FinTech-driven Joint Ventures and M&A Transactions by Banks or Securities Dealers

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Digitalization, the use of innovative technologies and its implications for the traditional business model of banks and securities dealers has also become an important factor in the Swiss financial market regulation. Although opinions often differ on how and to what extent FinTechs can replace established service providers, there are hardly any banks or securities dealers that are currently not implementing, or at least analyzing, FinTech initiatives. The focus of such initiatives is often to acquire the relevant technologies and know-how from the outside in order to react, or adapt to, new developments and competitive challenges.

While the Swiss government recently proposed changes to the banking legislation in order to ease certain regulatory requirements for FinTech business models, FinTech-driven (and other) M&A transactions of banks and securities dealers with FinTech companies are also subject to financial market regulation rules even if the FinTech company is not regulated. Regulatory notification and approval requirements applicable to banks and securities dealers require a careful analysis and coordination of the transaction, in particular if, in addition stock exchange or merger control notification requirements apply.

Key takeaways:

- **In order to react to new technologies and adapt to business models and new competitors, banks or securities dealers often acquire new technology and know-how from FinTech companies, be it by means of M&A transactions or joint ventures.**
- **M&A or JV transactions by banks or securities dealers are subject to financial market regulations, even if the involved FinTech company is itself not regulated, for example, as a consequence of the consolidated supervision of financial groups.**
- **Depending on the transaction structure, banks or securities dealers are subject to regulatory notification or approval requirements.**
- **In the course of the initialized legislative process to ease the regulatory requirements for FinTech, it is important (to continue) to ensure that established banks and securities dealers investing in FinTech are not unnecessarily being placed at a disadvantage relative to non-regulated market participants and investors.**

1. Acquisition of innovative technologies by banks and securities dealers

Digitalization and innovative technologies provide for challenges. Established banks and securities dealers need to transform their business models in order to adapt to new technologies and competitors. As the "technology part" of FinTech (as opposed to the "finance part") is often not (yet) a core competence of established banks and securities dealers, the relevant technology or know-how is often acquired from the outside. Such M&A and JV transactions by banks and securities dealers are subject to a variety of laws and regulations.

Such rules and regulations are similar for banks and securities dealers. Therefore, in the following sections, in order to facilitate reading, reference is only made to "banks".

2. New regulatory rules for FinTechs

Currently, many FinTech business models are subject to regulation by FINMA. Business models involving the handling of public deposits on a commercial basis are in principle regulated by the Banking Act (BA) and require a licence from FINMA.

Therefore, in spring 2016, in order to lower entry barriers for FinTech startups, FINMA and the Swiss government announced respective changes to the banking regulation. On 1 February 2017, the Swiss government specified the new regulation by launching a public consultation on respective proposed amendments to the BA and the Banking Ordinance (BO):

- Firstly, the new rules provide for a prolonged timeframe of up to 60 days for the acceptance and holding of public deposits for settlement purposes, which is particularly relevant for crowdfunding platforms as these providers need to hold client monies for a certain time before they can fund specific projects. If settled within such timeframe, such business models will not require a banking licence as long as no interest is paid on the accepted monies.

- In addition, for the purposes of testing a business model on its marketability, the acceptance of public deposits of up to CHF 1 million shall not qualify as operating on a commercial basis and can be exempt from authorization (innovation sandbox), provided no interest is paid on the client deposits and the funds are not invested.

- Finally, it is proposed to create a specific banking licence "light" which provides for lower regulatory requirements. Companies accepting public deposits of up to a maximum of CHF 100 million (or even more in specific circumstances), but do not operate in the lending business, i.e., no interest is paid on the public deposits and the funds are not invested, shall benefit from less stringent requirements, particularly in the areas of accounting, auditing and deposit protection as well as with respect to minimum capital, equity and liquidity requirements.

Other regulatory laws still apply: Despite the (proposed) exemptions and reliefs granted with respect to the BA, FinTech business models may still be subject to a variety of financial market regulations and laws, e.g., anti-money laundering, financial market infrastructure, collective investment, consumer credit, insurance supervision or the exchange and securities trading laws (SESTA).

Further changes to the future FinTech regulation expected: With the above summarized proposals, the implementation of a FinTech specific regulation is still in its rather early stages. In the course of the ongoing legislative amendments things may still change, maybe also by amending other financial market regulation laws or even in the course of the implementation of the new legislative project for a Financial Services Act (FinSA) and a Financial Institutions Act (FinIA).

In any event, it seems fair to say that the intended exemptions and reliefs are likely to boost innovative financial technologies and, likewise, respective FinTech-driven M&A transactions and joint ventures involving banks and securities dealers.

3. Technology transfer / asset deal

To obtain important technology or expertise, a bank may acquire specific assets from a FinTech company (e.g., specific technology/IP-rights or even a whole part of its business, including employees). Such transaction can be done by way of an asset deal under the Swiss Merger Act (SMA) or outside the SMA, and may be subject to mandatory laws, which may cause joint liabilities, employee information, consultation or other disclosure duties to apply.

a) The bank's perspective in connection with carve-outs

In principle, no FINMA notification or approval requirements apply: From a regulatory point of view, an asset deal by a bank is per se not subject to FINMA notification or approval requirements. However, in order to (receive and) keep a banking license, banks need to comply with their licence requirements at all times and, for example, need to be adequately organized and guarantee a proper business conduct (article 3 BA or article 10 SESTA for securities dealers).

Circumstances in which notification or approval requirements may apply: For example, the articles of association or other organizational regulations of the bank need to provide a precise factual and geographical description of the bank's business and have to be compatible with the bank's finances and organization. To the extent that the FinTech transaction causes a change in the bank's business activities, these changes may need to be reflected in the bank's organizational regulations which needs FINMA's prior approval.

Depending on the type and scale of the acquired assets or (parts) of a business, such acquisition may involve (or lead to) a non-banking related activity. Although there is no per se prohibition to be active in a non-banking business, banks are required to explicitly mention any of their non-banking activities in their articles of association. Any amendments to the articles (caused by a FinTech-driven transaction or otherwise) need FINMA's prior consent before such changes may become legally effective by filing it with the competent commercial register. Also, a FinTech transaction may have implications on a bank's ongoing ability to comply with certain requirements, such as compliance with capital adequacy, risk diversification and liquidity rules.

Arguably, often a FinTech-driven acquisition may not have the scale (compared to the bank) to cause changes in a bank's licence requirements that may be problematic from a regulators point of view. However, as no bank wants to risk any (subsequent) FINMA intervention due to non-compliance with licence requirements, such type of transactions (depending on its type and scale) are usually pre-discussed with FINMA as well as with the bank's regulatory auditor, even if only a notification requirement applies.

b) The FinTech's perspective in connection with carve-outs

Today, as well as following the enactment of the anticipated regulatory changes (see section 2), many FinTech business models are, and will remain, subject to some sort of a banking licence. For these regulated FinTechs, the requirements summarized above would also apply to the FinTech company itself.

As per the proposed regulatory changes (and materials published in connection with the public consultation of February 2017) the rules relating to the licence requirements (article 3 BA) shall be applied to banking licence "light" holders by analogy. Therefore, (FinTech) companies licenced with a ("light" or "normal") banking licence will still need to comply with their licence requirements, causing them to obtain prior approval from (or notification to) FINMA before entering into certain carve-out transactions and/or before adapting their business activities in connection with, or as a consequence of, a transaction.

4. Investment / share deal

As opposed to acquire specific assets or parts of a business, the bank may also invest in a FinTech company and acquire some or all of its shares.

a) Investing in a regulated FinTech company

In case the bank intends to acquire shares in a FinTech company active in a (bank) regulated business, the same rules apply as if the bank would invest in another bank. Therefore, a share deal involving the acquisition of more than 10% of a FinTech company's voting or capital rights as well as the exceeding, or falling below, of certain thresholds (20, 33 or 50% of the voting or capital rights) have to be notified to FINMA before closing the transaction (article 3 para. 5 BA or article 28 SESTO with respect to securities dealers).

Such notification duty also applies for (FinTech) companies that will hold a banking licence "light" (see section 2), as the proposed regulatory changes (and materials published in connection with the public consultation of February 2017) provide for article 3 BA to apply by analogy.

b) Investing in a non-regulated FinTech company

In principle, no FINMA notification or approval requirements apply: If the FinTech company does not qualify as a bank, bank "light" or securities dealer, FinTech-driven share transactions by banks are not per se subject to FINMA notification or approval duties under the BA or SESTA. As opposed to an asset deal situation, the investment in a separate legal entity does not necessarily need to cause an immediate change in the investing bank's business activity and licence requirements.

However, prior FINMA notification or approval may be necessary depending on certain circumstances: In the event that the bank's articles need to be amended (for example in order to allow a shareholding in a company that is active in a non-banking activity or to provide for an increased nominal capital etc.). Also, for example, a prior notification duty applies in case the bank acquires a (FinTech) company that is active in a foreign financial market (article 3 para. 7 BA).

Depending on the implications of the transaction on the bank's own business and organization (and the possible business transformation that follows thereafter), a notification or approval requirement may also apply indirectly, as the banks need to comply with their listing requirements, now and in the future. As a FinTech investment is usually made in order to adapt and change the future business activity and organization of the bank, a change of business activities can be a (indirect) consequence of a FinTech transaction. Without having the activity and steps (that follow the FinTech transaction) cleared with FINMA, such transaction or associated business development may not be worth the costs or may even become subject to a later intervention by FINMA.

Clearly, a relatively small investment to a (compared to the bank) small FinTech company is unlikely to cause an immediate change at the level of the investing bank that would cause FINMA to step in. However, in the context of an M&A transaction, as often any sort of uncertainty is not acceptable, such transactions are usually pre-discussed with FINMA as well as with the bank's regulatory auditor.

Investing in a "FinTech" company that is not (yet) active in the financial sector: As the name "FinTech" suggests, FinTech companies are likely already active in the financial sector. However, it is also possible that a company active outside the financial sector owns or develops a technology relevant for FinTech and is therefore acquired by a bank. In this respect it is noteworthy that in case a bank acquires a "qualified interest" (meaning above 10% of the voting or capital rights) in a company active outside the financial or insurance sector, such single investment may not exceed 15% of the bank's equity capital, and all investments in such type of companies may not exceed 60% of the bank's equity capital.

c) Group supervision

If the FinTech company is mainly active in the financial sector, the acquisition of control by a bank may, in addition to the above mentioned requirements, also lead to a financial group subject to regulatory consolidated supervision by FINMA. Generally, the same supervisory regulations apply to financial groups as they do at single entity level, but on a consolidated basis (i.e. capital adequacy, liquidity, risk diversification etc.) and the group's organization and management needs to be adequate and must guarantee a proper business conduct in view of the group as a whole, including for the controlled FinTech company.

Group supervision comes in addition to individual supervision of the bank itself, which can cause additional costs and efforts for affiliated companies and could cause the (controlled) FinTech company to become to some extent subject to FINMA regulation. For example, a financial group needs to notify FINMA in advance before its (controlled) FinTech company becomes active in foreign financial market.

It is noteworthy that the necessary level of "control" to cause an affiliated group company to come within the scope of a regulatory consolidated supervision can occur with comparatively low shareholding numbers: A 20% stake in a FinTech company may be sufficient if there is a joint control situation with (also non-regulated) third parties (by way of contractual or factual circumstances).

Often, from a regulatory point of view, the activities of a FinTech company may not be considered as critical. In justified cases, notably when the FinTech company has no material significance for consolidated supervision, FINMA can exempt the FinTech company from consolidated supervision or declare the supervision only partially applicable (article 23 para 2 BO).

The possibility to exempt a FinTech investment from consolidated supervision is one way that should allow FINMA to ensure that established banks can benefit in the reliefs and exemptions of the FinTech regulation in the same way as non-regulated market participants do (see section 7).

5. Cooperation / Joint Venture

In case the bank wishes to establish a substantial cooperation with a FinTech company, such cooperation may often involve the incorporation of a (jointly controlled) JV company as well as the JV partners' contribution of assets and liabilities, or even a whole part of their business, to the JV-company.

Such carve-out transactions are challenging from a legal point of view. To name a few, the transfer of parts of the business that include employees is for example subject to mandatory employment laws (article 333 CO), may cause joint liabilities to apply and the incorporation of the JV company may have to comply with certain disclosure duties in view of the anticipated transaction between affiliates after incorporation (beabsichtigte Sachübernahme).

Furthermore, regulatory rules apply: Essentially, the carve-out of assets and liabilities into a newly incorporated JV company combines the requirements as set out in sections 3 and 4 above. Simplified, the participation of a bank in the JV company follows the rules of a share deal (section 4) and the carve-out from a bank into the JV company follows the rules of an asset deal (section 3).

In addition to these approvals, depending on whether the JV company's business is itself regulated ("full" licence or a licence "light", see section 2), the JV needs to obtain the relevant licences before completion of the JV transaction. If not a bank, but active in the financial sector, regulatory rules may still become relevant for the JV as, for example, the controlled JV company may become subject to regulatory consolidated supervision and the incorporation of the JV abroad is subject to FINMA notification (article 3 para. 7 BA).

6. Contractual Cooperation

A partnership between the bank and the FinTech company may also be based on contracts only (as opposed to forming a separate entity). In this respect, one legal question that may arise is whether the cooperation leads to an outsourcing from the bank to the FinTech company as such outsourcing will have to follow the rules as stipulated in FINMA circular 2008/7.

However, it is noteworthy that currently the applicable rules and standards requested by FINMA for outsourcing are in the process of being amended in order to become (more) harmonized with outsourcing rules applicable for insurers. Based on a draft of such new FINMA circular as published in early 2017, it is expected that all the requirements defined in the circular will now apply equally to intra-group outsourcing. In addition, systemically important banks must meet more stringent requirements when outsourcing critical services.

7. Implications for a future FinTech regulation

The focus of the ongoing FinTech discussion lies on creating a regulation favourable to FinTech companies. While this is clearly to be welcomed, it needs to be ensured that established banks and securities dealers can also take advantage of the new regulations. In order for Switzerland to keep its position as a strong financial center, it is of paramount importance that the digitalization of the financial industry can deliver its full potential. Thus, a smooth interaction between established financial institutions, bringing in the customer contacts and the financial/banking expertise, and FinTech companies, contributing the technology part and adapted business models, is key.

In the course of the ongoing legislative process it is therefore important (to continue) to ensure that co-operation and other M&A transactions between banks and FinTech companies are facilitated in a sense that general regulatory rules applicable to banks (for example rules in connection with consolidated supervision) do not cause the banks be put at a disproportionate disadvantage compared to other non-regulated Fintech investors and/or competitors when investing in FinTech companies.

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