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John L. Douglas

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BANKING ORGANIZATIONS: STRUCTURAL
AND OTHER CONSIDERATIONS INVOLVING
NON-BANKING ACTIVITIES

JOHN L. DOUGLAS

INTRODUCTION

As banking organizations address the future, they find an incredible need to maximize the value of the customer relationship. This leads to the exploration of additional products and services that can be funneled through the existing distribution system, as well as the exploration of alternative delivery systems that can more efficiently and effectively deliver products and services.

As banks undertake this effort, the existing bank regulatory structure does not easily resolve the issues presented. The difficulties associated with the delivery of securities products have lasted for almost twenty years, and still have not been adequately addressed. Bank insurance issues have been to the Supreme Court twice in the last twenty-four months.

Everyone is talking about, and many are actually grappling with, the issues associated with such relatively esoteric items as banking on the Internet, smart cards, electronic cash, and digital signatures. Banks and lawyers alike are attempting to apply statutory and regulatory principles to these new technologies, with decidedly uncertain results. Lines that may have previously seemed bright in the past in terms of permissible activities, disclosure requirements or possible structures for specific activities appear not quite so bright today.

One of the critical issues in addressing new technologies arises because of the need to involve non-bank participants in the effort to deliver products and services. Either the non-bank is better able to deliver the product in a specific way, or the non-bank has a particular product that the bank wishes to run through the bank delivery system. In either event, issues arise regarding permissibility: the extent to which direct investment is permissible, structuring that investment,

† Partner, Alston & Bird, Atlanta, Georgia; B.A., 1972, Davidson College; J.D., 1977, University of Georgia. Mr. Douglas is a former General Counsel to the Federal Deposit Insurance Corporation.
dealing with incidental impermissible activities, and so on predomi-
nate.

This outline is an attempt to provide a framework for addressing
many of the legal issues that arise from the combination of non-
banking providers with banking organizations. It begins with an ele-
mentary discussion of where specific types of activities may be placed
in the bank structure, then focuses more specifically on particular is-
ues arising with various types of combinations and arrangements.

I. NON-BANKING ACTIVITIES—GENERAL CONSIDERATIONS

While addressing bank structure has relatively mild complexities,
addressing the structuring on non-banking activities can be even
more daunting. The array of structural alternatives is vast, and the
regulatory framework can be incredibly complex. This portion of the
outline moves through the basic alternatives: in the bank or out of the
bank and in a holding company subsidiary or in a bank subsidiary.
The issues become more complex, and frankly, more interesting,
when the prospect of joint ownership is introduced. Accordingly, a
separate section is devoted to joint ventures and other structures with
bank and non-bank participants.

An introductory caution: in speaking of non-banking activities,
in general terms we are speaking of activities that are very closely
related to the business of banking. With two significant exceptions,
banking organizations are limited in their activities to those that are
financial in nature or which are integral parts of their operations.
The major exceptions are the subsidiaries of state chartered banks,
where state law may allow great flexibility in investments and activi-
ties (subject to the FDIC's oversight under Section 24 of the FDI
Act),¹ and the activities of unitary thrift holding companies which, so
long as their thrift subsidiaries meet the QTL test, may either directly
or through non-thrift subsidiaries engage in any activity without re-
striction.²

A. In the Bank or Outside the Bank

Virtually any activity in which a bank engages other than deposit
taking can be conducted outside the bank. Clearly, any activity
(other than deposit taking) that can be conducted in a bank may be

². A discussion of the unitary thrift charter is not contained in this outline. This
outline is part of a much broader outline prepared by the author called “Structuring the
Bank,” and is available on request.
conducted in a subsidiary of that bank. Conversely, almost any activity conducted by a bank holding company, bank holding company subsidiary or bank subsidiary can be conducted within a bank. Determining whether or not to conduct an activity outside the bank, then, generally depends not on the nature of the activity but other factors.

1. Why an Activity Might Be Moved Outside the Bank

a. Location

Banks are restricted in the locations in which they operate. Accordingly, if an activity must be conducted at a location other than a place where a bank may branch or establish a facility, consideration must be given as to whether the activity might constitute impermissible branching, and thus to moving the activity outside the bank.

b. Licensing

Certain activities require special licenses or approvals, and may subject the entity to examination or supervision. For instance, insurance agency operations, or credit life underwriting, may be licensed and supervised by the state insurance commissioner. Banks may resist opening the institution to supervision or regulation by a party other than the bank regulator, and may wish to house these operations in separate corporate entities.

c. Potential Liabilities

Certain activities may expose the bank to unacceptable risks, even though they could be conducted within the bank. Common examples are real estate holdings, which may include not only foreclosed properties but the bank's own facilities. Claims that result from the ownership or operation of properties or other businesses outside the scope of the bank's core business may be moved outside the bank to protect the institution.

d. Tax Considerations

Certain activities are better conducted outside the bank for tax purposes. For instance, certain states grant favorable tax treatment to "wholesale" institutions. Others provide special incentives for captive insurance operations, credit card operations, data processing, or other types of activities.
e. Marketplace and Positioning

While there may be little validity to the perception, on occasion certain activities perhaps should best be conducted outside the bank because of fear of being tainted by the general reputation of banks in certain areas. For example, many banks are conducting investment advisory activities outside the bank’s trust department for fear that the stodgy reputation of trust departments may interfere with attracting funds from wealthy clients.

f. Management and Personnel Issues

Certain activities may be best conducted outside the traditional bank hierarchy so as to not interfere with the more entrepreneurial nature of certain activities. Compensation concerns may result in shifting highly commissioned salespeople out of the bank in order to avoid jealousies or salary complaints.

g. Need to Involve Third Parties as Participants in an Activity

On many occasions the success of a particular venture or activity depends on the successful involvement of third parties that may require equity interests in the venture. It may be difficult to structure such participation within the bank, or the venture may create certain liabilities or risks as described above. Creating a separate entity can facilitate both the equity participation of the third party and potentially lessen liability or other risks.

h. Regulatory Pressure

On occasion the regulators prefer that activities be conducted outside the bank based primarily upon their perceptions of risk and propriety.

2. Keeping an Activity in the Bank

One of the primary reasons activities are moved outside a bank is because if the activity were conducted in the bank, the office at which the activity is conducted would be considered a branch. Even with the expanded branching authority contained in Riegle-Neal, banks do not have unlimited authority to conduct their activities nationwide. The issue is whether conducting the activity in an office transforms that office into a branch.

The definition of a branch may vary. The traditional definition is that a branch is an office owned or leased by a bank at which deposits are accepted or loans approved.\(^4\) As the acceptance of deposits is the essence of a bank, and probably constitutes “conducting a banking business” under the laws of most jurisdictions, it is extremely unlikely that deposit taking activities could be conducted from a location that is not a bank branch.\(^5\) On the other hand, lending activities can often be structured so that no impermissible banking activities are conducted at the office.

The OCC has given substantial guidance on when an office becomes a branch. Under its loan production office (LPO) rulings, an office may solicit loans, accept applications, and otherwise assist in the closing of a loan so long as it does not either approve the loan or actually close the loan and disburse proceeds.\(^6\) With advances in technology, transmitting completed loan packages to a bank branch for final approval is only a slight inconvenience, and unless the funds need to be delivered personally to the customer at the office, using mail, wire transfers, or the offices of a third party can accomplish the desired result.

Similarly, the OCC has ruled that an office that is not accessible to the public, and thus provides no competitive advantage, is not a branch.\(^7\) Accordingly, a back office might be set up to support non-banking activities that could facilitate the activities and still not constitute a branch. An example might be a processing center, where applications are received, analyzed and approved, and which could coordinate loan closings and the like.

State laws need to be consulted. Most states have prohibitions on conducting a banking business. Those prohibitions may key on things other than merely accepting deposits or approving loans. States often have representative office, loan production, or deposit production statutes. A national bank might be able to ignore certain of these statutes on the grounds of preemption, however, a state bank would not.

\(^4\) See 12 C.F.R. § 5.30(b) (1996).
\(^6\) See 12 C.F.R. § 7.7310 (1996); see also Banking Circular 199.
B. In a Bank Subsidiary or a Bank Holding Company Subsidiary

Once the decision is made to move an activity outside the bank, there are two basic choices: (1) the activity will be placed below the bank, in a bank subsidiary, or (2) it will be placed in a bank holding company subsidiary. If the activity is to be housed in a bank subsidiary, it can either be in a bank operating subsidiary or a bank service corporation subsidiary.

1. The Bank Holding Company Subsidiary

The Bank Holding Company Act of 1956, as amended (the BHCA), grants the Federal Reserve Board the authority to supervise and regulate the activities of bank holding companies and their subsidiaries. Importantly, the BHCA imposes strict limits on the ability of a bank holding company to engage in activities, either directly or through a subsidiary, by limiting the activities of a bank holding company to those of banking, or of managing or controlling banks, or so closely related to the business of banking or of managing or controlling banks as to be a proper incident thereto.

In order to establish or acquire a non-bank subsidiary, a bank holding company must comply with the requirements of the BHCA as implemented by the Federal Reserve in its Regulation Y. The activity must either be one of the statutory or regulatory activities already deemed by the Federal Reserve to be permissible, or the applicant must obtain a specific determination of permissibility from the Federal Reserve.

Certain types of activities may be undertaken without notice to or approval from the Federal Reserve. These activities include performing services for the bank holding company or its affiliates, engaging in the safe deposit business, fiduciary investments, securities eligible for investment by a national bank, securities representing less than 5% of the shares of any company, shares of an investment company that does not own more than 5% of the outstanding shares of any company, and certain acquisitions to engage in activities for which approval has already been obtained.

Regulation Y contains a list of additional permissible activities. For the listed activities, prior notice must be given to the Federal Reserve and approval must be obtained prior to commencing the activity or acquiring an entity engaged in the activity. There are ex-

pedited procedures for small acquisitions.¹⁰

Importantly, the Federal Reserve has proposed revisions to its Regulation Y governing non-banking activities of bank holding companies. The proposal, published for comment in September 1996, would substantially streamline the approval process, particularly for well capitalized institutions. These proposed revisions were affected by sections of the regulatory relief provisions contained in the 1996 budget legislation, providing similar relief for well capitalized, well managed institutions engaging in small acquisitions.

2. The Bank Operating Subsidiary

Both the Comptroller of the Currency and every state regulator will permit a bank to establish an operating subsidiary. An operating subsidiary is a subsidiary of the bank established to engage in activities which the bank itself could engage in directly. The decision to engage in bank-permissible activities through subsidiaries is viewed as a corporate and strategic decision. While banks do conduct a wide variety of fairly mundane activities through operating subsidiaries, they have become the vehicles for some of the most interesting developments in the expansion of products and services, particularly joint activities with non-bank entities.

Establishing an operating subsidiary generally requires the approval of the bank's chartering authority, either the OCC for national banks or the state for state banks. There is no separate approval required from the Federal Reserve or the FDIC for a state bank to establish an operating subsidiary.

The OCC has recently revised its rules for establishing operating subsidiaries in part 5 of its regulations. The regulation previously required that the parent bank own at least 80% of the voting stock of the subsidiary. That requirement has been reduced to 50%. The revision provides that certain types of activities may be conducted in subsidiaries without the need for any notice to the OCC. An after the fact notice is sufficient for well capitalized, well managed institutions. Other banks must generally go through a notice or approval process, and this process will be applied to all banks with respect to certain types of activities. The OCC may condition its approval of an operating subsidiary.¹¹

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¹⁰. For a more complete list of permissible activities, see infra notes 18-41 and accompanying text.
No notice or approval from the OCC is required for an operating subsidiary if the activities are limited to those previously approved for an operating subsidiary of the bank, those activities continue to be legally permissible, and the activities are conducted in accordance with any previously imposed conditions.

The OCC's regulations generally require that the operating subsidiary must limit its activities to those permissible for the bank, and will be subject to the same examination and supervision as the parent bank. The revised regulations hold out the possibility that an operating subsidiary might not need to limit its activities precisely to those permissible for the bank, and indicate that the subsidiary need not necessarily be supervised and examined as a bank. Various orders of the OCC indicate that compliance even with the 50% requirement is not mandatory, and that various ventures are permissible through operating subsidiaries which, while not impermissible for a bank to engage in, are in practical terms unlikely to be subject to bank-like supervision and regulation.

The OCC's regulations speak in terms of subsidiary corporations. The OCC has approved a bank's participation in an operating subsidiary structured as a limited liability company, and has allowed a bank to be a limited partner in a partnership. The OCC cannot approve a bank becoming a general partner of a partnership, due to concerns relating to the unlimited liability of a partner, but the OCC has allowed a bank to establish a corporate subsidiary to serve as the general partner of a partnership.

Depending upon the activity, the OCC may impose limitations on a bank's investment in an operating subsidiary. Such limitations are typically imposed when the bank is engaging in activities perceived to be risky or where there is substantial participation by non-affiliated entities. “Investment” includes both the direct equity investment in the operating subsidiary, as well as any loans or extensions of credit to or for the benefit of the subsidiary. The common limitation is 5% of assets.

3. The Bank Service Corporation

Banks may also invest in bank service corporations, authorized by the Bank Service Corporation Act. A bank service corporation may only have insured banks as shareholders. It is a useful vehicle for a bank which is not a subsidiary of a bank holding company to

invest in non-banking activities, or for affiliated or non-affiliated banks to join together in various ventures.

There are three types of bank service corporations. The first is the true service corporation, one that only engages in back office services such as check and deposit sorting and other clerical, bookkeeping, accounting, or similar functions for other financial institutions. A bank may establish such a subsidiary without prior notice or approval.\(^4\)

The second type of service corporation is little different than an operating subsidiary. A bank may establish a service corporation to engage in activities permissible for its parent bank (or banks), so long as it engages only in activities permissible for its parent(s) at locations where its parent(s) could perform such services. In order to invest in such a service corporation, the bank must receive the approval of its primary federal regulator.\(^5\)

The third type of bank service corporation may engage in any activity the Federal Reserve Board has determined to be permissible for a bank holding company (other than deposit taking), and may do so at any geographic location. In order to invest in such a service corporation, the bank must receive the prior approval of the Federal Reserve.\(^6\)

A bank may not invest more than 10% of its capital in a bank service corporation, and may not invest more than 5% of its assets in all service corporations. As with the operating subsidiary, "invest" includes both equity investments and extensions of credit.\(^7\)

Because the powers of a bank are not substantially different from the permissible powers of a bank holding company, there are relatively rare occasions when a bank service corporation will be required. It does, however, have some attractiveness in unique situations.

4. Comparison of Powers

There is no major difference in the powers that may be conducted through a bank holding company subsidiary and a bank subsidiary. The Federal Reserve is the arbiter of the Bank Holding Company Act\(^18\) (the BHCA), which defines permissible bank holding

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15. See 12 U.S.C. §§ 1864 (c)-(e) and § 1865(a) (1994).
company powers, and through statute, regulation, and order, the list of activities is extensive. For the sake of simplicity, this portion of the outline will address only the BHCA-permissible powers. The OCC list of permissible powers and activities is virtually identical.

a. The Statutory List

The BHCA provides that a bank holding company may not own voting shares of any company, with the following significant exceptions:

- shares of a company engaged solely in holding or operating properties used by a bank subsidiary, in conducting a safe deposit business or furnishing or performing services for the bank holding company or its subsidiaries;¹⁹ shares of a company acquired in satisfaction of a debt previously contracted in good faith, subject to certain limitations relating to how long the shares may be held;²⁰ shares held in a fiduciary capacity;²¹ shares of the kinds and amount eligible for investment by national banks;²² shares which do not represent more than 5% of the voting shares of the company;²³ shares of any company which the Federal Reserve Board determines are engaged in activities so closely related to the business of banking or of managing or controlling banks as to be a proper incident thereto;²⁴ shares of a company which conducts no business in the United States except as an incident to its international or foreign business if the Board determines that the exemption would not be in variance with the purposes of the BHCA and be in the public interest;²⁵ shares of an export trading company, subject to certain limitations.²⁶

b. The Regulatory List

The Federal Reserve has by regulation set forth those non-banking activities which it is prepared to approve on a routine basis. The list, contained in section 225.25 of title 12 of the Code of Federal Regulations is long and detailed, but there are many significant authorities. These authorities include making and servicing loans, including consumer finance, credit card, mortgage, commercial fi-

¹⁹. See § 4(c)(1).
²⁰. See § 4(c)(2).
²¹. See § 4(c)(4).
²². See § 4(c)(5).
²³. See § 4(c)(6).
²⁴. See § 4(c)(8).
²⁵. See § 4(c)(13).
²⁶. See § 4(c)(14).
nance or factoring; performing trust company functions; or acting as an investment or financial advisor. In addition, these authorities include engaging in certain leasing activities of real or personal property, subject to limitations designed to assure that the leasing is roughly equivalent to financing; engaging in data processing activities that are financial, banking or economic, and in connection therewith, providing hardware subject to limitations; engaging in credit life and equivalent insurance underwriting, insurance agency activities in towns of less than 5,000 (although unlike the OCC, the Federal Reserve limits the agency activities to residents of the small town), and certain other limited insurance activities; operating a savings association; providing courier services; management consulting to depository institutions, or selling money orders, savings bonds or travelers checks; providing real and personal property appraisal services and arranging real estate equity financing, although real estate brokerage is not permitted; engaging in a wide variety of securities activities, including brokerage, underwriting and dealing in government obligations and money market instruments, providing foreign exchange advisory and transactional services, serving as a futures commission merchant, and providing investment advice on financial futures and options; providing consumer credit counseling, engaging in tax planning and preparation, providing check guarantee services, or operating a collection agency or a credit bureau.

The Federal Reserve has proposed revisions to Regulation Y that would update and modernize the provisions, bringing them into general conformity with past orders and current board thinking. Important procedural revisions are contemplated, including granting the Board authority to add new activities to the list on its own initiative.

creating a less formal process where an institution could obtain rulings on the permissibility of additional activities, and adding greater flexibility particularly in the management consulting and data processing areas.

c. The Order List

There is no easily accessible list of powers approved by the Federal Reserve under its discretionary authority. In each instance, the approvals have been for activities that are "so closely related to the business of banking or of managing or controlling banks as to be a proper incident thereto." The majority are simply modest extensions of the listed powers rather than groundbreaking new activities. The major exceptions are the securities underwriting powers of the so-called "Section 20" subsidiaries.

Under Section 20 of the Glass-Steagall Act, banks may not affiliate with entities that are principally engaged in underwriting or distributing securities impermissible for national banks. The Federal Reserve has interpreted this provision by stating that a company otherwise engaged in the securities business is not principally engaged in impermissible activities so long as its underwriting and distribution of the bank ineligible securities does not amount to more than 10% of its total securities revenues.

All of the Section 20 authorities have been granted by order of the Board, each with substantial conditions attached to protect the holding company and any affiliated bank from dangers that might result from the securities activities.

5. Regulatory Jurisdiction

In simple terms, where an activity is placed in the structure will determine who regulates the activity. If the activity is conducted in the bank or a bank subsidiary, the bank's regulator regulates. If the activity is conducted in a bank holding company subsidiary, the Federal Reserve regulates. Moving the activity outside the bank may require registration, and thus supervision and regulation, by other regulatory bodies other than the bank regulators. For example, a securities brokerage activity conducted outside the bank will require registrations with the Securities and Exchange Commission and the National Association of Securities Dealers, and supervision by those bodies, while maintaining those activities within the bank avoids such requirements.

The Federal Reserve's Regulation Y states that a bank subsidiary of a bank holding company must comply with the Regulation Y requirements if an activity is conducted in a subsidiary that is not wholly owned or whose activities are not limited to those permissible for the bank itself. This assertion of jurisdiction appears inconsistent with the regulatory structure itself, which would leave regulation of the bank and its activities, either directly or through subsidiaries, to the bank's regulators, while leaving regulation of the bank holding company and its activities, either directly or through non-bank subsidiaries, to the Federal Reserve.

In *Citicorp v. Board of Governors*, the issue was squarely joined. Delaware had adopted a law which provided state banks with the authority to underwrite and broker insurance, provided the activities were either conducted in a separate division of the bank or in a bank subsidiary. The law contained elaborate provisions (regarding the requirements to engage in insurance activities), designed to separate the banking and insurance activities and assure that neither would be adversely affected if either ran into difficulties.

The Federal Reserve challenged the activity, on the basis that its jurisdiction extended to non-bank subsidiaries of banks whenever the subsidiary was engaging in an activity impermissible for the bank to engage in. The Board believed that this was an evasion of its jurisdiction, and sought to stop this type of state action.

The Second Circuit reviewed the relevant provisions of the BHCA and other statutes governing the supervision of banks and bank holding companies, and determined that the appropriate jurisdictions of the regulators would be as follows: whoever regulates the bank will regulate subsidiaries of the bank. Therefore, since the Federal Reserve regulates bank holding companies and non-bank subsidiaries of bank holding companies. The court determined that this allocation of responsibilities was rational, avoided conflicts and comported with reasonable expectations of the parties.

While the Federal Reserve has not amended its Regulation Y to comport with the *Citicorp* decision, we are unaware of the Federal Reserve attempting to challenge a bank or bank subsidiary on the basis of the Regulation Y provision following the *Citicorp* ruling.

6. Funding and Sections 23A and B

Selecting whether to place an activity in a bank subsidiary or a bank holding company subsidiary results in a major difference in how the activity may be funded. If a bank subsidiary is used, the bank may fund the activity directly, subject only to limitations as to the aggregate investment in the subsidiary. If a bank holding company subsidiary is used, the bank's ability to fund the affiliate will be constrained by Sections 23A and B of the Federal Reserve Act.

Sections 23A and B of the Federal Reserve Act impose stringent limits on the ability of a bank to engage in "covered transactions" with its "affiliates." An affiliate is any entity that controls the bank or is under common control with the bank. A bank holding company is an affiliate of its subsidiary bank, as are most non-bank subsidiaries of a bank holding company. A subsidiary of the bank, however, is not an affiliate of the bank, nor is another bank subsidiary of the parent bank holding company. Accordingly, a bank may engage in transactions with its own subsidiaries or with sister bank subsidiaries of its parent bank holding company free of the restrictions of Section 23A.

A covered transaction is an extension of credit to the affiliate, the purchase or investment in securities issued by the affiliate, the purchase of assets from the affiliate, the acceptance of securities issued by the affiliate as collateral for a loan or extension of credit to any person or company, or the issuance of a guarantee, acceptance or letter of credit on behalf of the affiliate.

Section 23A imposes a limit on transactions with an affiliate of 10% of the bank's capital and surplus, and an aggregate limit on transactions with all affiliates of 20% of the bank's capital and surplus.

Any loan or extension of credit to, or guarantee or letter of credit issued on behalf of, an affiliate must be secured by government securities, or a segregated deposit or equivalent equal to 100% of the exposure, or obligations of a state or political subdivision equal to 110% of the exposure, or other debt instruments, including receivables, equal to 120% of the exposure, or stock, leases, or other real or personal property equal to 130% of the exposure. Low quality assets are not eligible for collateral, nor are securities issued by an affiliate.

Any transaction with an affiliate must be on terms and conditions that are consistent with safe and sound banking practices, and must be on terms and conditions that are substantially the same as, or at least as favorable to the bank, as those prevailing for non-affiliated transactions. 48

Both the absolute limits on the amount of credit that may be extended to an affiliate and the collateralization requirements mean that the bank may not be the best source of funding for the operations of the affiliate. Accordingly, for bank holding company subsidiaries, in addition to limited funding from an affiliated bank, the subsidiary must look to the holding company or other third parties for funds. And while there are limits on the ability of a bank to fund its own subsidiaries (many imposed by order, not statute), there are no collateral requirements, and thus much greater ease of funding.

7. Differences in Application/Notice/Approval Procedures

In selecting a location for a particular activity in a banking organization, there are certain differences in the approval process. These differences are relatively slight; however, in certain circumstances, these slight differences may be critical.

a. The Bank Holding Company Subsidiary

Under Regulation Y, a bank holding company that wishes to commence de novo an activity listed as permissible in Regulation Y must provide the Federal Reserve Bank with a notice detailing the activities, the identity of the company that will conduct the activities, and if done through a subsidiary, the identity of the subsidiary. For acquisitions of existing companies, the notice must also provide certain financial, competitive and expected public benefits information. Public notice and a comment period are provided. The Reserve Bank has thirty days after receipt of a completed notice to approve the request or to defer it to Washington for Board action. If sent to Washington, the Board attempts to act within sixty days of initial submission of the notice. 49

For unlisted activities, the procedure is similar, although the notice must also contain an analysis of why the activity is so closely related to banking as to be a proper incident thereto. The company must also commit to comply with all conditions or limitations previ-
ously imposed by the Board in connection with the activity. In all such cases, the final approval will come from the Reserve Board in Washington, rather than through one of the Reserve Banks.

The Board has an expedited notice procedure for acquisitions of small businesses where the book value or acquisition costs do not exceed the greater of $15 million or 5% of the consolidated assets of the acquirer, up to a maximum of $300 million. If the activity is listed in Section 4(c)(8), the applicant has previously received Board approval for the activity, and the applicant meets all required capital levels, the public comment period is shortened to ten days and the Reserve Bank is to act within fifteen days.\textsuperscript{50}

For acquisitions of companies engaged in making, acquiring or servicing consumer loans, no application is required if the acquirer has already received approval to engage in the activity in the area served, the assets acquired during any twelve month period do not exceed the lesser of $25 million or 25% of consolidated assets, no more than 50% of the acquirer's assets are devoted to the activity and the acquirer meets capital adequacy guidelines. Notice within thirty days following the acquisition is required.\textsuperscript{51}

b. Bank Operating Subsidiaries

The procedure for establishing a bank operating subsidiary is somewhat similar. For a national bank, the bank must notify the OCC for the district in which it is located, providing information regarding the activity, the location, and relevant financial information. Unless otherwise notified, the bank may commence the activity following the expiration of the thirty-day period.\textsuperscript{52}

If the activities of an operating subsidiary are limited to activities previously allowed by the OCC for that bank, they continue to be permissible, and will be operated in accordance with any previously imposed conditions applicable to the bank, no prior notification is required.\textsuperscript{53}

c. Bank Service Corporation

Each regulatory agency has its own procedures for obtaining approval for a bank operating subsidiary. The OCC requires a letter

\textsuperscript{50} See 12 C.F.R. § 225.23(e) (1995).
application to the district office, with basic financial and related data
demonstrating, among other things, compliance with the limitations
and requirements of the Bank Service Corporation Act. The OCC
may require certain applicants to provide information relating to fi-
nancial, managerial, or other supervisory concerns. In general, the
OCC will render a decision on completed applications within ninety
days of submission.54

8. Activities Required To Be in a BHC Subsidiary

While the lists of activities that may be conducted in either a
bank subsidiary or a bank holding company subsidiary are virtually
identical, there are some exceptions.

a. Equity Interests of Less than 5%

Banks generally are not permitted to make equity investments. Under Section 4(c)(6) of the BHCA, a bank holding company may
own shares of any company which do not represent more than 5% of
the outstanding voting shares of the company.55 These less than 5%
investments must be passive in nature, and cannot be combined with
other interests in the company so as to give the bank holding com-
pany the power to elect a majority of the board of directors or
otherwise exert a controlling influence over the management or poli-
cies of the company. With these exceptions, however, a bank holding
company or subsidiary may own minority interests in any entity, in
either voting (less than 5% of the class) or non-voting (less than 25%
of the total equity) shares. Banks generally cannot own equity inter-
ests.

One alternative in this area is the small business investment
company (SBIC), a permissible investment for both national banks
and bank holding companies.56 SBICs, in turn, may hold non-
controlling (i.e., less than 50%) equity investments in small busi-
nesses. A variation of the SBIC is the MESBIC, the minority
enterprise small business investment corporation, providing a vehicle
for investing in small minority and women-owned businesses.

b. Certain Securities Activities

The Glass-Steagall Act prohibits a bank from engaging in certain
securities activities. However, a member bank may affiliate with a

firm that is not principally engaged in impermissible securities activities. As discussed above, this so-called Section 20 power allows a bank holding company to create a subsidiary to engage to a limited extent, in underwriting and dealing in bank ineligible securities, something that would not be permitted for either a Federal Reserve member bank (which would include a national bank) or for a subsidiary of a member bank.

The Federal Reserve, in carrying out its supervisory function of bank holding companies, will strongly discourage a state bank subsidiary of a bank holding company from engaging in securities activities outside the bounds of those permitted bank holding company subsidiaries, even if permitted under state law. While the Federal Reserve lacks the authority to enforce such a prohibition, its position as regulator provides strong incentive for a bank to cooperate.

On the other hand, the prohibitions of Section 20 of the Glass-Steagall Act does not reach non-member banks. Accordingly, those state banks that are not part of a holding company system or otherwise affiliated with national banks may permissibly establish securities subsidiaries to the full extent permitted by state law.

II. SPECIAL CONSIDERATIONS IN NON-BANKING ACTIVITIES

The preceding section addressed the various considerations affecting the structural choices with respect to non-banking activities. This section will address particular, peculiar issues associated with those activities.

A. Joint Ventures

Often with respect to non-banking activities, there is a compelling need to involve another participant. That need may result from lack of expertise or management skills, need for capital, increased geographic breadth, or special marketing or positioning considerations. Often joint ventures are undertaken to limit risks, to allow participants to pool resources to enter new endeavors, but without necessarily exposing one single entity to the entire risk of loss if the endeavor fails.

Regardless of the nature of the other participants, the activity may be housed in either a bank or bank holding company subsidiary. As a general rule, joint venture-type activity may not be conducted directly in the bank, as the regulatory authorities frown on exposing the bank to potential liabilities resulting from these ventures.
1. The BHC Subsidiary and Joint Ventures

Of all the possible structures, the bank holding company subsidiary is perhaps the easiest to accommodate to the joint venture. Under Section 4 of the BHCA, the Federal Reserve is required to approve voting investments of greater than 5% in any entity; the clear implication is that the investment need not be a majority or controlling investment. Indeed, the Federal Reserve Orders dealing with participating in activities with other entities regularly involve less than majority positions.

The Federal Reserve does require that the venture limit its activities to those permissible for bank holding companies and their subsidiaries. It reserves the right to examine the activities of the venture, and will in fact do so on a routine basis.

The Federal Reserve has approved ventures involving multiple participants structured as partnerships, limited partnerships, corporations or joint ventures under state law.

The Board has a series of concerns with respect to joint ventures that have been reflected in its orders over time. These concerns include the following:

The Board wants to be sure that participants in a venture otherwise engaged in impermissible activities do not use the venture to allow the bank holding company to engage in the impermissible activities. Accordingly, the Board will often impose a series of commitments designed to assure that the venture will be kept separate from the activities of the other participants. Such conditions are common in joint ventures with securities firms, for instance, where specific types of management interlocks may be prohibited, joint employees may be restricted, or physical separation of offices may be required. The Board may require a commitment on the part of the bank holding company to divest its interest in the venture on request of the Board.

When a non-bank venturer has control over the venture, the Board has two concerns. First, the Board believes that it has the right to supervise and examine all non-bank subsidiaries of a bank holding company. Such supervision may be seen as intrusive by non-regulated entities. Second, the Board wants to assure that the venture continues to engage only in permissible activities.

The Board is occasionally concerned where the participants in joint ventures are very large or the activities are to be extensive, that

the venture may result in an undue concentration of resources. In Deutsche Bank/Fiat Credit, such a joint venture was disapproved, even though the venture was strictly limited to otherwise permissible activities. On the other hand, the Board recently approved a joint venture between Wells Fargo and Nikko Securities in 1990, relating to trust and investment management services, and in 1983 approved a joint venture between Citicorp and Harrison Credit Corp., a large company engaged in the manufacture of farm equipment.

The Board has on occasion determined that a bank holding company should limit its exposure in a joint venture, and has disapproved certain ventures where it has determined that the investment in a single venture or group of ventures is too great.

Notwithstanding the concerns that have been expressed in various orders, the Board has routinely approved joint ventures in virtually every area: data processing, trust activities, investment advisory services, mortgage banking, financing and leasing activities, ATM services, travelers checks, municipal securities brokerage, merchant credit card processing, and holding real property obtained through or in lieu of foreclosure.

The Federal Reserve in the past required responses to a specific set of questions if a 4(c)(8) application involves a joint venture. The questions reflected many of the concerns expressed above. For example, the applicant was required to describe whether the parties could each engage in the application independently and indicate why the joint venture was being formed. The applicant was required to state the actions to be taken to inform customers that they were not required to take services offered by the joint venture. Certain questions addressed the issue of control, and required the applicant to indicate willingness to divest the interest in the venture the non-banking organization obtains control and the venture commences impermissible activities. Those general questions have been eliminated, although applicants seeking to form joint ventures should be prepared to address many of these concerns as part of the application.

58. See James McAfee, Deutsche Bank AG, Frankfurt, Germany, 67 FED. RESERVE BULL. No. 5 449 (1981).
2. Bank Operating Subsidiaries

The bank operating subsidiary, in spite of the apparent restrictions that appear from the OCC's operating subsidiary regulations, is an extraordinarily useful vehicle for structuring arrangements with non-bank providers. As noted above, the regulations appear to require that a bank own not less than 50% of the subsidiary, it appears that no such limitation is recognized in actual practice. The OCC has for several years approved a variety of subsidiary ventures where the actual ownership in the operating entity was much less than 50%.

The OCC has developed over the past two years reasonably straightforward ground rules for joint venture-type investments by banks. OCC precedents squarely demonstrate that the percentage ownership held by banks in the underlying venture is not relevant to the determination of permissibility. The OCC has approved a number of arrangements in the past through operating subsidiaries where the operating subsidiary's participation in a joint venture, partnership or corporation was less than 50%. The principal determination of permissibility relates to the nature of the activity itself. So long as the enterprise conforms its activities to those permissible to national banks, the banks retain the ability to prohibit impermissible activities, the OCC retains the supervisory power to examine the venture, the investment relates to the bank's ongoing business, and the bank does not become liable for the debts or obligations of the venture, the percentage ownership is immaterial.

The determining criteria are: first, whether the activity is permissible; second, whether the bank can limit the activities of the venture to those permissible for national banks; third, whether the bank's liability is limited from both an accounting and a legal perspective; and fourth, whether the investment is convenient or useful to the bank in carrying out its business, and not merely a passive investment unrelated to that bank's banking business.

Over the years, the OCC has permitted banks to form operating

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subsidiaries to engage in and carry out permissible activities. As long as the ownership is incidental to the banking business of the bank, and not a "speculative" investment of the bank, the prohibitions of Section 16 of the Glass-Steagall Act contained in section 24(Seventh) of title 12 of the United States Code relating to stock ownership simply do not apply. This view is consistent with an interpretive ruling of the OCC issued in 1966, declaring that Section 16 was not intended to prohibit, and did not impair, the ability of national banks to "acquire and hold stock in corporations as an incident to and to facilitate the banks' conduct of their banking business." 64 This analysis applies to minority stock purchases just as it applies to wholly owned operating subsidiaries. We note that in that same year, the OCC permitted a bank to acquire a minority interest in a credit card clearinghouse owned by a number of institutions. 65

The Comptroller has authorized similar arrangements for a wide variety of activities. For instance, the OCC has permitted national banks to make equity investments in a corporation operating a point of sale and ATM network; 66 in a corporation providing advice on the government securities market; 67 in a corporation affiliated with a captive insurer; 68 in a corporation providing services to participants in government securities markets; 69 and in a state chartered trust company. 70

The second requirement is that the bank have the ability to limit the venture to bank-permissible activities. In past letters, this requirement has been addressed in a number of ways. For instance, in partnerships, the partnership agreement can provide that the national bank retain a veto over new activities. This is a common requirement for partnerships. 71

While minority shareholders in a corporation do not possess a

64. 12 C.F.R. § 5.34 (1996).
70. See Letter from Stephen R. Steinbrink, Senior Deputy Comptroller OCC to Charles A. Neale (Nov. 15, 1995).
veto power as a matter of corporate law, there are other ways, principally by contract, of assuring that the entity does not engage in impermissible activities. A common requirement is that the articles of incorporation or bylaws limit the activities to those permissible for national banks. The OCC recently indicated that restricting activities through a shareholder’s agreement could also satisfy this requirement.

Banks normally satisfy the third requirement, that of limiting liability, through using the corporate structure for their operating subsidiaries. The corporate structure generally insulates the bank from liability or loss beyond its investment in the shares of the subsidiary.

Further, as minority investments in operating subsidiaries are generally unconsolidated subsidiaries of the Banks, the investment in the operating subsidiary would be reported under the equity method of accounting. This generally provides that losses in the subsidiary are limited to the amount of the investment (including extensions of credit or guarantees, if any, if shown on the investor’s books).

The final requirement, that the investment must be convenient or useful to the bank in carrying out its business, and not merely a passive investment unrelated to that bank’s banking business, requires that a distinction be drawn between investments consistent with the bank’s business and plans, as opposed to investments made because they are good investments. A presentation of the business reasons driving the bank to carry out its businesses through the subsidiary is required.

3. Bank Service Corporations as Joint Venture Participants

Banks have found that the bank service corporation may also be a useful vehicle for participating in joint ventures with other bank and non-bank parties. Under the statute, a bank service corporation may only be owned by one or more insured depository institutions. Even the participation of a non-banking subsidiary of a bank holding company in the direct ownership of a bank service corporation will destroy the character of the entity and may call into question the ability of the bank to participate through its service corporation.

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Accordingly, just as with the operating subsidiary, banks will structure the service corporation as a wholly owned subsidiary, or as a subsidiary owned solely by banks, and the operating subsidiary will then participate as a venturer in the venture, either as a partner in a partnership, shareholder in a corporation, or in some other similar capacity.

As noted above, there are three basic types of bank service corporations; the "back office" corporation, performing check sorting, posting and similar services for depository institutions, and for which no approval is required; the "bank permissible" corporation, engaging only in activities which the parent bank could engage, for which the approval of the bank's primary federal regulator is required, and the "4(c)(8)" corporation, engaging in BHCA permissible activities, and for which the approval of the Federal Reserve is required. Although the list of bank permissible and 4(c)(8) activities is virtually identical, there are occasions when it is easier and more appropriate to go to the Federal Reserve than the OCC, particularly when there are a number of bank participants operating under a number of different charters, and the venture will operate on a broad geographic basis.

Recently banks have used bank service corporations to engage in merchant credit card processing, trust activities and mortgage banking activities.75

4. The Use of LLC's, Limited Partnerships and the Like

The LLC has become a useful entity for banks in structuring joint ventures involving non-banking activities. A limited liability company (LLC) is a creature of state law, combining some of the advantages of the partnership form (primarily with respect to flow through tax treatment) with those of the corporate form (primarily limited liability). The law of LLCs is relatively new. Not all states have LLC statutes, and accordingly, there are still some unanswered questions regarding LLCs. On the other hand, because of the combination of flow through tax treatment and limited liability, the structure is uniquely suited to bank joint venture arrangements.

In general, a LLC has all of the flexibility of a partnership, in that the participants may by contract allocate equity, responsibilities, and governance issues. In order, however, to preserve both the part-

75. See Letter from Steven R. Steinbrink, Senior Deputy Comptroller OCC, to Charles A. Neale (Nov. 15, 1995).
nership tax treatment and the limited liability of a corporation, the LLC may not possess most of the following characteristics: continuity of life, centralized management, or free transferability of interests.\textsuperscript{56} While these characteristics are easily avoided in theory, in practice they may interfere with business expectations and objectives. For example, dissolution by operation of law under specific circumstances may interfere with the ability to obtain third party financing. Decentralized management may interfere with the business necessity of controlling decisions and eliminating meaningful participation by unqualified investors. Restricting transferability may interfere with the business objective of those participants desiring liquidity.

A bank holding company may invest in a LLC under the same terms and conditions as it may invest in a corporation. The OCC approved its first LLC investment for a bank in 1994,\textsuperscript{77} and has since approved several others.\textsuperscript{78} The criteria for investing in an LLC are: is the activity permissible; can the bank limit the activities of the LLC to those permissible for a bank or its operating subsidiaries; is liability limited from an accounting and legal perspective; and is the investment part of the banking business and not merely a passive investment. A recent Federal Reserve order relating to LLCs is the Integron order of December 1996, in which several banks were permitted to acquire interests in this bank processing joint venture.

Banks often choose partnerships or limited partnerships for non-banking activities, primarily due to the flow through nature of tax treatment. The partnership is not taxed, but the tax attributes of the entity are allocated among the partners in accordance with the partnership agreement.

While banks may not be general partners of a partnership,\textsuperscript{79} a bank may establish a limited liability entity such as a corporation that in turn may serve as the partner of a partnership.\textsuperscript{80} A bank may serve as a limited partner of a partnership, as liability for the debts and obligations of the partnership are limited. However, most banks choose

\textsuperscript{79} See Merchants' Nat'l Bank of Cincinnati v. Wehrmann, 202 U.S. 295 (1906).
to establish a corporation as an operating subsidiary to serve as a limited partner. Such an arrangement provides additional protection against the liabilities or obligations of the partnership, and is of slightly greater comfort to the regulators.

B. The Problem of the Impermissible Incidental Activity

In structuring acquisitions of non-banking activities, whether or not a joint venture or other arrangement is used, there is the lingering problem of the residual impermissible activity. If the activity is conducted through a bank or bank subsidiary, the entity is only to engage in activities in which it is permissible for the bank to engage. If conducted through a non-bank subsidiary of the bank holding company, the entity is only to engage in activities "so closely related to the business of banking or managing or controlling banks as to be a proper incident thereto." The list of permissible activities, while broad, is not all inclusive. When acquisitions or investments are made, particularly in the technology area, often there will be activities that are not permissible for the bank or bank holding company.

The general rule has been that impermissible activities should be discontinued as soon as practicable, and in any event within two years of the date of acquisition. Three recent rulings, one from the OCC and two from the Federal Reserve, give some hope that there might be some leeway to continue, at least in some modest fashion, certain impermissible activities that are merely incidental to the major focus of the business.

1. The OCC's Interpretive Letter Regarding MECA

In June 1995, the OCC approved requests by BankAmerica and NationsBank to establish operating subsidiaries that in turn would acquire MECA Software, the developer and marketer of a number of computer software products, including the popular "Managing Your Money" personal financial management program. MECA, using the program as the basis for offering home banking services, had entered into several licensing and distribution agreements with banks. The banks proposed to acquire MECA, convert its ownership to a limited liability company, and continue the activities of MECA related to the home banking and financial management services.

The OCC in its approval analyzed the intent and purpose behind its requirements relating to data processing and related services associated with banking, financial, or other related economic data. The OCC had little trouble with the home banking, financial management, financial planning, investment analysis, tax estimation, and the
other components of the software provided by MECA. Nor did the OCC have a problem with the ancillary services related to the foregoing, including providing checks and other financial forms. The OCC pointed to a number of prior approvals relating to such services. The OCC also noted that its prior ruling allowed a national bank to use data processing equipment and technology to perform for itself or others these financial services related to the business of banking.

Of particular interest in the approval was a discussion of the ability to market the software to individuals or entities that were not financial institutions and were not customers of either of the acquiring institutions. The OCC noted that as most of the software in question was financially related, it could permissibly be marketed to non-customers. With respect to non-financial products that might have been or might be developed, the OCC viewed them as permissible "by-products" of the financial and banking products which the banks were intimately involved in developing with MECA.

The request to the OCC asked for the ability to use MECA's excess capacity in equipment, personnel, and facilities for the production and distribution of some software products that may be non-financial in nature. The OCC noted that approximately 25% of the total units, and 7% of the total revenue, were non-financial in nature. The OCC indicated that this excess capacity would diminish over time. The OCC determined that this was a permissible use of the excess capacity, pointing to earlier letters allowing marketing of records management systems manuals and supply and purchasing manuals as part of permissible data processing activities, allowing the acquisition of equipment with excess capacity, and allowing the resale of excess long lines telecommunications capacity. The OCC analogized the use and sale of the excess capacity to the ability of a national bank to lease excess real property to other businesses.

Accordingly, while the OCC imposed the typical conditions (articles limited to bank-permissible activities, the ability of the banks to withdraw if the company engages in impermissible activities, and no liability on the part of the banks for the debts, liabilities or obligations of the company), the flexibility to actually engage in impermissible activities is not insubstantial.

Other OCC interpretive letters indicate perhaps an even greater willingness to accommodate activities that might otherwise seem to pose problems. In a letter dated August 19, 1996, the OCC indicated that a national bank could act as an Internet service provider in connection with its home banking service. The bank wished to offer
home banking services to its customers and believed that it needed to offer an Internet access option for that service. The OCC determined that the Internet access service was incidental to the home banking service, and allowed the bank to provide such service to customers and non-customers alike. The OCC has allowed a bank to design and operate a toll booth on a toll road, determining that the collection and transmission of funds was a part of the business of banking, and in connection therewith the bank could design and contract out the building of the toll booths and related devices.

2. The Federal Reserve’s MECA and Paribas Orders

The Federal Reserve has long permitted bank holding companies to engage in data processing activities. In 1971, data processing was added to the list of activities deemed to be closely related to banking, and permitted the processing of banking, financial or related economic data. The Board noted at the time that banks had historically performed certain types of billing and processing services for its customers, and concluded that such billing and data processing services were integrally related to the basic money transmission functions traditionally performed by banks.

In 1982, the Board expanded its data processing regulation to allow additional types of related activities. Bank holding companies were allowed to engage in processing all financial, banking, or economic information, thus permitting the processing of all types of economic data without the requirement that the economic data be related to other banking or financial data. It was clear that the deletion of the term “related” was intended to be significant.

Regulation Y, containing the laundry list of permissible non-banking activities, now permits the following data processing activities:

Providing to others data processing and data transmission services, facilities (including data processing and data transmission hardware, software, documentation or operating personnel), data bases, or access to such services, facilities or data bases by any technological means, if:

(i) The data to be processed or furnished are financial, banking,
or economic, and the services are provided pursuant to a written agreement so describing and limiting the services;

(ii) The facilities are designed, marketed, and operated for the processing and transmission of financial, banking, or economic data; and

(iii) The hardware provided in connection therewith is offered only in conjunction with software designed and marketed for the processing and transmission of financial, banking, or economic data, and where the general purpose hardware does not constitute more than 10% of the cost of any packaged offering.

In approving applications under 4(c)(8) over the years, the Federal Reserve had consistently limited the ability of the bank holding company to engage in impermissible activities not falling within the ambit of the regulation. To the extent that a target engaged in impermissible activities, those activities would be phased out as quickly as possible. Under no circumstances would the company be permitted to engage in the impermissible activities for an extended period of time.

While the two recent Federal Reserve orders do not provide unlimited authority for bank holding companies to engage in impermissible activities through these otherwise permissible investments, the flexibility granted is significant and important.

a. The MECA Order

On February 6, 1996, the Federal Reserve permitted The Royal Bank of Canada to acquire 20% of the voting stock of MECA Software, L.L.C. Royal Bank applied to join BankAmerica, NationsBank, Fleet, and First Bank Systems as owners of MECA. Each of the other banks owned their respective shares of MECA through bank operating subsidiaries; Royal Bank, as a foreign bank, needed the Federal Reserve's approval under Regulation Y.

The MECA "Managing Your Money" software and related services easily fall within the parameters of Regulation Y. It is a computer program that allows customers to conduct basic banking functions and personal financial management using personal computers. The software, and related financial software, is marketed both to

84. See Fed. Reserve Reg. Serv. 4-472 (Aug. 1995), available in WL FRRS 4-472 (noting that the Board only allowed a bank holding company to offer home shopping, travel and news information as part of a limited pilot research program to test home banking services).

consumers and financial institutions, to allow the institutions to offer such services to their customers. From the Federal Reserve's point of view, there was no problem associated with the acquisition of at least that portion of MECA that was engaging in the financial software programs.

Importantly, MECA had also developed and markets various non-financial software, including games, a computer security program, a medical reference library, and a program providing basic legal forms. These activities do not fall within the Regulation Y limitations. The Board, however, permitted MECA to keep, and indeed continue, these activities. MECA and the Bank indicated that the revenues from the impermissible activities were small, amounting to approximately 7% of 1994 revenues, that MECA had no intention of developing new non-financial software or to upgrade, enhance or promote its current non-financial programs, and that the non-financial portion of the company's business was expected to diminish over time. Based on the limited nature of the activity, the Board approved the acquisition and did not require the cessation or divestiture of the impermissible activities.

b. The Paribas Order

On February 26, the Board approved an application of Compagnie Financiere de Paribas to engage de novo in providing an integrated software program to operators of digital mobile telephone networks to perform billing and account-related services for customer accounts. The software calculates bills based on data provided by the telephone operator, such as date, time, duration, and destination of the call, the customer's service contract, and individual account balances. The company also provides general accounting services, such as recording payments and balances, provides billing and settlement services, and generates various related reports to the operator.

Part of the services performed consist of customer identification and account information and the generation of certain reports used by the operator to detect fraud. While these functions would be performed only in connection with the data processing and billing services, they are not within the list of "banking, financial or economic" information described in Regulation Y. The Board, however, allowed the company to engage in these activities, describing them as a "relatively small part" of the operation of the company, "incidental" to the primary billing and account functions to be provided to the telephone operator.
Interestingly, and perhaps significantly, Paribas owns a majority of France Telecom, the French national telephone operating company, and owns 49.9% of Financiere Sema, a French investment company that in turn owns 41.6% of Sema Group plc, which developed the software. It was not stated whether Sema offered the product overseas. Sema proposed to establish the company as a wholly-owned U.S.-based subsidiary to sell the software described in the proposal.

c. Other Considerations

The two orders are extremely significant. The limited authority to retain or engage in some modest non-financial activities provides important "real world" opportunities for financial institutions to participate more directly in the technological revolution that will surely transform banking over the coming years. The apparent rationales for the approvals may be instructive.

In part, the Board's acquiescence in the MECA order may have been driven by the OCC's approvals of the acquisition of MECA by BankAmerica and NationsBank. The OCC permitted the acquisition without requiring cessation of the non-financial activities. The OCC stated that the non-financial software activities, amounting to approximately 25% of total units sold and 7% of revenues was a permissible use of what it termed "excess capacity," consistent with prior OCC interpretive letters and rulings.

The interplay between the Federal Reserve's treatment of the impermissible activities and the OCC's treatment is interesting. The OCC viewed the non-financial activities as minimal by-products of the permissible financial activities, and imposed no obligation to cease the activities. Factors cited in the OCC letter gave support to the conclusion that these merely incidental activities posed no problem. On the other hand, the Federal Reserve relied upon statements that there was no intent to develop new nonfinancial programs or to upgrade or enhance these programs. Accordingly, the Federal Reserve's view that they would simply die out over time supported a decision not to require immediate divestiture or cessation of the activities.

More importantly, however, the acquiescence may have been driven by a need to assure that banking organizations are not unnecessarily prevented from becoming active participants in the technological developments that will likely radically change banking over the next several years. Non-bank providers of services, such as Microsoft, Intuit, and others, have targeted the banking market as
prime territory for expansion. Such enterprises may have greater access to talent, greater ability to experiment, and greater aptitude in finding successful approaches for delivering banking services to consumers than the banks themselves. If banks are precluded from taking advantage of the expertise in the computer industry, they may well find themselves also-rans in the financial services industry of the future.

With Paribas, the Board may have had some sympathy for Paribas’ extensive involvement in the telecommunications industry through its ownership of France Telecom. While no U.S.-based banking organization would be permitted a similar ownership position in AT&T, for instance, Paribas had substantial experience with the industry, and had developed, through its subsidiaries, useful products and services which it sought to use in the United States.

More significantly, however, the Paribas order demonstrates the difficulties in drawing bright lines in the data processing/computer area. Having to force all activities squarely within the tests of “banking, financial, or economic” requires the elimination of activities that are natural outgrowths of such services. By eliminating these natural outgrowths, however, the ability to provide the permissible services is endangered. It is not entirely clear from the order, but it would appear that Paribas’ ability to successfully offer its package of billing and accounting services is enhanced by its ability to offer the services facilitating the detection of fraud. A non-bank competitor would have no such constraints, and if the services were at all useful or beneficial, the non-bank competitor would eventually capture the business. The flexibility to offer otherwise impermissible services as an adjunct to permissible services is critical in many instances to the ability to compete in the marketplace.

Of course most of this would be solved if the Federal Reserve adopts its proposed revision to Regulation Y. The 30% basket for otherwise impermissible processing activities provides greater flexibility than is evidenced in either the MECA or Paribas orders.

C. Minority Equity Investments

Often banking organizations wish to make small investments in companies, either as a prelude to a subsequent potential acquisition, or simply because of the belief that the investment may be worthwhile.

Investing in equity securities through the bank is difficult. National banks in general are precluded from owning common or
preferred stock for investment purposes, and state banks may not make any minority equity investment impermissible for national banks. There are two avenues for minority equity investments, however, that may be available: the minority investment through a bank holding company, and minority investments through SBICs.

1. The Minority Investment Under the BHCA

The BHCA allows a bank holding company to acquire shares of a company without approval of the Board so long as the ownership interest is less than 5% of the voting shares of the company. This leeway investment authority allows a bank holding company to make minority equity investments in companies.

The Federal Reserve does not want to allow these minority investments to become a substitute for more active or controlling investments, and accordingly has placed two important glosses on the statutory language. First, the minority investment must be passive, and may not be used in a way that allows the investing bank holding company to participate actively in the business. When a group of twenty bank holding companies each proposed to invest in five percent of the outstanding voting shares of an insurance entity with the intent of participating in certain underwriting and related activities, the Board determined that the 4(c)(6) exemption was not available. It went on to state that the exemption was only available for passive investments.

Second, the investment, regardless of how structured, cannot give the investor effective control over the company or permit it to exercise a controlling interest over the management or policies of the company. Various bank holding companies have attempted to expand the limits of permissible investments under the BHCA, and have attempted to stretch the less than 5% voting share exemption to its fullest (and beyond).

One common structure was to combine the less than 5% voting interests with large non-voting interests, contractual provisions

granting control or options, warrants or other interests that provided strong assurances of compliance with the will of the investor. The Board has indicated that many of these provisions can create effective control or, at the least, may amount to impermissible controlling influence over management and policies.  

The earliest statements from the Board related to non-voting equity investments by bank holding companies in other banks or bank holding companies. Often described as "stake out" investments, these investments were intended to give the investing bank holding company an effective leg up on subsequent acquisitions when interstate banking became legal and the acquisition could finally be consummated. In a policy statement issued in 1982, the Board stated that a less than 5% voting interest, when combined with an investment in non-voting securities of less than 25% of the total equity, could be consistent with the BHCA. However, the Board warned that restrictions on the ability of the acquiree to sell or transfer shares or assets of its subsidiaries or otherwise restrict the rights of the owners of the shares of the acquiree could result in impermissible control. The Board indicated that various covenants or contractual provisions could not impermissibly limit the existing management's control over operations, policies or business decisions. The Board also indicated that contractual provisions that substantially hindered the acquisition of the target by a third party would be disfavored.

Other items that the Board has indicated may be impermissible include:

- the acquisition of shares which are non-voting only in the hands of the bank holding company, and which become voting when transferred to a third party. The Board indicated that the ability to control the transfer of voting shares may constitute control over those shares; contractual provisions limiting discretion with respect to normal management decisions, such as sale of assets, dividends, mergers or acquisitions, or the like. Similarly, entering into a merger agreement with an unusually long period for consummation, without providing a mechanism for the target to terminate the agreement is problematic; agreements giving control over the selection of directors, the voting of shares or other corporate matters, or requiring that

the target consult with the investor prior to taking certain significant actions.

On the other hand, the Board has indicated that if the total equity investment remains below 25%, if any shares must be sold in a public offering of wide distribution, and if the target can terminate the agreement on reasonable terms and conditions, the arrangement is more likely to be acceptable. The Board indicated that each such arrangement must be evaluated individually, and requested that parties contemplating such arrangements should first consult with the Board.

The ability to use the minority investment provisions of the BHCA while following the Federal Reserve's guidelines for nonvoting equity investments provides significant advantages in certain situations. While the bank holding company cannot take too active a role in the business, the ability to make an investment and participate in its growth can be very useful. Not only are relationships generated, but useful information may be obtained. Opportunities for business synergies may result.93

2. The Use of SBIC’s for Minority Investments

A small business investment company is a permissible investment for a national bank under section 24(seventh) of title 12 of the United States Code. A national bank may invest up to five percent of its capital and surplus in a SBIC.94 As the BHCA permits bank holding companies to acquire, without approval, shares of the kinds, and in the amounts, eligible for investment by national banks, the Federal Reserve allows such investments as well. The Federal Reserve does limit the amount of investment by a bank holding company to approximate that which a national bank could invest.95

D. Percentage Leases, Dual Employees, Sales of Customer Lists and Similar Devices

In many instances, banking and non-banking parties may wish to enter into a cooperative venture that allows the non-bank provider to take advantage of products, expertise, and technology, while allowing the bank to lend credibility and customer access. Each organization

93. See Board Letter of Nov. 25, 1986, (noting that the Board approved, subject to conditions, Sumitomo’s acquisition of a 24.9% nonvoting interest in Goldman Sachs, subject to numerous restrictions on common activities).
will certainly wish to be compensated for what it brings to the table. However, neither party may wish to commit significant dollars or manpower to a more formalized venture. Limited relationships, such as percentage leases, shared employees, referral arrangements or joint marketing arrangements may allow a more limited commitment while still permitting each organization to benefit financially.

1. The Percentage Lease

Banks are generally able to rent lobby space to non-bank providers of services, either on a flat fee basis or a percentage rent basis. This arrangement allows a bank to provide, through a third party, additional products and services to its customers on its premises, and to benefit financially through the arrangement. It may solidify customer relationships, allow the more productive use of retail floor space, and provide an additional source of fee income.

The leasing arrangements are useful in areas where the investment to create a fully competitive product is too high for the banking organization, where regulatory constraints prohibit or impede the offering of the product directly, or where a third party provider has significant marketplace advantages over the bank. Accordingly, leasing arrangements have been used with securities, insurance, travel agencies and various other businesses.

The OCC approved percentage lease arrangements in December 1983, noting that leasing excess space “was merely an incident to the banking business,” and stating that the bank should be able to spread expenses and operating costs by renting excess space to a variety of tenants without restriction. The OCC recognized that it was possible to structure a lease arrangement so that the bank might be construed as entering into a joint venture or partnership with the non-bank provider, which would raise other issues and could even be impermissible. Such concerns could arise if the lease rate were unusually high or the terms and conditions of the lease gave the bank effective control over the operations of the lessee. Accordingly, the OCC indicated that national banks should contract on terms and conditions customary in the field of commercial leasing. The OCC also indicated that certain terms ought to be incorporated in the arrangement, including:

language specifically negating the creation of a joint venture or partnership; language expressly stating that the bank would not be liable for the debts or liabilities of the lessee; separate identification of the non-banking company, with disclosures to avoid customer confusion; appropriate advertising, indicating the separate and
independent ownership and operation of the business; and an arm’s length lessor-lessee relationship.\textsuperscript{96}

Based on the OCC guidance, the OCC has permitted lease arrangements with insurance agencies, securities brokers, and investment advisors, and indeed has stated that a national bank may enter into a percentage lease with any business.\textsuperscript{97} Accordingly, a bank may enter into an arrangement with essentially any retail organization in order to expand the products and services offered to its customers.

Somewhat ironically, banks are entering into lease arrangements with other businesses as lessees, in order to gain access to the customers of other businesses. The most prevalent example is the grocery store branch, where the bank will typically lease a modest amount of space and establish a branch operation. The in-store branch operates not only as a convenience for existing bank customers, it provides a meaningful opportunity to attract new customers. Essentially the same principles that permit a bank to sub-lease space to non-bank businesses also permit a bank to lease space from non-bank businesses.

2. Dual Employees

Banks have expanded on the lease arrangement by coupling the lease with provisions where the bank and non-bank entity share employees. These employees may be either back office employees, involved in clerical or administrative functions, or they may be sales agents or representatives offering the products and services to customers.\textsuperscript{98}

The dual employee relationships raise a series of concerns regarding separateness of the businesses of the lessee and the bank. Written contracts, specifically stating duties, responsibilities, control, and compensation are required. The bank should have no duty or obligation to monitor or control the employees while engaging in their duties on behalf of the lessee. None of the bank’s other employees should be providing services to the lessee. If the employee is to engage in activities on the bank’s premises, the activities must be

\textsuperscript{97} See OCC No-Objection Letter No. 87-8 Fed. Banking L. Rep. (CCH) ¶ 84,037 (Nov. 17, 1987) (subject, of course, to safety and soundness considerations).
\textsuperscript{98} See OCC Interpretive Letter from Richard Fitzgerald, OCC Chief Counsel, to Thomas Russo (June 4, 1985), available in 1985 WL 187368(OCC) (hereinafter INVEST letter).
limited to those that would be permissible for the national bank. However, it should be noted that the OCC has also stated that a national bank employee can also act as agent for another entity, even if the activity is impermissible, so long as the bank receives no share of the profits resulting from the employee's activities on behalf of another, and the activity does not constitute an unsafe and unsound banking practice.99

The other federal banking agencies have taken positions with respect to leases and employee sharing that are fairly consistent with the OCC statements. The FDIC has cautioned regarding the need for adequate contractual limitations on liability to avoid concerns regarding the bank's exposure to the activity.

States have expressed concern about leasing and employee sharing, particularly in the insurance area. A number of states have anti-affiliation statutes, prohibiting in various forms the combination of banking and insurance agency activities. Certain of these states have viewed the leasing and employee sharing arrangements as attempts to circumvent the anti-affiliation laws, and have issued fairly extensive guidelines on permissible arrangements in the insurance area.

3. Sales of Customer Lists or Referral Fees

Although a bank may be precluded from engaging in an activity directly, banks have historically been able to act as a finder or referral source for a fee, and have been able to sell customer lists and other information. Such arrangements can allow access to the customer base in exchange for additional fee income, providing advantages to the bank without any capital investment.

The OCC has stated that a national bank may act as a finder for companies offering financial and non-financial products or services.100 While the bank must limit its activities to those of a "finder," and may not become involved in negotiating the actual sale of the product or service, it does allow the bank to participate to some degree in an activity that may be otherwise off limits.

Banks have used the authority to act as finder in merger and acquisition transactions, real estate transactions, and other service functions. The OCC permitted a national bank to act as a finder in informing its customers of automobile club memberships, assisting

99. See Letter from Ford Barrett, OCC Assistant Chief Counsel, to Max Repermeiner (July 23, 1982).
100. See OCC Interpretive Ruling No. 7.7200 (codified at 12 C.F.R. § 7.7200 (1996)).
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them in filling out applications, and otherwise facilitating the matching of the bank's customers with the automobile club.101

Banks can sell or lease their customer lists to non-bank providers, who in turn will solicit the bank's customers, typically by mail or by telephone. The OCC allows such activities so long as there are no tie-in arrangements with the non-bank provider. The OCC is concerned that customers will believe that they might be forced to acquire the non-bank product or service as a condition to obtaining some service from the bank or in exchange for more favorable treatment from the bank.

Similar to the sale of the customer list, banks are permitted to include promotional materials from non-bank providers in the banks' mailings to their customers. These "statement stuffers" allow the bank to capitalize on its customer relationships, hopefully in an appropriate manner. Banks, of course, will want to review and approve the materials sent, and will be rightfully concerned regarding the nature of the product or service offered. The bank may be compensated either on a flat fee basis or on some basis relative to the success of the solicitation.102

E. Considerations Involving Contracting

Obviously, one mechanism for entering into a relationship with a third party is simply a contractual arrangement. Examining all of the issues associated with bank contracting is beyond the scope of this outline, but clearly many of the alliances and relationships being established today among banking and non-banking enterprises are the purely contractual relationships. Whether they are the now relatively common contracts with Intuit to provide a linkage to the home banking services, or the major outsourcing contracts with major enterprises such as EDS, IBM, or Unisys, these contracts involve a series of significant issues and strategic and business decisions.

Some of the advantages of the contractual arrangements are obvious. There can be substantial cost savings, both with the management of the service to the development costs associated with future requirements. Through the contractual arrangement, the bank may be able to access substantially greater expertise, technology, or service levels. Many of these third parties have devoted resources to

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particular products or services that a banking organization cannot hope to match, and were it to attempt to do so, could never generate savings or revenues justifying such an investment.

On the other hand, one of the most serious issues relates to control over the product, the service, or the delivery mechanism. For example, with the Intuit/Quicken arrangements, control over the customer is of paramount concern to many participants. Is a customer using the Intuit product the customer of the bank or the customer of Intuit? Is that customer more easily lost to another institution? Is there a real relationship with the bank that the bank can capitalize upon?

In the major outsourcing arrangements, a long term dependence on a vendor is created. The bank will have lost, in most instances, equipment, personnel, and control. The fate of the vendor may become the fate of the bank.

There are certain statutory and regulatory provisions to keep in mind in the contracting area.

Contractual arrangements entered into by a bank and a third party may create regulatory oversight. The Bank Service Corporation Act has a relatively peculiar provision stating as follows:

[W]henever a bank that is regularly examined by an appropriate Federal banking agency, or any subsidiary or affiliate of such bank that is subject to examination by that agency, causes to be performed for itself, by contract or otherwise, any services authorized under this chapter, whether on or off its premises—

(1) such performance shall be subject to regulation and examination by such agency to the same extent as if such services were being performed by the bank itself on its own premises, and

(2) the bank shall notify such agency of the existence of the service relationship within thirty days after the making of such service contract or the performance of the service, whichever comes first.103

Not all contracts with non-bank providers are subject to this provision; however, to the extent that a bank has contracted out its back office processing, customer service operations, or other banking functions to a third party, the bank regulators will want to have the right to examine the activities to assure that they are being conducted properly and appropriately.

In an Interpretive Letter, the OCC stated that the right under the Bank Service Corporation Act to oversee these nonbank providers of services is "probably narrower" than the authority to examine a bank and its subsidiaries. It went on to state that it was probably only the "performance" of the services that would be subject to examination and regulation.\textsuperscript{104}

Finally, the FDIC has the right, under FDICIA, to address contracts. Under Section 30 of the FDI Act, a bank may not enter into a written or oral contract with any person to provide goods, products, or services to or for the benefit of such bank "if the performance of the contract would adversely affect the safety and soundness of the institution."\textsuperscript{105} The FDIC is given the authority to promulgate regulations implementing the prohibition of the statute. Although regulations were proposed, the FDIC had a difficult time defining the types of contracts that fell within the prohibition. While the regulation was withdrawn, apparently because "the existence of adverse contracts has decreased considerably since the proposed rule was issued for comment, and because of overwhelmingly negative comments received,"\textsuperscript{106} the lingering power of the FDIC to address these adverse contracts by order must be respected.

III. CASE STUDY—MERCHANT PROCESSING

The recent developments in merchant processing highlight pressures facing banking organizations in addressing particular lines of business where technology is rapidly changing the nature of the business. The varied responses of banking organizations gives a feel as to the flexibility of the bank regulatory structure to accommodate differing business and strategic objectives.

The merchant processing business involves a series of activities undertaken in connection with the sale of goods or services by a merchant though the use of a credit or debit card. The activities include card authorizations at the time of purchase; acquiring and processing card transactions; settlement of card transactions; and depositing funds in merchant accounts. The transactions and arrangement are subject to a number of protections and safeguards appropriate for and consistent with the nature of the business and the risks involved.

\textsuperscript{104} See OCC Interpretive Letter dated July 26, 1989, available in 1989 WL 300421(OCC) (addressing the scope of the OCC's oversight with respect to CHIPS (the Clearing House Interbank Payments System) and SWIFT (Society for Worldwide Financial Telecommunications)).


As an initial matter, it is clear from past precedent that merchant processing activities are permissible for national banks, whether conducted directly or through operating subsidiaries.\textsuperscript{107} Similarly, merchant processing activities are permissible for bank holding companies and their non-bank subsidiaries under Regulation Y.\textsuperscript{108} Accordingly, banking organizations have the flexibility to place their merchant processing activities virtually anywhere in their corporate structures.

The merchant processing business is intensely competitive and national in scope. The nature of the business requires a substantial investment in technology necessary to reduce costs, provide the level of service required, and to maintain profitability. Because of the high investment in technology, there are significant economies associated with size; that is, with a larger transaction base, the costs of technology can be spread over many customers, yielding lower transaction costs and associated competitive advantages. Over recent years, much of the competition in the merchant processing business has come from non-banking competitors that have made the investment in technology needed to compete effectively in the business.

While banks are major participants in the merchant processing business, they are not the largest. Indeed, the largest participants in the merchant card business are not banks; the major processors for bank cards\textsuperscript{109} include NaBANCO/First Data Systems/Card Establishment Services, First USA and National Data Corporation. For all cards, major competitors include NaBANCO/First Data Systems/Card Establishment Services, American Express, Discover, GE Capital, Sears and National Data. Major bank players include Bank of America and First Bank System.

Many banks have exited the business over the past several years. Numerous banks have sold their merchant processing business outright to non-bank participants in the marketplace, including Citibank, Signet, Marine Midland Bank, Chemical Bank, AmSouth, Chase Manhattan Bank, Security Pacific and First National Bank of Maryland.\textsuperscript{110} Numerous other banks have sold their merchant processing


\textsuperscript{109} Such as VISA and MasterCard

business outright to other banks with larger businesses, including Central Fidelity (to Michigan National), Deposit Guaranty (to Society) and Shawmut (to CoreStates).

Other banks have determined to enter into strategic alliances with non-bank providers. Card Establishment Services, Inc. (CES), a subsidiary of First Data Systems, has entered into arrangements with Barnett Banks, Inc., U.S. Bancorp, Norwest Corporation, BancOne Corporation and Wells Fargo Bank, N.A. to provide merchant services. These arrangements have been structured in various ways by the banks and their non-bank partners. For instance, the United States National Bank of Oregon, the lead bank subsidiary of U.S. Bancorp, established an operating subsidiary that would in turn own, with CES, shares of a limited liability company. The subsidiary banks of Barnett Banks, Inc. provided a notice under the Bank Service Corporation Act, to establish bank service corporation subsidiaries of the banks that in turn would engage in a joint venture with First Data and CES to engage in the merchant processing activities. These arrangements have involved contributions of processing to the venture, with a territorial “franchise” for soliciting and developing new business.

First Union recently contributed its merchant processing business to NOVA Information Systems, Inc. (NOVA), the nation’s twelfth largest merchant processor, in exchange for a substantial equity stake. The transaction was structured so that each First Union bank established a wholly-owned operating subsidiary that received the merchant processing business of its parent. The operating subsidiary in turn contributed the business to a new holding company in exchange for an equity ownership. This equity ownership represented approximately 40% of the resulting equity of NOVA. NOVA intended to undertake a public offering of its shares, which would further reduce the First Union ownership to slightly over 30% of the entity. The OCC approved the investment in early 1996, and NOVA completed its initial public offering in May, 1996. The transaction provided an alternative for First Union to realize the inherent value associated with its merchant processing business while still maintaining a substantial stake in the future appreciation and growth.

112. See Letter from Michael W. Briggs to Federal Reserve Bank of Atlanta (July 21, 1995).
of the business. First Union announced that its unrealized gain as a result of the NOVA transaction is approximately $280 million.

Finally, Synovus Financial Corporation, a bank holding company, through its subsidiary Total Systems, is forming a joint venture with VISA to offer merchant processing services to compete with First Data/CES. Synovus is applying under Section 4(c)(8) to form a new subsidiary that in turn will become a 50% participant with VISA in a new limited liability company.\footnote{See Application to Federal Reserve Bank of Atlanta (Feb. 26, 1996).}

The differing structural responses to a common problem, that of addressing the business and technological requirements of the merchant card business, illustrate the flexibility of the regulatory framework to accommodate a number of different answers. Major banking organizations have opted for strategies ranging from sale to acquisition, and have structured joint ventures with non-bank providers within the bank, as a bank operating subsidiary, as a bank service corporation, and as a bank holding company subsidiary. There is no “best” solution for every organization; rather, there are a variety of solutions from which to choose in meeting the needs of each particular organization.