STRUCTURING BANK AND FINTECH COLLABORATIONS

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Some bankers view the rapid rise of “fintech” as an existential threat to traditional banks, especially community banks. But while fintech surely is changing financial services, it is also creating new opportunities for banks. For fintech companies, banks are potential partners with a loyal customer base, stable and inexpensive funding, and extensive infrastructure to support financial transactions and regulatory compliance. For banks, fintech companies can be partners that help provide the technology and innovation that bank customers now demand. Given these potential synergies, it is no surprise that the pace of bank and fintech collaboration is growing exponentially.[1]

Structuring a collaboration between a bank and a fintech company can be a substantial and complex undertaking. In addition to the traditional business considerations for any investment, joint venture, licensing, or business combination transaction, there are significant additional legal and regulatory considerations for both the bank and the fintech company when the two decide to “partner” in some way. The business of banking is heavily regulated in order to protect the public. A fintech company cannot simply decide to go into the banking business without coming into contact with the bank regulatory system. Likewise, a bank may not establish a significant third-party relationship or invest in a business without complying with applicable banking laws and regulations. So what are the options for a fintech company and a bank considering a collaboration?

As an initial step, the bank and the fintech company should determine what they hope to achieve from the collaboration. Relevant considerations include: What are the business objectives that each seeks to address by collaborating with the other? Is the bank merely looking to purchase a product or service from a vendor, or would it like to establish an ongoing relationship with a fintech company in which the bank has an ownership interest? Is the fintech company looking to the bank as a potential customer, investor, or partner to help bring its product or service to market, or some combination of these? Will the fintech company provide products or services exclusively to the bank or to other (perhaps competing) banks as well, and is this expected to change over time?

On one end of the collaboration spectrum is the traditional third-party vendor arrangement where a bank engages a fintech company to license or provide a product or service in exchange for fees. A bank's relationship with its core processor is an example. Such arrangements are typically governed by a written contract that sets forth the respective rights and obligations of the parties. Regulatory guidance in this area focuses primarily on the bank's due diligence, selection, and ongoing oversight of the third party relationship and associated risk management principles, policies, and procedures.[2]

On the other end of the collaboration spectrum are situations in which a bank makes an equity investment in fintech - that is, to have some manner of economic rights or control with respect to a fintech company or its technology. The maze of legal and regulatory requirements and restrictions for this type of collaboration can be difficult to navigate. It is important for both parties to get the structuring right - the bank due to regulatory expectations, and the fintech company due (often) to limited resources and runway.

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Many banks are owned by a bank holding company. Those that are may consider structuring their investment in a fintech company through a nonbank subsidiary of the bank holding company. The Bank Holding Company Act allows bank holding companies to own or control non-banking companies that are engaged in certain activities that are closely related to banking.[3] If the fintech company is not engaged in activities that are permissible under the Bank Holding Company Act, then any investment by the bank holding company must be non-controlling.[4] "Control" by a bank holding company over a fintech company subjects it to regulation, supervision, and examination by the Board of Governors of the Federal Reserve System. Most fintech companies would want to avoid this. Furthermore, if a bank holding company makes a controlling investment, the bank holding company must monitor the activities of the fintech company to make sure they remain permissible, or it must negotiate contractual provisions that prevent the fintech company from engaging in impermissible activities (or, ideally, do both). For these and other business reasons, such investments are often structured to be non-controlling.

In the case of a bank without a holding company that wishes to make an equity investment in a fintech company, generally the fintech company's activities must be activities that would be permissible for the bank to conduct directly under applicable law. National banks have broad authority under the National Bank Act and OCC policy to engage in electronic activities that are functionally equivalent to or a logical outgrowth of a recognized banking activity.[5] "Wild-card" state banking statutes allow state-chartered banks to engage in activities that are permissible for national banks.[6] Under Massachusetts law, for example, Massachusetts state-chartered banks generally may engage in activities that are permissible for national banks upon notice to the Massachusetts Commissioner of Banks.[7]

As a corporate structuring matter, a bank or a bank holding company may make an investment either in a fintech company directly or in an entity created to facilitate the collaboration - either to form a joint venture or partnership with the fintech company or as a special purpose entity owned by the bank or holding company and formed to hold its investment. Legal, tax, and accounting considerations may cause the parties to favor one structure over another. The manner and scope of the investment will dictate the initial regulatory requirements, such as whether a regulatory application or notice is required, as well as any ongoing regulatory requirements and restrictions.[8] Banks may want to meet with their regulator early on in the process to discuss whether the collaboration is workable from a regulatory standpoint and any particular regulatory concerns.

Collaboration structuring will also, of course, depend on the business terms of the relationship. For example, any rights of the bank to terminate its investment (for regulatory reasons or otherwise), to protect its investment through additional purchases of equity, to sell its equity in the event that the fintech company engages in an initial public offering, or even to ultimately acquire the fintech company, should be thought through and appropriately reflected in the documents governing the relationship. Attention should also be paid to the regulatory consequences of any of these actions.

The considerations discussed above are just a sampling of the many business, legal, and regulatory issues that banks and fintech companies must confront when seeking to collaborate. While these issues may seem daunting, the potential rewards of a successful collaboration - more engaged, satisfied customers doing more business with the bank through better technology - are significant. Moreover, there is a growing sense that banks which do not embrace the innovative technologies being developed by fintech companies may soon find themselves left behind by their competitors.

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[1] *See* "Is Fintech Small Banks' Equalizer in Fight with Big Rivals", American Banker (Dec. 7, 2016), *available at* https://www.americanbanker.com/news/is-fintech-small-banks-equalizer-in-fight-with-big-rivals (citing a survey of 37 community bank executives, 84% of whom responded that they had already met with a fintech company about a possible collaboration).

[2] *See, e.g.*, OCC Bulletin 2013-29, Third-Party Relationships: Risk Management Guidance (Oct. 30, 2013); OCC Bulletin 2017-21, Third-Party Relationships: Frequently Asked Questions to Supplement OCC Bulletin 2013-29 (June 7, 2017).

[3] 12 U.S.C. § 1843(c)(8); 12 C.F.R. § 225.28. Bank holding companies that have elected to be treated as a financial holding company under the Bank Holding Company Act may engage in an expanded set of activities, which may be relevant to the structuring of a fintech collaboration, depending on the activities conducted by the fintech company.

[4] A bank holding company is deemed to control another company if it owns, controls, or has the power to vote 25% or more of any class of voting securities, or has the power to elect a majority of the directors, of the company, or the Board of Governors of the Federal Reserve System otherwise determines that the bank holding company exercises a controlling influence over the management or policies of the company. 12 U.S.C. § 1841(a)(2). A bank holding company that owns, controls, or has the power to vote less than 5% of any class of voting securities of a company is presumed not to control the company. 12 U.S.C. § 1841(a)(3). Determining whether control exists in situations in between depends on the facts and circumstances. *See* Board of Governors of the Federal Reserve System Policy Statement on Equity Investments in Banks and Bank Holding Companies (Sept. 22, 2008), 12 C.F.R. § 225.144.

[5] *See* 12 C.F.R. § 7.5001(c).

[6] Under federal law, subsidiaries of state-chartered banks generally may not engage in activities that are not permissible for subsidiaries of national banks. *See* 12 U.S.C. § 1831a; 12 C.F.R. Part 362. The regulations and regulatory guidance of the state bank's primary federal regulator should be considered as well, particularly those that may deal with the activities which are the subject of the collaboration. *See, e.g.*, FDIC FIL-50-2016, Proposed Examination Guidance for Third-Party Lending.

[7] *See* M.G.L. c. 167F § 2(31).

[8] *See, e.g.*, OCC's Licensing Manual on Investment in Subsidiaries and Equities, *available at* https://occ.gov/publications/publications-by-type/licensing-manuals/opsubs.pdf.

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