# Office of the Comptroller of the Currency

## Interpretations - Letter 720

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Re: First Union and First Fidelity National Banks, Establishment of Operating Subsidiaries to Hold Interests in Merchant Credit Card Business, Control Nos. 95-ML-08-027 through -035

Dear Mr. Anderson:

This is in response to your operating subsidiary notification dated November 30, 1995. The notification was filed on behalf of eight national bank subsidiaries of First Union Corporation, Charlotte, North Carolina, and one national bank subsidiary of First Fidelity Bancorporation, Newark, New Jersey. We have completed our review and the notification is hereby approved, subject to the conditions set forth herein.

PROPOSAL

**A. Background**

The notification was filed on behalf of the First Union National Banks of North Carolina [Charlotte], South Carolina [Greenville], Georgia [Atlanta], Florida [Jacksonville], Tennessee [Nashville], Virginia [Roanoke], Maryland [Rockville], and the District of Columbia; and First Fidelity Bank, N.A., Elkton, Maryland (collectively, "the Banks"). The purpose of this transaction is for the Banks to acquire an interest in an existing merchant credit card processor and thereafter conduct their own merchant credit card processing businesses through that entity.

The merchant credit card processing (or simply, "merchant processing") business involves verifying card authorizations at the time of purchase, processing card transactions, settlement of card transactions, and depositing funds in merchant accounts. It is an intensely competitive business, national in scope. It requires a substantial investment in technology necessary to reduce costs, provide the level of service

required, and 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.

While banks are major participants in the merchant processing business, they are not the largest players. Much of the competition in the merchant processing business comes from non-banking competitors that have made the investment in technology needed to compete effectively in the business. This has caused many banks to exit the business in recent years, or enter into strategic alliances with non-bank providers.

The Banks are presently active in the merchant processing business. However, due to the competitive pressures described above, they have decided to restructure their operations in this area. They have determined that the best way to do this is to acquire an interest in an established, non-bank merchant processor and then to conduct merchant processing activities through that entity. Accordingly, they propose to contribute their merchant processing business to NOVA Information Systems, Inc. ("NOVA"), in exchange for a substantial equity ownership. Located in Atlanta, NOVA is currently the nation's twelfth largest merchant processor.

**B. The Transaction**

The transaction will be structured as follows. Each of the Banks <**NOTE:** First Fidelity Bank, Stamford, Connecticut, a state-chartered bank, will also participate in the transaction and will obtain separate approval from its regulator.> will establish a wholly-owned operating subsidiary tentatively named "First Union NOVA Holdings of [State], Inc." Each Bank will contribute its present merchant processing business assets and liabilities to its respective operating subsidiary. The operating subsidiaries will then transfer these assets and liabilities to a newly formed holding company, NOVA Holdings, Inc. ("Holdings"), in exchange for common shares of Holdings. Holdings, in turn, will transfer the assets and liabilities to NOVA and will hold all the outstanding shares of stock of NOVA.

The present owners of NOVA will exchange all of the shares of NOVA for approximately 61 percent of the outstanding shares of Holdings, thus retaining a substantial interest in the restructured business. These shareholders are Warburg, Pincus Investments, Inc., Worldcom, Inc., and individual members of NOVA's management. Thus, after the transaction is consummated, NOVA will be owned jointly by the Banks and NOVA's current owners through Holdings. The respective contributions of the parties to NOVA Holdings are anticipated to qualify, for federal income tax purposes, as a tax-free contribution to a controlled corporation pursuant to section 351 of the Internal Revenue Code of 1986, as amended, 26 I.R.C. 351 (1986).

Collectively, the Banks initially will own approximately 80 percent of the outstanding common shares of Holdings, with the other 20 percent owned by the non-bank shareholders. In addition to common stock, Warburg, Pincus and Worldcom will also own shares of voting, convertible preferred stock. Giving effect to the voting rights associated with the preferred stock, the Banks will control approximately 39 percent of the voting power of Holdings, <**NOTE:** The individual interests of the Banks will vary from a low of .22 percent to a high of 14.6 percent of the voting shares of Holdings.> Warburg, Pincus and Worldcom, 60 percent, and the NOVA managers, one percent. In addition to their common shareholdings, the NOVA management shareholders will have options to acquire additional shares of common stock. If all outstanding options are exercised and all preferred shares are converted to common stock, the Banks

would then own approximately 35 percent of the outstanding common stock of Holdings.

Each of the parties will enter into a Shareholders Agreement governing certain aspects of the relationships among the NOVA Holdings shareholders and the management of Holdings and NOVA. Among other things, the Shareholders Agreement provides for:

- A right of first refusal in the event that Holdings issues new securities or other shareholders attempt to sell some or all of their Holdings capital stock.

- The right of various Holdings shareholders, including the Banks through their operating subsidiaries, to designate persons to serve as directors of Holdings. At the time the transaction is consummated, First Union National Bank of North Carolina ("FUNB-NC") shall have the right to designate two nominees for the Board of Directors of Holdings.

- Limits on the ability of Holdings and its subsidiaries to engage in business activities not permissible for banking organizations and a process to cooperate in entering new lines of business to meet the needs of the Banks' customers.

- A framework for the Banks either to sell to Holdings or to require Holdings to service merchant credit card portfoios subsequently acquired by the Banks.

- Limits on the ability of the Banks to acquire, without the approval of a distinterested majority of the Board of Directors of Holdings, more than 40 percent of the outstanding shares of Holdings common stock (assuming conversion of all outstanding convertible preferred stock and exercise of all outstanding options, warrants, and other rights to acquire Holdings common stock).

- The right of various major shareholders of Holdings, including the Banks, to certain financial and other information about Holdings.

The Banks will further enter into a Voting Agreement providing that so long as the Banks own shares of Holdings, they will grant a revocable proxy in favor of FUNB-NC permitting FUNB-NC to vote their shares of Holdings stock on any matter that comes before the shareholders of Holdings for a vote. While the Voting Agreement is revocable by any of the Banks at any time, the intent of the Agreement is to allow FUNB-NC to exercise all voting control over the Banks' shares of Holdings.

It is contemplated that FUNB-NC will provide banking and other related services to NOVA. FUNB-NC will serve as the member bank for the VISA®, MasterCard®, and other payment networks on behalf of NOVA. It may also provide lines of credit and other forms of loans to NOVA to allow it to conduct its business. All such loans will be on terms and conditions similar to those imposed on such arrangements with parties not affiliated with it, and the aggregate amount of loans and extensions of credits will not exceed five percent of FUNB-NC's capital and surplus.

**ANALYSIS**

*A. National Bank Incidental Powers (12 U.S.C. 24(Seventh))*

The OCC has long permitted national banks to own stock in operating subsidiary corporations. Under the OCC's current regulations, a national bank must own at least 80 percent of the voting shares of an operating subsidiary. 12 C.F.R. 5.34(c). While this requirement will be satisfied for the various first-tier operating subsidiaries of the Banks, the Banks' respective indirect interests in NOVA Holdings and NOVA will be far less. Therefore, the issue presented by your notification concerns the authority of a national bank to hold -- directly, or indirectly through an operating subsidiary -- a minority equity interest in an enterprise such as NOVA.

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. Letter of Stephen R. Steinbrink, Senior Deputy Comptroller, Bank Supervision Operations (November 15, 1995) ("Steinbrink Letter"). This letter concluded that ownership of a non-controlling interest in a corporation is permissible, provided that four standards are satisfied. These standards, drawn from OCC precedents, are the following:

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;

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 (December 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 of Robert B. Serino, Deputy Chief Counsel (November 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).

It is clear that merchant processing activities are permissible for national banks, whether conducted directly or through operating subsidiaries. *See, e.g.*, Interpretive Letter No. 689, [Current] Fed. Banking L. Rep. (CCH) 81-004 (August 9, 1995); Banking Bulletin 92-24, Merchant Processing (May 5, 1992). Therefore, this standard is satisfied.

*2. The bank must be able to prevent the enterprise from engaging in activities that do not meet the foregoing standard.*

It is not enough that the enterprise's activities are permissible at the time the bank first purchases stock; they must also remain permissible for as long as the bank has an ownership interest. However, minority shareholders in a corporation do not possess a veto power as a matter of corporate law. One way to address this problem 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 of Peter Liebesman, Assistant Director, Legal Advisory Services Division (January 26, 1981 and January 4, 1983).

Contractual solutions are also feasible. In the present case, the parties have handled restrictions on the activities of Holdings through the Shareholders' Agreement. Under the Agreement, Holdings is specifically prohibited from engaging in any new business activity without notifying the Banks and providing an opportunity for the Banks to obtain all necessary regulatory approvals or consents. The Banks and their respective holding companies have agreed to cooperate in obtaining such consents. Shareholders' Agreement, 3.9.

These provisions assure that neither Holdings nor NOVA will engage in any activity for which the Banks cannot obtain, or have not obtained, regulatory approval. Thus, the Banks will effectively have a veto power over any impermissible activity as long as they continue to own their shares.

*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 investing in a corporation, for it is generally accepted that a corporation is an entity distinct from its shareholders or members, with its own separate rights and liabilities. 1 W. Fletcher, Cyclopedia of the Law of Private Corporations 25 (rev. perm. ed. 1990). Thus, shareholders are protected by the "corporate veil" from personal liability for the debts of the corporation. The Banks will be well protected in the present case. Not only will they be protected by the "corporate veil" of NOVA, itself, but there will be two additional corporate entities -- an operating subsidiary and Holdings -- between each Bank and NOVA.

Further, the Banks will report their investments in Holdings, an unconsolidated subsidiary, under the cost method of accounting. This treatment is used for equity interests of less than 20 percent in corporations. Under this method, 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) (cost method of accounting for investments in common stock).

Therefore, for both legal and accounting purposes, the Banks' potential loss exposure will be limited to the amount of their investment (plus, potentially, the amount of any additional extensions of credit). That exposure will be quantifiable and controllable, and this 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 12 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 only intended to make it clear that section 16 did not authorize speculative investments in stock. Steinbrink Letter, *supra.* Therefore, a consistent thread running through our precedents concerning stock ownership is that it must be convenient or useful to the bank in conducting *that bank's* 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 (February 13, 1991) (purchase of stock in a corporation providing information on the government securities market; ownership of the stock would be useful to the investing bank's business as a primary dealer in U.S. government securities); Interpretive Letter No. 427, [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) 85,651 (May 9, 1988) (purchase of stock in the Federal Agricultural Mortgage Corporation where stock ownership was necessary for banks to participate in the agricultural mortgage secondary market promoted by the Corporation); Interpretive Letter No. 421, [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) 85,645 (March 14, 1988) (purchase of stock in a corporation providing services to participants in the government securities market; national bank would benefit in its own banking business through reduced costs and being able to take advantage of services provided by the corporation); Interpretive Letter No. 380, *supra* (purchase of stock in an options clearing corporation, necessary for the bank to do business as a futures commission merchant).

The Banks all are presently active in the merchant processing business and wish to remain so. However, as discussed earlier, the investments in technology and the transaction volume needed for economic success in today's environment make it difficult for the Banks to continue in this business individually. If the transaction is consummated, NOVA would be the eighth largest merchant processor in the country. It would continue to be managed by its current, highly qualified management team. By joining forces with each other and with NOVA, the Banks will be able to achieve economies of scale and a level of management expertise that they could not achieve on their own. Indeed, you believe that this transaction will enable the Banks to expand their service and reach new customers because of the substantial advantages the relationship with NOVA offers.

Moreover, the Banks will not be making passive financial investments, but rather, each will contribute its present merchant processing business. While the amount of assets contributed by each Bank will vary, the total is clearly substantial. <**NOTE:** You have requested that the actual figures be kept confidential.> Under these circumstances, the Banks essentially will continue their present merchant processing business under a different form. This change in form will bring substantial benefits just described. Therefore, the Banks' respective investments in Holdings and NOVA are not passive investments unrelated to their banking business. On the contrary, the investments will provide a benefit that is convenient or useful to the Banks in carrying out their banking businesses, and the fourth standard is therefore satisfied.

*B. Other Issues*

Sections 23A and 23B of the Federal Reserve Act, 12 U.S.C. 371c and 371c-1, place restrictions on transactions between member banks and their affiliates. As noted earlier, FUNB-NC will hold voting proxies from the other Banks. Combined with its own shares,
this will enable it to vote all shares of Holdings owned by the Banks. This approximately 39 percent

voting control will qualify Holdings and NOVA as subsidiaries of FUNB-NC for purposes of section 23A. <**NOTE:** With respect to a specified company, a "subsidiary" is a company that is controlled by the specified company, 12 U.S.C. 371c(b)(4); and a company is deemed to control another company if it has the power to vote 25 percent or more of any class of voting securities of that company, 12 U.S.C. 371c(b)(3)(A)(i).> Since the statute excludes non-bank subsidiaries of member banks from the definition of "affiliate," 12 U.S.C. 371c(b)(2)(A), subsidiaries are not subject to the restrictions on transactions with affiliates. Notwithstanding this, FUNB-NC commits that all transactions with Holdings and NOVA will comply with the requirements of section 23B, 12 U.S.C. 371c-1. Holdings and NOVA may be affiliates of the other Banks, and those Banks commit that their transactions with Holdings and NOVA will comply with the requirements of both sections 23A and 23B.

The OCC requires that national bank operating subsidiaries and ventures involving operating subsidiaries be subject to OCC examination and supervision. *See* 12 C.F.R. 5.34(d). According to your letter, Holdings has agreed that it and NOVA will be subject to examination by the OCC as long as the Banks own, control, or hold voting shares of Holdings.

*CONCLUSION*

For the reasons discussed above, the operating subsidiary notification of the Banks is approved, subject to the following special conditions:

1) the operating subsidiaries, Holdings, and NOVA may engage only in activities that are part of, or incidental to, the business of banking, and the Banks must submit a notification to the OCC pursuant to 12 C.F.R. 5.34 before these entities may engage in activities not covered by the present notification and this letter;

2) the Banks will have veto power over any activities and major decisions of Holdings and NOVA that are inconsistent with condition number one, or will withdraw their investments from Holdings in the event that it or NOVA proposes to engage in an activity that is inconsistent with condition number one;

3) Holdings and NOVA will be subject to OCC supervision and examination; and

4) the Banks will account for their investments in Holdings and NOVA under the cost or equity method of accounting.

Please be advised that the conditions of this approval are deemed to be "conditions imposed in writing by the agency in connection with the granting of any application or other request" within the meaning of 12 U.S.C. 1818. If you have any questions, please contact Richard Erb, Licensing Manager, Multinational Banking, at (202) 874-4610.

Sincerely,
/s/
Steven J. Weiss
Deputy Comptroller for
Bank Organization and Structure