGKW]; 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 [https://perma.cc/3P6W-DUER]; Accenture, *supra* note 13; *Fintech: Are banks responding appropriately?*, EY, http://www.ey.com/cn/en/industries/financial-services/banking---capital-markets/ey-fintech-are-banks-responding-appropriately [https://perma.cc/PG5M-6R9F]; *Financial Technology Software and Services*, DELOITTE, http://www2.deloitte.com/us/en/pages/risk/solutions/financial-technology-software-and-services.html [https://perma.cc/Z6R2-QWW3].

[18] Deborah Crowe, *Green Dot Completes Bank Acquisition*, L.A. BUS. J. (Dec. 9, 2011), http://labusinessjournal.com/news/2011/dec/09/green-dot-completes-bank-acquisition/ [https://perma.cc/8GJU-7T4A].

[19] 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 [https://perma.cc/K4JM-5M3H]; Press Release, N.Y. State Dep't of Fin. Serv., 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 [https://perma.cc/3P8F-XHRY].

[20] The proposal noted that the charter would be available to institutions involved in one of three core banking activities: accepting deposits, making loans, or paying checks (i.e. payment activities). However, a subsequently-issued proposed licensing supplement strongly suggested that the OCC would not have an appetite for granting charters to institutions that accept deposits. Fannie Chen et al., *OCC Forges Ahead With Fintech Charter, Releasing Draft Licensing Manual Supplement*, BEYOND SANDBOX (Mar. 21, 2017), http://www.beyondsandbox.com/single-post/2017/03/21/OCC-Forges-Ahead-With-Fintech-Charter-Releasing-Draft-Licensing-Manual-Supplement [https://perma.cc/E5GA-9FAD]; *Beyond FinTech: The OCC's Special*

of groups—the American Bar Association, Independent Community Bankers of America, Conference of State Bank Supervisors (CSBS), consumer advocacy groups, and Democratic senators—have strongly criticized the proposal on various grounds, arguing that the OCC does not have the power to charter institutions that do not accept deposits, and that the charter would blur the traditional line between banking and commerce, among other complaints.[21] The CSBS has filed suit in the D.C. Circuit Court seeking to prevent the OCC from moving forward with the charter.[22]

Even accounting for this blurring line between banks and FinTechs, and industry worries that banking organizations' business is at risk from stand-alone FinTechs, there are a number of factors pointing to why banking organizations will ultimately survive and thrive notwithstanding the technological onslaught.[23] First, banking organizations have capital and almost unparalleled access to funding, something that all but a handful of new entrants lack. They have long-standing 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

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Purpose National Bank Charter, DAVIS POLK (Dec. 9, 2016), https://www.davispolk.com/publications/beyond-fintech-occs-special-purpose-national-bank-charter/ [https://perma.cc/3SNV-PYZV].

[21] Rachel Witkowski, *Democratic Senators Criticize Fintech-Charter Plan*, WALL ST. J. (Jan. 9, 2017), http://www.wsj.com/articles/democratic-senators-criticize-fintech-charter-plan-1483996432 [https://perma.cc/8RLZ-5QLR]; Press Release, Indep. Cmty. Bankers of Am., 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 [https://perma.cc/QWH3-TAKH]; Press Release, 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 [https://perma.cc/CJC6-PRJC].

[22] *See* Press Release, Conference of State Bank Supervisors, *CSBS Files Complaint Against Comptroller of the Currency* (Apr. 26, 2017), https://www.csbs.org/news/press-releases/pr2017/Pages/042617.aspx [https://perma.cc/8CUB-N4YL].

[23] PWC, REDRAWING THE LINES: FINTECH'S GROWING INFLUENCE ON FINANCIAL SERVICES (2017), https://www.pwc.com/jg/en/publications/pwc-global-fintech-report-17.3.17-final.pdf [https://perma.cc/64PQ-RNDZ].

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 entering the business of banking also creates obstacles preventing banking organizations from straying too far outside what the regulators consider the business of banking.

Obviously, there are many 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 banking organization can acquire FinTechs. 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 a U.S. technology company or in a new company where the technology company is a co-investor or participant. Although banking organizations can also make certain additional investments in non-U.S. companies under the authority of Regulation K, that is beyond the scope of this article.

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 (BHCA), the National Bank Act, the Volcker Rule, and other laws that might apply.

Following this introduction, Part II addresses 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. Part III 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, Part IV discusses how state bank powers in the FinTech area generally parallel those of national banks. Part V then discusses the restrictions of the Volcker Rule, Part VI provides a summary of various investment alternatives and associated considerations, and finally, Part VII provides a conclusion.

II. The Opportunities and Constraints of the BHCA

The BHCA provides the basic framework for investments made by companies that control banks, known as bank holding companies (BHCs).[24] The framework applies to U.S. BHCs and also to foreign BHCs that control U.S. banks or that control foreign banks that have branches or agencies in the United States. Since the BHCA framework also applies to investments made by subsidiaries of bank holding companies, 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.[25] Investments made by banks and their subsidiaries (i.e., the bank chain) are discussed in Part III.[26] In its simplest form, the BHCA will allow BHCs 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.[27] If the target company does not fall within the "banking" or "closely related" buckets, the BHC is precluded from making a controlling investment.[28]

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?

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[24] 12 U.S.C. §§ 1841–52 (2012).
[25] *Id.* § 1842.
[26] *See* discussion *infra* Part III.B (discussing various possibilities for investment under the National Bank Act).
[27] § 1843(c)(8).
[28] §§ 1843(a)(1), (c)(8).

A. Non-Controlling Investments

Many investments by banking organizations into FinTechs are structured to be non-controlling. For a banking organization to make a non-controlling investment, it must not have a significant level of ownership or contractual or other powers that would allow it to exercise a controlling influence over the management or policies of the target.[29] A non-controlling investment need not be totally passive, but the target must retain the power to make business and policy decisions.[30]

Banking organizations may prefer to make a non-controlling investment in FinTechs instead of a controlling investment generally for one of three reasons: (1) impermissible activities by the target, (2) allowing the target freedom of exploration and development, and (3) avoiding intrusive regulation and supervision of the FinTech. In some situations, the target's activities are not permissible for a banking organization, and therefore the investment by the BHC or any subsidiary in the non-bank chain must be limited to a non-controlling investment.[31] Permissible activities are discussed in detail in Part II.B. In others instances, the banking organization is unclear which direction the target company will take, and having to continually monitor the target company to assure that it is only engaging in permissible activities is seen as intrusive and perhaps inhibiting the creative development of the target's 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.[32]

For example, a startup could be engaged in building a payments network, an activity that would likely interest a banking organization looking to make a FinTech investment. However, the startup may be engaged in using its underlying technology for non-financial applications, such as helping telecommunications companies manage their wireless spectrum portfolios, which a potentially impermissible activity for a banking organization. While the banking organization

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[29] § 1841(a)(2).
[30] § 1841(a)(2)(c).
[31] § 1841(a)(2); § 1843(a)(1).
[32] § 1841(a)(2)(A).

can still invest in the startup, it will likely make a non-controlling investment in order to allow the FinTech to continue to explore and grow its telecommunications-related business.

The definition of control determines much of the applicability of the BHCA.[33] A company that controls a bank is a BHC.[34] Companies controlled by another company are subsidiaries of that company.[35] Parent companies are deemed to control shares of companies controlled by their subsidiaries.[36] Affiliates are companies that control, are controlled by, or are under common control with another company.[37] A qualified family limited partnership may only control a single BHC.[38]

Control (or lack thereof) determines whether or not the activities of the target must conform to the activity limitations of the BHCA.[39] If controlling, the activity must be permissible; if not, no such activity limitations apply.[40] Control also determines the nature of the Federal Reserve's jurisdiction to supervise, examine, and regulate.[41] 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.[42]

Control for BHCA purposes is set at an intentionally low threshold, compared to control as typically understood in a business sense. A company is deemed to control another if it: (1) "owns, controls, or has the power to vote 25 per centum or more of any class of voting securities"; (2) has the power to elect "a majority of the directors"; or (3) 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.[43]

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[33] § 1841(a)(2).
[34] § 1841(a)(1).
[35] § 1841(d).
[36] § 1841(g)(1).
[37] § 1841(k).
[38] § 1841(o)(10)(B).
[39] §§ 1841 (a)(2), (d); § 1843(a).
[40] § 1843(a).
[41] FED. RESERVE, SUPERVISING AND REGULATING FINANCIAL INSTITUTIONS AND ACTIVITIES 73, https://www.federalreserve.gov/pf/pdf/pf_5.pdf [https://perma.cc/L5JP-QQ99]; *see also* § 1841(a)(2).
[42] *See* § 1843(c)(12)(A); FED. RESERVE, *supra* note 41, at 74.
[43] § 1841(a)(2); *see* 12 C.F.R. § 225.2(e)(1) (2016); Donald N. Lamson et al., *Nonbanking Activities of Foreign Banks*, *in* REGULATION OF FOREIGN BANKS AND AFFILIATES IN THE UNITED STATES 865, 888–96 (Randall D. Guynn ed., 8th

Whenever a company owns, controls, or has the power to vote less than 5 percent of any class of voting securities of a company or bank, the first company is presumed not to have control over the second.[44] There is, of course, a bit of a gap between the 25 percent threshold, where one has control, and the less than 5 percent level, where one is presumed not to have control.[45]

For years, that gap was the subject of a lot of uncertainty. In 1982, and more importantly in 2008, the Federal Reserve issued policy statements providing much-needed guidance on controlling and non-controlling investments.[46] 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.[47] The 2008 policy statement was prompted by significant investments by nonbanking companies into banking organizations.[48] In each case, the investing party wanted to avoid triggering the application and approval requirements of the BHCA, which would have, in the first circumstance, precluded the investment completely, and in the second, resulted in the investing company being subject to the full panoply of activity and other restrictions of the BHCA.[49] The control principles in the policy statements are applicable to investments by banking organizations in nonbanking companies.[50]

Without attempting to address all of the nuances of the policy statements, in general, a company will not be presumed to exercise a controlling influence over another company under the following circumstances:

i. *Director representation*. The Federal Reserve indicated that a company is unlikely to exercise control if the investor

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ed. 2014).

[44] Lamson et al., *supra* note 43, at 899; *see* § 1841(a)(3).

[45] *See* §§ 1841(a)(2)–(3).

[46] Policy Statement on Nonvoting Equity Investments by Bank Holding Companies, 47 Fed. Reg. 30,966 (July 19, 1982) (codified at 12 C.F.R § 225.143); BD. OF GOVERNORS OF THE FED. RESERVE SYS., POLICY STATEMENT ON EQUITY INVESTMENTS IN BANKS AND BANK HOLDING COMPANIES (2008), https://www.federalreserve.gov/newsevents/press/bcreg/bcreg20080922b1.pdf [https://perma.cc/7BQS-QT3L] [hereinafter POLICY STATEMENT 2008].

[47] 12 C.F.R. § 225.143(a).

[48] POLICY STATEMENT 2008, *supra* note 46, at 1.

[49] *Id.* at 1; *see* 12 C.F.R. § 225.143.

[50] *See generally* 12 C.F.R. § 225.143; POLICY STATEMENT 2008, *supra* note 46.

(1) has a single representative on the board of directors, or potentially two members if the representation is proportionate to the investment; (2) does not exceed 25 percent of the voting members; and (3) there is another controlling shareholder that is a BHC.[51] The representative of a minority investor may serve on a committee, but the representative may not serve as chair of the committee or occupy more than 25 percent 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.[52]

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, represent[ed] less than one-third of the total equity," and "less than one-third of any class of voting securities, assuming conversion of all convertible non-voting shares held by the investor," and its ownership did not exceed 15 percent of any class of voting securities.[53] The non-voting shares may not be convertible in the hands of the investor.[54] 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 in which no transferee (or group of associated transferees) would receive two percent or more of any class of voting securities," or "to a transferee that would control more than fifty percent of the voting securities of the banking organization without any transfer from the investor."[55]

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 advocate for mergers, acquisitions, sales, or divestitures.[56] However, the decisions

[51] POLICY STATEMENT 2008, *supra* note 46, at 7.
[52] *Id.* at 8.
[53] *Id.* at 10.
[54] *Id.*
[55] *Id.*
[56] *Id.* at 11.

must rest with the organization's shareholders, as a group, its board, or its management, and the investor must limit its participation to voting its shares or exercising its rights as a director.[57] It may not launch a proxy contest (although it may grant another (independent) shareholder its proxy), and may not threaten to dispose of its shares if its desires are not acted upon.[58]

iv. *Business relationships*. The Federal Reserve indicated that business relationships that were "quantitatively limited and qualitatively nonmaterial" could be permissible, "particularly in situations where an investor's voting securities percentage in the organization was closer to ten percent than twenty five percent."[59] 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.[60]

v. *Covenants*. The Federal Reserve continues to be sensitive to covenants that limit management's discretion over major policies and decisions.[61] 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.[62] The Federal Reserve does allow covenants that basically protect the nature of the investment.[63] For example, covenants that prohibit the issuance of senior securities modifying the terms of the investment or liquidating the organization are covenants that protect investor rights.[64] The Federal Reserve acknowledges that covenants regarding access to limited

[57] *Id.* at 12.
[58] *Id.*
[59] *See id.* at 13.
[60] *Id.*
[61] *Id.* at 13–14.
[62] *Id.*
[63] 12 C.F.R. § 225.171(e)(1) (2016).
[64] § 225.171(d); POLICY STATEMENT 2008, *supra* note 46, at 14.

> financial information or requiring consultation would not normally indicate control.[65]

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 result in the banking organization being deemed to control the startup if it owns at least 5 percent of the voting equity of the startup.[66] 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 robo-advisor and a banking organization investor. The banking organization makes what it hopes is a non-controlling investment, purchasing 10 percent 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 percent 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. However, 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 percent.

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 is the recent investment by Deutsche Bank, HSBC, KBC, Natixtis, Rabobank, Société Générale, and UniCredit in Digital Trade Chain, a prototype Blockchain trade finance tool.[67] The

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[65] § 225.171(d)(3); POLICY STATEMENT 2008, *supra* note 46, at 14.

[66] § 225.143(b)(1).

[67] Ian Allison, *Deutsche Bank*, *HSBC and Five Other Big Banks Form 'Digital Trade Chain' Consortium*, INT'L BUS. TIMES (Jan. 16, 2017), http://www.ibtimes.co.uk/deutsche-bank-hsbc-five-other-big-banks-form-digital-trade-chain-consortium-1601259 [https://perma.cc/DFA5-99RN]; Oscar Wil-

banks signed a Memorandum of Understanding to build Digital Trade Chain and will be equal investors in the newly formed consortium.[68] One can hypothesize that 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 that if 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.[69] 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.[70]

B. Permissible BHCA Activities and Controlling Investments

Besides engaging in non-controlling investments, BHCs and their non-bank chain subsidiaries are permitted to engage in a variety of activities and controlling investments, all of which directly relate to the business of banking.[71] Relevant to FinTech investments are provisions that allow BHCs to own (1) "shares of any company the activities of which had been determined by the Board by regulation or order . . . to be so closely related to banking as to be a proper incident thereto,"[72] (2) "shares which are of the kinds and amounts eligible for investment by national banking associations,"[73] and (3) shares of companies engaged in "furnishing services to or performing services for" the BHC and its subsidiaries.[74]

1. The Business of Banking

The BHCA establishes a comprehensive framework that limits the activities of bank holding companies and their subsidiaries.

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liams-Grut, *Deutsche Bank, HSBC, and Five Other Big Banks are Collaborating on a Blockchain Project*, BUS. 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 [https://perma.cc/YY4G-VHY4].

[68] Allison, *supra* note 67; Williams-Grut, *supra* note 67.

[69] 12 C.F.R. § 223.3(g) (2003).

[70] *Id.*

[71] 12 U.S.C. §§ 1841–52 (2010).

[72] § 1843(c)(8).

[73] § 1843(c)(5).

[74] § 1843(c)(1).

The starting point is the definition of a BHC, which is any company that controls a bank.[75] No BHC may acquire control of any voting shares of any company that is not a bank[76] or, once it become a BHC, retain control of any voting shares of any company which is not a bank or BHC or engage in any activities other than those of banking or of managing or controlling banks[77] absent specific authority under the BHCA.

Unlike the OCC, the Federal Reserve appears not to have elucidated with any precision what constitutes the business of banking. Rather, its regulations and decisions focus on activities "so closely related to the business of banking as to be a proper incident thereto."[78] It seems somewhat anomalous to devote substantial attention to the "proper incidents" of banking without a more substantial focus on the business of banking itself. While one would certainly think that if an activity is part of the business of banking, it would be a proper incident to that business (although from a purely logical perspective something that is a proper incident to banking may not necessarily be part of the business of banking). While it might seem of no particular practical import, there is in fact a difference between the OCC's view of the business of banking (which, as we shall see, includes incidental activities that are convenient or useful in connection with carrying out express powers) and the Federal Reserve's view of the business of banking and the permissible incidents thereto. That difference in perspective may require that certain activities be conducted in a bank or bank subsidiary rather than a non-BHC subsidiary.

There are some areas where the Federal Reserve could introduce some clarity to the parameters of permissible banking activities. For instance, nowhere in the laundry list of permissible activities are the person-to-person payments activities of a Western Union or Venmo found. Yet person-to-person payments are clearly part of what banks do. We do not doubt that the Federal Reserve would approve an investment in a company engaged in such activities. On the other hand, the OCC has approved a wide variety of extremely innovative activities in the electronic banking area, including permitting banks to offer website development activities to customers leasing computer

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[75] § 1841(a)(1).

[76] *Id.*

[77] § 1843(a)(2).

[78] § 1843(c)(8). See Part III.A for further discussion of the OCC's views on what constitutes the business of banking or incidental thereto.

equipment,[79] provide a suite of services to merchants to create web stores,[80] and engage in web design services for merchant customers.[81] It is not clear whether the Federal Reserve would approve these as permissible incidents, given the way the laundry list is constructed. Clarity would be extremely helpful in these areas.

2. Permissible Closely Related Activities

Under the BHCA, there is a so-called 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.[82] 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.[83] Investments in companies engaged in such activities are permissible under 12 U.S.C. § 1843(c)(8),[84] and the laundry list of permissible activities is found in Regulation Y at 12 C.F.R. § 225.28.[85]

There is a clear intent in the BHCA implementing regulations to tie all permissible activities to banking and bank-related activities, which supports one of the purposes of the BHCA—to separate banking and commerce.[86] Included in the permissible activities are aspects of the core business of banking, including extending credit,

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[79] Off. of the Comptroller of the Currency, Corporate Decision No. 2002-13 (July 31, 2002), https://www.occ.gov/static/bit/cd02-13.pdf [https://perma.cc/J5JG-7869].

[80] Off. of the Comptroller of the Currency, Corporate Decision No. 2001-18, (July 3, 2001), https://www.occ.gov/static/bit/cd01-18.pdf [https://perma.cc/6ZLF-PVQ3] .

[81] Off. of the Comptroller of the Currency, Interpretive Letter No. 875 (Oct. 31, 1999), https://www.occ.gov/static/interpretations-and-precedents/jan00/int875.pdf [https://perma.cc/4W5U-LN7S].

[82] 12 C.F.R. § 225.28 (2003).

[83] *Common Questions and Answers on Regulation Y*, FED. RESERVE BANK S.F. (2017), http://www.frbsf.org/banking/regulation/regulations-policies-guidance/reg-y/ [https://perma.cc/DT3R-MFD9].

[84] 12 U.S.C. § 1843(c)(8) (2010).

[85] 12 C.F.R. § 225.28 (2003).

[86] JOHN KRAINER, FEDERAL RESERVE BANK OF S.F., 1998-21 THE SEPARATION OF BANKING AND COMMERCE (1998) http://www.frbsf.org/economic-research/publications/economic-letter/1998/july/separation-banking-commerce/ [https://perma.cc/PQM3-4A8D].

servicing loans, and other activities related to extending credit.[87] Trust and fiduciary activities are also permissible, as are many securities brokerage activities.[88] The laundry list also includes management consulting and data processing, although each comes with certain limitations. The data processing exception is important, because much technology relates to capture and manipulation of data.[89] Accordingly, investments in FinTech companies that engage in or offer support for the foregoing activities are generally permissible. Importantly, the exception mandates a strong link to financial data, for in order to satisfy the "closely related" standard, the banking organization may engage in:

> Providing 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 . . . .[90]

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."[91] 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 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."[92] The OCC has generally shown greater flexibility in interpreting the limits of the permissible data processing

[87] §§ 225.28(b)(1)–(2).
[88] §§ 225.28(b)(5)–(7).
[89] §§ 225.28(b)(9), (14).
[90] § 225.28(b)(14)(i).
[91] § 225.28(b)(14)(i)(B).
[92] § 225.28(b)(14)(ii).

activities (for national banks) than the Federal Reserve (for BHCs and their non-bank chain subsidiaries).[93]

In the management consulting area, a BHC may provide management consulting advice "on any matter" to another unaffiliated banking organization.[94] However, to the extent it provides management consulting to other nonbanking organizations, its advice must be limited to "financial, economic, accounting, or audit matter[s]."[95] There is a 30 percent limit in total annual revenue for any consulting activities that fall outside the permissible parameters.[96]

The laundry list covers much in the FinTech area, including consumer-financing nonbank FinTech.[97] Within this area are such companies as the marketplace lenders (e.g., Lending Club), payments companies (e.g., Venmo), robo-advisors (e.g., betterment.com) and personal financial management tools (e.g., Mint), all of which perform services that banks commonly perform, and all of which could permissibly be owned, controlled and operated by banking organizations.[98] Digital currency activities would be permissible as a payments or funding activity within the scope of the business of banking.[99] 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.[100]

Still, there are some challenges in making controlling investments in FinTech relying on the laundry list. First, there may be some form of application to and approval from the Federal Reserve required (or after-the-fact notification) depending upon the

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[93] *See* discussion *infra* Part III.A–B.
[94] § 225.28(9)(i)(A)(1).
[95] § 225.28(9)(i)(A)(2).
[96] § 225.28(9)(i)(C).
[97] *See* § 225.28(9).
[98] Victoria Finkle, *Will financial technology startups disrupt traditional banking?*, SAGE BUS. RESEARCHER (Sept. 12, 2016), http://businessresearcher.sagepub.com/sbr-1775-100731-2748617/20160912/fintech# [https://perma.cc/PX8M-YDA2].
[99] *See* Nikolei M. Kaplanov, Note, *Nerdy Money: Bitcoin, the Private Digital Currency, and the Case Against its Regulation*, 25 LOY. CONSUMER L. REV. 111, 134 (2012).
[100] *See* Jessie Cheng & Benjamin Geva, *Understanding Block Chain and Distributed Financial Technology: New Rails for Payments and an Analysis of Article 4A of the UCC*, BUS. L. TODAY, Mar. 2016, at 2.

banking organization and its condition.[101] 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.[102] Second, the target must continue to assure regulators that its activities fall within the permissible boundaries set forth in the regulations and interpretations.[103] This may limit some of the flexibility[104] a FinTech may wish to have in order to respond to changing conditions.[105] 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.[106] Finally, the Federal Reserve will have the right to examine the target, which the target may find to be intrusive.[107] For all of these reasons, even if the activity is permissible, the BHC may wish to make a non-controlling investment, discussed in Part II.A above.[108]

3. Shares of the Kinds Eligible for Investment by National Banks

The Federal Reserve takes a very restrictive view of the second BHC authority 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.[109] However, because under the Small Business Company Investment Act, national banks (and state banks) may invest in Small

[101] 12 U.S.C. § 1843(j) (2012).
[102] *See* § 1843(j)(1)(C).
[103] § 1843(l).
[104] *Id.*
[105] *See* Patrick Laurent & Nicolas Vauclin, *Fintech CIOs as Venture Capitalists,* DELOITTE: INSIGHT, no. 10, 2015, at 1, 8, https://www2.deloitte.com/content/dam/Deloitte/ch/Documents/financial-services/ch-en-financial-services-inside-magazine-issue-10-october-2015.pdf [https://perma.cc/447Q-7DVZ].
[106] *See* § 371c(b)(1).
[107] *See* § 1843 (j)(2).
[108] *See* discussion *infra* Part II.A.
[109] § 24; *see* 12 C.F.R. § 225.111 (2016).

Business Investment Companies, parallel investment authority is available for BHCs.[110]

4. The Services Exemption

The third BHC authority, the services exception, is quite important.[111] Under this exemption, the business of banking includes much more than simply accepting deposits and making loans.[112] What is considered to be "[n]ecessary and essential to carry on the business of banking" includes 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; maintaining, furnishing, and operating bank premises; maintaining and storing records; designing signs, logos, and other materials; advertising; communicating with customers; and thousands of other activities.[113] Banks and bank holding companies do not perform all those services themselves, although they certainly could do so.[114]

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[110] *See § 225.111.*

[111] *See* 12 C.F.R. § 225.22 (2001).

[112] Off. of the Comptroller of the Currency, Interpretive Letter No. 1077 (Jan. 11, 2007), https://www.occ.gov/static/interpretations-and-precedents/feb07/int1077.pdf [https://perma.cc/4ZCJ-3CUN].

[113] *See* OFF. OF THE COMPTROLLER OF THE CURRENCY, OCC BULL. 2016-13, GUIDANCE FOR BANKS' MAINTENANCE OF RECORDS, RECORDS RETENTION, AND EXAMINER ACCESS (2016), https://www.occ.gov/news-issuances/bulletins/2016/bulletin-2016-13.html [https://perma.cc/33T4-WREP]; Deloitte, *For Banks, Rethinking Regulatory Compliance Management*, WALL ST. J.: RISK & COMPLIANCE J. (July 29, 2014), http://deloitte.wsj.com/riskandcompliance/2014/07/29/for-banks-rethinking-regulatory-compliance-management/ [https://perma.cc/GDD9-CR4P]; Stan Phelps, *Keeping Pace: Four Trends in Banking Customer Experience*, FORBES (May 25, 2016), https://www.forbes.com/sites/stanphelps/2016/05/25/keeping-pace-four-trends-in-banking-customer-experience/#731e21067338 [https://perma.cc/PAL2-E2G4].

[114] *See* OFF. OF THE COMPTROLLER OF THE CURRENCY, *supra* note 113; *see generally* Off. of the Comptroller of the Currency, *supra* note 112; SANJAY JAIN & MIKE MCGINTY, FIN. MANAGERS SOCIETY, INC., TRANSFORMING CONSUMER LENDING—SALES AND BACK-OFFICE PRODUCTIVITY SOLUTIONS 6–7 (2014), http://www.fmsinc.org/Documents/MemberCenter/WhitePapers/TransformingConsumerLending.pdf [https://perma.cc/2U8N-E7AS].

The Federal Reserve permits a BHC to establish or acquire a company that engages solely in servicing activities for the BHC or its 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.[115] It also permits such investments in companies engaged solely in servicing activities for the internal operations of the BHC 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.[116]

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 BHC and its subsidiaries.[117] To the extent that it offers those services outside the BHC—even to other unaffiliated BHCs—it must find another authority to do so.[118] The rationale for this limitation is fairly straightforward. Just because a bank needs to print statements does not 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.[119]

However, banking organizations can invest in companies providing these services under the services exception. 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 BHC 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.[120] Viewpost streamlines payment processes but is involved

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[115] § 225.22.
[116] § 225.22(b)(2).
[117] § 225.22(b).
[118] *See id.*
[119] *See generally* Bank Holding Companies and Change in Control; Revision of Regulation Y, 49 Fed. Reg. 794 (Jan. 5, 1984) (codified at 12 C.F.R. § 225).
[120] *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-pay-

in nonbank partnerships such as with Comdata, a credit card issuer for MasterCard.[121] 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. Since Viewpost provides services to companies other than Bank of America and its affiliates, it is unlikely that Bank of America is relying upon the services exception as its authority for investment into Viewpost.

Another point of flexibility to the limitation is that to the extent that services go to the core financial operations or processes of the bank, they are likely to be found to be permissible under other authority. The limitation of permissible activities still has its flexibility and is not as restrictive as one might think.[122] 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.[123]

In that vein, numerous companies are trying to enhance the efficiency of various back office operations of banking organizations.[124] Much of this progress is invisible to customers, but critically important to banking organizations.[125] The same is true for many activities that

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ments-to-smes/ [https://perma.cc/57DM-RJRX]; *Viewpost Inks Partnership with Bank of America*, PYMTS (Aug. 23, 2016), http://www.pymnts.com/news/partnerships-acquisitions/2016/viewpost-bank-of-america-partnership/ [https://perma.cc/2XME-3L39].

[121] *See Viewpost and Comdata Team Up to Streamline Secure ePayables*, BUS. WIRE (Nov. 13, 2016), http://www.businesswire.com/news/home/20161213005451/en/Viewpost-Comdata-Team-Streamline-Secure-ePayables [https://perma.cc/7SHN-KW78].

[122] *Id.* at 808.

[123] OFF. OF THE COMPTROLLER OF THE CURRENCY, OCC BULL. 2013-29, RISK MANAGEMENT GUIDANCE (2013), https://www.occ.gov/news-issuances/bulletins/2013/bulletin-2013-29.html [https://perma.cc/8JDF-ZBT8].

[124] *See generally* Emily Frost, *The Future of Banking - Can Back-Office Outsourcing Improve Regulatory Compliance?*, INT'L BANKER (Mar. 1, 2017), https://internationalbanker.com/banking/future-banking-can-back-office-outsourcing-improve-regulatory-compliance/ [https://perma.cc/C6YZ-YRSS]; Joao Dias et al., *Automating the Bank's Back Office*, MCKINSEY & CO. (July 2012), http://www.mckinsey.com/business-functions/digital-mckinsey/our-insights/automating-the-banks-back-office [https://perma.cc/6FAD-RCMT].

[125] Dias et al., *supra* note 124.

are necessary in connection with lending, deposit taking, financial data processing, and the like.[126]

C. Financial Holding Companies

Qualifying BHCs may elect to become financial holding companies (FHCs) 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," and in merchant banking activities.[127] Those activities are over and above those permissible for BHCs under the BHCA.[128] Indeed, virtually all large bank holding companies have elected to become FHCs.[129] The additional authorities available to FHCs are largely illusory when it comes to FinTech investments, however, as discussed below.

1. Qualifying as an FHC

In order to qualify as an FHC, both the holding company and all of its depository subsidiaries must be well-capitalized and well managed.[130] The holding company must file a declaration with the Federal Reserve affirmatively electing to be an FHC.[131] If it fails to maintain the well-capitalized and well-managed standards, the Federal Reserve will impose limitations on further use of the FHC provisions.[132] The Federal Reserve may, if the condition persists, require divestiture of any subsidiary depository institution.[133] Alternatively, the company may elect to cease all activities other than those permissible for

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[126] *See* ASPECT, BRIDGING THE GAP BETWEEN FRONT AND BACK OFFICE, (2014), https://www.aspect.com/globalassets/bridging-the-gap-between-front-and-back-office-wp.pdf [https://perma.cc/HE2C-QV4A]; Marc Borbas, *Banks Struggle to Harness Big Data*, FIN. DIG. (Dec. 1, 2015), https://www.financedigest.com/banks-struggle-to-harness-big-data.html [https://perma.cc/ZEZ3-74UJ].

[127] 12 U.S.C. § 1843(k)(4) (2012).

[128] *Id.*

[129] Dafna Avraham et al., *A Structural View of U.S. Bank Holding Companies*, FRBNY ECON. POL'Y REV., July 2012, at 65, 67, https://www.newyorkfed.org/medialibrary/media/research/epr/12v18n2/1207avra.pdf [https://perma.cc/SR3E-QPAE].

[130] § 1843(l).

[131] *See id.*

[132] *Id.*

[133] *Id.*

BHCs.[134] If one of the insured depository institution subsidiaries of the FHC fails to maintain at least satisfactory Community Reinvestment Act records, the Federal Reserve may preclude new activities or further acquisitions using the FHC powers.[135]

2. Financial in Nature or Complementary to Financial Activities

It is clear that Congress intended activities that are financial in nature to constitute a broader category of activities than the banking and closely related to banking activities permissible for bank holding companies.[136] As elucidated in the statute and implementing regulation, a broad range of insurance and securities activities are deemed to be financial in nature, as well as activities permissible for bank holding companies outside the United States.[137]

However, the Federal Reserve has been quite reluctant to extend the parameters of "financial in nature" beyond the stated regulatory limitations, and has only used this power to allow complementary activities related to FHC physical commodities activities.[138] Wishes that broader data processing, software, or other technological activities would be deemed permissible have been unfulfilled.[139] Accordingly, the limitations of permissibility described above for BHCs seem to define the outer boundaries for FHCs.

3. Merchant Banking Activities

An FHC 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.[140] Through the merchant banking powers, an FHC may make virtually any type of and an unlimited amount of debt or equity investment in

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[134] *Id.*
[135] *Id.*
[136] *See generally* MICHAEL S. BARR ET AL., FINANCIAL REGULATION: LAW AND POLICY (2016).
[137] § 1843(k); 12 C.F.R. § 248.11 (2014); 12 C.F.R. § 380.8 (2013).
[138] BARR ET AL., *supra* note 136, at 676.
[139] *See* 12 C.F.R. § 225.28 (2003).
[140] 12 U.S.C. § 1843(4)(k) (2012); 12 C.F.R. § 217 (2014); 12 C.F.R. § 225 (2016).

any company, regardless of the activities of the company.[141] When a banking organization has made a merchant banking investment into a company, the company is called a portfolio company of the banking organization. While it is clear that the FHC may control any portfolio company it acquires under the merchant banking authority, it may not "routinely manage or operate" the company.[142] This severely limits day-to-day involvement with the company, except in those instances where necessary to protect the investment.[143] There are certain cross-marketing restrictions that apply to the portfolio company and any bank or bank subsidiary of the FHC.[144] Further, if the FHC owns or controls more than 15 percent 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.[145]

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.[146] Thus, as a result of the restrictions imposed on relationships between the FHC 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

Instead of investing out of the nonbank chain, a banking organization can have its bank subsidiary or the bank's subsidiaries make the investment. Most U.S. banks are owned by BHCs, and many banks are national banks chartered by the OCC. The national bank charter provides surprising flexibility with respect to investments in the FinTech area. The following sections discuss, first, the activities that a national bank itself is allowed to engage in, which impacts the

[141] 12 C.F.R. § 225.170(a)–(c) (2013).
[142] § 225.171(a).
[143] § 225.171(e)(1).
[144] 12 C.F.R. § 225.176 (2011).
[145] *Id*.
[146] Jon Marino, *Big Banks Shift Fintech Strategy*, CNBC (Apr. 11, 2016), http://www.cnbc.com/2016/04/11/big-banks-shift-fintech-strategy.html [https://perma.cc/HV88-5AKC].

kinds of investments in FinTechs the bank or its subsidiaries can make, and, second, different options for structuring investments in FinTechs by a national bank. As explained in these sections, this framework largely applies to state-chartered banks as well. Subsection C explains the drawbacks of investing through the bank chain instead of the non-bank chain.

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

The OCC has a long tradition of viewing the national bank charter as flexible and adaptable to changing economic and market conditions.[147]

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 . . .[148]

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.[149] It uses a three-part test as to whether an activity is a permissible component of the business of banking, which asks: (1) Is the activity functionally equivalent to or a logical outgrowth of a recognized banking activity; (2) Would it respond to customer needs or otherwise benefit the bank or its customers; and (3) Would it involve risks similar to those already

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[147] Michael Nonanka, *OCC to Issue Special Purpose National Bank Charters to Fintech Companies*, HARV. L. SCH. F. ON GOVERNANCE & FIN'L REG. (Dec. 11, 2016), https://corpgov.law.harvard.edu/2016/12/11/occ-to-issue-special-purpose-national-bank-charters-to-fintech-companies/ [https://perma.cc/9VXQ-CQPX]; *see also*, 12 C.F.R. § 5.2(e)(1) (2010).

[148] 12 U.S.C. § 24 (Seventh) (2010).

[149] BARR ET AL., *supra* note 136, at 192.

assumed by banks?[150] If banks have traditionally engaged in the activity as part of their business, that business is entitled to evolve and grow as times change.[151] The OCC recognizes that banks are justified in taking advantage of technological developments to conduct and expand their businesses.[152]

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."[153] The OCC has taken a broad view of the incidental powers, which has been upheld in various court decisions.[154] In 1972, the First Circuit Court of Appeals found that incidental power was defined 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.[155] In its *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.[156]

In 1996, the OCC issued a provocative decision relating to the authority of a national bank to serve as an internet service provider to both customers and non-customers.[157] Although the precedent is somewhat old, it demonstrates how the OCC has dealt with and expanded the basic concept of the business of banking, as well as how it interprets incidental powers.[158] 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.[159] As a preliminary matter, the

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[150] *See*, *e.g.*, 12 C.F.R. § 7.5001(c) (2016).
[151] BARR ET AL., *supra* note 136, at 189.
[152] *See id*.
[153] *See id.*
[154] *See id.* at 193–209.
[155] Arnold Tours, Inc. v. Camp, 472 F.2d 427, 433 (1st Cir. 1972).
[156] *See generally* NationsBank v. Variable Life Annuity Co., 512 U.S. 251 (1995).
[157] *See* Off. of the Comptroller of the Currency, Interpretive Letter No. 742 (Aug. 19, 1996), https://www.occ.gov/static/interpretations-and-precedents/sept/int742.pdf [https://perma.cc/LRD2-9QW9].
[158] *Id*.
[159] *Id.* at 1.

OCC determined that providing facilities to provide banking services to its customers is simply the use of electronic technology to provide recognized banking services.[160] The OCC claimed that this activity is functionally equivalent to recognized banking activities; is convenient and beneficial for the bank and its customers; and involves risks similar to those already assumed by banks.[161] The OCC then termed the provision of Internet access as a permissible incidental activity, which provides a mechanism for its customers to conduct the business of banking.[162] 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.[163] The OCC reasoned that it would be impractical to separate the banking from the nonbanking services, as "the full access service adds virtually nothing to the cost of providing Internet home banking and does not dominate the Bank's home banking package."[164] 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.[165] Finally, it indicated that the bank would be justified in offering full internet access as a permissible use of excess capacity acquired in good faith.[166]

The most interesting and surprising aspect to OCC letter was its justification for allowing the bank to offer internet access to non-customers as an incidental power.[167] It considered it to be a form of marketing and advertisement, promoting its reputation as a good corporate citizen in the community.[168] It also used the "excess capacity" rationale to justify providing the service to non-customers.[169]

The OCC issued this letter authorizing banks to act as internet service providers over twenty years ago.[170] The themes and rationales used in the letter, however, have a wonderfully broad applicability to a

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[160] *Id.* at 3.
[161] *Id.*
[162] *Id.* at 7.
[163] *Id.* at 5.
[164] *Id.*
[165] *Id.*
[166] *Id.* at 6.
[167] *Id.* at 7.
[168] *Id.*
[169] *Id.*
[170] *See generally id.*

variety of very interesting activities. Using these same guidelines, the OCC approved the following diverse set of activities as permissible incidental bank powers: certification authority for digital signatures, dispensing transportation and event tickets, offering electronic data interchange services, commercial website hosting for retailers, creating and operating an electronic marketplace, providing electronic storage and safekeeping of documents or information, providing internet access to customers, selling excess capacity to non-customers, and selling website editing software as part of web hosting services for customers.[171]

The OCC has also taken a flexible and broad approach to the parameters of electronic activities of national banks. The OCC has authorized 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);[172] and authorized electronic activity as incidental to the business of banking if that activity is useful or convenient to a specifically authorized activity for banks.[173]

The Federal Reserve also permits BHCs to engage in data processing (including data storage, and data transmission hardware, software, documentation, or operating personnel) activities, as discussed previously.[174] But the Federal Reserve has not been as flexible or as broad in interpretations of the data processing activities as the OCC has regarding the electronic activities of national banks through its line of precedents.[175]

Accordingly, the OCC appears to have a broad perspective on the parameters of the business of banking and permissible incidental

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[171] *See Bank Information Technology (BIT),* U.S. OFF. COMPTROLLER CURRENCY, http://www.occ.gov/topics/bank-operations/bit/opinions-and-letters.html [https://perma.cc/A4DR-CZW4].

[172] *See* 12 C.F.R. § 7.5001(c) (2008).

[173] *See* § 7.5001(d); Off. of the Comptroller of the Currency Corporate Decision No. 2002-11 (July 28, 2002), https://www.occ.gov/static/bit/cd02-11.pdf [https://perma.cc/XG28-H6H6]; Off. of the Comptroller of the Currency Corporate Decision No. 2003-6 (Mar. 17, 2003), https://www.occ.gov/static/bit/cd03-6.pdf [https://perma.cc/XA5Y-YDF3].

[174] 12 C.F.R. § 225.28(b)(14) (2003); *supra* Part II.B.

[175] *See* Off. of the Comptroller of the Currency Corporate Decision No. 2003-6, at 3 (Mar. 17, 2003), https://www.occ.gov/static/bit/cd03-6.pdf [https://perma.cc/XA5Y-YDF3].

activities relating to that business.[176] 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.[177]

B. The Structural Flexibility of the National Bank Charter

The OCC permits broad flexibility in structuring investments, permitting both controlling and non-controlling investments.[178] There are five relevant types of FinTech investments or acquisitions: controlling investments in operating subsidiaries, non-controlling investments; bank service companies, authorized by the Bank Service Company Act (BSC Act); financial subsidiaries controlled by the bank; and investments in small business investment companies (SBICs) under provisions of the Small Business Investment Company Act.[179]

1. Controlling Investments in Operating Subsidiaries

A bank can make an investment in an operating subsidiary.[180] In order to make this investment, the bank must own and maintain more than 50 percent of the operating subsidiaries' voting interest or must otherwise control the subsidiary.[181] It is possible for a bank to own less than 50 percent of the voting interest and still make a controlling investment in an operating subsidiary, as long as no other party controls a percentage greater than the bank's interest or another party controls 50 percent of the voting interest of the subsidiary.[182] OCC regulations also allow a bank's operating subsidiary to either

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[176] *See id.*

[177] 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.

[178] *See* OFF. OF THE COMPTROLLER OF THE CURRENCY, COMPTROLLER'S LICENSING MANUAL: INVESTMENT IN SUBSIDIARIES AND EQUITIES app. B (2008) [hereinafter NONCONTROLLING INVESTMENT GUIDELINES].

[179] 15 U.S.C. §§ 631–697g (2012).

[180] *See* NONCONTROLLING INVESTMENT GUIDELINES, *supra* note 178, at 6.

[181] *Id.*

[182] *Id.*

engage in a partnership, or become a member of a joint venture.[183] This allowance, however, comes with a predictable caveat. The bank, by way of the operating subsidiary, must be able to control the conduct of the business, or otherwise be able to control the venture so as to ensure that it only performs activities that are permissible as the business of banking.[184]

2. Minority, Non-Controlling Investments

Through a series of regulatory interpretations that date back approximately twenty years, the OCC expanded the scope of a national bank's investment authority by permitting minority, non-controlling investments.[185] These investments must also be limited to bank permissible activities,[186] and be "convenient and useful to the bank in carrying out its business and not a mere passive investment unrelated to the banking business."[187] 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.[188] 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.[189] As with the other target entities, the enterprise into which the bank invests must agree to be subject to OCC supervision and examination.[190]

The minority investment is particularly useful for ventures between banks and technology companies. For example, unaffiliated nonbanks can be shareholders and a bank need not control the company (as with operating subsidiaries).[191] 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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[183] *Id.*
[184] *Id.*
[185] *See* NONCONTROLLING INVESTMENT GUIDELINES, *supra* note 178.
[186] *See id*. at 23–24.
[187] *Id* at 24.
[188] *See id*.
[189] *Id*.
[190] *Id*.
[191] *See id.* at 5, 19

3. 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 its depository institution investors, such as accounting or statistical functions.[192] These companies are not restricted from providing services to noninvestors, and cannot "unreasonably discriminate" against noninvestors, but they can refuse service to noninvestors if it would be "beyond the practical capacity" of the bank service company.[193]

Banks are limited by statute to investing no more than 10 percent of their capital and surplus in any single bank service company, and no more than 5 percent of their total assets in all bank service companies.[194] Banks may only invest in service companies at locations that the investing depository institution could perform the same contract service.[195]

4. 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 FHCs.[196] 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.[197] The bank must also have at least a satisfactory Community Reinvestment Act rating.[198] The aggregate amount of investments in financial subsidiaries may not exceed 45 percent of the consolidated total assets of the parent

[192] 12 U.S.C. §§ 1861–67 (2012).
[193] *Id.*
[194] § 1862.
[195] §1864(c). 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. *See* §1835a.
[196] 15 U.S.C. §§ 6801–09, 6821–27 (2010).
[197] *See* NONCONTROLLING INVESTMENT GUIDELINES, *supra* note 178, at 14–15.
[198] *Id*. at 14.

bank or $50 billion, whichever is less (these numbers are indexed by the Federal Reserve and the Treasury).[199]

For national banks, the authority is intended to parallel the authority granted to FHCs to engage in financial activities.[200] 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.[201] Further, to the extent that there are Section 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.[202]

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.[203] Federal Reserve Act Sections 23A and 23B will generally apply to transactions between the bank and any financial subsidiary.[204] If the bank fails to maintain qualifications to invest in financial subsidiaries, the OCC may impose limitations upon the bank or the subsidiary.[205] Under certain circumstances, the OCC may even require divestiture of control of the subsidiary.[206]

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.

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[199] *Id*. at 15.

[200] See *infra* Part III.B.3, for a discussion of the use of financial subsidiaries by FHCs. Both bank financial subsidiaries and BHC financial subsidiaries were intended to provide broader flexibility to engage in activities than that afforded under the National Bank Act or the BHCA. In practice, other than securities activities (for both national banks and BHCs), 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.

[201] *See* NONCONTROLLING INVESTMENT GUIDELINES, *supra* note 178, at 16.

[202] *See id*. at 34.

[203] *See id*. at 16.

[204] *Id*.

[205] *Id*. at 18.

[206] *Id*.

5. SBICs

Banks may invest in one or more SBICs, or any entity established to invest solely in SBICs under the Small Business Investment Act of 1958 (as amended).[207] SBICs are defined as privately owned and managed investment funds licensed and regulated by the U.S. Small Business Administration (SBA).[208] SBICs operate by "rais[ing] 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."[209] No single bank may invest more than 5 percent of its capital and surplus in SBICs.[210]

SBICs are limited to investing "only in small businesses and must allocate a minimum of 25 percent of their capital to smaller enterprises."[211] A small business is defined for SBIC purposes as a business, inclusive of 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."[212] A business may also be deemed "small" using the SBA's North American Industry Classification System (NAICS) codes.[213] A "smaller enterprise," meanwhile, is a small business that (1) together with its affiliates, and alone, meets the NAICS size standard for its industry at the time of financing; or (2) "together with its affiliates has a net worth of not more than $6 million and average net income after Federal income taxes (excluding any carry-over losses) for the preceding two years no greater than $2 million."[214] 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

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[207] OFF. OF THE COMPTROLLER OF THE CURRENCY, SBA'S SMALL BUSINESS INVESTMENT COMPANY PROGRAM 2 (2016).
[208] *See id.*
[209] *See id.* at 1.
[210] *See id.* at 2.
[211] *See id.* at 1.
[212] 13 C.F.R § 121.301(c) (2016). The net worth, average net income after federal taxes standards were adjusted for inflation in 2014. *See* 79 Fed. Reg. 33, 647 (June 12, 2014) (codified at 13 C.F.R. § 121).
[213] § 121.201.
[214] § 107.710.

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.[215]

SBICs may make both debt and equity investments in qualifying small businesses.[216] To the extent that a FinTech company meets the qualification, using an SBIC can provide a useful vehicle for national bank investments.[217]

One example of an SBIC investment is the BBVA deal with Propel.[218] 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.[219] Propel is a FinTech VC which "will focus on payments, credit, insurance, wealth management, e-commerce, security and compliance."[220] The move from BBVA's portfolio to Propel Ventures allows BBVA to structure the fund as an SBIC, which BBVA states "will give them

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[215] OFF. OF THE COMPTROLLER OF THE CURRENCY, SMALL BUSINESS INVESTMENT COMPANIES: INVESTMENT OPTION FOR BANKS 2 (2015).

[216] *See* OFF. OF THE COMPTROLLER OF CURRENCY, ACTIVITIES PERMISSIBLE FOR A NATIONAL BANK, 2011 ANNUAL EDITION 92 (2012).

[217] 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 excludes SBICs from the definition of covered fund. *See* 12 C.F.R. § 44.10(c)(11) (2017).

[218] 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/ [https://perma.cc/3AQN-8BMT].

[219] *Id.*

[220] *Id.*

flexibility in stake size."[221] Previously while within BBVA, the fund could only invest up to 5 percent per funding round due to how it was structured.[222]

C. 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).[223] First, the activities must be bank permissible, regardless of the amount of the investment.[224] 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.[225] While the OCC has shown great flexibility in connection with expanding its definition of the business of banking and of permissible incidental activities, that flexibility is not unlimited.[226] As discussed in Part II.A, when a BHC makes a non-controlling investment, there are no activity limitations associated with such investment.[227]

Second, the target will be subject to OCC supervision and examination, again, regardless of the size of the investment.[228] 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).[229] To the extent that a FinTech would not otherwise be subject to OCC oversight because of the services it provides a bank, the FinTech may want to avoid OCC oversight stemming from an investment by a bank. The prospect of

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[221] *Id*.

[222] *Id*.

[223] 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. *See generally*, 12 C.F.R. § 121 (2016).

[224] *See* OFF. OF THE COMPTROLLER OF CURRENCY, *supra* note 216, at 1.

[225] *See* NONCONTROLLING INVESTMENT GUIDELINES, *supra* note 178, at 71.

[226] *See* OFF. OF THE COMPTROLLER OF CURRENCY, *supra* note 216, at 1.

[227] *See* POLICY STATEMENT 2008, *supra* note 46.

[228] *See* OFF. OF THE COMPTROLLER OF CURRENCY, *supra* note 216, at 1.

[229] *See* POLICY STATEMENT 2008, *supra* note 46 (citing 12 U.S.C. § 1841(a)(2)).

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.[230] Many states, for instance, authorized insurance brokerage powers for their banks, and some even permitted broad real estate development powers.[231] Most states, however, have enabling statutes for their banks that are roughly parallel to those afforded national banks.[232] Indeed, a common element in many statutes is a "wild card" provision, allowing state banks to engage in any activity permissible for national banks.[233]

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.[234] Section 24 of the Federal Deposit Insurance Act provides that a state-chartered bank may engage as principal only in those activities that are permissible for national banks, and those approved by the Federal Deposit Insurance Corporation (FDIC) under procedures set forth in its regulations.[235] As a general proposition, investments in other entities are treated as "principal" rather than agency activities.[236] 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.[237] The FDIC has the power to authorize investments by a state-chartered

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[230] *See* Arthur E. Wilmarth, Jr., *The Expansion of State Bank Powers, the Federal Response, and the Case for Preserving the Dual Banking System*, 58 FORDHAM L. REV. 1130, 1177–81 (1990).
[231] *See id.* at 1149.
[232] *Compare, e.g.*, TEX. FIN. CODE ANN. § 32.001 (West 2017), *and* WIS. STAT. ANN. § 221.0301 (West 2017), *with* 12 U.S.C. § 24.
[233] *See*, *e.g.*, N.Y. BANKING LAW § 12-a(2) (LexisNexis 2017).
[234] *See* 12 U.S.C. § 1831a(a)(1) (2012).
[235] *Id.*
[236] § 1831a(c).
[237] *Id.*

bank beyond those imposed on national banks, but banks do not appear to have used this procedure for technology investments.[238]

State-chartered banks have the power to invest in controlled and non-controlled companies, operating subsidiaries,[239] bank service companies, and in financial subsidiaries under the same terms and conditions as are applicable to national banks.[240] The state statute must grant them the investment power; the federal statutes authorizing these investments provide the contours.[241] While 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.[242]

V. The Volker Rule

Added as part of the Dodd-Frank Act in 2010, the Volcker Rule has two primary prongs.[243] 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 Investment Company Act of 1940).[244] 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.[245] Control is determined using the BHC test described in Part II.B.[246] 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 one thousand pages.[247] While compliance with the Volcker Rule generally should not be a

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[238] *See* § 1831a(a); *Decisions on Bank Applications*, FDIC (July 25, 2012), https://www.fdic.gov/regulations/laws/bankdecisions/InvestActivity [https://perma.cc/C5HV-DVMN].

[239] NONCONTROLLING INVESTMENT GUIDELINES, *supra* note 176,

[240] *See* § 1831a; 12 U.S.C. § 24a(a)(1) (2010).

[241] *See* § 24a(a)(2).

[242] 15 U.S.C. § 682(b)(1) (2012).

[243] 12 U.S.C. § 1851 (2012).

[244] *Id.*

[245] § 1851(h)(1).

[246] *Id.*

[247] § 1851; 12 C.F.R. §§ 44, 248, 255, 351 (2016).

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 vehicles for reform, the Financial CHOICE Act, repealing the Volcker Rule completely.[248] On the other hand, Trump's treasury secretary, Steven Mnuchin, is working on revising the Volcker rule, not repealing it.[249]

A. Proprietary Trading

Entities covered by the Volcker Rule may not engage in proprietary trading.[250] This is 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, benefiting from short-term price movements, realizing short-term arbitrage profits, or hedging one of those positions.[251] There is a presumption that any security, derivative, or future held for fewer than sixty days involves proprietary trading.[252] 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.[253]

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[248] *See* H.R. 10, 115th Cong., (2017); *Trump Transition: Financial CHOICE Act—Only the Beginning*, DAVIS POLK (Nov. 17, 2016), https://alerts.davispolk.com/10/2493/uploads/2016-11-17-trump-transition-financial-choice-act-only-the-beginning.pdf [https://perma.cc/R36F-6TER]; Elizabeth Gurdus, *Parts of Dodd-Frank affecting small businesses will be rolled back under Trump, Steve Mnuchin says*, CNBC (Nov. 30, 2016), http://www.cnbc.com/2016/11/30/exclusive-parts-of-dodd-frank-will-be-rolled-backtrump-treasury-pick-steve-mnuchin-says.html [http://perma.cc/X79D-VRQ5].

[249] Peter Madigan, *Mnuchin: FSOC Working on Revised Volcker Rule*, FINREG ALERT (Apr. 20, 2017), http://www.finregalert.com/mnuchin-fsoc-working-on-revised-volcker-rule/ [https://perma.cc/6BXK-E235].

[250] § 1851(a)(1)(A).

[251] § 1851(h)(4).

[252] WILMER HALE, THE VOLCKER RULE HANDBOOK (2013), https://www.wilmerhale.com/uploadedFiles/Shared_Content/Editorial/Publications/WH_Publications/Client_Alert_PDfs/Volcker%20Rule%20Alert_12%2023%2013.pdf [https://perma.cc/C7NA-GUVW].

[253] § 1851(d)(1).

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 banks or BHCs, and that control is the regulatory definition of control, having only a slight relationship with whether actual control exists.[254] 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 Volker Rule, banking entities are precluded from sponsoring or acquiring an interest in covered funds.[255] What is 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.[256] 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.[257]

The definition of covered fund certainly covers most hedge funds and private equity funds, as they rely on the Section 3(c)(1) (100 investors) or 3(c)(7) (all investors are "qualified purchasers") exemptions.[258] 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 Section 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.

[254] § 1851(h)(1).
[255] § 1851(a)(1).
[256] § 1851(h)(2).
[257] *Id.*
[258] *Id.*

Additionally, a FinTech controlled by a banking organization cannot itself violate the funds prohibition of the Volcker Rule.[259]

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 (e.g., if the target company is engaging in activities that are not permissible for a bank or the BHC), or 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.[260] 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)

[259] § 1851(h)(1).
[260] § 1851(d)(4)(B)(i).

	Type	Nature of Investors	Degree of Control	Type of Activities	Other Limitations
Bank Investment	**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 control	Required	Any bank permissible activity	Subject to examination as is bank
	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 an FHC	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, but must be a "Small Business" and 25% of investments must be in "Smaller Enterprises"	Limited investment horizon

VII. Conclusion

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.[261] 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 objectives. The $7 billion 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 (1) is the activity likely to be—and remain—permissible; (2) do I want to subject the company to bank regulation and supervision; (3) do I need to control the company from an operational or business perspective; (4) who are the other investors and how might they be structuring their investments; and (5) will the structure trigger a regulatory approval that might be difficult or time-consuming to obtain. For many organizations, the non-controlling investment through the BHC or nonbank subsidiary of the holding company provides the easiest and quickest path to closing.

[261] 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.