Fintech companies face investment company status challenges

Leslie S. Cruz and Stephanie M. Monaco

Leslie S. Cruz (lcruz@mayerbrown.com) is a counsel and Stephanie M. Monaco (smonaco@mayerbrown.com) is a partner, both in the Washington, DC, USA office of Mayer Brown LLP.

Abstract

Purpose – *To inform readers of the challenges that fintech companies can have regarding investment company status, using two recent examples.*

Design/methodology/approach – *The article provides an introduction to the subject, discusses two examples of fintech companies that had investment company status challenges, and provides concluding remarks regarding each.*

Findings – *Navigating investment company status can be challenging for fintech companies, and in some cases, as was the case with the two companies discussed in the article, it may be necessary, or at least advisable, to seek to obtain an order from the SEC.*

Practical implications – *It is important for fintech companies to evaluate their investment company status in early stages and continue to monitor their status thereafter, particularly if they are considering a public offering.*

Originality/value – *Technical guidance from experienced investment company status lawyers.*

Keywords *Fintech, US Investment Company Act of 1940 (1940 Act), Public offering, Cloud-based, Lending platform*

Paper type *Technical paper*

Fintech companies can face a variety of regulatory challenges under the federal securities laws, including one that often receives minimal attention, namely a company's status as an "investment company" under the US Investment Company Act of 1940 (the "1940 Act"). Fintech companies that possibly meet the threshold definition of "investment company" under the 1940 Act, but are not publicly offering their securities and do not plan to do so, generally may seek to rely on the exceptions from the definition afforded by Section 3(c)(1) or Section 3(c)(7). [1] But if a public offering is planned or underway, those exceptions are unavailable, forcing the company to seek out other possible exceptions or ask the US Securities and Exchange Commission ("SEC") for exemptive or similar relief. In the fall of 2020, two fintech companies sought and received exemptive or similar relief but through very different paths.

One company, the operator of a cloud-based data platform, sought and received an order under Section 3(b)(2) of the 1940 Act declaring it to be primarily engaged in non-investment company business, i.e. a business other than that of investing, reinvesting, owning, holding or trading in securities and thus not an "investment company" under the 1940 Act (the "Cloud-Based Data Company"). [2] In contrast, another company sought and received an exemptive order under Section 6(c) of the 1940 Act to permit it to operate an artificial intelligence ("AI")-based lending platform ("Platform") that facilitates the issuance of small consumer general purpose loans without being subject to the 1940 Act ("Lending Platform Company"). [3] The two SEC orders are discussed below.

Cloud-based data company

As mentioned above, the Cloud-Based Data Company sought and received an SEC order under Section 3(b)(2) declaring it to be primarily engaged in a business other than that of investing, reinvesting, owning, holding or trading in securities directly, through majority-owned subsidiaries or controlled companies conducting similar types of businesses, notwithstanding the fact that the company may fall within the definition of "investment company" in Section 3(a)(1)(C).

Section 3(a)(l)(C) defines an investment company as an issuer that is engaged or proposes to engage in the business of investing, reinvesting, owning, holding or trading in securities and owns or proposes to acquire investment securities having a value in excess of 40% of the value of the issuer's total assets (exclusive of US government securities and cash items) on an unconsolidated basis. "Investment securities" includes all securities except US government securities, securities issued by employees' securities companies and securities issued by majority-owned subsidiaries of the issuer that are not themselves investment companies and are not relying on Section 3(c)(1) or Section 3(c)(7).

At the time of the request, the company did not meet the definition of "investment company" in Section 3(a)(1)(C), but it believed that it would likely meet that definition in the near future and over the long term.

The company's business consists of operating a cloud-based platform that enables customers to consolidate data regarding business insights, build data-driven applications and share data. The company stated that the cloud computing industry is a capital-intensive industry that requires it to have and maintain significant amounts of readily available capital for ongoing operations and expenditures. The company also said that it needed to maintain substantial liquid capital to fund research and development activities; address fluctuations in the results of its operations; and pursue potential strategic transactions, including acquisition of businesses, new technologies, services and other assets and strategic investments that complement its business.

Pending the deployment of capital in business operations, the company wanted to invest its capital in cash items and government securities, as well as short-term investment-grade and liquid fixed-income and money market instruments that earn competitive market returns and provide a low level of credit risk ("Capital Preservation Investments"), adopting a term used in 1940 Act Rule 3a-8 for research and development companies. The company represented that it does not invest in securities for short-term speculative purposes. In addition, it had recently engaged in an initial public offering ("IPO"), thus eliminating any possibility of relying on Section 3(c)(1) or Section 3(c)(7). The company wanted to invest a significant portion of the IPO proceeds in Capital Preservation Investments, which presented a problem for its investment company status as the investments are considered to be "investment securities."

The company also said that it may make limited investments in private companies related to its corporate development strategy ("Strategic Investments") and that such investments would be "investment securities" for purposes of Section 3(a)(1)(C). However, the company stated to the SEC that it does not plan to invest more than 10% [4] of its unconsolidated assets (excluding US government securities and cash items) in investment securities that are not Capital Preservation Investments, including Strategic Investments. [5] Interestingly, this 10% limitation was not set out as a condition to the SEC's relief.

The company said that once the proceeds from the IPO are invested, approximately 89% of its total (presumably unconsolidated) assets (excluding US government securities and cash) would be composed of "investment securities," substantially all of which would be Capital Preservation Investments. [6] As is the case with many fintech and similar companies, the company maintained a significant amount of internally generated intellectual property and other intangible assets that may not appear on its balance sheet.

Without such assets reflected on the company's balance sheet, the company's total assets would be lower and would result in a higher percentage of "investment securities."

In addition to assets and income, the SEC considered the three other factors utilized by the SEC and its staff in evaluating an issuer's primary engagement under Section 3(b), [7] namely the historic development of the issuer, the issuer's public representations of policy and the activities of the issuer's officers and directors.

The SEC granted the requested Section 3(b)(2) order, subject to only two conditions: (1) the company will continue to allocate and use its accumulated cash and investment securities for bona fide business purposes; and (2) the company will refrain from investing or trading in securities for short-term speculative purposes. [8]

Lending platform company

As mentioned above, this company sought and received an SEC order under Section 6(c) [9] to permit it to operate the Platform without registering under the 1940 Act. The Lending Platform Company's journey began in December 2013, when it was organized to become the holding company of an existing company (organized in 2012) that operated an [10] internet-based platform that connected graduates with investors and provided funding to the graduates in return for a portion of the graduate's future income ("Existing Company"). The Existing Company used its AI and related modeling to assess that future income.

In 2014, the Existing Company adapted its AI models to support the origination of consumer loans and shifted its business model to focus on operating the Platform. The AI models are used by partner US banks to quantify the credit risk of potential borrowers and to determine whether to originate a loan, e.g. if the AI models show the loan meets applicable underwriting standards. [11] The Existing Company also operates the Platform, which among other things, aggregates consumer demand for the loans and connects that demand to the banks for purposes of originating the loans. The Existing Company also provides banks with various services, including an application flow interface used to facilitate origination of loans, risk underwriting, verification of borrower information and support for borrowers during the origination. Banks can use these services either by originating loans on the Platform or by "white-labelling" the technology on their own websites. The Existing Company also services the loans originated through the Platform.

The Existing Company purchases most of the loans originated through the Platform shortly after origination in order to help facilitate loan origination activity and liquidity. Most of the loans that the Existing Company purchases from the originating banks are sold to third parties on the day of purchase [12] and thus do not appear on the Lending Platform Company's balance sheet. In 2019, loans immediately sold to third parties constituted 70% of all loans originated through the Platform.

Loans not retained by the originating bank or immediately sold to third parties are held by the Existing Company until the loans are eventually sold, placed in securitization vehicles that may be sponsored by the Existing Company or an unaffiliated third party or eventually mature. [13] In 2019, these loans constituted 7% of the loans originated through the Platform.

The assets on the Lending Platform Company's consolidated balance sheet consist primarily of the loans, [14] certain certificates issued by the securitization vehicles ("ABS"), [15] cash and cash equivalents. The amount of loans reflected on the Lending Platform Company's balance sheet fluctuates, as the Existing Company's loan purchases generally serve as a backstop for excess loans originated on the Platform. The Lending Platform Company represented that the amount of loans purchased and held by the Existing Company depends on the market for the loans and is not based on any decision regarding whether to purchase specific loans or on the amount of loans that the Lending Platform Company wants

to retain. Further, the Existing Company only holds to maturity those loans that it cannot ultimately sell or securitize.

The Lending Platform Company had publicly filed a Form S-1 registration statement and intended to effect an IPO of its equity securities, extinguishing any potential reliance on Section 3(c)(1) or Section 3(c)(7). After the IPO, the Lending Platform Company intended to invest excess IPO proceeds in US government securities and Capital Preservation Investments.

The Lending Platform Company thought that it may meet the definition of an "investment company" under Section 3(a)(1)(C). On an unconsolidated basis, approximately 70% of the total value of the Existing Company's assets would be held in investment securities, including its interests in its direct wholly-owned subsidiaries, which (excluding cash) hold only the loans purchased by the Lending Platform Company and therefore would be investment companies, and interests in the securitization vehicles. Therefore, the Existing Company would meet the definition of an investment company on an unconsolidated basis as well. The Lending Platform Company also thought that it may be an investment company under Section 3(a)(1)(A). In each case, the assumption was that the loans may be treated as securities for purposes of the 1940 Act. [16] Based on the Lending Platform Company's consolidated financial statements for 2019, approximately 87% of its consolidated total assets (of which 76% were represented by loans), were composed of "investment securities."

Although loans comprised the vast majority of the Lending Platform Company's assets, its net revenues (the Lending Platform Company was operating at a net loss) were almost exclusively derived from Platform fees, loan servicing fees and loan referral fees. In 2019, 97% of its net revenue was derived from these fees, 71% of which was related to the loans that were sold immediately upon origination. Net interest revenue from the loans in 2019 represented approximately 3% of total net revenues.

The Lending Platform Company stated that it views itself, and has consistently represented itself publicly, as being primarily engaged in the business of providing technology and related services to financial institutions and not in the business of being an investment company or investing in loans. The Lending Platform Company's view was that the loans and other investment securities that are held by the Existing Company are a byproduct of these technology activities [17] and are acquired not for an investment purpose but rather to support the loan origination activity by its partner banks by finding financing for those loans.

The Lending Platform Company also pointed out that it and the Existing Company are subject to a range of regulations governing its business activities, i.e. state licensing and registration related to consumer lending, loan brokering and servicing, and that the Platform generally has been structured to comply with banking regulations (given the Existing Company's role as a service provider to its bank partners).

The SEC granted the requested relief, subject to no less than seven conditions:

1. The Lending Platform Company will not hold itself out as being engaged in investing, reinvesting or trading in securities other than loans originated through the Platform. [18]
2. The Lending Platform Company, directly or indirectly, will only hold loans that are originated through the Platform.
3. Any loans held to maturity will represent less than 15% of the total volume of loans held, directly or indirectly, by the Lending Platform Company on a rolling basis for the last four most recent fiscal quarters combined.
4. The Lending Platform Company, directly or indirectly, will not hold loans for speculative purposes.

5. The Lending Platform Company will allocate and use its accumulated cash and any investment securities (other than loans) for bona fide business purposes in accordance with a cash-management investment policy adopted by its board of directors and will refrain from investing or trading in securities for short-term speculative purposes. As of the last date of each most recent fiscal quarter, at least 90% of investment securities other than the loans or ABS held only for purposes of satisfying the Risk Retention Rules, held by it on a consolidated basis, will be in Capital Preservation Investments.

6. Net revenue earned from interest on the loans will comprise, on a rolling basis for the last four most recent fiscal quarters combined and in combination with interest on any other investment securities, no more than 10% of the Lending Platform Company's total net revenue. For purposes of this condition, net revenue excludes (from both the numerator and the denominator) interest generated by cash holdings, US government securities and risk retention vehicles, as well as fair value adjustments for the loans, and will be calculated net of interest paid on any credit facilities used to purchase the loans.

7. The Lending Platform Company may continue to rely on the order granting the requested relief so long as the operations that gave rise to the request for the exemptive order do not differ materially from those described in its application for relief. [19]

Conclusion

The Cloud-Based Data Company and the Lending Platform Company approached their respective investment company status challenges quite differently. The Lending Platform Company's approach essentially concedes that it is likely an "investment company" (without any exceptions on which to rely) and thus requests relief from the registration and other requirements under the 1940 Act that would otherwise apply to it. In contrast, the Cloud-Based Data Company asked the SEC to declare that it was not an investment company as a threshold matter. The Cloud-Based Data Company could have relied on Section 3(b)(1), which is a self-executing provision regarding non-investment company status. [20] However, in doing so, the SEC, a court of law or other interested party could disagree with and challenge the Cloud-Based Data Company's conclusion in that regard. [21]

One noteworthy aspect of the Lending Platform Company's relief is the treatment of the consumer loans as securities under the 1940 Act, which may explain why it requested relief under Section 6(c) as opposed to Section 3(b)(2). The definition of "security" under the 1940 Act is broad (e.g. it includes any evidence of indebtedness) and is interpreted by the SEC and its staff more broadly as compared with the definition under the Securities Act of 1933 and the Securities Exchange Act of 1934. Accordingly, given the Lending Platform Company's significant loan holdings, and the treatment of those loans as "securities" under the 1940 Act, it likely would have been difficult for it to represent that it is primarily engaged in a non-investment company business.

Notes

1. In sum, Section 3(c)(1) provides an exception from the definition of "investment company" for an issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than 100 persons (or, in the case of a qualifying venture capital fund, 250 persons) and that is not making and does not presently propose to make a public offering of its securities. As a general matter, Section 3(c)(7) provides an exception for an issuer whose outstanding securities are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers and that is not making and does not at that time propose to make a public offering of its securities.

2. www.sec.gov/rules/ic/2020/ic-34085.pdf(order);https://www.sec.gov/rules/ic/2020/ic-34049.pdf(notice); www.sec.gov/Archives/edgar/data/1640147/000164014720000015/snowflake-40appa.htm(application). Seealsohttps://www.sec.gov/rules/ic/2007/ic-27877.pdf(notice)andwww.sec.gov/rules/ic/2007/ic-27888.pdf(order)(digitalmediaservicesandsoftwarecompany).

3. https://www.sec.gov/rules/ic/2020/ic-34124.pdf(order);https://www.sec.gov/rules/ic/2020/ic-34088.pdf (notice); https://www.sec.gov/Archives/edgar/data/1647639/000119312520285907/d27815d40app.htm (application).
4. The 10% limit has origins in 1940 Act Rule 3a-8, which is designed for research and development companies.
5. Notably, the asset percentages set out in the Notice did not reference "value" as that term is defined in the 1940 Act, although the term "value" is used in Section 3(a)(1)(C) and is generally used by the SEC staff and practitioners in evaluating asset composition for investment company status purposes under this section, Section 3(a)(1)(A), and related rules.
6. Interestingly, the Notice did not include any representations regarding the percentage of income or revenues expected to be derived from "investment securities" once the IPO proceeds are invested.
7. These five factors, commonly referred to as the "Tonopah" factors, are also used to evaluate primary engagement for purposes of Section 3(a)(1)(A), as well as for other investment company status purposes (e.g., relevant exceptions in Section 3(c) of the 1940 Act).
8. These two conditions are consistent with a number of other Section 3(b)(2) orders, although some such orders have no conditions and others have more than two.
9. Section 6(c) permits the SEC to exempt, among others, an issuer from any provision of, or rule or regulation under, the 1940 Act if and to the extent such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the 1940 Act.
10. The Existing Company became a "wholly-owned subsidiary" of the Lending Platform Company, and the Lending Platform Company's assets consist entirely of its interest in the Existing Company.
11. The Existing Company is an exempt reporting adviser in the state of California, apparently due to its role as investment manager or general partner of a private fund.
12. The purchases and sales are for exactly the same amount, and, accordingly, the Lending Platform Company does not make any net profit on them.
13. Certain wholly-owned subsidiaries of the Existing Company hold certain loans originated on the Platform until such loans are sold to third parties or placed in the securitization vehicles. Other wholly-owned subsidiaries hold loans that are purchased or repurchased by the Existing Company, which it believes cannot be sold in the future. (These loans are held to maturity unless they are ultimately sold to third parties or securitized.)
14. The average length of time that loans remained on the Lending Platform Company's consolidated balance sheet was just over three months (calculated as weighted average time of loans on the balance sheet as of 1Q 2020).
15. The Lending Platform Company stated that it seeks to hold only the amount of ABS it is required to retain for purposes of compliance with Regulation RR under Section 15G of the Securities Exchange Act of 1934 and will sell them as soon as the Lending Platform Company is no longer required to hold all or part of those interests.
16. The Lending Platform Company believed that it could not rely on Section 3(c)(4), which excepts from the definition of "investment company" any person substantially all of whose business is confined to *making* small loans, industrial banking or similar businesses, because it is not primarily engaged in the business of *originating* loans. The Lending Platform Company also believe that it could not rely on Section 3(c)(5) because it is not primarily engaged in purchasing or acquiring loans, and the loans that it does hold are not of the types specified in this section. Section 3(c)(5) excepts from the definition of "investment company," in relevant part, any person who is primarily engaged in one or more of the following businesses: (A) *purchasing or otherwise acquiring* notes, drafts, acceptances, open accounts receivable and other obligations representing part or all of the sales price of merchandise, insurance and services; (B) *making* loans to manufacturers, wholesalers, retailers and prospective purchasers of specified merchandise, insurance and services; and (C) *purchasing or otherwise acquiring* mortgages and other liens on and interests in real estate. Notably, Section 3(c)(5)(C) generally applies to mortgage *originators*.
17. In this regard, the Lending Platform Company stated that most of its employees spent their time developing the AI models, facilitating the origination and financing of loans through the Platform, performing roles supporting the operations of the Platform and servicing the loans, with a small percentage of employees spending a negligible amount of time on activities related to managing the loans themselves.
18. Notably, the Cloud-Based Data Company's relief was not subject to a similar condition.

19. The Cloud-Based Data Company's relief was not subject to a similar condition, although as a general matter an exemption may no longer be relied on if there has been a material variance from the structure or other fact described in the application for relief.
20. Section 3(b)(1) states that, notwithstanding Section 3(a)(1)(C), an issuer primarily engaged, directly or through a wholly-owned subsidiary or subsidiaries, in a business or businesses other than that of investing, reinvesting, owning, holding or trading in securities is not an "investment company."
21. Generally speaking, an SEC exemptive order precludes both SEC and private actions, and can be relied upon only by the applicant(s).

Corresponding author

Leslie S. Cruz can be contacted at: lcruz@mayerbrown.com