



Office of the Comptroller of the Currency

Interpretive Letter #732

Published in Interpretations and Actions July 1996

12 U.S.C. 24(7)23C

May 10, 1996

[]

Dear []:

This is in response to your letter of March 29, 1996, requesting confirmation that [] ("Bank"), may lawfully acquire and hold a minority interest in [] ("Company"), which offers electronic data interchange services. <NOTE:The Company currently is in the process of changing its corporate name to "[]."> For the reasons set forth below, I agree with your conclusion.

BACKGROUND

The Bank intends to acquire a 5.5% interest <NOTE:This percentage calculation is based on all presently owned Company voting shares (both common and preferred). The percentage calculation is 7.8% if based solely on presently owned common shares.> in the Company, which is engaged in the design, development, marketing and maintenance of a network for electronic funds transfers and electronic data interchange, including transacting electronic commerce and marketing software products for use on its world-wide electronic commerce network. Through the network, subscribing businesses, using appropriate Company-developed software, can send and receive payments worldwide, send and receive invoices electronically involving other subscribing companies, send purchase orders electronically to other subscribing companies and receive sales orders electronically from any company world-wide. The Company's marketing activities involve the recruitment of banks as submarketers and the recruitment of businesses as network end-users by such banks. The Bank and the Company have entered into a contractual arrangement whereby the Bank is acting as the recruiter of major banks as submarketers for the network and its associated software. The submarketers will recruit businesses as network end-users. The Bank also will offer the network's services to its own customers. The Bank's fee income from these efforts will be based on the number of transactions moving through the network. This contract will expire in two years unless the Bank invests in the Company and, thereby, becomes the sole owner of the Company's Series B Common stock.

The Company has two series of common stock and two series of preferred. There are eight holders of the almost 5 million shares of Series A common outstanding. These shareholders are company principals and various capital investors. The Bank intends to acquire 400,000 shares of Series B Common and obtain warrants for the remaining 400,000 shares. Series A Preferred has 625,000 shares outstanding, held by 21 holders. Series B Preferred has almost 2 million shares outstanding held by 33 holders. As a holder of the

Series B Common, the Bank will be entitled to elect one member of the Company's board of directors and to vote, along with all other common and preferred shareholders, on all matters not specifically requiring voting by class or series.

A number of provisions governing the relationship between the Company and the Bank will cause the Company to restrict its activities to those permissible for national banks:

- The articles of incorporation of the Company will be restated to limit its activities to those permissible for national banks.
- If the Bank decides at any time that the Company is engaging in activities impermissible for national banks, it may demand redemption of the Series B Common Stock.
- As holder of Series B Common, the Bank will be entitled to vote by series on (and effectively veto) changes in, among other things, the rights or number of Series B Common or Series A Preferred and Series B Preferred, the creation of new classes or series of shares having preferences superior or equal to those of Series B Common or Series A Preferred and Series B Preferred shares, and any change in the provision of the articles of incorporation according such voting rights.

ANALYSIS

The Bank's plan to purchase a 5.5% interest in the Company initially raises the issue of the authority of a national bank to hold a minority interest in a corporation. A recent OCC interpretive letter extensively analyzed the authority of national banks under 12 U.S.C. 24(Seventh) to own stock, and reviewed OCC precedents on the ownership of stock in amounts less than that required for an operating subsidiary, *i.e.*, non-controlling stock investments. Interpretive Letter No. 697, [Current] Fed. Banking L. Rep. (CCH) 81-013 (Nov. 15, 1995). That letter concluded that ownership of a non-controlling interest in a corporation is permissible provided that four standards, drawn from OCC precedents, are satisfied. They are:

- 1) The activities of the enterprise in which the investment is made must be limited to activities that are part of, or incidental to, the business of banking;
- 2) The bank must be able to prevent the enterprise from engaging in activities that do not meet the foregoing standard, or be able to withdraw its investment;
- 3) The bank's loss exposure must be limited, as a legal and accounting matter, and the bank must not have open-ended liability for the obligations of the enterprise; and
- 4) The investment must be convenient or useful to the bank in carrying out its business and not a mere passive investment unrelated to *that bank's* banking business.

Each of these factors is discussed below and applied to your proposal.

1. The activities of the enterprise in which the investment is made must be limited to activities that are part of, or incidental to, the business of banking.

Our precedents on minority stock ownership have recognized that the enterprise in which the bank takes an equity interest must confine its activities to those that are part of or incidental to the conduct of the banking business. *See, e.g.*, Interpretive Letter No. 380, [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) 85,604 n.8 (Dec. 29, 1986) (since a national bank can provide options clearing services to customers, it can purchase stock in a corporation providing options clearing services); Letter from Robert

B. Serino, Deputy Chief Counsel (Nov. 9, 1992) (since the operation of an ATM network is "a fundamental part of the basic business of banking," an equity investment in a corporation operating such a network is permissible).

You have represented that the Company's activities will involve the design and development of a network for electronic transfers of funds and financial information, along with the development and marketing of related software. The OCC previously has approved the activities the Company will perform.

OCC Interpretive Ruling 7.1019, Furnishing of products and services by electronic means and facilities, 61 Fed. Reg. 4849, 4865 (1996) (to be codified at 12 C.F.R. 7.1019), permits national banks to provide permissible services by electronic means. The OCC has permitted a national bank to participate in a communications link between subscribers and their banks as well as permitted subscribers to communicate with each other. Interpretive Letter No. 346, [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) 85,516 (July 31, 1985). The OCC also has approved electronic data interchange services for financial information, Interpretive Letter No. 653, [1994-1995 Transfer Binder] Fed. Banking L. Rep. (CCH) 83,601 (Dec. 22, 1994) (informational and payments interface). National banks may use automated data processing to provide billing services and accounts receivable services for itself and others, Interpretive Letter No. 419, [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) 85,643 (Feb. 16, 1988), and engage in data processing related to funds transfer and cash management, *id.* (funds transfer); Letter from Peter Liebesman, Assistant Director, Legal Advisory Services Division (Dec. 13, 1985) (cash management); Interpretive Letter No. 611, [1992-1993 Transfer Binder] Fed. Banking L. Rep. (CCH) 83,449 (Nov. 23, 1992) (cash management, funds transfer).

Thus, the activities to be performed by the Company are activities that are part of or incidental to the business of banking, and the first standard is satisfied.

2. The bank must be able to prevent the enterprise from engaging in activities that do not meet the foregoing standard, or be able to withdraw its investment.

The activities of an enterprise in which a national bank invests must be part of or incidental to the business of banking not only at the time the bank initially purchases stock, but they must remain so for as long as the bank has an ownership interest. However, minority shareholders in a corporation do not possess a veto power over corporate activities as a matter of corporate law. One way to assure continuing compliance with the first standard is for the corporation's articles of incorporation or bylaws to limit its activities to those that are permissible for national banks. *See, e.g.,* Letters from Peter Liebesman, Assistant Director, Legal Advisory Services Division (January 26, 1981 and January 4, 1983).

You have stated that the Company's articles of incorporation will be amended to limit its activities to those permissible to national banks. Also, several other provisions, described in the "Background" section above, provide additional avenues for the Bank to ensure that while it has an investment in the Company, the Company's activities will remain permissible. These provisions assure that the Company will not engage in any activity that is not permissible for a corporation having a national bank shareholder. The Bank effectively will be able to prevent the Company from engaging in any impermissible activity as long as it continues to own shares in the Company. Thus, the second standard is satisfied.

3. The bank's loss exposure must be limited, as a legal and accounting matter, and the bank must not have open-ended liability for the obligations of the enterprise.

A primary concern of the OCC is that national banks should not be subjected to undue risk. Where an investing bank will not control the operations of the entity in which the bank holds an interest, it is important that a national bank's investment not expose it to unlimited liability. Normally, this is not a concern when a national bank invests in a corporation, for shareholders are protected by the "corporate veil" from liability for the debts of the corporation. 1 William M. Fletcher, *Fletcher Cyclopedia of the Law of Private Corporations* 25 (perm. ed. rev. vol. 1990). In the present case, both the Company and the Bank will be separate corporations, with their own capital, directors, and officers.

Further, the Bank has advised that the appropriate treatment for its investment in the Company will be the cost method of accounting. Under this method, which is used for equity interests of less than 20 percent in corporations, losses recognized by the investor will not exceed the amount of the investment (including extensions of credit or guarantees, if any) shown on the investor's books. *See generally*, Accounting Principles Board, Op. 18, 19 (1971).

Therefore, for both legal and accounting purposes, the Bank's potential loss exposure should be limited to the amount of its investment. Since that exposure will be quantifiable and controllable, the third standard is satisfied.

4. The investment must be convenient or useful to the bank in carrying out its business and not a mere passive investment unrelated to that bank's banking business.

Twelve U.S.C. 24(Seventh) gives national banks incidental powers that are "necessary" to carry on the business of banking. "Necessary" has been judicially construed to mean "convenient or useful." *Arnold Tours, Inc. v. Camp*, 472 F.2d 427, 432 (1st Cir. 1972). The provision in section 24(Seventh) relating to the purchase of stock, derived from section 16 of the Glass-Steagall Act, was intended only to make it clear that section 16 did not authorize speculative investments in stock. Interpretive Letter No. 697, *supra*. Therefore, a consistent thread running through our precedents concerning minority stock ownership is that such ownership must be convenient or useful to the investing bank in conducting its banking business. The investment must benefit or facilitate that business, and cannot be a mere passive or speculative investment. *See, e.g.*, Interpretive Letter No. 543, [1990-1991 Transfer Binder] Fed. Banking L. Rep. (CCH) 83,255 (Feb. 13, 1991); Interpretive Letter No. 427, [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) 85,651 (May 9, 1988); Interpretive Letter No. 421, [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) 85,645 (Mar. 14, 1988).

As set forth in the "Background" section, the Bank and the Company already have a contractual relationship relating to the Company's business which is limited to two years unless the Bank becomes and remains sole owner of the Series B Common stock. Thus, the proposed investment will facilitate the Bank's continued participation in the network. As discussed, the Bank is using participation in the network as a means to offer its customers and correspondent banks a range of electronic banking services that the Bank could not as economically offer directly. It is clear that the Company's services will provide the Bank and other banks involved in the network with the opportunity to offer electronic data interchange without establishing separate systems and maintaining them themselves. Thus, the investment is "necessary" to the continuation of those services. This investment also will provide the Bank a more favorable fee treatment in its recruiting role, in accordance with the agreement between the Company and the Bank. Where, as here, a bank uses a third party to make services available to its customers and correspondents, the bank normally will receive a higher level of the profits from the referred business if it is an owner of the servicing company rather than a mere contractor. Thus, a

minority investment enables the bank to increase the profitability of its business. Also, you indicate that by having a seat on the Company's board of directors, the Bank will be able to monitor and influence the development of the network in ways best adapted to the needs of the Bank's customer base. In this way, a minority investment enhances the Bank's ability to serve and preserve its customer and correspondent relationships.

You note that the Series B Common is restricted in its transferability. Once acquired by the Bank, Series B Common shares may not be sold to a third party unless they have been offered to the Company at the same price. Thus, the Bank will not be able to dispose of its stock as freely as a shareholder merely interested in a passive investment.

For these reasons, the proposed investment is convenient and useful to the Bank in carrying out its business and is not a mere passive investment. Thus, the fourth standard is satisfied.

CONCLUSION

Based upon the representations made on behalf of the Bank and for the reasons outlined above, we conclude that the Bank's investment in the Company would satisfy the four standards the OCC has applied to non-controlling minority investments, provided the Bank complies with the following conditions:

- 1) the Company may engage only in activities that are part of, or incidental to, the business of banking;
- 2) the Company's articles of incorporation will limit its activities to those permissible for national banks;
- 3) the Company will be subject to OCC supervision and examination; and
- 4) the Bank will account for its investment in the Company under the cost method of accounting.

These conditions are conditions imposed in writing by the OCC in connection with its action on the request for a legal opinion confirming that the proposed investment is permissible under 12 U.S.C. 24(Seventh) and, as such, may be enforced in proceedings under applicable law.

Sincerely,

/s/

Julie L. Williams
Chief Counsel