BANK PARTNERSHIPS WITH & INVESTMENTS IN FINTECH COMPANIES

Charles Horn and Donald Waack

May 18, 2020

Before we begin: Morgan Lewis and Global Technology

Be sure to follow us at our website and on social media:

Web: www.morganlewis.com/sectors/technology

Twitter: @MLGlobalTech

LinkedIn Group: ML Global Tech

Check back to our Technology May-rathon page frequently for updates and events covering the following timely topics:

21st Century Workplace	Cybersecurity, Privacy and Big Data	Medtech, Digital Health and Science
Artificial Intelligence and Automation	Fintech	Mobile Tech
COVID-19	Global Commerce	Regulating Tech

Agenda

- Overview
- Contractual Partnership Model v. Investment Model
- Contractual Partnership Model
  - Business Objectives and Incentives
  - Vendor Risk Management
  - Contractual Considerations and Deal Points
- Investment Model
  - Business Objectives and Incentives
  - Structuring Considerations
  - Control and Other Regulatory Issues
- Questions

OVERVIEW

Overview - “Banks” and “Fintechs”

- Various kinds of banks:
  - State or federal commercial banks or thrifts
  - Bank holding companies
  - Savings and loan holding companies
  - Nonbank subsidiaries of the same
- All of these banking organizations share similar characteristics:
  - Highly regulated; new line of business may require regulatory approval or buy-in
  - Safety and soundness
  - New initiatives are developed within an extensive compliance framework

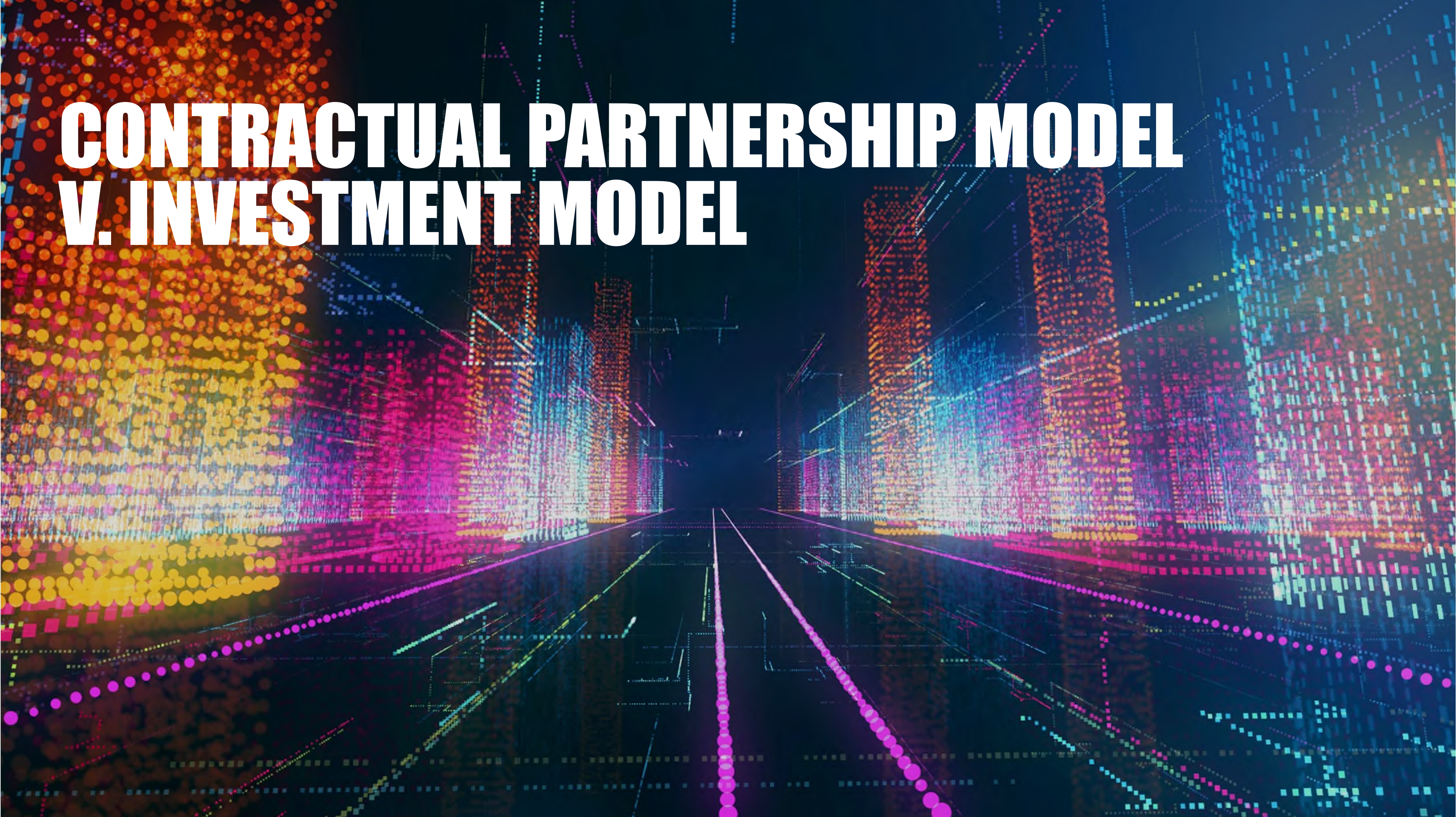
- Fintech is broadly defined
- For our purposes, we are focused on early- and mid-stage companies engaged in a financial services business that uses technology to deploy new financial products or services, or to deliver products and services in a new way
  - Often unregulated (or less regulated)
  - Limited staffing and budget for compliance infrastructure (compared to regulated banking organizations)
  - Innovative and able to move quickly

Overview - “Banks” and “Fintechs”

Relationships between the traditional banking sector and the fintech sector have evolved significantly over last several years

Adversarial	Shift	Cooperative
• Fintechs seeking to displace traditional banks • Banks view fintechs primarily as threat for market share	• Traditional banks recognize benefits of incorporating fintech into traditional business; inability to match innovation • Fintechs recognize the benefits of bank partnership (branding, customers, delivery channels, funding, infrastructure)	• Increasingly seeing traditional banks seeking to harness new technologies; banks and fintech startups finding ways to work with one another • Partnerships and joint ventures • Minority investments • Other cooperative relationships

CONTRACTUAL PARTNERSHIP MODEL V. INVESTMENT MODEL



Contractual Partnership Model v. Investment Model

Partnership Model

- **Contractual relationship for the provision of a product or service**
  - Customer-facing or back office
  - Add-on to existing platform or stand-alone
- **Lowest-cost option with the least level of commitment for bank partner**
  - Time-limited; arm's length
  - Scope of relationship limited to what is covered by contract
  - No debt or equity financing; bank pays only for the product/service
  - More limited regulatory/supervisory obligations
- **Least intrusive option for the fintech partner**
  - Retain equity and business control
  - Not giving up access to trade secrets, "special sauce"
  - Arms-length commercial relationship, typically non-exclusive

Contractual Partnership Model v. Investment Model

Investment Model

- **Strategic equity investment**
- **Often, parties also will have a contractual relationship for the provision of a product or service**
- **Higher-cost option with a greater level of commitment for bank partner**
  - Equity investment/upside
  - Often accompanied by other commercial relationships (e.g., debt financing, vendor relationship)
  - Board or observer rights – access to fintech technology and expertise
  - Heightened regulatory and supervisory obligations
- **More intrusive option for the fintech partner**
  - Giving up some equity
  - Bank partner receives access to trade secrets and could bring this in house over time
  - Relationship more likely to have exclusivity provisions/restrictions on dealing with other banks
  - Increases risk that the fintech itself will be directly subject to state or federal bank/financial regulatory obligations

Contractual Partnership Model v. Investment Model

- Many variations on partnership v. investment exist
  - Contractual partnership relationships can be extensive, covering core functions of the bank, and may be exclusive, or may be more limited in scope and depth
  - Conversely, investment relationships can be purely passive in nature where a bank is just taking a flyer on limited equity upside on a portfolio investment
  - Joint ventures may be viewed as a hybrid variant of partnership/investment models
  - Internal incubation of fintech by the banking organization itself – today, it is much more common for large banking organizations to devote substantial resources to internal fintech initiatives
- Overall, the theme of "contractual partnership" versus "investment" provides a useful model to think about the relevant regulatory, structural and transactional issues

DEEPER DIVE: CONTRACTUAL PARTNERSHIP MODEL

Contractual Partnership Model – Business Objectives and Incentives

- Pros for the bank
  - Lower-cost alternative for the banking organization
  - Potentially more limited regulatory obligations
  - Allows banking organization to "test the waters" on a new product or service
  - Affords bank more control over proprietary information (e.g., customer data)
- Pros for the fintech
  - Fintech retains trade secrets and equity
  - Potentially more limited regulatory obligations
- Cons
  - Banking organization must address bureaucracy/challenges with technology integration
  - Regulatory exposure for the bank and the fintech

Contractual Partnership Model – Business Objectives and Incentives

- Examples
  - Referral relationships: one party provides an online gateway to the other party's products/services
  - Distribution relationships: one party acts as distributor of a financial product or service for another party
  - Joint marketing relationships: banking organization and fintech join together to market a financial product/service
  - Service support relationships: fintech looks to bank to provide specific services supporting a multi-dimensional financial product that it cannot provide itself (e.g., financial asset custody, depository services)
  - Data management relationships: data aggregation and similar activities
  - Regulatory coverage relationships: fintech looks to rely on banking organization's regulated status to reduce its own regulatory obligations

Contractual Partnership Model – Vendor Risk Management

- With no equity investment or control relationships, fintech remains outside the scope of the regulated banking organization group
- As a result, the primary regulatory considerations from the perspective of bank investor are vendor risk management obligations
  - The significance of vendor risk management and the degree of regulatory scrutiny has materially increased in recent years
  - High-risk compliance issue for banking organizations
  - This can be the most intrusive and contentious aspect of the contractual partnership model for many fintechs

Contractual Partnership Model – Vendor Risk Management

Office of the Comptroller of the Currency Bulletin 2013-29, *Third Party Relationships: Risk Management Guidance*

- Scope: Applies to national banks and their operating subsidiaries; highlights the potential risks arising from the use of third party service providers (TPSPs); describes the elements of an appropriate risk-based TPSP risk management program.
- Core elements of an expected risk management program:
  – Strategy and risk assessment
  – Due diligence and selection of service providers
  – Written contract provisions and considerations
  – Ongoing monitoring of service providers
  – Contingency plans for termination of relationship
  – Roles and responsibilities in managing risk
  – Accountability: documentation and reporting
  – Independent review and management reporting/assessment

Contractual Partnership Model – Vendor Risk Management

Federal Reserve Board Supervisory Letter SR 13-19, *Guidance on Managing Outsourcing Risk* (2013)

- Scope: Applies to FRB-regulated (state member banks, bank and savings and loan holding companies, nonbank subsidiaries, U.S. operations of foreign banking organizations); highlights the potential risks arising from the use of service providers; describes the elements of an appropriate service provider risk management program.
- An effective service provider risk management program usually includes the following core elements:
  - Risk assessments
  - Due diligence and selection of service providers
  - Contract provisions and considerations
  - Incentive compensation review
  - Oversight and monitoring of service providers
  - Business continuity and contingency plans.

Contractual Partnership Model – Vendor Risk Management

Federal Deposit Insurance Corporation, Financial Institutions Letter 13-2014, *Technology Outsourcing: Informational Tools for Community Bankers* (2014)

- Scope: Informational tools for community banks in establishing and managing outsourcing of technology products and services
- Key substantive elements:
  - Risk assessment
  - Due diligence in selecting a third party
  - Contract structuring and review
  - Oversight
- Cross-references FFIEC guidance (next slide)

Contractual Partnership Model – Vendor Risk Management

FFIEC, *Outsourcing Technology Services* (2004)

- This is interagency guidance to which all federal bank regulators look. It comprises one element of a formal interagency program for IT management and supervisory activities
- Scope: Assists examiners in assessing a financial institution's risk management processes to establish, manage, and monitor IT outsourcing relationships
- Key substantive elements:
  - Board and management responsibilities
  - Risk management and risk assessment
  - Service provider selection, including due diligence and arms-length agreements with affiliates
  - Contract issues, including pricing and SLAs
  - Ongoing monitoring
  - Outsourcing business continuity planning

Contractual Partnership Model – Contractual Considerations and Deal Points

- Careful identification of services provided and service standards
- Confidentiality of banking organization information; protection and proper management of nonpublic customer information; privacy requirements
- Systems integrity; data protections; service interruptions; safeguards and remedies for breach
- Compliance obligations; allocation of same between the parties
- Reporting obligations
- Audit and access rights
- Regulatory access rights (see 12 U.S.C. 1867(c))
- Suitable indemnities
- Clear termination provisions

DEEPER DIVE: INVESTMENT MODEL

Investment Model – Business Objectives and Incentives

- Pros for the Bank:
  - May receive board or observer rights and access to fintech technology and expertise
  - Equity upside on the technology/business
  - Long-term plan to scale the technology, bring in house
  - ***But consider***: Compliance challenges, governance, risk management, cultural fit/comfort bringing fintech within the regulated organization
- Pros for the Fintech:
  - Financial backing
  - Leverage branding/reputation of established bank, access to large client base
  - Access to expertise on bank issues, regulatory/compliance infrastructure
  - ***But consider***: Fintech may become subject to regulatory oversight/drag on its business as well as certain risks, such as loss of its technology and expertise to the bank

Investment Model –
Structuring Considerations: Bank or Holding Company?

Initial Question: Where will the banking group hold the investment?

Bank

- Limited to bank-permissible functions (lending is okay, but brokerage or securities activities probably are not okay)
- More likely to be subject to regulatory application or approval requirements (especially if the HoldCo is an FHC)
- Affiliate transaction (23A/23B) restrictions apply to the bank, but not to the HoldCo or nonbank subsidiaries
- Typically a bank is the investor only if the product or service is a core bank function

BHC/SLHC (including nonbank subs)

- More expansive array of permissible activities, providing greater flexibility for the fintech as it evolves
- Structuring options may be available that do not require regulatory approval
- Fintech may be able to avoid direct supervisory or examination authority of any bank regulator whereas this is unlikely for equity investments held by a bank

Investment Model – Bank Equity Investments

- Banks are subject to substantial restrictions on their ability to make equity investments in other companies
  - Typically requires regulatory notice and/or prior approval
  - Generally limited to companies engaged in activities permissible for the bank to conduct directly
- OCC Equity Investment Authorities
  - National Banks
    - Operating Subsidiaries
    - Bank Service Companies
    - Financial Subsidiaries
    - Other Equity Investments
  - Savings Associations
    - Operating Subsidiaries
    - Service Corporations
    - Pass-Through Investments
- State-Chartered Banks
  - Varies by state, most impose similar restrictions to those outlined above

Investment Model –
Holding Company Equity Investments

- Investments held by BHC itself or nonbank subsidiary (e.g., broker-dealer, investment adviser, finance company)
- Regulatory Gating Issues: (1) Section 4 Authority and (2) Control v. Non-Control
- Bank Holding Company Act, Section 4 – BHCs and their subsidiaries generally prohibited from engaging in, or investing in any company engaged in, any activity other than managing or controlling banks, except pursuant to a specific BHCA exemption
  - Section 4(c)(6)
    - Passive investments in any company, less than 5% voting shares and 33.3% total equity
  - Section 4(c)(8)
    - Investments in companies engaged in activities "so closely related to banking or managing or controlling banks as to be a proper incident thereto"
  - Section 4(k)
    - Available only to financial holding companies ("FHCs"), permits investments in companies engaged in 4(c)(8) activities <u>plus</u> additional "financial activities" such as insurance and securities
    - Merchant banking exemption for companies engaged in nonfinancial or "mixed" activities

Investment Model – Section 4(c)(6) Investments

- BHC may invest in up to 5% of the voting shares of any company, so long as the investment is otherwise passive/non-controlling
- No regulatory notice or approval requirements; little or no Federal Reserve reporting
- Fintech is not part of the regulated holding company group: no regulatory restrictions on activities, no supervisory or examination authority
- Other business relationships and contractual minority investment protections permitted
- Additional non-voting equity is possible (up to 33.3%), often achieved via "BHC Partner" or "BHC Investor" provisions that convert equity exceeding 4.9% into non-voting shares
- Some BHCs/FHCs rely exclusively (or nearly so) on 4(c)(6) for fintech investment portfolio given its flexibility, lack of regulatory drag

Investment Model –
Section 4(c)(8) and 4(k) Investments

- If the BHC's investment will exceed a 5% voting interest, the parties must identify another Section 4 authority
- Select 4(c)(8) permissible nonbanking activities:
  - Lending: making, acquiring, brokering, or servicing loans, plus related activities
  - Trust company functions
  - Financial and investment advisory activities
  - Transactional services as agent (e.g., securities brokerage, riskless principal, private placements)
  - Data processing activities
- Select 4(k) permissible financial activities (FHCs only):
  - Securities underwriting and dealing
  - Insurance
  - Finder activities
  - Merchant banking (time-limited investments in any company, no day-to-day management)

Investment Model – Section 4(c)(8) and 4(k) Investments

- Section 4(c)(8) and 4(k) investments can be non-controlling (generally 5%-24.9% voting interest) or controlling
- Even if non-controlling, fintech will at a minimum be required to conduct its business in accordance with regulatory definitions of permitted activities
  - BHC will typically seek contractual limits on scope of activities
  - Right to limit fintech business to activities permissible under Section 4 and/or "regulatory out" provision should the fintech engage in impermissible activities
- Depending on various factors, regulatory notice/approval may be required for the investment (mainly for BHCs that are not FHCs)
- Investment generally will be subject to some degree of Federal Reserve reporting

Investment Model – BHCA "Control" Issues

- Second gating issue from a regulatory perspective is whether the BHC's investment in the fintech company will be controlling or non-controlling
- Why does it matter?
  - All controlled companies are subsidiaries of the BHC for regulatory purposes and must conduct activities in accordance with a Section 4 exemption
  - Regulatory notice/approval likely required for the transaction unless BHC is an FHC
  - Controlled subsidiaries are part of the regulatory control group subject to Federal Reserve supervisory, examination and enforcement authority
  - Enterprise-wide risk management, BSA/AML and other compliance obligations
  - Fintech is subject to and must have a Volcker Rule compliance program (restrictions on securities/derivatives trading, private fund activities)
- Mutual concern of the banking group and the fintech
  - Banking group may be reluctant to assume oversight responsibility for fintech's activities/compliance
  - Fintech may be reluctant to limit potential scope of its business and undertake extensive regulatory obligations associated with being part of a BHC control group

Investment Model – Regulatory Definition of Control

- BHCA Definition of "Control"
  - Ownership or control over 25% or more of the shares of any outstanding class of voting securities
  - Control in any manner over the election/appointment of a majority of a board of directors, trustees, general partner, or managing member
  - Power to exercise a "controlling influence" over the management or policies of an investee company (as a technical matter, after Federal Reserve Board provides notice and opportunity for hearing)
- Regulatory control does not mean actual, operational control; a company can be controlled by multiple entities
- BHCs must be vigilant about investments where they are deemed to have control as a regulatory matter but lack the ability to actually limit/control the activities of an investee company so as to ensure legal and regulatory compliance

Investment Model – Background on Controlling Influence

- Vast majority of regulatory control issues that arise in the context of fintech investments involve "controlling influence" issues
- For many years, controlling influence analysis was highly subjective and lacking in legal certainty
  - Very few published interpretations or parameters
  - Federal Reserve generally evaluated controlling influence issues on a transaction-specific basis, communicating its determinations only informally to the affected parties
  - Analysis based on all facts and circumstances, essentially an aggregation of "indicia of control" such as the amount of voting and non-voting equity, board representation, other business relationships, contractual covenants/veto rights, director/officer interlocks
- Standards in some cases were highly restrictive (e.g., 5% revenue cap on business relationships), particularly problematic for investments in early stage fintech companies where BHC was also a customer/client

Investment Model –
Final Rule on Controlling Influence

- Federal Reserve on January 30, 2020, announced final regulation (the "Final Rule") establishing new standards for controlling influence determinations
- Final Rule originally scheduled to take effect April 1, 2020; delayed to September 30, 2020, in response to COVID-19 crisis
- Largely an articulation of existing/traditional Board policies, but with some important changes
- Most importantly, the Final Rule establishes a matrix of "tiered presumptions" of control that identifies, based primarily on readily identifiable objective criteria, those relationships that will be presumed to give rise to a controlling influence over an investee company
- Clarity, transparency, and predictability – significant for facilitating minority investments in fintechs

Investment Model – Presumptions of Control

Summary of Tiered Presumptions				
	Less than 5% Voting	***5%-9.99% Voting***	***10%-14.99% Voting***	***15%-24.99% Voting***
Directors	Less than 50%	Less than 25%	Less than 25%	Less than 25%
Director Service as Board Chair	N/A	N/A	N/A	No director representative is chair of the board
Director Service on Board Committees	N/A	N/A	1/4 or less of a committee with power to bind the company	1/4 or less of a committee with power to bind the company
Business Relationships	N/A	Less than 10% of revenues or expenses of second company	Less than 5% of revenues or expenses of second company	Less than 2% of revenues or expenses of second company
Business Terms	N/A	N/A	Market	Market
Officer/Employee Interlocks	N/A	No more than 1 interlock; never CEO	No more than 1 interlock; never CEO	No interlocks
Contractual Powers	No management agreement	No limiting contractual rights	No limiting contractual rights	No limiting contractual rights
Proxy Contests (directors)	N/A	N/A	No soliciting proxies to replace more than permitted directors	No soliciting proxies to replace more than permitted directors
Total Equity	BHCs – less than 1/3 SLHCs – 25% or less	BHCs – less than 1/3 SLHCs – 25% or less	BHCs – less than 1/3 SLHCs – 25% or less	BHCs – less than 1/3 SLHCs – 25% or less

Investment Model –
Presumptions of Control – Business Relationships

- Key issue for industry participants in the lead-up to the final regulation, and attracted many public comments
- Concern about Board's historical approach was particularly acute in the context of BHC investments in fintech and other startup companies
- The final regulations reflect a compromise position:
  - Less than 5% voting shareholders: No possibility of a presumption of control based on business relationships where an investor holds less than 5% of a class of voting shares of an investee company
  - 5%-24.99% voting shareholders: Board rejected industry requests for relief, maintaining caps ranging from just 2% of annual revenue or expenses of an investee company (more restrictive than prior policy) up to 10% of annual revenues or expenses

Investment Model – Presumptions of Control – Contractual Rights

- Similar to business relationships factor, a less-than-5% voting shareholder will not be subject to any presumption of control based on "limiting contractual rights"
- 5%-24.99% voting shareholders, on the other hand, will be subject to a presumption of control based on just a single limiting contractual right
- Many rights designated as limiting contractual rights are standard minority investor and creditor protections
- The upshot of the final regulations is that a BHC investor that holds virtually any contractual rights other than those consistent with a "non-voting security" under Regulation Y will need to be in the less-than-5% voting category

Investment Model – Presumptions of Control

- The Board "generally does not expect to find that a company controls another company unless the first company triggers a regulatory presumption of control with respect to the second company."
- However, these are only "presumptions" – Board retains discretion to make a control determination based on the particular facts and circumstances of a given relationship.
- Extent to which industry participants—BHC investors and fintech investee companies—can rely on presumptions with confidence will be tested after the Final Rule takes effect

Investment Model – Conclusions

- BHC equity investments in fintechs can be a significant and mutually beneficial add-on to contractual relationship
- Careful consideration required by both parties to develop optimal structure and terms so that regulatory treatment facilitates business objectives
- Final regulation on controlling influence provides greater legal certainty and less regulatory risk than in the past for minority investments
- Heightened incentives for BHC investors to rely on 4(c)(6) authority (less than 5% voting) when it has other relationships with the fintech
- If the parties are seeking a more substantial relationship, need to consider key aspects of control: activities restrictions; governance, compliance, and risk management infrastructure; cultural "fit" with the regulated entity

ATTORNEY BIOGRAPHIES

Charles M. Horn

Washington, DC

T +1.202.739.5951

F +1.202.739.3001

charles.horn@morganlewis.com

Charles M. Horn counsels US and international banks and other financial institutions on corporate, regulatory, supervisory, enforcement, and compliance matters before all major federal and state financial regulatory agencies. He advises clients on major federal financial services statutes and regulations, as well as on US and international financial reform developments. Charles also counsels banks and other financial services firms on issues affecting their governance, structure, management, and operations.

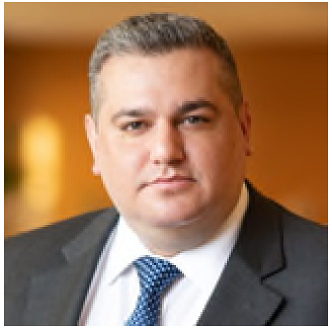
Charles represents clients before the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), the Federal Reserve Board of Governors, and the Consumer Financial Protection Bureau (CFPB), among other agencies. He also counsels clients on financial institutions laws that include the National Bank Act, the Bank Holding Company Act, the Federal Reserve Act, the Federal Deposit Insurance Act, the International Banking Act, and the Dodd–Frank Wall Street Reform and Consumer Protection Act. Additionally, he guides clients on global regulatory capital requirements and key state banking law requirements.

Clients seek Charles's advice on matters relating to their corporate, institutional, and retail business activities, as well as their asset management, fiduciary, and asset administration products and services. He has experience developing new capital markets, treasury and cash management, asset and wealth management, asset allocation, and other financial products and services.

He also assists financial services clients throughout the banking, securities, and insurance sectors on corporate and business expansion matters. These include mergers and acquisitions, business integrations, strategic alliances, and third–party vendor relationships. Charles represents financial institutions in regulatory enforcement and compliance matters before federal and state financial institutions regulatory agencies.

Before joining Morgan Lewis, Charles was a partner in the financial services practice of another international law firm. Prior to entering private practice, he held several positions in the Securities and Corporate Practices Division of the OCC and with the US Securities and Exchange Commission (SEC).

Donald S. Waack



Washington, DC

T +1.202.739.5277

F +1.202.739.3001

donald.waack@morganlewis.com

Donald S. Waack counsels globally active financial services firms on their most challenging regulatory, transactional, and enforcement matters. He devotes the majority of his practice to advising banks, bank holding companies, and other financial institutions on complex strategic and regulatory matters, including regulatory control determinations; investment authority issues and activities restrictions; fund formation; fintech partnerships and investments; regulatory capital; affiliate transactions; vendor management issues; and proprietary trading and private fund restrictions arising under the Volcker Rule. He is regarded as having a "strong reputation in the market across a range of … Dodd-Frank compliance work, as well as [on] M&A activity." (*The Legal 500 US*, 2019)

Don also assists financial services clients with structuring significant investments and provides strategic advice and regulatory support for mergers and acquisitions and other complex transactions. He also counsels hedge funds, private equity funds, and other firms regarding investments in the commercial banking sector and transactions with banks and other regulated counterparties. In connection with his regulatory counseling practice, Don works frequently with the staffs of the major federal and state bank regulatory agencies.

Don also advises domestic and non-US financial services firms in connection with sensitive internal investigations and similar matters. He counsels financial services clients on internal regulatory compliance reviews and has represented clients in connection with a broad range of regulatory inquiries and investigations, including federal and state enforcement matters.

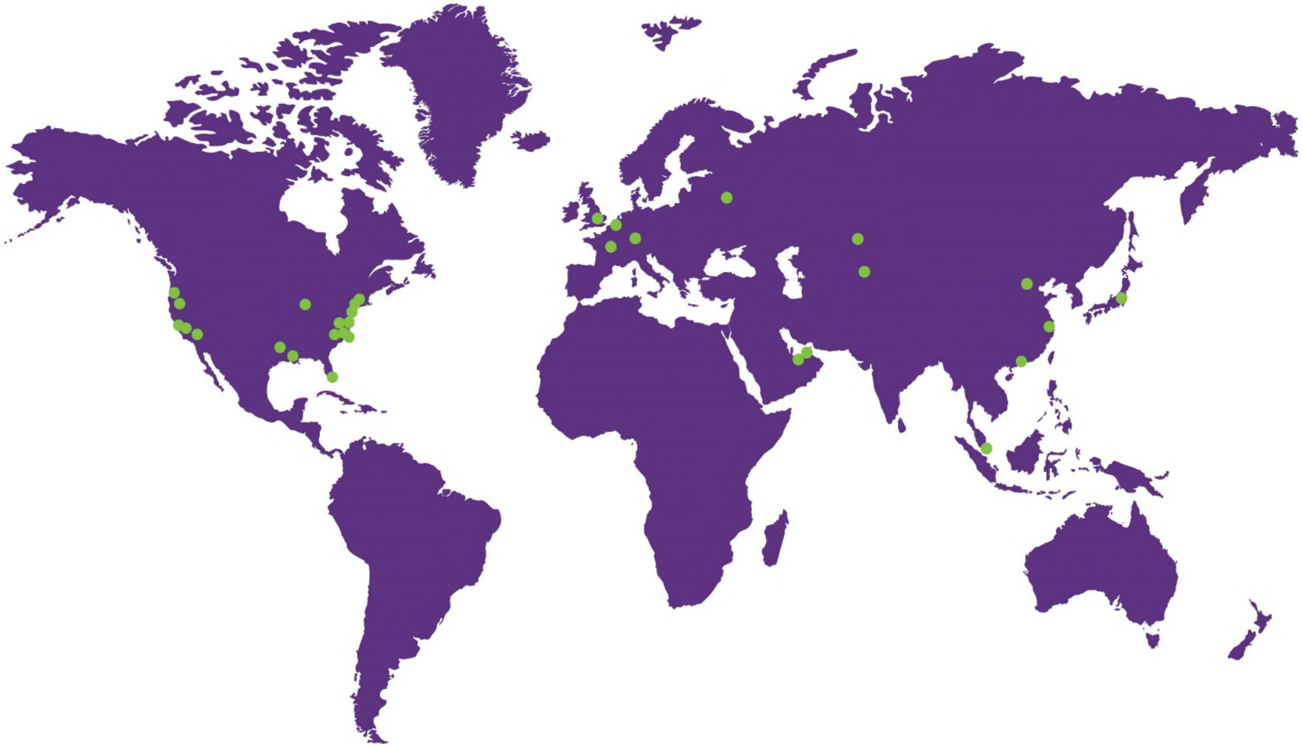
Before joining Morgan Lewis, Don was a partner at another global law firm.

Our Global Reach

Africa
Asia Pacific
Europe
Latin America
Middle East
North America

Our Locations

Abu Dhabi
Almaty
Beijing*
Boston
Brussels
Century City
Chicago
Dallas
Dubai
Frankfurt
Hartford
Hong Kong*
Houston
London
Los Angeles
Miami
Moscow
New York
Nur-Sultan
Orange County
Paris
Philadelphia
Pittsburgh
Princeton
San Francisco
Shanghai*
Silicon Valley
Singapore*
Tokyo
Washington, DC
Wilmington



Morgan Lewis

*Our Beijing and Shanghai offices operate as representative offices of Morgan, Lewis & Bockius LLP. In Hong Kong, Morgan Lewis operates through Morgan, Lewis & Bockius, which is a separate Hong Kong general partnership registered with The Law Society of Hong Kong as a registered foreign law firm operating in Association with Luk & Partners. Morgan Lewis Stamford LLC is a Singapore law corporation affiliated with Morgan, Lewis & Bockius LLP.

THANK YOU