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The Securitization of U.S. Bank Activities in the Eurodollar Market—Issues for U.S. Counsel

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I. Introduction

Not long ago U.S. banks were largely content to confine their activities in the Eurodollar market to making loans funded by interbank deposits. Because the normal presumption was that a loan once made would be held to maturity, banks were not overly concerned with the transferability of the loan. Promissory notes were rarely drafted to ensure negotiability.¹ Assignment clauses typically confined the permitted class of transferees to banks and other financial institutions and frequently required borrower consent to transfer. The primary task of legal counsel was to draft a loan agreement containing representations, covenants, defaults, yield protection and other provisions adequate to protect the bank as an asset holder for the medium term.

In recent years, however, commercial banks have found it increasingly difficult to survive in their classic role as intermediary in the Eurodollar market. Borrowers have demanded lower interest rate margins over the Eurodollar interbank deposit rate. At the same time, Eurodollar depositors have demanded a higher rate of return on their investments and have shown an increasing willingness to

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¹ Under the laws of many jurisdictions, in order for a note to be negotiable it must evidence an obligation to pay a sum certain. *See, e.g.*, U.C.C. § 3-104(1)(b) (1978). This requirement destroys the negotiability of most notes evidencing Eurodollar loans, since the interest rate on such loans fluctuates with the interbank deposit rate and cannot be reduced to a fixed sum.

place funds directly with the borrowers to obtain that rate.² The market for Eurocommercial paper and other Euromarket securities has flourished; and the decline in new money sovereign credits has reduced the demand for international bank lending. As a result, banks have had to rely increasingly on income from new types of activities. Rather than making loans and holding them to maturity, banks are now originating financial assets with borrowers to sell them to investors at a profit or for a fee. This practice has placed a premium on the transferability of financial assets created by banks in the Eurodollar market.

The transferability of Eurodollar assets has gained further importance due to the mounting pressure on banks by bank regulatory authorities to increase their capital to asset ratios.³ An obvious way to increase this ratio without having to increase capital is to decrease assets. Thus, the management of capital to asset ratios is directly related to the transferability of bank assets.

The creation by banks of easily transferable financial assets is

² The sovereign debt crisis, among other factors, has encouraged investors to shift their funds away from interbank deposits and into top quality corporate and government issuers in the Eurosecurities markets. See Shirreff, *The Euronote Explosion*, EUROMONEY, Dec. 1984, at 31; *Placings Hampered by Flat Yield Curve*, Fin. Times, Mar. 10, 1986, at 20, col. 1.

³ Because of bank concerns regarding this ratio, fee generating off-balance sheet transactions have become particularly attractive. In the Eurodollar market a primary example of this type of transaction has become the note issuance facility, or NIF. See *infra* notes 12-14 and accompanying text. The ability of banks to commit themselves contingently under NIFs without affecting the capital to asset ratio is rapidly nearing an end, however. In April 1985 the Bank of England issued capital guidelines requiring United Kingdom (U.K.) banks (including U.K. subsidiaries, but excluding U.K. branches, of foreign banks) to include the undrawn amount of standby commitments under NIFs in the risk-asset ratio with a weighting of 50% (*i.e.*, half that required for normal loan assets). BANK OF ENGLAND, OFF-BALANCE SHEET RISKS: NOTE ISSUANCE FACILITIES/REVOLVING UNDERWRITING FACILITIES, BSD/1985/2 (Apr. 1985). In January 1987 the Bank of England together with the Federal Reserve Board, the Comptroller of the Currency and the Federal Deposit Insurance Corporation announced a joint proposal which, if adopted, would require banks under their respective supervision to maintain capital against NIFs at a risk weighting of 10% in respect of commitments of one year or less, 25% in respect of commitments of over one year and less than five years and 50% in respect of commitments of over five years (thus imposing capital requirements on U.S. banks for the first time in respect of NIFs, while easing the regulatory burden presently in effect for U.K. banks). Joint News Release by Comptroller of the Currency, Federal Deposit Insurance Corporation and Federal Reserve Board, Jan. 8, 1987; see also 52 Fed. Reg. 5,119, 5,124 (1987). The bank regulatory authorities of several other jurisdictions, including Japan, West Germany, the Netherlands and Hong Kong, have either enacted or are considering enacting similar requirements. See Kirkland, *Banks Seek Life Beyond Lending*, FORTUNE, Mar. 3, 1986, at 54; Lascelles, *Bankers Shrug Off NIF Weighting*, Fin. Times, June 27, 1986, at 34, col. 1; Carr, *W. German Banks Face Euronote Risk Rule*, Fin. Times, June 9, 1986, at 29, col. 6; Hong Kong Banking Ordinance 1986 (May 29, 1986). In March 1986 the Bank for International Settlements issued a report examining off-balance sheet risks including those incurred by banks under NIFs and encouraging supervisory authorities in the G-10 countries to modify capitalization requirements to take these risks into account. BANK FOR INTERNATIONAL SETTLEMENTS, COMMITTEE ON BANKING REGULATIONS AND SUPERVISORY PRACTICES, THE MANAGEMENT OF BANKS' OFF-BALANCE-SHEET EXPOSURE: A SUPERVISORY PERSPECTIVE (Mar. 1986).

frequently termed "securitization."⁴ The drive toward securitization in the Eurodollar market has led commercial banks down two basic paths. First, they have increased activity in certain types of Eurodollar debt securities, especially floating rate notes and Euronotes. Second, they have taken measures to facilitate the ability to transfer Eurodollar loans and other bank assets, concentrating in particular on programs for the sale of participations in such assets.

This Article begins with a basic description of floating rate notes, Euronotes and current loan participation sales programs of U.S. banks in the Eurodollar market. Then the Article addresses various issues that arise under U.S. law for U.S. banks⁵ that are involved with these types of securities and programs. In particular, the Article focuses on issues arising under the federal securities, tax, and banking laws.

A. *Floating Rate Notes*

Floating rate notes (FRNs) are medium to long-term promissory notes typically issued in the Eurodollar market in bearer form. The notes evidence an obligation of the issuer to pay a stated amount of principal in full (usually 5,000 or 10,000 dollars) on a final maturity date,⁶ and to pay interest on specified payment dates. The primary distinction between an FRN and other Eurobonds is its fluctuating interest rate, which, like medium-term Eurodollar loans, is based on the Eurodollar interbank deposit rate for successive short-term interest periods.⁷ The note's reverse side contains a number of terms and conditions, including mechanics for determining the interest rate and certain yield protection provisions typically found in a Eurodollar loan agreement (including alternative interest rate and tax protection provisions but excluding illegality and increased cost protections), certain covenants of the issuer (frequently limited to a negative pledge), and basic default provisions (such as failure to pay

⁴ As explained below, the term "securitization" is something of a misnomer from the standpoint of banks, in that their principal aim in many cases is to maximize transferability of a financial asset while at the same time preventing characterization of the asset under relevant law as a "security." See, e.g., *infra* text accompanying note 66.

⁵ The term "U.S. bank" is used in this Article to refer to national banks organized under U.S. federal law and banks organized under state law that are members of the Federal Reserve System.

⁶ Typically a borrower in the case of both Eurodollar loans and FRNs can voluntarily prepay or redeem the debt prior to final maturity. Conventional medium-term Eurodollar loans differ from FRNs, however, in that they normally require principal to be amortized over the term of the debt. While FRNs normally provide for payment of principal in full at final maturity they occasionally provide for amortization, in which case each installment of principal is evidenced by a box (or talon) on the face of the note which is cancelled upon presentation for payment to the paying agent. Alternatively, an FRN may provide for a sinking fund, which obliges the issuer to repay or repurchase in the market a predetermined amount of the issue per year while the sinking fund is in place.

⁷ See *infra* note 23.

interest or to perform other obligations under the note, cross-default and bankruptcy). Such a note contains none of the representations and warranties typically found in a Eurodollar loan agreement. The subscription agreement, however, pursuant to which the managers of an FRN issue commit to purchase any unsubscribed notes,⁸ generally does contain representations and warranties running in favor of the managers.⁹

Upon the satisfaction of conditions precedent specified in the subscription agreement, the FRNs are issued and authenticated by a fiscal agent of the borrower in the manner prescribed by a fiscal agency agreement. The fiscal agency agreement contains further provisions regarding payment of principal and interest through the fiscal agent or other paying agents of the borrower. In addition, the fiscal agency agreement often provides for meetings of the noteholders for the purpose of accelerating the maturity of the notes, waiving defaults, or amending the terms and conditions of the notes.

U.S. banks have become actively involved with FRNs in both the primary and secondary markets. In the primary market they act as managers and underwriters of FRNs through their foreign merchant banking subsidiaries.¹⁰ In the secondary market those subsidiaries trade in FRNs and, along with the foreign offices of U.S. banks, acquire FRNs for their investment or loan portfolio.¹¹

⁸ The subscription agreement is typically one of several agreements relating to the actual purchase and sale of the FRNs. Although the content of these documents may vary, the documents typically consist of selling agreements, the subscription agreement and an agreement among managers. Pursuant to individual selling agreements the members of a selling group (previously uncommitted to the issue except to the extent also acting as managers) agree to purchase up to a certain face amount of the FRNs and to comply with detailed selling restrictions and procedures (*see infra* note 35 and accompanying text) designed to avoid violation of the securities laws of the U.S., the U.K. and other jurisdictions. As indicated in the text, pursuant to the subscription agreement the managers agree (typically jointly and severally, but sometimes only severally) to purchase the FRNs to the extent not purchased by selling group members (or to purchase the entire issue with a view to reselling to selling group members or to other purchasers). For a description of certain other provisions normally contained in a subscription agreement, *see infra* text accompanying notes 61-64. Where the selling group is the same as the management group, these agreements are usually combined into one document. The agreement among managers deals with such matters as the respective liability percentages of the managers as between themselves, the authority of the lead manager to over-allot, stabilize and take other actions on behalf of the managers in relation to the issue, the distribution of fees and the extent to which expenses incurred by the lead manager in connection with the issue may be passed on to the other managers.

⁹ Misrepresentation under the subscription agreement does not ordinarily constitute a default entitling holders to accelerate the issuer's obligations (as it normally would under a loan agreement). If, however, the misrepresentation is also made in a prospectus or in other information distributed in connection with the sale of the securities, the holders may be entitled to remedies under applicable securities laws. *See infra* notes 57-60 and accompanying text.

¹⁰ *See infra* text accompanying note 165.

¹¹ *See infra* text accompanying note 173.

B. Euronotes

A Euronote is a short-term promissory note typically issued in the Eurodollar market in bearer form. The face of the note evidences an obligation of the issuer to pay a fixed amount on maturity, which normally falls three or six months after issuance, corresponding to the customary funding periods in the Eurodollar interbank market. Although Euronotes sometimes evidence a further obligation to pay interest at maturity, expressed as a fixed rate but determined two days prior to issuance with reference to the interbank deposit rate, they are more typically issued at a discount to yield interest at a rate so determined.¹² The terms and conditions of the note, typically consisting of little more than a tax indemnity, are far less expansive than those found on the reverse of an FRN, and, thus, are frequently included on the face of the note. As in the case of FRNs, Euronotes are issued under a fiscal agency agreement setting forth the mechanics for issuance and payment of the notes through agents appointed by the issuer. Normally, however, the agreement contains no provisions regarding noteholder meetings in view of the short-term nature of the notes and the usual absence of any acceleration right.

The primary aim of Euronote issuers is to take advantage of the lower interest rates normally available for short-term borrowings in the Eurodollar market. The issuer's corresponding disadvantage is the possibility of a sharp rise in interest rates between borrowings, when the need to roll them over arises. To deal with this disadvantage, bankers developed the "note issuance facility" (NIF). Under the typical NIF, an uncommitted tender panel of financial institutions competitively bids to purchase Euronotes in an aggregate face amount requested by the issuer, which results in the lowest possible interest expense to the issuer. Under a variant of the NIF, sometimes called a "revolving underwriting facility" (RUF), a sole placing agent will try to procure purchasers for Euronotes in an amount requested by the issuer. To cover the risk of the tender panel or placing agent producing bids in an insufficient amount or at unacceptable rates, the NIF further provides for a syndicate of standby banks to take up any shortfall by purchasing Euronotes or making advances at an agreed discount or interest rate based on the Eurodollar interbank deposit rate. The standby banks' obligations are subject to the satisfaction of conditions, the truth of representations, and the absence of covenant breaches and other defaults ordinarily found in credit agreements. The usual NIF remains in effect

¹² In order to permit the issuance of Euronotes under Eurocommercial paper programs (described *infra* text accompanying notes 12-14) on the same day as a request is received from the issuer, these notes are frequently issued at a discount based on a rate offered by the dealer on an absolute basis (*i.e.*, without reference to a funding rate).

for three to seven years. Consequently, the issuer may take advantage of lower short-term interest rates while being assured of funds at an agreed spread for the medium term.

Under recent market conditions, issuers with a high credit standing have been willing to issue Euronotes under facilities without the assurance of funds from a committed group of standby banks. These facilities are commonly called Eurocommercial paper programs. In addition to the absence of a committed standby facility, these programs are normally sold through one or more dealers instead of a tender panel.

Foreign merchant banking subsidiaries of major U.S. banks have become active in Euronotes as tender panel members under NIFs and as dealers under Eurocommercial paper programs.¹³ In addition, both these subsidiaries as well as foreign branches of U.S. banks act as standby banks under NIFs.¹⁴

C. *Loan Participation Sales Programs*

In response to market and regulatory pressures, U.S. banks have also recently turned to a familiar banker's product—the loan participation¹⁵—in an effort to enhance their ability to transfer assets.¹⁶ In a loan participation the lender originates the loan, then “sells” a share to another entity without recourse.¹⁷ The transaction is evi-

¹³ See *infra* text accompanying note 165.

¹⁴ See *infra* text accompanying note 173.

¹⁵ Sometimes market participants use the term “subparticipations,” although no difference in meaning is intended. Loan participations are to be distinguished from loan syndications, although they both were developed by banks in response to increasing credit needs of customers that outstripped the lending capacity of a single institution. Under a loan syndication, which like loan participations has been around for years, many banks share in a lending facility from the outset, with each lending bank being a party to a single loan agreement and responsible for funding its own share of the total committed facility.

¹⁶ Although this discussion is generally limited to participation sales by U.S. banks in the Eurodollar market, many of the considerations apply to such sales domestically as well. There are a number of variations on the theme of loan participation programs. A recent one, not described in the text, is the Transferable Loan Certificate (TLC). TLCs facilitate loan transfers by the use of one of two techniques, both of which differ from participation sales in that they result in privity of contract between the borrower and the transferee. Pursuant to the assignment technique, loan installments are evidenced by debt instruments called transferable loan instruments (TLIs) that are assignable by means of a transfer recorded in a register. The registered holder is issued a separate TLC as evidence of title to the TLI. Pursuant to the novation technique, the borrower, the syndicate lenders and their agent offer, pursuant to a TLC held by the transferor, to discharge the rights and obligations of the transferor in respect of a loan installment under the loan agreement and to accept the transferee as a new party to the agreement with identical rights and obligations as those discharged. The transferor and transferee accept this offer by signing and delivering the TLC to a registrar, and the registrar then registers the transfer and issues a new TLC to the transferee. U.S. banks which are party to loan agreements incorporating TLCs are faced with most of the U.S. law issues discussed in the text.

¹⁷ A fundamental objective of loan participation programs is to remove the amount of the loan participation sold from the seller's balance sheet. Under a 1985 pronouncement by U.S. bank regulatory authorities, the sale of a participation can be treated as a “true” sale (rather than a borrowing), with the result that the portion of the loan that is

denced by a participation certificate or agreement that sets forth the rights and obligations *inter se* of the buyer and seller of the participation.¹⁸ The borrower usually is not a party to this agreement. When the borrower is not even informed of the sale, the participation is said to be "silent." The seller normally holds the underlying note or documentation evidencing the loan in which the participation is sold, thereby retaining virtually complete control over the administration, servicing, collection, and enforcement of the participated loan. This may be true even though a seller has sold all of its credit exposure in a particular loan to other participants.

By acquiring a participation, the participant becomes entitled to receive a specified portion of the borrower's principal and interest payments on the participated loan, but only if and when the seller *qua* lender receives the payments from the borrower.¹⁹ The participation may be sold simultaneously with the origination of the loan or at a later date. Increasingly, banks originate loans with the intention to sell down their interests immediately. In some cases, participation sales are even arranged in advance of the actual borrowing date.

Loan participations have long been a recognized means by which U.S. banks share risk. In particular, local and regional banks have been able, through selling participations, to share credit and funding risks with their "upstream" correspondent money center banks. Conversely, large loans originated by money center institutions have been participated out to their "downstream" correspondents, often familiar with the borrower because they serve its local credit needs. While these reasons continue to be valid for some banks engaged in selling participations, many U.S. banks now look to this business primarily for its fee-income-generating potential.²⁰

sold is removed from the seller's assets for the period while the participation is outstanding, only if the seller "(1) retains no risk of loss transferred from any cause and (2) has no obligation to any party for the payment of principal or interest on the assets transferred resulting from . . . any . . . cause." FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL, REPORTS OF CONDITION AND INCOME—REVISION OF THE INSTRUCTION FOR THE TREATMENT OF SALES AND ASSETS, at A-32 (Oct. 28, 1985).

¹⁸ Since no uniform legal definition of a "participation" exists under U.S. law, careful drafting of the participation certificate or agreement is essential to achieving the desired allocation of responsibilities and risks between the seller and the participant.

¹⁹ While a participant is entitled to share in the payment stream of a particular loan, it does not stand in privity of contract with the borrower. The absence of privity underscores the U.S. view that no legal assignment of contract rights or obligations occurs when a loan participation is purchased, while the result when a TLC is transferred is just the opposite. See *supra* note 16. This will mean, in the usual case, that under U.S. law a participant will not have a common law right of setoff against the borrower because no debtor-creditor relationship is established between the participant and the borrower. *In re Yale Express Sys., Inc.*, 245 F. Supp. 790 (S.D.N.Y. 1965). Litigation that followed the collapse of Penn Square Bank in 1982 illustrated other legal risks borne by participants when the seller of participations becomes insolvent. While a review of those risks is beyond the scope of this Article, they should be investigated and understood by banks that are contemplating the purchase of participations from U.S. banks.

²⁰ The extent to which banks can generate income from their participation programs

The active sellers usually are money center or large regional banks with a sizeable corporate clientele, credit expertise, and strong loan origination capabilities, for whom corporate lending is no longer profitable. By capitalizing on their basic strengths, these banks are transforming a traditional risk management tool into a part of their arsenal of new banking products designed to generate fees.

In reaction to the changing environment in which loan participations are being sold, many selling banks have set up special units completely separate from the bank's loan origination department, charged solely with marketing participations. In some instances, these units have been lodged in the investment banking divisions or affiliates, wherein lies the expertise in distributing financial assets. As the volume of participation sales continues to grow rapidly, a centralized unit seems well suited, if not indispensable, to manage the various business and legal matters involved in the sale of participations.

The heightened emphasis on the income potential of selling loan participations has led to other changes in this burgeoning market. The class of purchasers of participations is becoming more diverse. Nonbanking institutions such as insurance companies, pension funds, mutual funds, and large corporations have joined the traditional correspondent and other bank purchasers. In addition, participation documentation is becoming more uniform as selling banks increasingly come to rely on master agreements to define the respective rights of the seller and the participant for a number of participation transactions, rather than documenting each sale separately.²¹ To maintain their inherent marketing advantages, however, in today's participation sales programs selling banks have been reluctant to relinquish control over either the assets or their relationship with the borrower, even though they often end up selling off a significant portion of the credit risk. Participations sold on a silent basis reinforce the legal and practical separation that typically exists between the borrower and the participant.

The surge in loan participation sales has also affected the struc-

depends largely on their ability to retain a portion of the interest payments from the borrower that are to be passed through to the participant. A participant may accept a lower yield on the participation than the seller would on its loan because the participant may have lower funding costs for its assets, or because it does not incur the expense of originating the loan. This allows the seller to retain (or "skim off," in the market's parlance) the difference between the interest rate on the loan and interest rate on the participation. When banks are able to "pre-sell" loan participations, borrowers may also share some of the benefit of the ultimate lower-cost funding source; the seller can price the loan to the borrower at a lower rate knowing that it will be able to sell the loan to participants and still make a profit.

²¹ The master participation agreement facilitates a quick turnaround of the participation sale, with an offer and acceptance often being made and consummated over the telephone. Pursuant to master participation documentation, the individual participation will usually be confirmed by a separate participation certificate issued by the seller.

ture of conventional revolving credit/term loan documentation used by U.S. banks. Since the current participation market is predominantly short-term and U.S. regulatory accounting rules permit a loan to be removed from the books of a U.S. bank only if the participation has been sold without recourse to the seller,²² many large banks have been preparing medium-term Eurodollar agreements in "strippable" form to meet the demand for short-term participations. Under the conventional structure, Eurodollar loans are repriced at the end of an interest period to reflect any change in the interbank deposit rate, but mature only upon the termination of the lending commitment or, in the case of a term loan, at scheduled amortization dates. Under a strip loan agreement, however, loans actually *mature* at the end of the related interest period.²³ The borrower can only renew the loan at the end of that period by satisfying new borrowing conditions at that time. Those conditions will be similar to, but not necessarily identical with, those that triggered the initial borrowing, frequently eliminating any representation by the borrower that no material adverse change in its financial condition or material litigation has occurred. This "strip loan" structure permits U.S. banks to sell nonrecourse short-term participations in what otherwise would have been a medium-term lending facility, while still achieving the paramount objective of removing the amount of the participation from their balance sheets.²⁴

II. The Federal Securities Laws

The principal provisions of U.S. federal securities law relevant to U.S. bank securitization activities in the Eurodollar market are the

²² See *supra* note 17. A participation sold for a period shorter than the actual term of the loan is effectively with recourse to the seller and therefore constitutes a sale with a repurchase obligation for most legal and regulatory purposes for U.S. banks.

²³ Interest rates on Eurodollar loans are fixed for specified periods, usually from one month to one year, selected by the borrower. These periods are referred to as interest periods in Eurodollar loan documentation.

²⁴ The death knell for off-balance sheet accounting treatment of sales of participations in "strip loans" may have been sounded during 1986. In August 1986 the American Institute of Certified Public Accountants (AICPA) took steps to limit the circumstances under which the seller could remove the participated (or sold) portion of a strip loan from its books by issuing a proposed practice bulletin, *Accounting for Sales of Loans Under Committed Facilities*, that would preclude off-balance sheet treatment unless the conditions precedent to the "rollover" loan include a material adverse change clause or other substantive conditions that would allow the lender to refuse to make the rollover loan in the event of a deterioration in the borrower's financial condition. The Comptroller of the Currency and the Federal Reserve Board, in responding to the AICPA proposal, took an even stricter position by saying, in effect, that the substance of the sale of a strip loan (or a participation therein) is a financing transaction and should be accounted for as such. Even if the AICPA proceeds on the limited basis contemplated, the U.S. bank regulatory authorities seem unlikely to be deterred from requiring U.S. banks to show loans (or participations therein) sold under strip loan facilities on their books for regulatory accounting purposes.

registration requirements of the Securities Act of 1933²⁵ (the Securities Act) and the antifraud provisions of the Securities Act and Securities Exchange Act of 1934²⁶ (the Exchange Act).²⁷ These provisions apply to securities transactions in the Eurodollar market only where there is a sufficient jurisdictional contact with the United States.²⁸ Nevertheless, the jurisdictional reach of these laws is broadly defined by statute and broadly construed by the courts, such that there is a significant risk that the provisions will apply to many securities transactions by a U.S. bank in the Eurodollar market, particularly where the issuer is a U.S. person.²⁹ Because of this risk, both U.S. banks and other managers frequently approach securities transactions in the Eurodollar market on the assumption that the laws will apply where an exemption is unavailable. It should be emphasized that antifraud and other relevant provisions of foreign law will also frequently apply to securities activities in the Euromarket. These considerations are, however, beyond the scope of this Article.

A. *The Securities Act of 1933*

In general, section 5 of the Securities Act requires registration with the Securities and Exchange Commission (SEC) of securities of-

²⁵ Securities Act of 1933, ch. 38, 15 U.S.C. § 77a-aa (1982) [hereinafter cited as the Securities Act].

²⁶ Securities Exchange Act of 1934, ch. 404, 15 U.S.C. § 78a-hh (1982) [hereinafter cited as the Exchange Act].

²⁷ One other element of the U.S. federal securities law system bears mention: The Trust Indenture Act of 1939, ch. 411, 15 U.S.C. § 77aaa-bbbb (1982). Under that Act, corporate debt securities generally may not be publicly offered and distributed in the United States unless they are issued under an indenture which prohibits the trustee and its affiliates from having certain other relationships with the obligor in respect of the securities governed by the indenture. If a merchant banking subsidiary or affiliate of a U.S. bank were to be a member of a NIF tender panel, a dealer under a Eurocommercial paper program or a selling group member with respect to an FRN issue, that entity would be deemed to be an "underwriter" for purposes of section 310 of the Act. *Id.* § 77jjj. Accordingly, if the U.S. bank is acting as indenture trustee in respect of other obligations of the same issuer (whether those obligations are as primary obligor or guarantor) under an indenture qualified under the Act, it would have a "conflicting interest" and would be required under the provisions of such indenture either to eliminate the conflicting interest or resign as indenture trustee. It is not clear whether such merchant banking subsidiary or affiliate would be deemed to be an "underwriter" for purposes of the Act if it arranged the placement of Euronotes but did not itself purchase the notes or make any direct or indirect commitments to do so.

²⁸ For the federal securities laws to apply the proscribed conduct must be effected by use of the jurisdictional means, *i.e.*, any means or instrumentality of interstate commerce (including use of the mails, the telephone or any other means of communicating between any foreign country and the United States). *See, e.g.*, 15 U.S.C. §§ 77e, 77l(2), 78j (1982).

²⁹ It is "well established" that "the jurisdictional hook need not be large to fish for securities law violations." *Lawrence v. SEC*, 398 F.2d 276, 278 (1st Cir. 1968); *SEC v. United Fin. Group, Inc.*, 474 F.2d 354, 356-57 (9th Cir. 1973). This is particularly true where securities transactions are in U.S. dollars, since use of the jurisdictional means to make payment in respect of a security may be viewed by the courts as their use to make an offer or sale in respect of the security. *See generally* L. LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 98, 103 (1983).

ferred or sold by use of the jurisdictional means,³⁰ unless an exemption is available.³¹ Eurodollar securities such as FRNs and Euronotes are rarely registered with the SEC. Thus, to avoid the sanctions applicable to underwriters for violation of section 5,³² a U.S. bank affiliate proposing to act as an underwriter in connection with an FRN or Euronote offering must make sure that the transaction is exempt from registration.

The exemption normally relied upon in Euromarket offerings is the so-called foreign offering exemption. The primary authority for this exemption is Securities Act Release No. 33-4708 issued by the SEC in 1964 (Release 4708).³³ Reasoning that the registration requirements of the Securities Act are primarily intended to protect American investors, the SEC indicated in Release 4708 that it would not take enforcement action for failure to register securities offered and sold exclusively to foreign investors if the offering is made in a manner that will result in the securities coming to rest abroad. According to Release 4708, such an offering may be made without registration regardless of where the offering originates, whether domestic or foreign underwriters are involved, and whether the mechanics of distribution involve interstate commerce. The offering must, however, be made in accordance with procedures reasonably designed to preclude distribution or redistribution of the securities within, or to nationals of, the United States.³⁴

Release 4708 does not describe the types of foreign offering procedures which the SEC considers reasonably designed to preclude U.S. distribution. In the case of FRNs, however, these procedures have been well defined by a number of no-action letters issued by the SEC since the Release.³⁵ Although the procedures vary with the circumstances of each issue, they normally include the following:

³⁰ 15 U.S.C. § 77e (1982). See *supra* note 28.

³¹ *Id.* § 77c(a).

³² The purchaser of any security sold in violation of section 5 of the Securities Act has the right within one year of the sale to recover from the seller or any controlling person (including a parent corporation) the consideration paid for the security with interest less the amount of any income received on the security or damages if the security is no longer owned by the purchaser. The seller has no defense to the lawsuit and the controlling person's only defense is that he had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist. 15 U.S.C. § 77o (1982). In addition, underwriters offering or selling securities in violation of section 5 are subject to enforcement action by the SEC. *Id.* § 77t.

³³ 17 C.F.R. § 231.4708 (1986).

³⁴ *Id.* Therefore, for Securities Act purposes, a U.S. bank in theory may be able to act (even from its head office) as underwriter in connection with a Eurodollar offering. Nevertheless, in order to comply with the Glass-Steagall Act and Regulation K of the Board of Governors of the Federal Reserve System (discussed *infra* in text accompanying notes 165-73), this conduct is performed offshore by foreign merchant banking subsidiaries or affiliates of U.S. banks.

³⁵ See, e.g., Fairchild Camera and Instrument Corp. Int'l Fin. N.V., SEC No-Action Letter (Dec. 15, 1976); The Singer Co., SEC No-Action Letter (Aug. 19, 1971); Raymond Int'l, Inc., SEC No-Action Letter (June 28, 1976); Pacific Lighting Corp., SEC No-Action

1) Agreement by the selling group members (including the underwriters), usually contained in the selling agreements or the subscription agreement, not to offer, sell or deliver in the United States or to or for the account of U.S. persons³⁶ any of the FRNs acquired in connection with the initial distribution or any of the FRNs otherwise acquired for a certain period (usually 90 days) after completion of the distribution, and to deliver to each purchaser of FRNs at or prior to confirmation of sale a notice pursuant to which the purchaser, by accepting the FRNs agrees to similar selling restrictions, and agrees, if a dealer, to deliver a similar notice to subsequent purchasers. This chain of notices from purchaser to purchaser is sometimes called a "daisy chain."

2) A "lock-up" of the FRNs for a period of time equal to the selling restriction period referred to above. The lock-up is usually accomplished by issuing a temporary global note to represent the FRNs during the selling restriction period, which is held by one of the Euromarket clearing systems (such as Euro-Clear or Cedel) or by a common depository on behalf of more than one system. Each beneficial owner of a portion of the global note must present a certificate of non-U.S. status in order to exchange such portion for FRNs in definitive form at the end of the selling restriction period or to obtain payment of any interest falling due prior to the end of such period. Ordinarily, interest is payable after the end of the period only on definitive notes thereby forcing beneficial owners to present such certificates.

3) A prominent legend on the prospectus or offering circular stating that the FRNs have not been and will not be registered under the Securities Act and may not be offered, sold or delivered in the United States or to U.S. purchasers, except in compliance with the registration requirements of the Securities Act or pursuant to an exemption. A similar legend is placed on the temporary global note, referred to above, but is normally not included on FRNs issued in definitive form since these securities are issued after termination of the selling restriction period.

Additional measures frequently taken in FRN offerings to prevent redistribution in the United States or to U.S. persons include agreements by the issuer and the selling syndicate to refrain from advertising or making any public announcements in connection with

Letter (May 14, 1974). See generally Evans, *Offerings of Securities Solely to Foreign Investors*, 40 BUS. LAW. 69, 70-76 (1984).

³⁶ For this purpose, "United States" is typically defined as the United States of America, its territories and possessions and all areas subject to its jurisdiction, and "U.S. person" is defined as any national or resident of the United States, any corporation, partnership or other entity created or organized in or under the laws of the United States or any political subdivision thereof, or any estate or trust which is subject to U.S. federal income taxation regardless of the source of its income.

the offering³⁷ and arrangements to close the issue outside the United States.³⁸

In theory, each of these foreign offering procedures could be employed in the context of a Euronote offering as well.³⁹ Because of the short-term nature of Euronotes, however, the imposition of a lock-up would cause an issue to be tied up in global form for most, if not all, of its tenor.⁴⁰ When Euronotes were first introduced, managers felt that this constraint on the issuance of notes in definitive form would prove a serious impediment to the Euronote's marketability. As a result, the foreign offering procedures employed in early Euronote offerings were similar to those for FRNs but were modified to reflect the short-term nature of the notes. In particular, the provisions relating to a lock-up often were omitted so that all notes were issued on each closing date in definitive form. The provisions relating to the daisy chain, however, were modified to prohibit sales in the United States and to U.S. persons throughout the entire tenor of the Euronotes (even beyond the normal lock-up period) and to require that notices be delivered to *all* subsequent purchasers (not simply to dealers).

Pursuant to a request made on behalf of First Interstate Bancorp, the SEC staff reviewed foreign offering procedures for a NIF, and, in early 1985, issued the first no-action letter relating to this type of facility.⁴¹ The First Interstate no-action letter imposes the following principal restrictions on offers and sales of Euronotes under a NIF:

1) The initial offer and sale of notes under the NIF must be made exclusively to entities which are not U.S. persons. Delivery of the

³⁷ This prohibition is usually worded so as to permit selling group members to furnish potential purchasers with a prospectus, offering circular, annual report or other financial statement relating to and approved by the issuer.

³⁸ See Evans, *supra* note 35, at 73-74.

³⁹ Section 3(a)(3) of the Securities Act exempts from the registration requirements of section 5 notes having a maturity of 270 days or less (exclusive of days of grace) if the notes arise out of or the proceeds have been or are to be used for "current transactions." 15 U.S.C. § 77c(a)(3) (1982). Thus, to qualify for the section 3(a)(3) exemption, Euronotes must be limited not only as to maturity but as to use of proceeds as well. Since issuers generally prefer not to restrict the use of proceeds of Euronotes, the foreign offering exemption is normally relied on rather than the 3(a)(3) exemption. Even where the issuer is prepared to restrict the use of proceeds to eliminate the need for foreign offering procedures to avoid registration under the Securities Act, such procedures will nevertheless be required in order to establish an exemption for the issuer and its paying agents from information reporting and backup withholding requirements under the Internal Revenue Code. See *infra* text accompanying notes 146-149.

⁴⁰ As mentioned in the text, the lock-up period for an issue of securities normally remains in effect for 90 days after completion of the distribution of the issue. Since Euronotes are continuously offered under a NIF, the distribution period for an initial tranche might be viewed as extended by a later tranche, thus potentially requiring the lock-up period for each tranche to extend throughout the entire term of the facility.

⁴¹ First Interstate Bancorp, SEC No-Action Letter (Feb. 13, 1985).

notes and payments of principal and any interest must be made outside the United States.

2) The NIF and related documents must prohibit the initial purchasers of the Euronotes from offering, selling or delivering any of the notes in the United States, or to or for the account of any U.S. person, except that a purchaser may offer, sell or deliver notes (provided certain safeguards are taken) to foreign branches of U.S. banks⁴² or to U.S. agents or custodians who are registered with the SEC as corporate broker-dealers and who represent that they are acting on behalf of non-U.S. persons.

3) Each purchaser must deliver to the transferee of any note, at or prior to confirmation of sale, a notice pursuant to which the transferee, by accepting the note, represents that it is not a U.S. person or that it is a foreign branch or agent or custodian referred to above, and agrees not to offer, sell or deliver the note in the United States to or for the account of any U.S. person other than such a branch, agent or custodian, and that if it transfers the note, it will deliver an equivalent form of notice to the purchaser.

4) Purchasers of notes are prohibited from offering or selling participations in the notes to any persons except persons to whom the notes may be offered, sold or delivered as described above.

5) Notes must be issued in large denominations, each bearing a prominent legend stating that the note has not been registered under the Securities Act and may not be offered, sold or delivered in the United States or to U.S. persons except as provided in the arrangements described above. The legend must also provide that by accepting the note the holder acknowledges that it is not, and is not acting on behalf of, a U.S. person other than an exempt recipient as defined in the Internal Revenue Code.⁴³

6) The financial institutions initially acquiring the notes may not issue any offering material or make any public announcement in connection with the purchase, reoffer or resale of notes, except that they may provide potential purchasers with an offering circular or other information document in a form approved by the issuer. The information document should contain a legend similar to that described in 5) above.

Since this no-action letter was issued, most NIFs and Eurocommercial paper programs have been structured to provide for the issuance of Euronotes without registration under the Securities Act based on foreign offering procedures similar to those described in the letter.

Recently, managers and issuers have reviewed the supposed need to issue Euronotes in definitive form. Because most Euronotes

⁴² See *infra* text accompanying note 47.

⁴³ See *infra* text accompanying note 149.

issued in definitive form rest in the vaults of the Euromarket clearing systems and trade only by book entry in their records, there is general agreement that the issuance of a single global note to represent each series results in significant cost savings for the issuer without significant adverse reaction from the market. The issuance of Euro-notes in global form, however, requires the omission of one aspect of the First Interstate foreign offering procedures—namely, the legend on definitive notes notifying holders of the restrictions on sales to U.S. persons.⁴⁴ Moreover, the second aspect of a conventional lock-up—the requirement that beneficial owners of a global note present certificates of non-U.S. status in order to exercise ownership rights—is usually considered impracticable in this context. In view of the volume of such certificates that would have to be processed over the term of a NIF or Eurocommercial paper program, paying agents and clearing systems ordinarily object to a requirement that such certificates be presented at maturity before owners may obtain payment.

As a result, no clear guidance may be derived from SEC no-action letters in establishing foreign offering procedures for the issuance of Euronotes in global form. Nevertheless, the basic requirement of Release 4708 is that securities be offered in a manner reasonably designed to preclude their distribution or redistribution in the United States or to U.S. persons.⁴⁵ If all the other procedures described in the First Interstate no-action letter are followed with respect to Euronotes issued in global form, a strong argument can be made that this requirement should be deemed satisfied despite the absence of legends on definitive notes. This is particularly true in view of the daisy chain's prohibition on sales to U.S. persons throughout the entire tenor of the notes, and that trading in the notes will be restricted to book-entries in the records of offshore clearing systems.

The restriction on sales to U.S. persons contained in the foreign offering procedures described above may prove to be a constraint where a U.S. bank wishes to acquire an FRN or Euronote for its loan or investment portfolio.⁴⁶ Obviously a U.S. bank cannot represent that it is not a U.S. person and will be unable to present the certificate of non-U.S. status normally required to obtain FRNs in definitive form when the lock-up period expires. Fortunately, however, the documentation for most FRNs and Euronote facilities is designed to take advantage of an exception, sanctioned by several SEC no-action letters,⁴⁷ permitting sales to foreign branches of U.S. banks in

⁴⁴ See discussion of backup withholding requirements in the text *infra* accompanying notes 151-57 for certain U.S. tax complications arising out of the use of book-entry securities.

⁴⁵ See *supra* text accompanying note 34.

⁴⁶ Cf. *infra* text accompanying note 173.

⁴⁷ See, e.g., Banco Popular Espanol Int'l S.A., SEC No-Action Letter (Nov. 21, 1972)

connection with a foreign offering. Although the precise rationale for this exception is difficult to discern from these no-action letters, the exception appears to be based partially on Release 4708 (foreign branches being viewed for this purpose as separate foreign entities),⁴⁸ and in part on the rationale underlying the private offering exemption discussed later.⁴⁹ Because the exception is thought to depend in part on the latter exemption, foreign branches which are permitted to acquire FRNs or Euronotes are normally required, under the related documentation, to represent that they have had sufficient access to information concerning the issuer and to represent that the acquisition is for their own account without any view to distribution or any other disposition of the notes.⁵⁰

The registration requirements of section 5 of the Securities Act ordinarily will not pose any problems for sales of loan participations under current programs. As discussed below, it is far from certain that loan participations constitute "securities" for purposes of the federal securities laws. Moreover, even if a participation is considered a security, the sale of a participation is routinely executed in a manner that has all the substantive trappings of a private placement and, thus, should qualify for exemption from registration as a private of-

(sale of FRNs to foreign branches of U.S. banks); Vizcaya Int'l N.V. Banco de Vizcaya, S.A., SEC No-Action Letter (Apr. 4, 1973) (sale of FRNs to foreign branches of U.S. banks); and First Interstate Bancorp, *supra* note 41. In a recent no-action letter, the SEC expanded this exception to cover foreign branches of U.S. insurance companies where (1) the branch is subject to the supervision of applicable foreign regulatory authorities, (2) the relevant securities are issued outside the United States by a non-U.S. company, (3) the branch purchases the securities for investment, and (4) the branch purchases the securities for investment and agrees that if it resells it will not do so in the United States or to U.S. persons. CIGNA Corp., SEC No-Action Letter (Mar. 26, 1986).

⁴⁸ See, e.g., First Interstate Bancorp, *supra* note 41, at page 7 of the letter of inquiry, where it is argued that "since a subsidiary incorporated abroad of a United States company would not be considered a national of the United States, the mere fact that such United States company organizes its foreign operations as a branch should not matter in substance . . . particularly . . . where precautions are taken to ensure that securities sold to a foreign branch will not flow back into the United States market." *Id.*

⁴⁹ See, e.g., Vizcaya Int'l N.V. Banco de Vizcaya, S.A., *supra* note 47, at page 7 of the letter of inquiry where it is argued that "the offering on the circumscribed basis explained above to . . . foreign branches of United States banks does not deprive the overall transaction of the exemptive treatment accorded to foreign offerings under Release No. 4708 The transaction is essentially equivalent to a private placement occurring concurrently with a foreign offering, and it is to be noted that such Release recognizes that under these circumstances the private placement is not to be integrated with the foreign offering." *Id.*

⁵⁰ Occasionally, a foreign branch of a U.S. bank is called upon in this connection to represent that it is acquiring the note for investment purposes, which in most cases will conflict with the bank's aim to establish that it is acquiring the note to evidence a loan. In order to satisfy certain requirements of TEFRA, the branch may be further called upon, as a condition of purchase of the note, to certify in writing that it is a financial institution as described in Treas. Reg. § 1.165-12(c)(1)(iv) (1984) purchasing for its own account or for the account of a customer without intending to offer or resell the note in the United States, and that it will comply with the requirements of § 165(j)(3)(A), (B), or (C) of the Internal Revenue Code and the regulations thereunder. See *infra* note 130 and accompanying text.

fering under section 4(2) of the Securities Act.⁵¹ Regulation D, promulgated by the SEC under the Act, provides a safe-harbor rule for limited offerings of securities that are deemed to be exempt from registration under section 4(2).⁵² Common characteristics of participation sales by U.S. banks that support the substantive, if not technical, compliance with this rule include: A small number of sophisticated purchasers;⁵³ a high minimum denomination for each participation; no general advertising with respect to the offering and sale of participations; and a prohibition against (or at least a material restriction on) the resale of participations by the participant.

Banks will not ordinarily be able to rely on the exemption for "securities" issued by U.S. banks under section 3(a)(2) of the Securities Act⁵⁴ because the SEC has indicated that this exemption is available only if the participant has recourse to the selling bank, which would defeat the desired off-balance sheet accounting treatment of the transaction.⁵⁵

B. Antifraud Provisions

The federal securities laws contain a number of provisions imposing liability for fraud or inadequate disclosure of material facts in connection with securities transactions. Assuming use of the jurisdictional means,⁵⁶ these provisions may be relevant to securities activities of U.S. banks in the Eurodollar market, regardless of whether the securities are exempt from the registration requirements of the Securities Act.⁵⁷ In some respects, the potential for liability under these provisions is more extensive than for common law misrepresentation. For example, liability may be broader for projections, forecasts, and nondisclosure.⁵⁸ Further, an underwriter may be lia-

⁵¹ Section 4(2) exempts from registration "transactions by an issuer not involving any public offering." 15 U.S.C. § 77d(2) (1982).

⁵² 17 C.F.R. § 230.506 (1986).

⁵³ Regulation D does not limit the actual number of "accredited investors" to which the "securities" can be offered, but banks typically restrict offerings to a reasonably small number of prospective sophisticated participants. "Accredited investor" includes any U.S. bank or insurance company as well as investors meeting a specified net worth test. *Id.* § 230.501(a).

⁵⁴ Section 3(a)(2) of the Securities Act defines a "bank" as "any national bank, or any banking institution organized under the law of any State, territory, or the District of Columbia, the business of which is substantially confined to banking and is supervised by the State or territorial banking commission or similar official." 15 U.S.C. § 77c(a)(2) (1982).

⁵⁵ *E.g.*, First National Bank of Chicago, SEC No-Action Letter (May 5, 1980) (interests sold in banker's acceptances were found to be an obligation of the acceptor bank because of the existence of a separate and independent right which the purchasers had to look to the bank for payment in respect of the draft).

⁵⁶ *See supra* note 28.

⁵⁷ *See, e.g.*, 15 U.S.C. §§ 771(2), 77g(a), 78j(b) (1982). *See also* 17 C.F.R. § 240.10b-5 (1984) (Rule 10b-5).

⁵⁸ *SEC v. Texas Gulf Sulfur Co.*, 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); *Speed v. Transamerica Corp.*, 71 F. Supp. 457 (D. Del. 1947). *Loss, supra* note 29, at 812, 813-14, 817, 825 and 1021-26. Under the antifraud provisions of the

ble for misleading offering materials prepared by the issuer even though unaware of their misleading nature, unless it can prove that in the exercise of reasonable care it could not have gained such awareness.⁵⁹ In addition, under certain circumstances the U.S. parent bank may be held liable for violations incurred by its merchant banking subsidiaries abroad.⁶⁰

A number of safeguards are usually employed by financial institutions to limit the risk of liability in connection with the distribution of FRNs and Euronotes.⁶¹ First, the issuer is required to prepare a prospectus, an offering circular, or other information document disclosing all material facts relating to itself and the securities to be issued.⁶² Second, the issuer agrees in the subscription agreement or other facility document to update the information approved for use in the distribution. In the case of Euronote facilities, under which notes may be offered continuously throughout their duration, the issuer undertakes to provide further information on a periodic basis. In the case of both FRNs and Euronotes, the issuer agrees to update the information prior to closing in the event of any change or circumstance that would render the information materially misleading.

Third, the issuer represents in the subscription agreement or other facility document that all information furnished by it for use in distributing the notes is accurate in all material respects. The accuracy of this representation is made a condition to closing. Fourth, the financial institutions offer no information concerning the issuer

Exchange Act (15 U.S.C. § 78j(b) (1986)) and Rule 10b-5 (17 C.F.R. § 240.10b-5 (1986)), the seller of "securities" may incur liability if it makes any untrue statement (whether oral or written) of a material fact or omits to state a material fact necessary to make any statements not misleading, in light of the circumstances under which they were made. The courts have grafted on to these antifraud provisions an affirmative obligation on the seller's part to disclose any material "inside" information possessed by the seller.

⁵⁹ 15 U.S.C. § 771(2) (1982). See *Jackson v. Oppenheim*, 533 F.2d 826, 829 n.7 (2d Cir. 1976); see also *Loss*, *supra* note 29, at 1028-29.

⁶⁰ See 15 U.S.C. §§ 77o, 78t (1982). See also *Loss*, *supra* note 29, at 1179-82.

⁶¹ Unlike the antifraud provisions of the Securities Act, the antifraud provisions of the Exchange Act, including § 10(b) (15 U.S.C. § 78j(b) (1982)) and rule § 10(b)(5) (17 C.F.R. § 240.10b-5 (1984)), may not apply to Euronotes. Section 3(a)(10) of the Exchange Act excludes from the definition of "security" notes issued with a maturity not exceeding nine months, "unless the context otherwise requires." 15 U.S.C. § 78c(a)(10) (1982). Courts, however, have concluded in the context of several cases that short-term promissory notes should be deemed securities for purposes of the antifraud provisions of the Exchange Act. See, e.g., *Baurer v. Planning Group, Inc.*, 669 F.2d 770 (D.C. Cir. 1981); *Anderson v. Francis I. DuPont & Co.*, 291 F. Supp. 705 (D. Minn. 1968); but see *Great W. Bank & Trust v. Kotz*, 532 F.2d 1252 (9th Cir. 1976).

⁶² Where the securities are to be listed on a foreign stock exchange, such as The Stock Exchange of the United Kingdom and the Republic of Ireland or the Luxembourg Stock Exchange, the prospectus or other information document is normally required by and prepared in accordance with rules of the exchange. In the case of Euronotes, which are not normally listed, an information memorandum or placement memorandum is prepared, usually incorporating by reference the most recently published financial statements of the issuer (including, in the case of a reporting company under the Exchange Act, those most recently filed with the SEC).

other than that approved by the issuer for use in distributing the notes.⁶³ Finally, the issuer agrees in the subscription agreement or other facility document to indemnify the financial institutions distributing the notes for any losses or liabilities they may incur as a result of false or misleading information approved by it for the distribution.⁶⁴

The antifraud provisions of the federal securities laws may also apply to loan participation programs in the Eurodollar market when the programs involve the requisite jurisdictional contact with the United States.⁶⁵ Unlike FRNs and Euronotes, however, the threshold issue of whether loan participations constitute "securities" for purposes of the federal securities laws is not clearly settled. Cases are split on this question, with the more recent cases holding that loan participations are not securities under the Exchange Act.⁶⁶

Notwithstanding this trend, current loan participation programs of U.S. banks may incorporate certain features that raise concerns regarding the characterization of participations as securities.⁶⁷ For

⁶³ The information distributed should clearly state at the outset that it has been prepared and approved by the issuer. It should further state that the underwriters accept no responsibility for the information, although underwriters sometimes take the decision to omit this further statement in the belief that it may unduly alarm investors.

⁶⁴ Indemnities purporting to hold underwriters harmless from liability under the antifraud provisions of the federal securities laws may not be enforceable. See, e.g., Securities Act Release No. 4936, 46(a) (1968) (requiring that prospectus of company that indemnifies officials for violations of the Securities Act state that SEC believes such indemnification to be against public policy and, therefore, unenforceable).

⁶⁵ See *supra* note 28.

⁶⁶ For cases in which loan participations were found to be securities, see *Lehigh Valley Trust Co. v. Central Nat'l Bank*, 409 F.2d 989 (5th Cir. 1969); *Commercial Discount Corp. v. Lincoln First Commercial Corp.*, 445 F. Supp. 1263 (S.D.N.Y. 1978); *NBI Inv. Corp. v. Chemical Bank*, [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,632 (S.D.N.Y. 1976). For cases holding that loan participations are not securities, see *Union Planters Nat'l Bank v. Commercial Credit Business Loans, Inc.*, 651 F.2d 1174 (6th Cir.), *cert. denied*, 454 U.S. 1124 (1981); *American Fletcher Mortgage Co. v. United States Steel Credit Corp.*, 635 F.2d 1247 (7th Cir. 1980), *cert. denied*, 451 U.S. 911 (1981); *United Am. Bank v. Gunter*, 620 F.2d 1108 (5th Cir. 1980); *United Cal. Bank v. THC Fin. Corp.*, 557 F.2d 1351 (9th Cir. 1977); *Citizens State Bank v. Federal Deposit Ins. Corp.*, 639 F. Supp. 758 (W.D. Okla. 1986); *Vorrius v. Harvey*, 570 F. Supp. 537 (S.D.N.Y. 1983); *Robbins v. First Am. Bank*, 514 F. Supp. 1183 (N.D. Ill. 1981); *Provident Nat'l Bank v. Frankford Trust Co.*, 468 F. Supp. 448 (E.D. Pa. 1979); *J. Henry Schroder Bank and Trust Co. v. Metropolitan Sav. Bank*, 497 N.Y.S.2d 931 (A.D. 1st Dep't 1986).

⁶⁷ The heavy reliance on the facts of each case and the differing tests used by the courts in attempting to define what constitutes a "security" under the federal securities law tend to make a generalization as to this issue extremely difficult. Among the host of tests utilized by the courts are: The "literalist" approach of *Lehigh Valley*, 409 F.2d at 992 (relying upon the plain meaning of the definition of security as "any note or certificate of participation" in § 2 of the Securities Act); the "commercial/investment" dichotomy of *McClure v. First Nat'l Bank*, 497 F.2d 490 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975) (relying upon the exclusion from § 3(a)(10) of the Exchange Act and the registration requirements of the Securities Act of short-term notes arising out of current transactions as support for disparate treatment of commercial, as opposed to investment-type, notes); the "economic realities" test of *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946) and *United Hous. Found. Inc. v. Forman*, 421 U.S. 837, 847-53 (1975) (concentrating on whether the instrument evidences an investment in a common venture premised on a reasonable ex-

instance, in today's loan participation programs, the participant normally lacks any real access to information, while all significant administration and enforcement rights of the loan are vested in the seller. These were prevalent factors in two early cases which held loan participations to be securities under the Exchange Act.⁶⁸ The methods employed by banks in selling loan participations, the passive nature of the participant's stake, the lack of any direct relationship between the borrower and the participant, the changing nature of the purchasers of participations, and the trend toward banks retaining little or no part of the credit for their own account all contribute to further uncertainty over the proper characterization of these transactions under the federal securities laws.

Because the case law is unsettled and recognizing that an aggrieved participant will almost certainly look to the federal securities laws for relief in any litigation with the seller,⁶⁹ U.S. banks are well advised to structure their loan participation programs so as to mitigate the legal risks posed by the antifraud provisions of the federal securities laws and related disclosure standards.⁷⁰ By structuring participation sales programs with these concerns in mind, the potential risks under analogous common law theories of liability for misrepresentation, fraud, and deceit can also be largely controlled, because the burden of proof for complainants under those theories generally tends to be stricter than under the federal securities laws.⁷¹

Banks which sell loan participations have generally dealt with potential securities law antifraud risks by taking a number of steps. First, disclosure of information to prospective participants is carefully controlled and usually restricted to SEC filings (such as Forms 10-K) and other publicly available information issued by the borrower. This practice reduces the chance that the participant can successfully claim to have relied on a materially false statement or

pectation of profits to be derived from the entrepreneurial or managerial efforts of others); the "risk capital test" of *Kotz*, 532 F.2d at 1257-58 (focusing on six factors: (1) the duration of the note or obligation, (2) the existence and extent of collateral, (3) the form of the obligation, (4) the circumstances surrounding issuance (single lender versus coterie of investors), (5) the relationship of the amount borrowed to the size of the borrower's business or investment, and (6) the contemplated use of proceeds); the "rebuttable presumption" test of Judge Friendly in *Exchange Nat'l Bank v. Touche Ross & Co.*, 544 F.2d 1126, 1137-38 (2d Cir. 1976), *cert. denied*, 105 S. Ct. 253 (1984) (emphasizing that all notes are securities unless the context otherwise requires); and the "alternate regulatory scheme" of *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 569-70 (1979) (emphasizing the presence or absence of an alternative regulatory mechanism to ascertain applicability of federal securities laws to the instrument). See generally Ianni, "Security" Under the Glass-Steagall Act and the Federal Securities Acts of 1933 and 1934: The Direction of the Supreme Court's Analysis, 100 BANKING L.J. 124 (1983); Note, *Loan Participations Under the Securities Act: Securities Treatment for the Unsecured*, 1 ANN. REV. BANKING L. (1982).

⁶⁸ See *Lehigh Valley*, 409 F.2d at 993; *Commercial Discount*, 445 F. Supp. at 1268.

⁶⁹ See, e.g., *In re Colcotronis Tankers Sec. Litig.*, 449 F. Supp. 828 (S.D.N.Y. 1978).

⁷⁰ See *supra* note 58.

⁷¹ *Id.*

omission by the seller. Second, selling banks generally offer only their better quality short-term assets in order to reduce the risk of loss. Third, sales are normally avoided if the seller possesses negative information on the borrower or if adequate and complete information is simply not publicly available to the participant. This is particularly important for large commercial banks that have close relationships with their borrowing customers. Finally, selling banks tend to deal mainly with participants that are experienced in assessing credit risk, which further decreases the likelihood that a participant will be able to establish that it relied on any misinformation furnished by the seller.

III. U.S. Tax Issues

This section addresses the three principal areas of U.S. tax law affecting U.S. bank efforts to securitize assets in the Eurodollar market: 1) provisions of the Internal Revenue Code of 1986 (the "Code")⁷² and related Treasury regulations regarding the withholding of U.S. federal income tax, 2) requirements that obligations be in registered form, and 3) requirements pertaining to information reporting and backup withholding.⁷³

A. Withholding of U.S. Income Tax

The Code imposes a thirty percent tax on the gross amount of interest (including original issue discount except as discussed below)⁷⁴ paid from sources within the United States to a foreign recipient to the extent that the income is not connected with the conduct of a trade or business within the United States.⁷⁵ Sections 1441 and 1442(a) of the Code require any person who has control over the

⁷² Section 2 of the Tax Reform Act of 1986 redesignated the Internal Revenue Code of 1954, as amended, as the "Internal Revenue Code of 1986" (referred to in this Article as the "Code"). Pub. L. No. 99-514, § 2, 100 Stat. 2085 (1986).

⁷³ Although there are broader U.S. federal income tax issues that must be considered in relation to the sale of loan participations, they are beyond the scope of this Article. As a general rule, for tax purposes the owner of a true participation is treated as the beneficial owner of an interest in the loan itself. See, e.g., Rev. Rul. 66-263, 1966-2 C.B. 237. If, as discussed *supra* in note 20, the yield to the beneficial owner is less than the yield on the loan in which the participation is sold, the difference may be accounted for either as a purchase premium (amortizable over the term of the participation) (see Rev. Rul. 71-399, 1971-2 C.B. 433) or as the purchase of a stripped bond (see discussion in text *supra* accompanying note 23); see also I.R.C. § 1286 (Supp. III 1985). If the participation is not a true participation the holder of the participation is not deemed to be a beneficial owner of an interest in the loan, but rather is a lender to the purported seller of the participation, collateralized by the loan purportedly participated out. Cf. Rev. Rul. 78-118, 1978-1 C.B. 219. Also note the effect of General Counsel Memorandum 39301 FED. TAXES (P-H) ¶ 290(84)-46 (May 23, 1983) [hereinafter cited as the General Counsel Memorandum]. If that Memorandum is correct, a short-term participation in a strippable loan may, from the standpoint of the seller, be only a collateralized borrowing, at least for tax purposes.

⁷⁴ See *infra* text accompanying notes 95-98.

⁷⁵ I.R.C. §§ 871(a) (individuals), 881(a) (corporations) (1982).

payment of such interest to a foreign recipient to withhold the tax⁷⁶ or to pay an amount equivalent to the tax upon failure to withhold.⁷⁷ Most types of facilities under which foreign persons extend financing to U.S. obligors contain a tax indemnity provision. These provisions generally require the obligor, subject to certain standard exceptions, to pay additional amounts necessary to ensure that the net payment of its obligations to the foreign persons after U.S. tax deductions⁷⁸ will not be less than the amount stated to be due and payable on the obligations. Nevertheless, obligors normally expect these facilities to be arranged in a manner that will avoid application of the withholding tax so as to preclude payment under the tax indemnity, absent a change in law. Furthermore, U.S. banks arranging these facilities frequently undertake to act as a paying agent for the obligor and, therefore, are subject to the liabilities of a withholding agent mentioned above, unless the facility is structured to avoid the tax.

The exemption normally relied on to avoid tax on interest payments on FRNs is the so-called "portfolio interest" exemption. Under sections 871(h) and 881(c) of the Code and related Treasury regulations,⁷⁹ interest (including original issue discount) received by most foreign investors in respect of obligations issued by U.S. persons after July 18, 1984, qualifies as "portfolio interest" and is exempt from the tax that would otherwise apply, so long as the obligation is in bearer form and satisfies the requirements for issuance in such form without penalty under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).⁸⁰ If, on the other hand, the obligation is in registered form, the U.S. person who would otherwise be required to withhold such tax has received a statement to the effect that the beneficial owner of the obligation is not a U.S. person.⁸¹ Congress enacted this exemption as part of the Tax Reform

⁷⁶ Section 1441(a) imposes this withholding requirement on payments to individuals, and section 1442(a) imposes such requirement on payments to corporations. In addition, section 4948(a) imposes tax at a rate of 4% on investment income from U.S. sources derived by foreign tax-exempt entities that are private foundations. Section 1443 provides for the withholding of that tax. *Id.* §§ 1441(a), 1443, and 4948(a).

⁷⁷ *Id.* § 1461.

⁷⁸ Bank lending agreements usually provide an indemnity against all U.S. federal income tax, whether paid in connection with the filing of a return by the foreign bank recipient or paid by withholding. Publicly offered debt instruments, by contrast, usually indemnify only against tax collected by withholding. In any event, interest paid to U.S. banks under these facilities is not subject to the withholding of U.S. tax (although under circumstances it may be subject to the withholding of foreign tax).

⁷⁹ Temp. Treas. Reg. § 35a.9999-5 (1986).

⁸⁰ I.R.C. §§ 871(h)(2)(A), 881(c)(2)(A) (Supp. III 1985); Temp. Treas. Reg. § 35a.9999-5(a), Q&A-1 (1986). For a description of these requirements, see *infra* text accompanying notes 127-133. A bearer obligation that need not comply with these requirements (because, for example, the obligation has a maturity of one year or less or is not of a type issued to the public) must nevertheless satisfy them in order for interest on the obligation to qualify as portfolio interest.

⁸¹ I.R.C. §§ 871(h)(2)(B), 881(c)(2)(B) (Supp. III 1985); Temp. Treas. Reg. § 35a.9999-5(b) (1986). An obligation is treated under the temporary Treasury regula-

Act of 1984 in order to enable U.S. persons to raise funds in foreign debt securities markets without resorting to international finance subsidiaries.⁸² The statutory definition of portfolio interest excludes payments received by a foreign bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of the bank's trade or business.⁸³ Also excluded is interest received by a ten percent or more shareholder of the issuer or by a controlled foreign corporation from an issuer that is a related party.⁸⁴

Until recently, temporary Treasury regulations restricted the availability of the portfolio interest exemption to obligations of a type offered to the public that were not issued by natural persons and that had a maturity in excess of one year at the time of issuance. In December 1986 the Internal Revenue Service (IRS) issued new temporary regulations that eliminated these restrictions,⁸⁵ so that the exemption is now potentially available to interest on obligations described in the preceding paragraph regardless of whether they are publicly offered or privately placed, issued by a corporation or a natural person (thus making the exemption available for certain securitized pass-through obligations),⁸⁶ or issued for a short⁸⁷ or a long

tions as being in registered form in one or both of the following two situations: First, where the obligation is registered as to both principal and any stated interest with the issuer (or its agent) and may be transferred only by the surrender of the old instrument and either the reissuance of the old instrument to the new holder or the issuance of a new instrument; and second, where the right to the principal of and stated interest on the obligation may be transferred only through a book entry system maintained by the issuer or its agent. *See id.* § 5f.103-1(c)(1) (1986) and *infra* text accompanying notes 152-57. An obligation that is not in registered form as described above, or that is in such form but may be converted to bearer form prior to maturity, is treated by the temporary Treasury regulations as being in bearer form. Temp. Treas. Reg. §§ 5f.103-1(e), 35a.9999-5, Q&A-18 (1984).

⁸² Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (codified in scattered sections of 26 U.S.C. (Supp. III 1985)). Prior to the repeal, U.S. corporations issuing medium- to long-term securities in the Eurodollar market typically avoided the withholding of tax by issuing through finance subsidiaries incorporated in foreign jurisdictions, usually the Netherlands Antilles. In an appropriately structured transaction, the U.S. corporation, which would borrow the proceeds of the securities offering from the subsidiary, could pay interest to the subsidiary free from U.S. tax under an applicable tax treaty, which the subsidiary would then use to pay interest on the securities free from withholding under the local laws of the foreign jurisdiction and free from secondary withholding of U.S. tax under the applicable tax treaty; *see, e.g.*, Convention Respecting Taxes on Income, Apr. 29, 1948, United States-Netherlands, as extended to Netherlands Antilles, art. XII, 62 Stat. 1757, T.I.A.S. No. 1855; Protocol Modifying the Extension to the Netherlands Antilles, Oct. 23, 1963, United States-Netherlands, 15 U.S.T. 1900, T.I.A.S. No. 5665.

⁸³ I.R.C. § 881(c)(3)(A) (Supp. III 1985).

⁸⁴ *Id.* §§ 871(h)(3), 881(c)(3)(B); Temp. Treas. Reg. § 35a.9999-5(f), 51 Fed. Reg. 45,465 (1986).

⁸⁵ Temp. Treas. Reg. § 35a.9999-5(a), Q&A-1, 5(b), Q&A-8, 51 Fed. Reg. 45,464 (1986).

⁸⁶ *See id.* § 35a.9999-5(e) (1984).

⁸⁷ The original maturity of an obligation must be in excess of 183 days in order to satisfy a further requirement of the exemption that the obligation be otherwise subject to tax. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1810(d)(1), 100 Stat. 2085. Obliga-

term. Simultaneous with this change, however, the IRS introduced a new paragraph (f) to the regulations to implement the exclusion from the exemption for interest received by related parties (*i.e.*, ten percent shareholders and controlled foreign corporations).⁸⁸ In sum, paragraph (f) establishes a presumption that a recipient of interest is a related party, thus requiring the issuer or its paying agent to withhold tax,⁸⁹ unless the obligations in question are publicly issued (which, among other things, requires that they be listed on a qualifying securities exchange)⁹⁰ or certain certification procedures are satisfied.⁹¹ Because these certification procedures are at best burdensome and in some cases impossible to satisfy,⁹² the practical effect of paragraph (f) is to reimpose the requirement that obligations be offered to the public (*i.e.*, publicly issued); and since obligations issued by natural persons (other than mortgage pass-through obligations) or issued with a short tenor are rarely listed on an exchange, a further practical effect is to reintroduce the requirements of corporate issuance and maturity in excess of one year. A top international tax official of the Treasury recently acknowledged that paragraph (f)

tions with a maturity of 183 days or less may be exempt from withholding tax under the so-called "original issue discount" exemption. *See infra* text accompanying notes 95-96. Prior to the elimination of the minimum maturity requirement for the portfolio interest exemption a "black hole" existed for Euronotes with a maturity from 184 days to one year since such notes were eligible for neither that exemption nor the original issue discount exemption.

⁸⁸ Temp. Treas. Reg. § 35a.9999-5(f), 51 Fed. Reg. 45,465 (1986). *See supra* note 84 and accompanying text.

⁸⁹ Temp. Treas. Reg. § 35a.9999-5(f), Q&A-23, 51 Fed. Reg. 45,465 (1986).

⁹⁰ *Id.* Q&A-24(i), Q&A-25. In addition to being listed on an exchange, an obligation to be "publicly issued" must not be subject to offering or sales restrictions for U.S. securities law purposes other than restrictions relating to citizenship, nationality or residence, and must be sold in a certain prescribed manner through an underwriter or to more than 35 purchasers. *Id.* Q&A-25(2), (3), 51 Fed. Reg. 45,466 (1986).

⁹¹ *Id.* Q&A-24, Q&A-27. The presumption may also be defeated (and withholding therefore avoided) if both the issuer and the recipient of interest are corporations whose stock is "publicly traded." *Id.* Q&A-24(ii). In order for a corporation to qualify as "publicly traded," a substantial portion of each outstanding class of its common stock (or of its parent, if it is a member of an affiliated group) must be traded on an exchange or over-the-counter, and none of its common stock may be represented by bearer certificates or be traded by bearer depositary receipts. *Id.* Q&A-26. Although in this case the certification procedures described in Q&A-27 do not apply, the paying agent will nevertheless require information from the recipient of interest in order to determine whether its stock qualifies as "publicly traded." For a discussion of these regulations, see *Report of the Committee on Foreign Activities of United States Taxpayers With Respect to Regs. section 35a.9999-5(f)*, TAX NOTES DOCUMENT No. 87-617 (Jan. 19, 1987) (available Feb. 2, 1987, on WESTLAW, Database FTX-TNT).

⁹² Under these procedures (which apply to obligations in both bearer and registered form) each recipient of interest must furnish a statement to the paying agent that it is not a related party together with information sufficient to confirm the validity of the statement. Unless the recipient is a retirement plan, mutual insurance company, foreign government or charitable organization, this information must, among other things, identify the ultimate individual beneficial owners of the recipient (a requirement practically, if not literally impossible to satisfy for all but closely-held corporations). Temp. Treas. Reg. § 35a.9999-5(f), Q&A-27, 51 Fed. Reg. 45,466 (1986).

is flawed and gives rise to unintended results (among others, a requirement that tax be withheld from interest payments on Treasury obligations).⁹³ On February 13, 1987, the IRS suspended the applicability of paragraph (f) retroactively to the effective date.⁹⁴ The suspension notice pointed out that the regulations contained in the paragraph continue to be proposed, and invited comments with respect to alternative approaches for enforcing the exclusion for interest received by related parties.

In the case of Euronotes, a different exemption from withholding tax may be available. This is the so-called "original issue discount" exemption which excludes from tax any original issue discount on an obligation payable 183 days or less from the date of original issue without regard to the period held by the taxpayer.⁹⁵ Original issue discount is defined by the Code as the difference between the issue price of an obligation and its "stated redemption price at maturity," including any interest payable at maturity on an obligation to which the exemption applies.⁹⁶ The IRS has issued several private letter rulings confirming the availability of this exemption to Euronotes sold under NIFs to persons not contractually required to purchase the notes.⁹⁷ Thus, Euronotes issued to NIF placing agents or tender panel members and Eurocommercial paper dealers should be eligible for this exemption, so long as they are issued with a maturity of 183 days or less.⁹⁸

Whether the original issue discount exemption is available for

⁹³ " 'Flaws' in 30 Percent Withholding Rules to be Cleared up Quickly," 48 Banking Report 22 (Feb. 2, 1987).

⁹⁴ I.R.S. Notice 87-24 (Feb. 13, 1987).

⁹⁵ I.R.C. § 871(g)(1)(B)(i) (Supp. III 1985).

⁹⁶ Thus, interest payable only at maturity is included within original issue discount even though the amount paid for the debt obligation is its face amount. *Id.* § 1273; Treas. Reg. § 1.1273-1(b)(1)(ii)(D) (proposed), 51 Fed. Reg. 12,060 (1986).

⁹⁷ Priv. Ltr. Rul. 8,647,003 (Aug. 27, 1986) (payments in respect of one, three and six-month Euronotes publicly offered by a placing agent under a NIF and sold to persons unrelated to the issuer or the placing agent held to be free from withholding tax based on this exemption); Priv. Ltr. Rul. 8,634,060 (May 27, 1986) (payments in respect of one, three and six-month global Euronotes sold under a NIF to unrelated parties through a continuous uncommitted tender panel mechanism held to be free from withholding based on this exemption). *See also* Priv. Ltr. Rul. 8,411,110 (Dec. 16, 1983) (payments in respect of three and six-month Euronotes sold through a placing agent to a subsidiary of the issuer held to be exempt from withholding based on this exemption), *withdrawn* (Dec. 18, 1985) (presumably due to the related status of the purchaser, *see infra* note 100). While by statute a private letter ruling may not be used or cited as precedent (I.R.C. § 6110(j)(3) (1982)), they often are a reliable indication of the view of the Internal Revenue Service with respect to the question presented.

⁹⁸ Euronotes issued to such persons with a maturity in excess of 183 days may be eligible for the portfolio interest exemption discussed *supra* in text accompanying notes 79-94. Euronotes issued by banks in the form of certificates of deposit may be exempt from withholding under I.R.C. §§ 871(i)(2)(A), 881(d) (Spec. West Supp. 1986). The basis for this exemption was restated by the Tax Reform Act of 1986 (which restatement failed to make the necessary cognate adjustments to the estate tax provisions). *See* 33 TAX NOTES 697 (1986).

Euronotes issued to standby banks under a NIF, however, is less clear. In General Counsel Memorandum 39301 dated May 25, 1983, the Interpretative Division of the IRS, in ruling on a facility similar to a NIF, found the original issue discount exemption inapplicable to such notes. The Division reasoned that the obligation of a standby bank to purchase new notes when insufficient notes are sold through the uncommitted facility caused Euronotes earlier issued to the bank to have an actual maturity at issuance equal to the entire period during which the standby bank could be compelled to purchase new notes, even though the nominal maturity was less. This Memorandum is purely an internal Treasury document and may not be cited as precedent (although as an internal matter the IRS treats such memoranda as precedential authority). Moreover, most practitioners feel that the reasoning and conclusion of the Memorandum may be distinguished from the facts applicable to most NIFs because the Memorandum fails to address the effect of any conditions on the obligation of the standby banks to purchase new notes.⁹⁹ Because the typical NIF obligation is conditioned upon the continued performance of covenants, the absence of other defaults, and unsuccessful resort to the tender panel, a good argument can be made that the nominal maturity of the outstanding Euronotes should be accepted as the actual maturity for tax purposes. Nevertheless, in view of the doubts raised by the ruling, most issuers have insisted that NIFs be structured to take the Memorandum into account.¹⁰⁰

⁹⁹ Neither the ruling request nor the Conference Memoranda of the tax law specialists involved in preparing the Memorandum discloses any argument by the taxpayer to the effect that the presence of conditions limited the obligation of the standby banks to purchase new notes.

¹⁰⁰ In Private Letter Ruling 8,647,003 (Aug. 27, 1986), the IRS expressly refused to rule on the availability of the original issue discount exemption to Euronotes purchased and held by a standby bank under a NIF. Moreover, Private Letter Ruling 8,504,012 (July 3, 1984) suggests that the IRS may hesitate to issue a favorable ruling despite the existence of conditions on the obligations of a standby bank. That ruling, which involved noninterest bearing commercial paper to be issued by a domestic subsidiary ("Sub") of a U.S. parent company and purchased in some cases on an uncommitted basis by foreign subsidiaries of the parent ("Related Purchasers"), held that the paper had a maturity for tax purposes equal to its nominal maturity (six months) so that, *inter alia*, payments to Related Purchasers could be made free from U.S. tax under the original issue discount exemption. But the ruling was issued with the following caveat: "The determination that the non-interest bearing commercial paper will have maturities not in excess of six months is expressly premised on the representation that the paper will contain no provision for an automatic rollover or option to renew, that any holder thereof, including the Related Purchasers, must take affirmative action to reinvest the proceeds from the paper in other Sub commercial paper, and that *under no circumstances will any holder be required to make such reinvestment.*" *Id.* (emphasis added). The significance of the caveat is not clear. It may only mean that the IRS was not prepared to confront the question whether the condition was so meaningless that it might be ignored. In mid-December 1985 this ruling and several others of like effect were revoked, and district directors were instructed to consider whether Related Purchasers could as a matter of fact make an independent decision to hold the debt obligation of the parent. *See, e.g.*, Priv. Ltr. Ruls., 8,612,020, 8,612,024 (Dec. 18, 1985).

Accepting the reasoning of the General Counsel Memorandum, the question that logically follows is whether the portfolio interest exemption may be relied on to avoid withholding tax on notes issued to standby banks. The answer is likely to be negative. As indicated above, the portfolio interest exemption does not apply to interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business.¹⁰¹ Because most NIFs contain representations, covenants, defaults and other provisions substantially similar to those found in an ordinary bank loan agreement, the IRS might well take the position that Euronotes held by standby banks constitute extensions of credit within the meaning of this exclusion. In any event, given the concerns under the Glass-Steagall Act for U.S. banks proposing to participate in NIFs,¹⁰² a U.S. bank would be ill-advised to take a contrary position for tax purposes.

In the case of Euronotes issued to standby banks, NIFs must therefore be structured to take into account the possibility that neither the original issue discount exemption nor the portfolio interest exemption will be available to exempt payments on the Euronotes from tax. This is usually accomplished by restricting the types of banks invited to participate in NIFs to three categories: 1) U.S. banks, because payments to such banks are free from withholding; 2) foreign banks entitled to benefits under a tax treaty with the United States exempting interest (including original issue discount) from U.S. tax;¹⁰³ and 3) foreign banks in a position to book their interests at an office in the United States such that payments received will be exempt from withholding because effectively connected with a trade or business in the United States.¹⁰⁴ This restriction is fre-

¹⁰¹ See *supra* text accompanying note 83. Even assuming the inapplicability of this exclusion, withholding may be required as a result of Treasury regulations that have been proposed to implement the exclusion with respect to interest paid by issuers to related parties. See *supra* text accompanying notes 84-94.

¹⁰² See *infra* text accompanying note 180.

¹⁰³ Interest paid by a U.S. borrower is completely exempt from U.S. tax under U.S. tax treaties if paid to certain lenders that are residents for tax purposes in the United Kingdom, France, Germany, the Netherlands, the Netherland Antilles, Luxembourg and Sweden, among others. Convention on Double Taxation of Income, July 22, 1954, United States-Federal Republic of Germany, art. VII, 5 U.S.T. 2768, 2784, T.I.A.S. No. 3133; Protocol Modifying the Convention, Sept. 17, 1965, United States-Federal Republic of Germany, 16 U.S.T. 1875, T.I.A.S. No. 5920; Convention Respecting Taxes on Income, Dec. 30, 1965, United States-Netherlands, art. VIII, 17 U.S.T. 896, T.I.A.S. No. 6051; Convention on Double Taxation of Income and Capital Gains, Dec. 31, 1975, United States-United Kingdom, art. 11, 31 U.S.T. 5668, 5680, T.I.A.S. No. 9682. Interest is subject to a reduced rate of withholding under U.S. tax treaties with Japan (10%), Switzerland (5%), Australia (10%), and New Zealand (10%), among others.

¹⁰⁴ See *supra* note 75 and accompanying text. To avoid the registration requirements of the Securities Act, NIFs are ordinarily structured so as to restrict the sale of Euronotes in the United States. In the case of a foreign bank not incorporated or otherwise resident in a jurisdiction with a tax treaty as described in the text, these restrictions may preclude participation by the bank in the facility, unless the facility contains an advances option, the

quently enforced by requirements in the NIF that each bank either represent that it is a U.S. person for tax purposes or, if it is a foreign bank, submit the forms prescribed by the U.S. Treasury to enable the issuer to claim one of the two exemptions from withholding described above.¹⁰⁵ In addition, the issuer must exclude from its tax indemnity any payment to a standby bank failing to comply with this requirement. Where NIFs contain exclusions from the issuer's tax indemnity of this sort, they are ordinarily drafted narrowly so that benefits are denied only to banks that fail to file forms that the banks are entitled to file under the law and treaties in effect at the time an exception is claimed. This places the risk of a change in any law or applicable tax treaty on the issuer.

These restrictions protect the issuer from paying additional amounts under its tax indemnity only so long as the standby bank continues to hold the note. They do not protect the issuer from paying such amounts to subsequent transferees. The maturity of a Euronote for purposes of the original issue discount exemption will be determined at the date of original issue without regard to the period it was held by the taxpayer.¹⁰⁶ If, as suggested by General Counsel Memorandum 39301, a Euronote issued to a standby bank has a tenor extending beyond its nominal maturity, the Euronote should continue to have that tenor for purposes of the exemption even in the hands of a transferee that is not bound to extend or renew. Nevertheless, the issuer may be able to rely on the portfolio interest exemption to avoid withholding on such notes, because the exclusion from this exemption relating to interest received by banks pursuant to loan agreements may not apply to interest received by subsequent transferees acquiring the notes in the secondary market.¹⁰⁷ In any event, short of relying on this exemption, the only

bank is in a position to fulfill its standby commitment by making advances from an office in the United States, and the advances are effectively connected with a trade or business in the United States.

¹⁰⁵ Treaty benefits are currently claimed by filing Form 1001 (updated triannually by filing another Form 1001). Treas. Reg. § 1.1441-6(c) (1971). Form 1001 will be effective for the successive three-calendar-year period during which the income to which the form applies is paid, and the withholding agent is required by the regulation to retain the form filed with it for four years after the end of the last calendar year in which the income subject to the form is paid. *Id.* § 1.1441-6(c)(2). Proposed Regulation § 1.1441-6(e) would also require the recipient of income entitled to tax treaty benefits to file a Certificate of Residence (Form 8306) with the withholding agent, as well as to require that the Form 1001 be signed by the beneficial owner. A claim that interest is effectively connected with a trade or business in the United States must be filed annually on Form 4224. A new Form 4224 must be filed with the withholding agent for each taxable year of the recipient, before payment of the income in respect of which it applies. *Id.* § 1.1441-4(a)(2) (1966).

¹⁰⁶ See *supra* text accompanying note 95.

¹⁰⁷ See *supra* text accompanying note 83. Unfortunately, the IRS has not interpreted this exclusion. Assuming the exclusion does not apply, withholding may nevertheless be required as a result of Treasury regulations recently proposed to implement the exclusion for interest paid by issuers to related parties. See *supra* text accompanying notes 84-94.

alternative is to exclude expressly from the issuer's tax indemnity on Euronotes issued to standby banks any obligation to pay additional amounts to holders (including subsequent transferees) not entitled to tax treaty benefits. This would require the issuance of Euronotes to standby banks in a form different from those issued to tender panel members, which lead managers generally discourage for marketing reasons. Most issuers have accepted this advice, thereby assuming the residual risk of withholding.

In order to encourage the IRS to rule in favor of applying the original issue discount exemption to Euronotes to be issued to tender panel members under a continuous tender panel NIF, at least one issuer has imposed further documentary restrictions presumably designed to address the concerns raised by General Counsel Memorandum 39301. According to Private Letter Ruling 8634060 dated May 27, 1986,¹⁰⁸ these restrictions included a requirement that tender panel members also acting as standby banks purchase Euronotes issued under the tender panel solely for the account of others, as well as an undertaking by such tender panel members to refrain from acquiring such Euronotes for their own account at any time in the secondary market.

The sale by U.S. banks of participations in their domestic loans¹⁰⁹ to foreign corporations¹¹⁰ also entails responsibilities and potential liability under the withholding tax provisions of the Code.¹¹¹ When the seller, as the lender of record, bears the responsibility for passing on income such as interest payments¹¹² to the participant, the seller, not the borrower, is deemed to have the requisite control over the payment and will be required to effect any necessary withholding unless an exemption is available.¹¹³ Since the

¹⁰⁸ See *supra* note 97.

¹⁰⁹ For purposes of this discussion, domestic loans include any loans to a borrower whose payment of interest is treated under the Code as derived in whole or in part from sources within the United States.

¹¹⁰ A foreign corporation is defined for tax purposes as any corporation not created or organized in or under the laws of the United States or of any state or the District of Columbia and, thus, would include any non-U.S. bank and any of its U.S. branch offices, but not a foreign bank's subsidiary or affiliate which is organized under the laws of the United States or any state thereof or the District of Columbia. I.R.C. § 7701(a)(3), (4), (5) (1982).

¹¹¹ See generally Dale, *Withholding Tax on Payments to Foreign Persons*, 36 TAX L. REV. 49, 82-83 (1980).

¹¹² Besides sharing of principal (usually on a straight *pro rata* basis) and interest (as noted above, the participant frequently earns a slightly lower yield on the principal amount of its participation than the borrower is required to pay on the underlying loan), the seller may also agree to share certain other types of payments made by the borrower in connection with the participated loan. For instance, if the participant commits to buy participations in loans made from time to time under a revolving credit facility it may be appropriate to share the commitment fee payable by the borrower. In addition, participants may share, on some agreed upon basis, in any amounts paid by the borrower in the event of a voluntary prepayment to compensate the seller for funding losses incurred by the seller as a result of the earlier than anticipated payment.

¹¹³ See *supra* text accompanying notes 76-77.

imposition of withholding tax will usually render a participation unprofitable from the participant's viewpoint, loan participation programs of U.S. banks are normally structured to take advantage of various exemptions to withholding available under the Code and tax treaties.

Withholding of tax is not required if the income is effectively connected with the foreign participant's conduct of trade or business within the United States.¹¹⁴ This exemption is commonly available to a foreign bank that is purchasing participations through a U.S. office, but may be relied on only if that office "actively participates in soliciting, negotiating, or performing other activities required to arrange" the purchase of the participation.¹¹⁵ Another exemption arises when a tax treaty confers a reduced rate of tax or an exemption from tax. Because loan participation programs do not usually involve sales requiring withholding, this exemption is relevant only if the tax treaty provides for a zero rate of withholding on any payments to be made to the participant. Tax on interest is reduced to zero in U.S. tax treaties with, most notably, the Federal Republic of Germany, France, the Netherlands, and the United Kingdom.¹¹⁶ The seller, as withholding agent, can generally rely on the requisite documents filed with it by the foreign participant in connection with either of the foregoing exemptions unless the seller knows or has reason to know that the participant does not qualify for the exemption claimed.¹¹⁷

A third exemption commonly relied upon by foreign purchasers of short-term participations is the original issue discount exemption discussed previously.¹¹⁸ This exemption is only available for participations sold in domestic loans if the original maturity of the loan does not exceed 183 days from the date of its issuance, and the interest is payable by the borrower only at the loan's maturity. It is irrelevant for purposes of this exemption how long the participation has been held.

A selling bank that permits the unrestricted transfer of participations or the sale of subparticipations by foreign participants may also be exposed to U.S. tax liability as a withholding agent with respect to payments to be made to the transferee or subparticipant. This risk is present when the foreign participant transfers its interest to a foreign corporation with a different withholding tax status, particularly if the transfer or subparticipation is made with the knowledge or consent of the seller and without notice to the borrower.¹¹⁹

¹¹⁴ See *supra* text accompanying note 75.

¹¹⁵ Treas. Reg. § 1.864-6(b)(2)(iii) (1972); see Rev. Rul. 86-154, 1986-52 I.R.B. 14.

¹¹⁶ See *supra* note 103.

¹¹⁷ Rev. Rul. 76-224, 1976-1 C.B. 268.

¹¹⁸ See *supra* text accompanying notes 95-96.

¹¹⁹ Treas. Reg. § 1.1441-3(c)(4) (1984).

The sale by U.S. banks of participations in their foreign loans¹²⁰ may have foreign withholding tax implications. Because of the diversity of laws in taxing jurisdictions it is beyond the scope of this Article to address the likely variations. Banks are, however, well advised to consult with local counsel, particularly in the jurisdiction where the borrower is organized, with respect to the tax status of the loan as well as the participation.¹²¹

B. Registration—Required Obligations

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) amended the Internal Revenue Code to require, subject to the exception referred to below, any debt obligation of a type offered to the public and issued by an issuer other than a natural person with a maturity of more than one year to be in registered form.¹²² The purpose of this requirement is to encourage compliance by the holders of such debt with their related tax obligations by facilitating their identification. If a debt obligation required to be in registered form (a "registration-required obligation") is not issued in such form, then the issuer may be denied an interest deduction under section 163(f) of the Code, and may be subject to a penal excise tax under section 4701 of the Code. In addition, holders are denied potential benefits for capital gain treatment¹²³ or loss deductions on the debt for federal income tax purposes¹²⁴ unless the holder satisfies specific conditions set forth in the Code and the temporary Treasury regulations promulgated thereunder.¹²⁵ Further sanctions apply to U.S. shareholders owning ten percent or more of a foreign issuer and to

¹²⁰ For purposes of this discussion, foreign loans would include any loans to a borrower whose payment of interest is treated for purposes of any law other than the Code as derived in whole or in part from sources other than the United States.

¹²¹ In particular, the following issues should be investigated by local counsel: What local withholding taxes are applicable and to whom; whether the borrower is viewed as having borrowed from the seller or the participant; if registration for a reduced or zero rate of withholding tax applies, whether the participant can benefit from the registration by the seller; what tax forms the seller and/or the participant are required to supply to the tax authorities; and whether the participation would in any way create a tax disadvantage for the borrower.

¹²² Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248, 96 Stat. 324, 594-95 (codified as amended at 31 U.S.C. § 3121 (1976)).

¹²³ I.R.C. § 1287(a) (Supp. III 1985); Treas. Reg. § 1.1287-1(a) (1986). Under the Tax Reform Act of 1986, the preferential capital gains tax rate was repealed beginning in 1988 (a slight preference remaining for 1987). Under the new law, therefore, the principal benefit of capital gains treatment is the right to deduct capital losses from such gains.

¹²⁴ I.R.C. § 165(j) (1982); Treas. Reg. § 1.165-12(a) (1986).

¹²⁵ I.R.C. § 165(j)(3) (1982); Treas. Reg. §§ 1.165-12(c), 1.1287-1(c) (1986). The holder sanctions apply regardless of whether the securities held were issued in bearer form in accordance with the exception described in the text accompanying notes 127-33 *infra*. Therefore, where it is likely that FRNs issued in bearer form might come into the hands of U.S. persons after the initial selling restriction period, the fiscal agency agreement should contain provisions permitting FRNs to be exchanged for FRNs in registered form. See I.R.C. § 165(j)(3)(D) (1982); Treas. Reg. § 1.165-12(c)(4) (1986).

holders that are controlled foreign corporations under the Code.¹²⁶

An exception to this general rule permits securities such as FRNs to be issued in the Eurodollar market in bearer form if certain conditions are met.¹²⁷ First, interest on the securities must be payable only outside the United States and its possessions.¹²⁸ Second, they must be issued in accordance with foreign offering procedures¹²⁹ sufficient to enable legal counsel to render an opinion that they need not be registered under the Securities Act because they are not intended to be sold to U.S. persons.¹³⁰ Finally, the securities issued in definitive form¹³¹ and all detachable interest coupons must bear the following legend: "Any United States person who holds this obligation will be subject to limitations under the United States income tax laws, including the limitations provided in sections 165(j) and 1287(a) of the Internal Revenue Code."¹³²

¹²⁶ These sanctions result in (1) an increase in Subpart F income of a controlled corporation under the Code because of the denial of the interest deduction to the corporation (*compare* Treas. Reg. § 1.952-2 (1982) with I.R.C. § 163(f) (1982)), and (2) a loss of deemed paid foreign tax credits because of a special earnings and profits rule (*compare* I.R.C. § 312(m) (1982) with I.R.C. § 902(c)(1) (1982)).

¹²⁷ I.R.C. § 163(f)(2)(A)(iv), (f)(2)(B) (1982); Treas. Reg. § 1.163-5(c) (1986).

¹²⁸ I.R.C. § 163(f)(2)(B)(ii)(I) (1986); Treas. Reg. § 1.163-5(c)(1)(ii)(A) (1986). Treas. Reg. § 1.163-5(c)(2)(v) (1986) provides that interest is considered to be payable only outside the United States if payment can be made only upon presentation of a coupon, or upon making of any other demand for payment, outside the United States to the issuer or a paying agent. The fact that payment is made by a draft drawn on a U.S. bank account or by a wire or other electronic transfer from a U.S. account does not affect this result. However, interest payments generally should not be made by a transfer of funds into an account maintained by the payee in the United States or by a draft mailed to an address in the United States.

¹²⁹ *See supra* text accompanying notes 35-38.

¹³⁰ In order for the exception to apply, there must be arrangements reasonably designed to ensure that the securities will be sold (or resold in connection with their original issuance) only to persons who are not U.S. persons or to U.S. persons who are financial institutions (as defined in Treas. Reg. § 1.165-12(c)(1)(iv) (1986)) purchasing for their own account or for the account of customers and who agree to comply with the requirements of I.R.C. § 165(j)(3)(A), (B), (C) (1982) and the regulations thereunder. Treas. Reg. § 1.163-5(c)(1)(i) (1986). Clause (A) of Treas. Reg. § 1.163-5(c)(2)(i) provides that this requirement will be considered satisfied if the issuer, in reliance on the written opinion of counsel received prior to the issuance of the securities, determines in good faith that the securities need not be registered under the Securities Act for the reason that they are intended for distribution to persons who are not U.S. persons. For obligations that are registered under the Securities Act, are exempt from registration under section 3 or 4 thereunder (15 U.S.C. § 77c, d (1982)), or do not qualify as securities under the Securities Act, clause (B) of § 1.163-5(c)(1)(i)(2) sets forth specific foreign offering procedures that must be complied with in order to satisfy this requirement. Treas. Reg. § 1.163-5(c)(2)(i)(B) (1986). The explanation contained in Treasury Decision 8110 indicates that the IRS considers the procedures described in clause (A) of § 1.163-5(c)(1)(i)(2) to be unavailable for exempt obligations covered by clause (B) of said section. T.D. 8110, 1987-6 I.R.B. 4. Exempt obligations meeting the conditions of clause (B), however, may be issued in a single public offering of bearer obligations together with non-exempt obligations meeting the conditions of clause (A). Treas. Reg. § 1.163(c)(2) (1986).

¹³¹ Temporary global notes (*see supra* text accompanying notes 36-37) need not bear the legend. Treas. Reg. § 1.163-5(c)(1)(ii)(B) (1986). Nor are they required to satisfy the condition described in *supra* note 130.

¹³² Treas. Reg. § 1.163-5(c)(1)(ii)(B) (1986).

Securities may be issued in bearer form without satisfying these conditions (other than the condition that interest be payable only outside the United States and its possessions) if issued solely outside the United States and its possessions by a non-U.S. issuer (or, under certain circumstances, by a foreign office of a U.S. bank) that does not significantly engage in interstate commerce with respect to the issuance of the securities either directly or through an agent, an underwriter or a selling group member.¹³³ Therefore, in most cases where the jurisdictional contacts of a securities offering are so minimal that the Securities Act is inapplicable,¹³⁴ the registered form requirements of TEFRA also will not apply.

Because the registered form requirement does not apply to Euronotes issued with maturities of one year or less, the requirement usually does not apply to Euronotes issued to Eurocommercial paper dealers or to NIF tender panel members. In view of General Counsel Memorandum 39301, however, there is a risk that Euronotes issued to standby banks under NIFs may be viewed for tax purposes as having a maturity of more than one year, and thus be subject to the requirement. Due to this risk and to the requirements for applicability of the backup withholding exemption,¹³⁵ most NIFs are structured to satisfy the conditions described above for issuance in bearer form. For purposes of the requirement that interest be payable only outside the United States, interest includes original issue discount.¹³⁶ Because it is not practicable to separate the discount portion of a Euronote from its principal portion, it is not possible to have a paying agent for principal on such notes in the United States without risking a violation of this condition.¹³⁷

With respect to sales of loan participations, because the "securitization" of a debt obligation may itself be an issuance subject to the section 4701 excise tax,¹³⁸ the certificate evidencing the participation should be in registered form if the participation certificate, were it a debt obligation, would require registration.

¹³³ *Id.* §§ 1.163-5(c)(1)(i), (1)(ii)(B), (2)(i)(C), (2)(ii) and (2)(iii) (1986).

¹³⁴ *See supra* text accompanying notes 28-29.

¹³⁵ *See infra* notes 146-49 and accompanying text.

¹³⁶ Treas. Reg. § 1.163-5(c)(2)(v) (1986).

¹³⁷ Temp. Treas. Reg. § 35a.9999-2, Q&A-12 (1983). Euronotes issued to standby banks in global form (*see supra* text accompanying note 40) may or may not be treated by the Code as being in registered form depending in part on the circumstances under which definitive notes may be exchanged for interests in the note. *See infra* notes 152-54 and accompanying text. If not, then in addition to satisfying the conditions described in the previous paragraph of the text, the legend referred to in such paragraph must appear in any book or record maintained to evidence ownership interests in the note. Treas. Reg. § 1.163-1(c)(1)(ii)(B) (1986).

¹³⁸ *Compare* Temp. Treas. Reg. § 5f.163-1(f) (example 10) (1982) *with* Temp. Treas. Reg. § 35a.9999-5, Q&A-20 (1984).

C. Information Reporting and Backup Withholding

A further tax compliance measure, the Interest and Dividend Tax Compliance Act of 1983,¹³⁹ amended the Code to require corporate issuers of obligations and their paying agents to obtain taxpayer identification numbers and certain other information from U.S. recipients of interest on the obligations and to file returns reporting this information to the IRS, except where a recipient is exempt.¹⁴⁰ Because "exempt recipients" are defined in section 6049(b)(4) of the Code as including corporations and most governmental bodies, these reporting requirements primarily apply only to amounts paid to U.S. individuals and unincorporated entities such as partnerships and estates.¹⁴¹ Further, they apply only to amounts paid by issuers that are U.S. persons or controlled foreign corporations or paid from sources within the United States.¹⁴² If a recipient fails to furnish information in the manner required, the payer of the interest is required to withhold twenty percent as tax.¹⁴³ This assessment is commonly called the "backup withholding tax."

The information reporting and backup withholding regulations appear to be premised on the notion that bearer obligations satisfying the requirements for the portfolio interest exemption from U.S. withholding tax¹⁴⁴ will not be held by persons subject to backup withholding and information reporting, so that lesser compliance measures can be required of them. Under the regulations, absent actual knowledge that the payee is a U.S. person, an issuer or paying agent need not obtain information on the recipient of interest on such an obligation (so that backup withholding will not apply) provided that the payment of the interest is made outside the United States.¹⁴⁵ If, however, the interest is payable in respect of a bearer obligation with a tenor of 183 days or less, and otherwise qualifies as original issue discount,¹⁴⁶ further conditions must be satisfied to avoid the information reporting and backup withholding requirements.¹⁴⁷ Not only must the obligation be paid outside the United States and be sold under procedures reasonably designed to ensure

¹³⁹ Interest and Dividend Tax Compliance Act of 1983, Pub. L. No. 98-67, Title I, 97 Stat. 369 (codified in scattered sections of 26 U.S.C. (Supp. III 1985)).

¹⁴⁰ I.R.C. § 6049 (Supp. III 1985).

¹⁴¹ *Id.* § 6049(b)(4).

¹⁴² *Id.* § 6049(b)(2)(D); Temp. Treas. Reg. § 35a.9999-5, Q&A-2, Q&A-3, Q&A-4 (1984).

¹⁴³ I.R.C. § 3406(a) (Supp. III 1985).

¹⁴⁴ See *supra* text accompanying notes 80 and 127-33.

¹⁴⁵ Temp. Treas. Reg. § 35a.9999-5, Q&A-2, Q&A-3 (1984). Whether a payment of interest is considered to be made outside the United States for this purpose is to be determined generally in accordance with the rules of A-37 of Temp. Treas. Reg. § 35a.9999-3 (1984). These rules are similar to those contained in Treas. Reg. § 1.163-5(c)(2)(v) (1986) summarized *supra* note 128.

¹⁴⁶ See *supra* notes 95-96 and accompanying text.

¹⁴⁷ Temp. Treas. Reg. § 35a.9999-5, Q&A-5, Q&A-6 (1984).

that U.S. persons will not acquire the obligation at the initial offering¹⁴⁸ (as in the case of obligations with a tenor in excess of 183 days); it must also be in a minimum denomination of 500,000 U.S. dollars (or its equivalent in foreign currency) and bear a legend to the effect that the holder, by his acquisition of the obligation, represents that he is not, and is not acting for or on behalf of, a U.S. person (other than an exempt recipient)¹⁴⁹ (conditions apparently intended further to inhibit U.S. individuals from holding the obligation). If the obligation is in registered form, then the full requirements of information reporting and backup withholding apply—that is, the issuer or paying agent must satisfy itself that the payee is an exempt recipient or receive a signed statement either disclosing the recipient's taxpayer identification number or certifying that the recipient is a non-resident alien individual; otherwise it must withhold.¹⁵⁰

In the case of Euronotes evidenced by global notes,¹⁵¹ the requirements applicable to securities in registered form may apply. Ownership interests in such notes are transferred through a book-entry system. Under the Code and regulations a book-entry system constitutes registered form, if ownership interests in the relevant obligation are transferable solely by book entries that identify the owners of such interests, and if the book-entry system is maintained by the issuer or an agent of the issuer.¹⁵² If these criteria are satisfied, then the paying agent in respect of a global note must either satisfy itself that the owners identified in the relevant book entries are exempt recipients or obtain the appropriate certifications discussed above.¹⁵³ Where owners have the right prior to maturity to exchange their interests for bearer notes issued in definitive form, how-

¹⁴⁸ *Id.* Q&A-5(i) and (iii), Q&A-6. The second condition may be satisfied by complying with Treas. Reg. § 1.163-5(c)(1)(i) as if the obligation were registration-required. Temp. Treas. Reg. § 35a.9999-5, Q&A-5(iii) (1984). See *supra* note 130.

¹⁴⁹ Treas. Reg. § 35a.9999-5, Q&A-4, Q&A-5(ii), (v) (1984). Short-term obligations bearing this legend for information reporting and backup withholding purposes need not bear the TEFRA legend described in text *supra* accompanying note 132. *Id.*; I.R.C. § 163(f)(2)(A)(iii) (1982). Conversely, obligations having a maturity of more than one year need not bear this legend (see text accompanying note 145 *supra*), but must bear the TEFRA legend (see text accompanying note 132 *supra*). Therefore, Euronotes issued to tender panel members under a NIF need bear only the backup withholding legend while Euronotes issued to standby banks which, according to the conclusion stated in the General Counsel Memorandum (see text accompanying note 100) have an effective maturity in excess of one year, need bear only the TEFRA legend. Since it is generally considered desirable for marketing reasons that all Euronotes issued under the same NIF be in the same form (and since the conclusion stated in the General Counsel Memorandum is not free from doubt), Euronotes issued to tender panel members and standby banks normally bear both legends.

¹⁵⁰ Temp. Treas. Reg. §§ 35a.9999-1, Q&A-26 (1984), 35a.9999-5, Q&A-5(iv) (1984).

¹⁵¹ See *supra* text accompanying notes 44-45.

¹⁵² I.R.C. § 163(f)(3) (1982); Temp. Treas. Reg. § 5f.103-1(c)(1)(ii), (2) (1986). See *supra* note 81.

¹⁵³ See *supra* note 150 and accompanying text.

ever, a global note is treated under the regulations as being in bearer, rather than registered form because interests are not then transferable solely by book entry.¹⁵⁴ If the book-entry system evidencing transfers in a global note is maintained by a clearing system (such as Euroclear or Cedel), the note would also be treated as being in bearer form, because the clearing system does not act as agent of the issuer.

Global notes evidencing Euronotes present a further technical difficulty under the rules for exemption from backup withholding applicable to short-term bearer obligations.¹⁵⁵ The depository of the global note may well resist accepting a note with the required legend, because it may lack sufficient knowledge to represent, as holder of the note, that it is not acting for or on behalf of U.S. persons other than exempt recipients. For the same reason, it is difficult to see how the legend on a global note can effectively inhibit U.S. individual ownership. The same objective is perhaps better achieved by placing the legend on the form of notice that is distributed to purchasers of the Euronotes to avoid registration under the Securities Act,¹⁵⁶ or by simply relying on the more restrictive representation already contained in the notice that the purchaser is not a U.S. person other than a foreign branch of a U.S. bank or an agent or custodian acting on behalf of a non-U.S. person. By analogy to the rules relating to the legend required under TEFRA, the backup withholding legend should also appear in any book or record maintained to evidence ownership interests in the global note.¹⁵⁷

As a practical matter, backup withholding and information reporting should not pose substantive problems in the context of loan participation sales because such sales are ordinarily made to institutional investors including banks, insurance companies, pension funds, mutual funds, and corporations. There is no such withholding on interest paid to such investors because they are all exempt recipients.

IV. The Glass-Steagall Act

No subject is of more immediate concern to U.S. banks in their efforts to "securitize" assets and redeploy their marketing strengths towards so-called "investment banking" products than the effect on such efforts of the Glass-Steagall Act as perceived by the courts, the bank regulatory authorities, the securities industry and (not least) by the banks themselves. As the U.S. banking industry tries to find a profitable role in the midst of deregulation, rapid technological

¹⁵⁴ Temp. Treas. Reg. § 5f.103-1(e) (Example 5) (1982). *See supra* note 81.

¹⁵⁵ *See supra* text accompanying notes 147-49.

¹⁵⁶ *See supra* paragraph 3 following the text accompanying note 42.

¹⁵⁷ *See supra* note 137.

change, turbulent economic conditions, and hard-fought competitive battles, the question on all sides is likely to be: "Can the banks take this step, or will it be illegal under this Depression-era law?" This Article concludes with a brief survey of the application of the Glass-Steagall Act to these "securitization" activities.

Section 16 of the Glass-Steagall Act states that, subject to certain exceptions,¹⁵⁸ a national bank "shall not underwrite any issue of securities," and that its authority to deal in securities is limited to purchasing and selling securities "without recourse, solely upon the order, and for the account of, customers, and in no case for its own account."¹⁵⁹ These restrictions also apply to state banks that are members of the Federal Reserve System.¹⁶⁰ Further, section 21 of the Act prohibits an entity engaged in the business of accepting deposits from engaging, at the same time, in the business of "underwriting, selling, or distributing" securities.¹⁶¹ The Supreme Court has indicated that sections 16 and 21 are to be construed consistent with each other and that section 21 should not be read to proscribe activities permitted under section 16.¹⁶²

Although the term "underwriting" is not defined by the Glass-Steagall Act and has not been interpreted conclusively by the Supreme Court for purposes of the Act, federal bank regulatory authorities have construed the term to mean one who purchases securities from an issuer intending to sell them to third parties thereby assuming the market risk on resale.¹⁶³ Because underwriters and selling group members of FRNs and tender panel members and Eurocommercial paper dealers in Euronotes¹⁶⁴ ordinarily acquire the securities from the issuer for resale to investors, the Act's underwriting prohibitions generally preclude U.S. banks from directly act-

¹⁵⁸ The exceptions include federal government securities, general obligation debt of states and municipalities, obligations of certain government agencies and investment securities of the sort described *infra* in the text accompanying notes 174-75.

¹⁵⁹ 12 U.S.C. § 24(7) (1982).

¹⁶⁰ *Id.* § 335.

¹⁶¹ *Id.* § 378.

¹⁶² *Securities Indus. Assoc. v. Board of Governors of the Fed. Reserve Sys.*, 104 S. Ct. 2979, 2986 (1984) [hereinafter cited as *SIA v. FRB-I*]. See also *Securities Indus. Assoc. v. Board of Governors of the Fed. Reserve Sys.*, 807 F.2d 1052 (D.C. Cir. Dec. 23, 1986), *appeal docketed*, No. 1429 (S. Ct. Mar. 5, 1987) [hereinafter cited as *SIA v. FRB-II*].

¹⁶³ See COMPTROLLER OF THE CURRENCY, FEDERAL DEPOSIT INSURANCE CORPORATION, AND FEDERAL RESERVE BOARD, COMMERCIAL BANK PRIVATE PLACEMENT ACTIVITIES (June 1, 1978); FEDERAL RESERVE BOARD STAFF STUDY, COMMERCIAL BANK PRIVATE PLACEMENT ACTIVITIES 87 (June 1977). In *SIA v. FRB-II* the United States Court of Appeals for the District of Columbia expressed the view that the Glass-Steagall Act's restrictions against "underwriting" should apply even to agency transactions such as a best efforts underwriting. *SIA v. FRB-II*, 807 F.2d at 1062 n.3. Since the court held that the term "underwriting" excludes private placement activity of the type at issue in the case, however, it had no reason to address the question of agency transactions.

¹⁶⁴ The Supreme Court has rejected the argument that domestic commercial paper (similar to Euronotes) should not be viewed as a security for purposes of the Glass-Steagall Act. *SIA v. FRB-I*, 104 S. Ct. at 2987-91.

ing in these capacities. Section 25(a) of the Federal Reserve Act and Regulation K of the Board of Governors of the Federal Reserve System promulgated thereunder, however, authorize U.S. banks to invest in subsidiaries that may engage, *inter alia*, in underwriting, distributing and dealing in debt securities outside the United States.¹⁶⁵ Pursuant to this authority, most major U.S. banks have established or acquired foreign merchant banking subsidiaries that engage in securities activities abroad, and it is these subsidiaries, rather than the parent banks, that participate generally as underwriters and dealers with respect to FRNs and Euronotes in the Eurodollar market.

Under certain facilities including Eurocommercial paper programs, a bank may have the option of selling securities as an agent of the issuer rather than as a principal. A U.S. bank that sells securities in this manner might argue that its activity should be permitted under the wording of section 16 of the Glass-Steagall Act, which authorizes banks to deal in securities "without recourse, solely upon the order and for the account of, customers."¹⁶⁶ In June 1985 the Federal Reserve Board issued a statement¹⁶⁷ (recently upheld by the United States Court of Appeals for the District of Columbia)¹⁶⁸ authorizing Bankers Trust Company, on the basis of this wording, to place domestic commercial paper to third parties as an agent of the issuer. The authorization, however, was granted subject to a number of conditions, including: 1) that the bank not enter into any type of arrangement under which it guarantees or assumes any market risk regarding the paper that it places (to ensure that the paper be sold "without recourse" to the bank); 2) that the bank place the paper only at the direction of the issuer (to ensure that the paper be sold "only upon the order [of] customers"); 3) that the bank place the paper as an agent of the issuer without purchasing and reselling for its own account or extending credit to the issuer in a manner that is

¹⁶⁵ 12 U.S.C. § 611 (1982); 12 C.F.R. §§ 211.5(b)(A), 211.5(d)(13) (1985).

¹⁶⁶ 12 U.S.C. § 24(7) (1982).

¹⁶⁷ *Commercial Paper Activities of Bankers Trust Company of New York Do Not Constitute Underwriting Securities*, [1984-1985 Transfer Binder] FED. BANKING L. REP. (CCH) ¶ 86,270 (June 4, 1985).

¹⁶⁸ *SIA v. FRB-II*, 807 F.2d at 1074. As is well known, the decisions of the Federal Reserve Board in the Bankers Trust case have been the subject of protracted litigation in the United States. The Board's decision in 1980 (Federal Reserve System, Statement Regarding Petitions to Initiate Enforcement Action (1980)), that commercial paper should not be viewed as a security for purposes of the Glass-Steagall Act, was ultimately reversed by the Supreme Court in *SIA v. FRB-I*, 104 S. Ct. at 2991. The Supreme Court then remanded the case for determination as to whether Bankers Trust's placement of commercial paper constituted an "underwriting" or "distributing" of securities in violation of the Act. The finding of the Board on remand, discussed in the text, was vacated by the U.S. District Court for the District of Columbia, *Securities Indus. Assoc. v. Board of Governors of the Fed. Reserve Sys.*, 627 F. Supp. 695 (D.C.C. 1986), but reinstated by the court of appeals as mentioned in the text. On Mar. 5, 1987, the Securities Industry Association filed a Petition for Certiorari with the Supreme Court.

functionally equivalent to purchasing the paper¹⁶⁹ (to ensure that the paper be sold "solely" for the account of customers and "in no case for its own account"); and 4) that the paper be placed in large denominations to a limited number of sophisticated investors without general solicitation or advertisement to the public with respect to specific issues (to ensure that the activity constitutes a private placement rather than an "underwriting" or a "distributing" of securities independently prohibited by the Act).¹⁷⁰ Moreover, in issuing the statement the Board expressly stipulated that its conclusions were based solely on the facts submitted by Bankers Trust Company and the particular practices followed in placing paper in the recognized, commercial paper market in the United States.¹⁷¹ Thus, the extent to which the statement may be relied upon by U.S. banks as authority for engaging in agency sales of securities in the Euromarkets may be limited. Nevertheless, it may provide support for such sales of Eurocommercial paper, depending on the structure of the particular facility, and assuming that the market for this paper in Europe continues to develop along the lines of its domestic counterpart.

In addition to the foregoing activities, U.S. banks may wish to acquire FRNs or Euronotes for their investment or loan portfolios. As in the case of underwriting and dealing, these activities also could be performed by a foreign subsidiary of the bank pursuant to the powers authorized under Regulation K.¹⁷² Because these subsidiaries may lack the capital base or credit evaluation expertise to engage in these activities on a large scale, however, U.S. banks often prefer to perform them through foreign branches of the parent institution.¹⁷³

As a part of the Glass-Steagall Act's regulation of bank securities activities, section 16 permits a national bank to acquire and hold investment securities to the extent permitted by regulations of the Comptroller of the Currency.¹⁷⁴ Generally, an FRN may qualify for

¹⁶⁹ According to the statement, a line of credit extended to the issuer will not be construed as the functional equivalent of the bank's purchasing the paper if the bank advances funds under the line of credit under different terms, at different times, and for different purposes than if the bank had purchased unsold commercial paper for resale. To this end, the Board would expect the bank to keep appropriate records to demonstrate that the advances were in fact made independently of the bank's role as commercial paper adviser and not for the purpose of backing an issue, and would further require the bank to assure itself that funds advanced to the issuer not be used to repay any commercial paper of the issuer placed by the bank or to cover an unsold portion of an issue placed by the bank. Statement Concerning Bankers Trust at 90,826-27.

¹⁷⁰ *Id.* at 90,829-32.

¹⁷¹ *Id.* at 90,836.

¹⁷² Foreign subsidiaries of U.S. banks are generally prevented under Regulation K from engaging in the business of making loans to U.S. persons for domestic purposes. 12 C.F.R. §§ 211.4(e)(4), 211.5(b)(3) (1986).

¹⁷³ See *supra* text accompanying note 11.

¹⁷⁴ 12 U.S.C. § 24(7) (1982); 12 C.F.R. Part 1 (1986). State member banks have analogous powers under state banking laws.

investment under this exception if it is readily marketable and of high credit quality.¹⁷⁵ Short-term promissory notes such as Euro-notes, on the other hand, would not ordinarily qualify as investment securities for this purpose.¹⁷⁶

Under appropriate circumstances promissory notes may also be acquired by a U.S. bank pursuant to its general banking power to make loans and discount promissory notes.¹⁷⁷ The acquisition and holding of notes by banks in connection with these traditional banking powers is not affected by the restrictions on securities activities imposed by the Glass-Steagall Act.¹⁷⁸ Before acquiring an FRN or Euronote to evidence a loan, however, a bank should apply its credit evaluation procedures to the issuer, and should be satisfied that the terms of the note and the related documentation provide the bank with legal rights and remedies sufficient to render the transaction sound and bankable. Upon acquisition, the bank should book the note as a loan, not as an investment, and should maintain the usual credit file of financial and other information on the asset. Further, a U.S. bank acquiring FRNs or Euronotes to evidence loans should do so with an intent to hold the instruments to maturity and not with a view to resell them.¹⁷⁹

The acquisition of Euronotes by a U.S. standby bank under a NIF may give rise to a further question under the Glass-Steagall Act. It might be argued that, by agreeing to acquire Euronotes only after, and to the extent that, the issuer has been unable to distribute them through the tender panel, the standby bank would be participating in the underwriting of those notes in violation of the Act.¹⁸⁰ So long as

¹⁷⁵ 12 C.F.R. §§ 1.3(b), 1.5(a) (1986).

¹⁷⁶ The Comptroller has never designated commercial paper (the closest domestic analogue to Euronotes) as an investment security. To the contrary, in 1971 the Comptroller's Chief Counsel took the position that commercial paper does not constitute an investment security. Letter of Comptroller's Chief Counsel to National Bank Counsel, Nov. 9, 1971, cited at *SIA v. FRB-I*, 104 S. Ct. at 164 (O'Connor, J., dissenting). Moreover, the Comptroller historically has treated commercial paper notes as loan notes subject to a national bank's lending limits under 12 U.S.C. § 84 (1982) rather than as securities subject to the investment limits of 12 U.S.C. § 24(7) (1982).

¹⁷⁷ In the case of national banks this power is found in the National Bank Act which grants to such banks the power to "carry on the business of banking; by discounting and negotiating promissory notes . . . [and] by loaning money on personal security." 12 U.S.C. § 24(7) (1982).

¹⁷⁸ *SIA v. FRB-I*, 104 S. Ct. at 2979. The Supreme Court observed in footnote 11 of its opinion in this case: "[Section 16's] prohibition on engaging in '[t]he business of dealing' in securities does not affect [the authority of a national bank to discount and negotiate promissory notes]; while the Glass-Steagall Act does not define the term 'business of dealing' in securities, the term clearly does not include the activity of 'discounting' promissory notes because that activity is defined to be a part of the 'business of banking.'" *Id.* at 2991 n.11.

¹⁷⁹ See *supra* text accompanying notes 159-61 and 163.

¹⁸⁰ See, e.g., Opinion 210 of 1948, where the Comptroller of the Currency in providing a general definition of the term "underwriting" for purposes of the Act mentioned standby arrangements "under which the issuer or some other party attempts to distribute the securities to the public, the underwriter agreeing, in consideration of a fee, to purchase, at a

the standby bank acquires the Euronotes to evidence a loan, however, the bank's conduct should be characterized as a lawful lending activity rather than a securities function proscribed by the Act. Accordingly, U.S. banks should take care to apply normal credit evaluation procedures to the issuer before accepting the role of standby bank, book extensions of credit under the NIF as loans and not as investment securities, and acquire the Euronotes with a view to hold them to maturity. To further diminish the risk of its activity being construed as impermissible under the Act, the bank should avoid any arrangements that suggest a direct or indirect participation by the bank in the placement activities of the tender panel members. Thus, a bank would be wise to avoid arrangements to acquire Euronotes purchased by an affiliated tender panel member, or provisions in the NIF documentation for an increase in the fees earned by the bank based on the amount of Euronotes purchased by the tender panel members, or any automatic decrease in the standby commitment of the bank based on the amount of Euronotes purchased by an affiliated tender panel member. U.S. banks participating in NIFs should also take care that related offer telexes, term sheets, and other documentation are consistent with the bank's intent to make loans under the facility and do not use terminology connoting impermissible activities. Finally, because it is impossible to preclude an adverse decision by a court or regulatory authority on the underwriting issue, U.S. banks should insist on NIFs containing an "illegality clause" entitling the bank to terminate its standby commitment in the event of any such decision.

NIFs often grant standby banks the option to extend credit in the form of an open-account advance rather than the purchase of Euronotes. The crucial question for purposes of complying with the Glass-Steagall Act is again whether the standby bank, in advancing funds to the issuer, intends to make a loan. Although an option to make advances, rather than acquiring Euronotes that are easily transferred, would furnish the bank with useful additional evidence of its proper intent in advancing funds, so long as the circumstances otherwise demonstrate this intent, the availability of this option should not be controlling.

specified price, any which cannot be sold to the public." Opinion No. 210, FED. BANKING L. REP. (CCH) at 49,202.10 (Aug. 1948). This opinion does not specifically address the situation where a standby bank holds a security to maturity. Indeed, the use of the term "underwriter" in the opinion may indicate that the Comptroller intended to refer solely to banks acquiring securities with a view to later selling them. In any event more recent discussions by the Comptroller of the term "underwriting" contain no reference to this opinion. OCC Interpretive Letter No. 329, FED. BANKING L. REP. (CCH) ¶ 85,499, at 77,763 (Mar. 4, 1985). It should also be noted that the express reference to NIFs in risk-based capital adequacy guidelines proposed by the Comptroller, the Federal Reserve Board, and the Federal Deposit Insurance Corporation would appear to assume the power of U.S. banks to participate in such facilities. *See supra* note 3.

Occasionally, a U.S. bank is invited to participate in a NIF that describes the standby banks as "underwriters" and contains other provisions optically offensive to Glass-Steagall concerns. Frequently in these cases, a foreign affiliate of the bank will become a party to the facility as a tender panel member.¹⁸¹ The affiliate may then wish to enter into arrangements with the bank by which the affiliate sells to the bank any Euronotes that it acquires under the facility but is unable to place in the market. Although this arrangement succeeds in removing the bank as a direct party to the NIF, it does not avoid the need for the bank to conclude that it has the lending or investment power to acquire the notes.¹⁸² In fact, this arrangement may render the conclusion more difficult, because the affiliate may attempt to sell Euronotes to the bank under circumstances in which the Euronotes are not readily marketable, thereby suggesting problems with the credit of the issuer. It may be more prudent for the bank to make an advance to the affiliate under normal credit lines which would enable the affiliate to hold the Euronotes until they can be resold in the market on acceptable terms.

If a U.S. bank acquires an FRN or Euronote to evidence a loan, it should do so with a view to hold it to maturity and without an intent to resell or sell any participation in the note. This resolve should not preclude the bank from later transferring or selling a participation in the note because, as discussed below, the sale of loans and loan participations is an accepted and established part of the commercial banking business. Any subsequent transfer, however, may cast doubt over the bank's original intent in acquiring the note. Therefore, any subsequent sale by a U.S. bank of an FRN or Euronote or of any participation in such a note should be made only to financial institutions in the ordinary course of business, and should not be made under circumstances suggesting that the note was originally acquired with a view to resale or that the sale involves a distribution.

The sale of loan participations by U.S. banks has long been recognized as a proper banking practice and, thus, has raised few questions under the Glass-Steagall Act. Banks have been engaged in selling participations to other banks for decades as part of the process of building and developing correspondent banking relationships, as well as meeting the expanding financial needs of customers that could not prudently be satisfied within the lending and funding limitations of a single institution. To justify this activity national banks generally rely on their express authority under the National Bank Act to engage in the business of banking "by discounting and

¹⁸¹ See *supra* text accompanying note 165.

¹⁸² Any such purchase must also comply with the restrictions contained in section 23A of the Federal Reserve Act with respect to extensions of credit (including the purchase of assets) by U.S. banks to their affiliates, unless an exemption is available. 12 U.S.C. § 371 (1982).

negotiating promissory notes, drafts, bills of exchange, and other evidences of debt" as well as their incidental banking powers under the Act.¹⁸³ Due to the established practice of selling loan participations¹⁸⁴ and ample regulatory precedent in favor of its permissibility,¹⁸⁵ it is not surprising that no definitive judicial precedent exists regarding the applicability of the Glass-Steagall Act to this activity.

Increasingly, however, the "investment banking" activities of U.S. banks are coming under greater scrutiny by the courts, bank regulatory authorities, and particularly, the securities industry. Due to changes occurring in the loan participation activities of U.S. banks—such as the expansion of the business to include purchasers that have not been traditional buyers of participations, regular and continuous selling patterns, and aggressive marketing techniques being employed by selling banks—the conventional legal justification for the present activities may seem somewhat less compelling. The issue thus arises whether, under certain circumstances, loan participation programs of U.S. banks might be said to involve "underwriting, selling, or distributing" notes or "other securities" in violation of section 21 of the Glass-Steagall Act.¹⁸⁶

While the current participation programs of U.S. banks may raise some concerns from a Glass-Steagall Act standpoint that did

¹⁸³ *Id.* § 24(7) (1982). (This is the same section in which section 16 of the Glass-Steagall Act is incorporated.) In a recent interpretive ruling the legal staff of the Comptroller of the Currency noted that "national banks, relying on their express powers and on any incidental powers thereto, have traditionally engaged in the sale of participations in certain bank assets of otherwise large unit value." OCC Interpretive Letter No. 268, [1983-1984 Transfer Binder] FED. BANKING L. REP. (CCH) ¶ 85,432, at 77,570 (Aug. 4, 1983). See also OCC Interpretive Letter No. 272, *id.* ¶ 85,436, at 77,581 (Aug. 4, 1983).

¹⁸⁴ In OCC Banking Circular 181, FED. BANKING L. REP. (CCH) ¶ 60,799, at 38,859-2 (Rev., Aug. 2, 1984), the Comptroller of the Currency stated that "[t]he purchase and sale of loans and participations in loans are *established* banking practices." (emphasis added).

¹⁸⁵ In the case of national banks, which are regulated by the Comptroller of the Currency, see, e.g., OCC Interpretive Letters Nos. 268 and 272, *supra* note 183; OCC Banking Circular 181, *supra* note 184 (addressing the issue of the safety and soundness considerations involved in the purchase of loan participations by national banks); 12 C.F.R. § 32.107 (1986) (the nonrecourse sale of loan participations results in the removal of the portion of the loan in which the participation is sold from the selling bank's legal lending limit to the borrower of such loan); *id.* § 12.2(e)(2) (1986) (recordkeeping and confirmation requirements that apply to securities transactions engaged in by a national bank specifically exclude loan participations from the definition of "securities" covered by that rule). More recently, the Federal Reserve Board, in finding that the placement as agent of third party commercial paper through a bank holding company subsidiary is "closely related to banking," observed that such activity is similar in function to "the traditional commercial bank function of arranging loan participations . . . with other banks and institutional lenders." Order of the Federal Reserve Board, FED. BANKING L. REP. (CCH) ¶ 86,770, at 92,149 (Dec. 24, 1986).

¹⁸⁶ See *supra* note 161. In view of the decision in *SIA v. FRB-II* which upholds the Federal Reserve Board's position that the prohibitions against "underwriting" and "distributing" contained in the Glass-Steagall Act are limited to a public offering, participation sales that are negotiated between the seller and the participants in private transactions would not usually come within the meaning of these terms. *SIA v. FRB-II*, slip op. at 19, 22. See *supra* text accompanying note 51.

not exist previously, these activities still represent the essence of the classical participation business that banks have practiced for years. And as the business of commercial banking responds to the changes taking place in the marketplace, it must be true that traditional lending and related activities of banks, including the business of selling loan participations, may evolve as well. To the extent an activity involves a permissible banking practice, the proscriptions of the Act do not apply, regardless of whether the particular instrument involved may be a "security" for purposes of the Act.¹⁸⁷ It would therefore seem that so long as loan participation programs of U.S. banks do not depart dramatically from traditional practices, they should remain safe from attack under the Glass-Steagall Act, although, depending upon the type of loan, the identity of the purchaser and the circumstances surrounding the sale, the risk that the Act might be applied to particular activities may be greater now than in the past.

V. Conclusion

In the rapidly changing world of the financial services industry, U.S. banks are being forced by competitive pressures, regulatory concerns and the need to find more profitable activities to "securitize" at least some of their assets. They are thereby able to transfer those assets off their books with greater ease, improve their capital ratios, and assist their customers in tapping financial resources at the lowest cost. Nowhere have these changes been more evident than in the Euromarket, where FRNs, NIFs, Eurocommercial paper, and loan participations have all recently assumed greater importance in bridging the gap between providers and users of capital. U.S. banks are playing an important role in these changing circumstances, even while their share of international lending diminishes. To enter the fray successfully and earn their share of the rewards for bearing the risks involved, these banks must understand, assess, and take reasonable steps to overcome the U.S. legal difficulties that necessarily will arise.

¹⁸⁷ See *supra* note 178.